NEGOTIATING REAL ESTATE LOAN EXTENSIONS AND MODIFICATIONS

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As a result of the Covid-19 pandemic, lenders and borrowers in the real estate industry are finding themselves re-negotiating existing debt in ways similar to what was seen during the Great Recession of 2008. This is especially true when it comes to office space. Although some Class A office buildings are still performing relatively well, many borrowers are unable to make their monthly loan repayments due to falling rents, low occupancy levels, and discounted market expectations.

As many employees continue to work from home on a consistent basis, tenants in office spaces are cutting back on square footage to save money on rent or are requesting discounted rents as they did during the height of the pandemic. In turn, borrowers are seeking to renegotiate the terms of their loans with lenders. This can be challenging for borrowers as these loan extensions and modifications are being negotiated with lenders at much higher rates and tighter terms than the initial loans.

As value in office buildings continues to decline, modifying and extending these types of loans in the current market may not be enough to avoid losses on such maturing loans. Various institutions (including the International Monetary Fund, the Mortgage Bankers Association, and Guggenheim Securities) reported that almost $1.2 trillion of commercial mortgage loans are maturing in 2024 and 2025, which makes it unlikely for lenders to simply agree to extend the initial maturity date without other modifications unfavorable to borrowers.

Each party should have a keen awareness of its strengths and weaknesses in the current market environment when approaching the negotiating table to discuss a loan modification or extension. Keeping in mind realistic resolutions for both sides, borrowers and lenders should have an understanding of the other party's position. Each party should have an understanding of the asset and the performance of the loan. Loans that are currently facing default due to inability to obtain refinancing are, for the most part, still performing and valuable assets. Most people practicing in the industry understand the key premise that loans facing default are not always troubled loans due to borrower's wrongdoing or lender's faulty underwriting. Those types of troubled loans may arise during this time period but hopefully in smaller numbers than during the Great Recession. As lenders and borrowers sit at the negotiating table to discuss solutions that benefit both parties, the best strategy is to be prepared and understand the particulars of the loan in question and the underlying commercial property.

Understanding the Real Estate Transaction and the Documentation

Review of the loan documents is the first and most crucial step when facing the potential default of a loan and renegotiating the terms. By looking at the interest rate, any amortization schedule or lack thereof, the maturity date, any loan-to-value, debt yield or debt service coverage ratio tests, or out-of-the-ordinary covenants, a sense of the original underwriting of the transaction can be ascertained. The parties must have a clear understanding of required reserves, their purpose, and the length of time they were intended to be collected.

If the loan documents contain cash management provisions, the parties must know whether the cash management system was in place at closing or if it was springing, and, if springing, whether any of the triggers have occurred since the loan's origination.

When negotiating, each party should fully comprehend the financial covenants. Certain provisions will provide the calculation terms to help determine whether the property generates sufficient income to meet the minimum debt-service coverage ratio requirement or the occupancy rate requirement so it is deemed "stabilized" to the lender.

Reviewing event-of-default provisions are also important to determine: (i) whether an event of default has occurred; (ii) whether there are any consequences for an event that, with the passage of time, would become an event of default; (iii) whether notice of a default is required; and (iv) what the lender's remedies would be following a default or an event of default. Sometimes the loan agreement provides that the lender may consider whether to waive its right to call a default or enforce a remedy and issue a waiver or consent letter to address the same, to the extent the conditions laid out in the loan agreement are satisfied.

Borrower covenants should be carefully analyzed, especially the separateness (bankruptcy-remote) covenants, to determine if any breaches have occurred under those provisions. If so, the borrower should review the requirements relating to the cure of such breach and should be in a position to persuasively present evidence to the lender that it is sufficiently curing the breach when confronted with the same at the negotiating table. Finally, each party should familiarize itself with the terms and provisions of the existing loan documents and the deal structure of the original transaction before tackling the issues and drawing conclusions in the current market situation.

An additional key is determining the execution status of the loan documents. At the time of closing

(and post-closing), the lender and its counsel should ensure that the parties have all loan files and final-form executed and recorded or filed (as necessary) documents, which may include: (i) a cash management agreement signed by all parties including the deposit bank; (ii) a collateral assignment of interest rate cap agreement signed by the rate cap provider and attaching a confirmation; (iii) a post-closing letter in which all obligations of borrower have been completed and confirmed by the lender; and (iv) UCC-1 financing statements that have been recorded in the land records where the property is located and/or filed with the secretary of state in which borrower is domiciled. The lender will be concerned primarily with the perfection of its security interests. It should be noted that any failure to file a UCC-1 financing statement or file or record any other security instrument and any omission in the cash management arrangement will serve as a lender weakness which provides leverage to the borrower in these types of negotiations. If the borrower has failed to fulfill a post-closing obligation or has breached some covenant, that omission provides a greater foundation for the lender's delivery of a notice of default. When both parties have a full set of documents and a clear understanding of how the original transaction was structured, then it will be easier to formulate arguments regarding the structure of any modification or extension agreement. As an added benefit, it will also be easier for each party to anticipate and counter any argument from the other side relating to its own weaknesses.

Understand the Other Party's Motivation and Perspective

There are only benefits to engaging in a detailed analysis of the position of each borrower and lender during these types of negotiations. Creating realistic expectations of the final business arrangement will benefit all sides and yield a better legal document in connection with the modification or extension.

From the borrower's perspective, it holds a performing asset that, at loan closing, several lenders would be offering to lend against, but now it is facing default at loan maturity because it is unable to find even a single lender to offer sustainable financing. Even those borrowers who have made every required loan payment on time and historically satisfied all covenants may find themselves in distress of the debt service payments due to higher interest rates. There are not many alternatives when borrowers only know months before loan maturity that refinancing is not available and the balloon payment due at maturity cannot be made, leaving them in a vulnerable position. As many tenants at commercial properties cut down on office space or close brick-and-mortar retail locations, the resulting unanticipated decreases in project cash flow weakens the borrower's position when it pushes for an extension or modification agreement with the lender. Usually, the cost for a lender to step into the shoes of a borrower is daunting and not the lender's first choice, especially when many borrowers have a track record of successfully operating their properties even in a difficult environment. At the negotiating table, this should strengthen the probability that a lender would enter into a loan modification or extension agreement with the owner of a well-managed property.

In weak real estate markets, underlying assets cannot be sold easily or can only be sold at discounts, and most lenders are not looking to accumulate a portfolio of commercial properties. Instead, lenders are looking to reduce their risk exposure and free up the capital currently tied up in non-market loans in order to maintain their own credit standing and funding resources in the credit markets. If a refinancing is not achievable, lenders want to be highly compensated for, and sufficiently protected against, any future risk that may arise from holding assets and owning property.

It is important to note that although a borrower may have had an outstanding relationship with the loan originator at the time the loan closed, new tensions may arise as the underwriting staff is forced to account for their loan portfolios by the lender's senior management. For a lender, the emphasis lies in the sufficiency of capital for the institution and the market adequacy of the deal structure in a weaker economic climate. There are exceptions to

this rule in rare situations where either a long-term relationship or a high-profile asset inspires a lender to enter the market.

If a mortgage loan has been securitized, split, syndicated, or had a mezzanine loan added to the stack, then there is at least one other layer of lender approval and consent that must be obtained prior to the execution of any extension or modification. A group of third-parties, such as rating agencies, mezzanine lenders, and members of the co-lender group, will likely maintain their focus on the bottom line. They will not worry about the originator's relationship with the borrower or the special circumstances relating to the underlying commercial property. In addition, these institutions will likely be pressured to reduce their exposure in a similar manner as the originating lender. Therefore, a lender who called all of the shots at origination will have significantly less authority and will attempt to negotiate a deal that it feels will be approved by any and all required third parties.

Understand the Property Situation in the Current Market Environment

Both lenders and borrowers should research the current status of the property and obtain updated third-party reports relating to the property, such as an updated title report, an appraisal, a property condition report, and an environmental site assessment. In efforts to reduce closing costs for the borrower, there may be some instances in which the lender is willing to waive an updated property condition report if the one provided for the original loan closing was recently done. It is important to understand the current economic issues at the property level, which may not have existed at the time of origination or may simply have been non-issues for the lender.

From the borrower's perspective, the sponsor should know what maintenance and/or repairs are recommended for the property. This premise is two-fold: (i) it provides the borrower with an estimation of the maintenance for which the lender may want to take project reserves; and (ii) it allows the borrower to better formulate an accurate and credible budget to present to the lender when it requests the loan extension or modification. Obtaining new reports also presents the borrower with an opportunity to formulate its arguments as to why certain capital improvements should not be required during the new term or why it would be unnecessary for the lender to impose reserves relating to certain tasks.

If applicable to the property, a borrower should obtain an updated leasing schedule and rent roll to give the lender an accurate representation of the current financial status of the property. Warning flags will be raised for a lender if the property has not been leased within the originally anticipated timeline, if the leases signed are at significantly lower rents than originally projected, if there is a significant amount of outstanding tenant improvements to be completed, or if there is a significant number of leases that are set to expire. Any factor that affects the property's income stream and results in cash-flow deficiencies should be closely examined and monitored. As such, it is better for a borrower to have an understanding of any property-related issues before being confronted with them at the negotiating table.

A lender will also want a clear understanding of the economic status and the surrounding factors of the underlying asset and asset type. The status of the property will largely determine the lender's ability to compromise. A lender will not want to take ownership of a property if there are environmental problems at the site or other unfavorable conditions that may lead to future liability. If the loan is one of many loans to affiliates of a certain sponsor and the portfolio is cross-defaulted, then a lender must seriously consider the repercussions of declaring a default and foreclosing on that single property. If a lender is oversaturated in that type of asset in that geographic region, then it may be more likely to declare the default and foreclose in order to lighten up its balance sheet. If the value of the property has declined to the extent that the foreclosure sale will not result in a sufficient amount to repay the loan, the lender may prefer to negotiate a viable loan work-out in the hope of adding property

value. Again, a lender will want a current report on the property to determine what project reserves, if any, it will be requiring. Also, a review of the leasing schedule and/or rent roll may encourage a lender to institute a hard cash management system for that property. If the cash flow has diminished since the loan origination or if it has not reached its anticipated level, the lender will be in a position to insist on tighter operating standards. Updated reports will allow for updated cash-flow projections factoring in the current weaker economic climate. This will help to determine what debt yield, debt service coverage ratio, and/or loan-to-value ratio the property is able to support in the current market environment. Each loan and its circumstances are quite different, and a lender will need to examine the situation from all perspectives prior to creating a viable proposal for modification of the loan.

Understand What Measures are Necessary to Work-Out the Project

Both parties must approach the negotiating table with realistic expectations about the work-out scenario. The borrower may prefer that the lender extend the term of the loan on its current terms (i.e., with an out-of-market loan-to-value ratio, no project reserves, no hard deposit account control or cash management, and no financial covenants). Conversely, the lender may wish for a loan with a significantly reduced loan-to-value ratio and a substantial equity infusion into the borrower and/or the property. Neither scenario is likely, so it is important for the parties to determine what may be agreed upon to keep the property afloat and the loan out of default. The borrower must determine how much equity it has available to make a principal repayment on the loan, if required by the lender, to lower the loan-to-value ratio to a more current market level. Any additional project reserves must be sized in a way that they are supported by the cash-flow of the property and do not cause borrower to be unable to pay debt service or operating expenses.

The length of the extension must be carefully analyzed. While it is not probable that the lender will agree to extend the term for another five- or 10-year period, a three-month extension likely will not be helpful. The borrower should obtain an extension as long as necessary to navigate through troubled times and to refinance the property. From the borrower's perspective, every day that the lender forbears on declaring a default is another day that the lender is not collecting default interest. Many lenders require cash management structures when a borrower requests a loan extension or modification. A borrower must carefully analyze the cash flow needed for operating the property and the remaining balance can accrue in a lockbox until the new maturity. Essentially, a borrower must consider any possible compromise on the property level to postpone the maturity date and prevent any principal guaranty from being called, while the lender needs to create a viable loan structure that will be approved by its credit committee and any relevant third parties in the capital stack.

Parties Should Address Deal Issues in a Roundtable

Borrowers and lenders should aim to create a roundtable for loan negotiation where all of the parties are on equal footing with a clear understanding of the real estate transaction. In a market where there is little incentive to take any risks, the parties must pull together and formulate a solution that makes sense for that particular loan and the underlying commercial property that works in this current financial climate. As the market forces at the time these loans were originated have radically changed, it is understandably difficult to formulate a refinancing strategy or an approach to handling a potential default when cornerstone financial institutions are going bankrupt or being merged into another entity.

Despite such change, both lenders and borrowers will need to create an action plan on how to address the loans that mature in the next four years. As the senior management structures in many businesses and financial institutions change, so do their market-driven targets and expectations. The best method to proceed with respect to a loan modification or extension request is to be as fully informed and prepared as possible. The measures developed for

loan work-outs for commercial real estate loans provide ample concepts to address the current lending issues. In times of market upheaval, it is important to understand each party's position and opportunities which will allow the parties to work together within the confines of a market-adequate solution. Given the drastically changed market conditions, neither party in a pre-existing real estate transaction has a significantly more powerful position. Therefore, it is important for both parties to be proactive and, to some extent, cooperative in dealing with forced loan extensions and modifications.