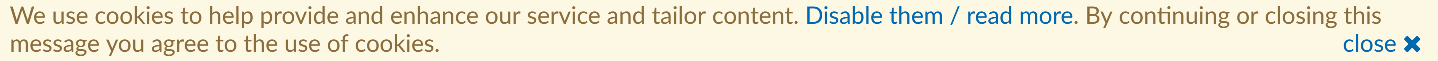

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Expert Analysis

Commercial Mortgage Loan Modifications Amid COVID-19

By **Fernando Landa**

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Law360 (June 23, 2020, 6:02 PM EDT) -- As the COVID-19 pandemic ravages the economy, commercial real estate lenders and borrowers find themselves triaging real estate debt. Capital markets are challenged to price risk — and the result is that commercial real estate debt markets have been at a near standstill, making new loans difficult to close and loan workouts challenging as well. With this in mind, it is important to formulate a proactive strategy to address loan workouts.

Fernando Landa

Loan Workout Strategies

In light of recent shelter-in-place mandates and restrictions on business operations as the economy reopens, borrowers are facing unprecedented cashflow challenges. Hotel occupancy is in single digits in many markets. Many retail tenants, such as bars and fitness facilities, have been unable to operate entirely since the early spring, and the lucky retail tenants that have been allowed to reopen face unprecedented government restrictions on operations.

Even office tenants mostly unaffected by the pandemic have been unable to operate in their leased space, causing them to ask for rent concessions. With property cashflows squeezed, borrowers need help but, unlike tenants and hoteliers, cannot turn to the government for assistance.

That being the case, borrowers are turning to their lenders for relief, and lenders are facing a wave of loan workouts. When addressing loan workouts, it is crucial to consider various options available to borrowers and lenders.

- Consider loan modifications where borrowers and lenders agree to change the terms of a loan to address changed economic circumstances. This seems to be the most prevalent workout strategy in the early lending response to COVID-19, and lenders and borrowers are agreeing to defer principal and/or interest for some period of time, with the deferred payments being due at the maturity of the loan.

- Note the use of reserve funds where borrowers are allowed to apply stored-up loan reserve funds to continuing operations.

- Note sales where a lender sells a distressed loan. Although this strategy was prevalent in the Great Recession, there has not been a large rise in loan sales in this early stage of the changed economy.

- Consider short sales where a lender agrees to permit a borrower to sell a property at a price lower than the debt owed. Like note sales, this workout has not been widely used at this point in the economic cycle in part because property pricing has not reset since the onset of the COVID-19 pandemic.

- Consider discounted payoffs where a lender agrees that its loan can be paid off by the borrower at an amount lower than the loan's outstanding balance. We have seen borrowers try to use the COVID-19 pandemic as a basis to negotiate discounted payoffs with limited success.

- Note receiverships where a lender obtains a court order to have a third party manage a property during the pendency of a foreclosure action. With court closures still in place in many parts of the country and case backlogs affecting open courts, receiverships are not yet on the rise, but many industry players expect a large increase in receiverships in the coming months.

- Consider deeds in lieu of foreclosure where a borrower turns over the property to a lender instead of being foreclosed upon, usually to obtain an important concession from the lender (such as getting relieved of personal guaranty obligations).

- Note foreclosures where the lender takes back its collateral property through legal process.

While all of these remedies are viable, at this point in the cycle, we are seeing a dramatic increase in loan modifications while other workout strategies are being shelved for now. Lenders remain open to working with cash-strapped borrowers, recognizing that the COVID-19 pandemic is unprecedented.

Also, lenders do not want a wave of defaults to negatively affect their business, particularly if the COVID-19 economic fallout turns out to be relatively temporary. However, if the recession deepens or endures for a long period of time, lenders will have no choice but to employ other workout strategies to resolve distressed debt scenarios.

While lenders and borrowers rely on loan modifications to address challenges posed by COVID-19, it is important both lenders and borrowers understand their relative leverage and the pathway to obtain a mutually beneficial loan modification.

Loan Modification Strategies Involving Different Types of Loans

With any loan modification, one must distinguish between the type of loan and lender involved.

Although there are many different types of lenders in the lending market (e.g., life companies, pension funds, regional banks, national banks, etc.), for the purposes of facilitating a loan modification, the industry distinguishes between balance sheet loans and conduit loans.

Balance sheet loans are held by the originating lender or a loan purchaser on its own balance sheet. By contrast, a conduit loan is one that is packaged with other real estate loans and securitized, with the securities sold on the open market to third-party investors. In other words, conduit loans are part of commercial mortgage-backed securities, or CMBS, and those loans are owned by investors, not traditional lenders.

Balance sheet loans are easier to modify because the lender itself owns the loan and, therefore, can more easily make decisions about the loan asset. Conduit loans, however, are more challenging to modify because the owners of the loan are widely disbursed investors that own a pool of loans, rather than one specific distressed loan that needs to be modified.

So how do conduit loans get modified when no one investor owns the distressed loan? In short, CMBS loans are governed by loan pooling and servicing agreements that rely on the appointment of a master servicer to oversee the general administration of the loans in the pool and a special servicer to handle more unique situations such as workouts.

Master servicers lack authority to approve almost all loan modifications and generally can only approve simple, nonmonetary or ministerial modifications (e.g., lease renewal issues or lockbox changes). Loan pooling and servicing agreements task special servicers with monetary and other complicated loan modifications.

That being the case, CMBS borrowers should first contact the master servicer to see if it can handle the relief sought. If not, the borrower will need the master servicer to transfer the loan to the special servicer. Such transfers typically occur only upon a loan default, but most borrowers prefer not to default simply to request a loan modification.

Thus, before an actual default event, a borrower must convince the master servicer that a default is imminent as a trigger to getting the loan transferred to special servicing. If a default is imminent, the master servicer generally has the discretion to transfer the loan to the special servicer before an actual default.

Requests to the master servicer for a transfer of an undefaulted loan to a special servicer should be sensitive to particularly situation at hand. For example, a borrower seeking to be cooperative may suggest a default is imminent, but the borrower has a proposed, mutually beneficial solution that requires a loan modification only the special servicer can grant.

Another strategy may take the form of a borrower forcefully demanding a transfer to special servicing or, otherwise, the borrower will default. At this point in the cycle, we generally recommend such requests to master servicers be in the form of a plea emphasizing the unforeseen circumstances surrounding COVID-19.

CMBS borrowers, however, should have no illusions. Although this cycle feels and may actually be different, historically, a large percentage of borrowers seeking CMBS loan modifications do default on their loans before their loans are transferred to special servicing. Even though special servicers possess more discretion to make grant modifications, CMBS loan modifications are relatively rare, especially without new money being invested into the property.

Best Practices to Request a Loan Modification

Regardless of whether a borrower's loan is a balance sheet loan or a conduit loan, borrowers should consider the following best practices when seeking a loan modification:

- Required loan payments should be made to the extent possible, particularly where loans are secured in part by full recourse or partial recourse personal guaranty obligations.

- Requests for relief should be reasonable and fit the circumstances of the property, loan structure and borrower. Generally, borrowers shouldn't waste their time seeking loan modifications on properties that face no cashflow constraints.

- Borrowers should be transparent and proactive with lenders about the challenges they face, communicating with their lender when concerns arise. Significant problems, like a tenant bankruptcy or the loss of a hotel flag, should be disclosed quickly.

- Borrowers should make the case that the nature of the relief sought presents a viable solution to a shared problem. Lenders understand that broad scale loan defaults are not in their best interest.

- Although each lender will have its own set of documentation requirements, borrowers should be prepared to provide updated rent rolls, property financials, borrower financials and guarantor financials.

- Borrowers should substantiate their operational capabilities, including relationships with tenants and hotel franchisors, and create a detailed COVID-19 workout plan that ties the property's success to the relief sought.

- Borrowers should demonstrate a commitment to the property and their relationship with the lender. Lending is ultimately a relationship business, so lenders should be incentivized to preserve borrowing relationships.

Borrowers and lenders will be well served to modify distressed loans in light of COVID-19 before employing other workout strategies. Lenders know that borrowers could not have foreseen the emergence of COVID-19 and the dramatic government response to the pandemic, and lenders do not want to take over large portfolios of properties in this economic climate.

Most lenders will be better off working with borrowers that know their properties — and their markets — to effectively navigate the economic fallout of COVID-19. In short, borrowers will be best able to maximize the value of lenders' collateral as we all work together to get through these unprecedented times.

Fernando Landa is a partner at Crosbie Gliner Schiffman Southard & Swanson LLP.

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6 Telework Still Reigns As NYC Firms Cleared To Reopen Offices

7 5th Circ. Says Bankruptcy Court Overstepped In Biz Loan Suit

8 Ex-Seyfarth Manager's Sons Say Estate Attys Exploited Dad

9 True Religion Gets Go-Ahead To Pay Brass Ch. 11 Bonuses

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