Strategies for Remediating Loan Defaults

americanbar.org/groups/real_property_trust_estate/resources/probate-property/2024-march-april/strategies-remediating-loan-defaults/

Probate & Property

March/April 2024

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Commercial Real Estate Mortgage Lending Financing

Summary

- Economic uncertainty and financial distress in the current economic climate are impacting office real estate borrowers.
- For lenders, recognizing the signs of distress can make the difference between receiving payment in full and taking a significant loss.
- For borrowers, recognizing the signs of distress can make the difference between retaining a business as a going concern and losing it all.
- Strategies that borrowers and lenders might deploy in the face of economic distress to remediate loan defaults are discussed.

A confluence of difficult circumstances has made borrowing from large banks more and more difficult. Interest rates continue to rise. In July 2023, the Federal Reserve raised its benchmark short-term rate for the 11th time in 17 months as part of its ongoing effort to curb inflation, resulting in an aggregate increase of 5.25 percent. Interest rates have not been this high in nearly 23 years. Office occupancy continues to decline at unprecedented rates since the onset of the COVID-19 pandemic and shows no credible sign of returning to anything close to pre-pandemic levels, notwithstanding return-to-office initiatives. As a result, office real estate values are declining and, with interest rates on the rise, the prospect of refinancing many office loans as they mature appears very grim. In the face of economic uncertainty, banks are not lending; or, if they are, they have become more selective about which loans to make and, perhaps more critically for many borrowers, which loans to extend at maturity.

Financial distress in the current economic climate is inevitable, and that distress is not limited to office real estate borrowers. For lenders, recognizing the signs of distress can make the difference between receiving payment in full and taking a significant loss. For borrowers, recognizing the signs of distress can make the difference between retaining a business as a

going concern and losing it all. Understanding strategies borrowers and lenders might deploy in the face of economic distress to remediate loan defaults has been and will continue to be critical as long as the factors underlying this distress persist.

Loan defaults tend to surface during times of economic distress. There are three basic types of loan defaults: payment defaults, performance defaults, and defaults of representations and warranties. A payment default occurs when a borrower fails to make one or more payments when due under the loan documents. The most common payment default is failure to meet the debt service obligations, whether principal, interest, or otherwise. A performance default occurs when a borrower fails to comply with the affirmative or negative covenants set forth in the loan documents. Common performance defaults include failure to comply with financial covenants, failure to comply with restrictions on additional liens and indebtedness, and failure to provide financial reporting. A breach of a representation or warranty occurs when the lender discovers, after making the loan, that statements made by a borrower at the time the loan was made, and supporting the lender's willingness to make the loan, were not or are no longer true.

Some defaults, such as payment defaults or financial reporting defaults, are immediately apparent. Other defaults, such as financial covenant defaults and failure to comply with restrictions on additional liens and indebtedness, do not surface without periodic reporting by the borrower or without inspections by the lender. Even in the absence of a default that is immediately apparent, lenders take notice (and borrowers should realize that lenders take notice) when borrowers take actions that are indicative of economic distress. Signs of economic distress include borrowers who become unresponsive to phone calls, emails, and other communications from the lender; borrowers who report material (and seemingly sudden) management and operational changes; borrowers who engage a restructuring consultant or counsel; entry of judgments, notices of garnishment, and imposition of tax liens against borrowers and their assets; borrowers who experience cash flow pressures (i.e., borrowers who are overdrawn, seek overdrafts, cannot make payroll, or requests over-advances); and borrowers whose industry is experiencing widespread economic distress and even bankruptcy.

The existence of a default enables the lender to exercise a variety of rights and remedies under the loan documents and applicable law. Initially, in response to a default, a lender will issue a notice of default, but only after all applicable notice requirements have been satisfied and cure periods have lapsed. Then, unless included in the notice of default, the lender may issue a notice of acceleration and demand for payment in full. Following the occurrence of a default, and certainly after accelerating the loan, the lender has a variety of remedies at its disposal. The lender may suspend or terminate an outstanding line of credit or exercise rights of setoff against funds and other assets in the lender's possession or control, as well as commence litigation to collect the loan from the borrower, any guarantors, and other obligors; foreclose on collateral securing the loan; and attach other assets of the borrower, any guarantors, and other obligors.

Just because the lender is entitled to exercise rights and remedies under the loan documents and applicable law in response to a default does not necessarily mean the lender will immediately do so. Rather than incur the time and expense, through litigation, of chasing the borrower and related obligors, as well as collateral and other assets, in response to the default, many lenders will attempt to work with the borrower to remediate the default—this process is often referred to as the "workout."

Before discussing any workout strategy, some lenders will insist that the borrower and related obligors execute a bilateral pre-negotiation agreement. A pre-negotiation agreement preserves the integrity of workout discussions and negotiations by requiring that all parties acknowledge that such discussions and negotiations remain confidential and will be inadmissible in any litigation that might ensue if the workout is unsuccessful. Although useful, the negotiation of a pre-negotiation agreement can be protracted and expensive and, as a result, leave the parties battling over the terms of the pre-negotiation agreement before addressing the existing defaults and workout action plan. Other lenders will issue a unilateral letter to preserve the integrity of workout discussions and negotiations and, thereby, focus more immediately on the existing defaults and workout action plan.

The workout will most often take the form of a unilateral consent, waiver, or reservation of rights letter, or a bilateral forbearance agreement or amendment or modification agreement. The form the workout will take will depend largely upon what the borrower and the lender each seek to accomplish in the workout.

A consent is used by the lender to confirm the lender's agreement that *future* action that would otherwise be a default under the loan documents will not, in fact, constitute a default. For example, when the borrower knows that a proposed corporate restructuring or sale of assets will trigger a default under the loan documents, the borrower should request that the lender consent to the transaction, in advance. A consent, therefore, is essentially an amendment or modification to the loan documents that prevents the default from occurring.

A waiver is used to erase *past* defaults under the loan documents. There are two types of waivers. An *express waiver* is a waiver that is indicated by the lender's actions. For example, a borrower that has breached a financial covenant may require a waiver from the lender before the borrower's accountant will release a clean audit. An express waiver is limited in scope and extends only to the specified default, does not extend to a default that may occur in the future (even if of the same type), and has no effect on the lender's exercise of remedies with respect to any other default and does not affect the borrower's other obligations under the loan documents.

An *implied* or *inadvertent waiver* is a waiver that is indicated by the lender's conduct, which can take the form of action or inaction (or silence). For example, a lender who routinely disregards the borrower's habit of routinely making debt service payments after the due date may be deemed by a court to have inadvertently waived the default and, thereby,

relinquished the right to enforce the borrower's obligation to make payments in accordance with the payment terms under the loan documents. An implied or inadvertent waiver is often found to exist when a repetitive pattern of defaults and waivers occurs over some period of time, creating a course of conduct that becomes the new norm. The waiver is inferred because the lender's conduct—what the lender did or did not do—allowed the borrower to reasonably believe that the lender would not exercise remedies in the future based on the same default.

A *reservation of rights letter* is used by the lender to protect itself from the risk of an inadvertent waiver during a period of inaction. For example, even though the borrower may have breached a financial covenant, the lender may not want to accelerate the loan or exercise other remedies while the lender discusses the underlying issues with the borrower. At the same time, the lender does not want to relinquish its right to do so in the future if discussions with the borrower don't go anywhere. In such circumstances, the lender should use a reservation of rights letter to protect and preserve its rights to exercise remedies with respect to existing defaults by expressly confirming that the lender's silence does not constitute an inadvertent waiver of those defaults.

A reservation of rights letter can be an effective tool to preserve the lender's rights and remedies with respect to existing defaults, but it is not a bilateral agreement between the borrower and the lender. At some point, if the period of inaction continues for too long, a court may find that the lender inadvertently waived those existing defaults by creating a course of conduct with the borrower that is inconsistent with the preservation of rights and remedies with respect to existing defaults. This often happens when the lender issues a reservation of rights letter, and then does nothing. It also happens when the lender issues serial reservation of rights letters, which create a course of conduct that suggests the lender will continue to take no action (and continue to issue one reservation of rights letter after another with respect to the same, repeated defaults), and continue to do nothing. In order to effectively guard against an inadvertent waiver, the lender should secure a forbearance agreement rather than issue one or more reservation of rights letters.

A *forbearance agreement* is a bilateral agreement between the lender and the borrower. By contrast, a reservation of rights letter is unilateral, usually in the form of a letter issued by the lender to the borrower. In a forbearance agreement, the period of inaction is often referred to as the "forbearance period." By expressly preserving existing defaults for the duration of the forbearance period, the lender avoids triggering an inadvertent waiver of its rights and remedies with respect to existing defaults. Typically, the borrower and lender use the forbearance period to develop an effective workout strategy or action plan for the period following the forbearance period. This might involve the engagement of a workout consultant or a broker to sell the lender's collateral or the other assets, or it might give the borrower time to provide financial reporting, secure an appraisal of the lender's collateral, or accomplish other tasks required by the lender to develop a workout strategy or action plan. Or it might simply give the borrower the time it needs to complete tasks that will move the workout

along, such as secure replacement financing, complete an audit, or file tax returns. The lender preserves existing defaults as leverage to compel the borrower to take actions necessary to remediate existing defaults and modify the loan or even to pay down or pay off the loan. In addition, a forbearance agreement will often include more aggressive terms than those contained in the existing loan documents and even an amendment, such as an onerous interest rate, a forbearance fee, and waiver of the automatic stay under the Bankruptcy Code.

At the expiration of the forbearance period, defaults addressed by the forbearance agreement, unless cured or waived, become actionable once again. They are no longer subject to the agreement to forbear. New or additional defaults that might occur during the forbearance period are actionable in accordance with the loan documents. They are not subject to the agreement to forbear.

By itself, a forbearance affects *past* compliance. If the default is cured or waived (directly or indirectly) as a result of the proposed forbearance agreement, then a forbearance is not appropriate. For example, if the only default is the borrower's failure to repay the loan at maturity, and the proposed forbearance agreement extends the maturity date, the transaction is not a "forbearance" because there is no existing default subject to the lender's agreement to forbear during the forbearance period. In that case, the lender should not forbear. Instead, the lender should amend the loan documents to reflect the new, extended maturity date.

An *amendment* should be used to document modifications to the loan documents that implement the workout under circumstances when a waiver, alone, is insufficient or forbearance does not apply. Although an amendment can implement the same terms as a forbearance, and with the same effect, an amendment does so without preserving existing defaults.

By itself, an amendment affects *future* compliance. For example, an amendment would be used to modify an expired maturity date to a new, extended maturity date; to modify financial covenants to targets the borrower can meet; or to implement new covenants that require the borrower to engage a restructuring consultant or a broker to sell the lender's collateral in order to pay down or pay off the loan. An amendment eliminates existing defaults, either by an express waiver contained in the amendment or by an inadvertent waiver because thelender will be deemed to have waived an existing default if the lender amends a loan without expressly preserving that default. In addition to specific modifications to the loan terms, common amendment (and forbearance) terms include the borrower's acknowledgment of the indebtedness and the borrower's reaffirmation of the loan, loan documents, liens, and collateral, as well as a general release in favor of the lender.

Workouts can be difficult. Certainly, in the face of looming economic uncertainty, lenders will be as concerned about recognizing losses as borrowers, guarantors, and other obligors will be concerned about their personal exposure. Understanding the borrower's distress and

what, if anything can be done about it, in the short and long term, will be a necessary first step in the development of any effective action plan. Implementing that plan in a workout will require patience, cooperation, and a realistic understanding of what needs to be done and, perhaps more importantly, what can be done under current circumstances.

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