Commercial Mortgage Loan Modifications: Looking Beyond the Basic Terms

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This article addresses some issues which may be considered by a lender and sponsor when modifying a commercial mortgage loan.

As we get into the late—or maybe even extra—innings of the current real estate cycle, we may begin to see an increasing number of commercial mortgage loans in default or likely to default. Should a loan modification become a reasonably likely route, whether you are on the borrower or lender side, it is important to keep in mind not only basic terms of a potential loan modification, such as the interest rate and/or the maturity date, but also other factors related to the modification.

This article addresses some issues which may be considered by a lender and sponsor when modifying a commercial mortgage loan. It is not intended to be a complete list of all of the issues, but it is intended to demonstrate that a loan modification frequently involves much more than possibly extending the term or changing the interest rate.

Discussions/Pre-Discussions Letter Stage

Communications between the Parties Prior to Modification

If a loan is in default and a modification is contemplated, each of the parties to a loan transaction must be careful when communicating with the other side—whether orally or in writing—and the parties should make a determination if a pre-discussions agreement is desirable. Indeed, if not made with the proper disclosures and disclaimers, a seemingly innocuous statement may come back to haunt a party.[1]

Often, a prudent course of action is to have a pre-discussions agreement in place before having any communications. If it is not possible or practical to enter into a pre-discussions agreement prior to having such communications, one possibility is to make certain disclosures and disclaimers before speaking or e-mailing, including, potentially among other

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things, making it clear that a party's communications are not binding upon either party and that they are being made in the context of settlement discussions only.

Confidentiality

When preparing a discussions letter, one aspect that one may want to consider is confidentiality, including terms which, among other things, address the scope, conditions and duration of the confidentiality arrangement. For certain borrowers or guarantors, it may be important to ensure that the details of a troubled loan not be disclosed to the general public or to other creditors. Similarly, many lenders may not want the public or other borrowers to learn how it is addressing a given distressed loan or how it may approach loan modifications generally. The parties must carefully consider how confidentiality provisions will affect not only itself, but also the other side.

Exit Strategy

Before heading too far down the loan modification path, each side may wish to re-review and analyze its ability to exit from the loan. Among the items to consider on the lender side are whether there are limitations as to whom the lender can assign its interest in the loan, and whether the consent of the borrower and/or the guarantor is required for such an assignment. On the sponsor side, it may be important to consider the borrower's prepayment rights, if any, and whether there any premiums or prerequisites associated with a prepayment and whether a prepayment triggers other obligations, e.g., with respect to an interest rate protection agreement or an exit fee. In short, it is important for both sides to understand what steps must be taken, and what documentation will be required, in connection with a potential exit from the loan.

Waivers and Releases

A lender and sponsor may find themselves at odds when entering into negotiations for a loan modification if the lender demands that the borrower and/or guarantor waive all of their respective claims against the lender and release all of the lender parties from liability as a prerequisite to a loan modification. Borrowers and guarantors may resist this demand; however, it is more likely than not that a version of such a waiver and/or release, if not obtained during the early stages of negotiations, will be required at the time of the closing of the loan modification. It is important to consider how the wording of any such waiver and/or release may impact the parties in the future, particularly if the loan were to require further modification or if a foreclosure were to ensue.

Term Sheet Stage

Costs, Timing, and Title Insurance

If a borrower and a lender are negotiating a term sheet which will embody the terms of a loan modification, it is important that the parties discuss and consider several factors that may have a direct impact on the timing of a modification closing and the costs relating thereto. For example, will updated appraisals, environmental reports, zoning reports and/or property condition reports be required, who will pay for them and how long will they take to be prepared? Can the loan documents be modified through a simple, short amendment or will some or all of the loan documents have to be amended and restated? And who will have to execute and deliver such documents? If the loan is syndicated, what steps must the administrative agent take to modify the loan and how long will such a process take? Will local counsel be needed in connection with the loan modification process (for a further discussion regarding local law, see below). Will a "date down" of lender's mortgagee title insurance policy be required? These are among the crucial questions which must be considered at the early stages of the loan modification process.

Depending upon the jurisdiction, date down endorsements can be very costly. For example, in New York, to date down a lender's title insurance policy, the title company must be paid a premium equal to 50 percent (or more, depending upon the circumstances) of the title premium paid at the original loan closing. As such, updated title insurance coverage may be a costly option, particularly if the loan modification is being contemplated because the borrower is already in trouble. And, should a borrower resist paying this cost, a lender must carefully consider the risks (such as those stemming from intervening lienors) and the benefits of a dated down title policy. In any event, a title search, a date down endorsement and/or other title endorsements (for example, a title endorsement which would insure a to-be-recorded amendment to a security instrument), may be required in connection with the closing of a loan modification, and the parties must consider the costs and timing relating thereto.

It should also be noted that, to issue date down endorsements, title insurers in several states may require that waivers from all contractors that have recently performed work (or that continue to perform work) on the property be provided, often times together with an indemnity from a sponsor. This may be a time consuming task for a borrower, especially where extensive work has recently been or is continuing to be performed at the property.

Construction Loans

If the loan being modified is a construction loan, there are likely to be many additional considerations for the parties, such as lien priority, cost overruns, keeping the loan "in balance," critical completion dates and insurance. Also, in connection with the original loan closing, the project's professionals (e.g., general contractor, engineer, and/or architect) often will have delivered to the lender certain consents and certifications which, among other things, would allow the lender to step into the shoes of the borrower and continue to use such professionals following a default and/or foreclosure. If construction work is on-going at the time of a loan modification, a lender may wish to analyze the status of the professionals' roles in the project and re-analyze the language in the consents and certifications.

Opinion Letters

Another point of contention may arise in connection with opinion letters, and it is important that the parties discuss the topic at the early stages of a loan modification. A lender may attempt to require that opinion letters be delivered in connection with a loan modification; however, a borrower may resist this requirement, claiming that one is not needed and/or that the cost of an opinion is too prohibitive. A lender may insist on updated opinion letters if, for example, there have been material changes to the organizational documents or parties thereto or if extensive, substantive changes are being made to the original loan documents in connection with the loan modification. However, once again, if the loan modification is contemplated because the borrower is already in trouble, costs must be considered and weighed against the potential risks to a lender should it choose not to obtain one or more opinion letters.

Documentation Stage

Potential New Loan Requirements and/or Revised Requirements

A lender may make a determination to enter into a loan modification only if it obtains additional collateral, a new guarantor, enhanced guaranty terms or additional protections which may make its path to foreclosure easier. For example, a lender may require a partial paydown of the loan, the posting of a letter of credit, entry into cash management/lock box arrangement or the addition of a new guarantor. On the flip side, a sponsor may wish to revamp certain requirements it deems to be too restrictive, such as a covenant which may have precipitated the requirement for the loan modification in the first instance.

Similarly, in connection with a loan modification, a lender may revisit the adequacy of the financial and other reporting requirements set forth in the original loan documents, including the right to access the books and records of the borrower and/or guarantor. Enhanced reporting in the form of more frequently delivered and/or more detailed compliance certificates, for instance, may be required as a lender re-considers its ability to monitor the loan, the borrower, the guarantor and/or the property. The time and cost involved with such enhanced reporting, particularly if audited or other accountant-prepared statements are required, should be discussed and considered early on in the loan modification process.

Local Law Issues

The parties must keep in mind that local counsel may have to be consulted in connection with a loan modification. This might occur, for example, if loan documents, including the loan modification documents, are governed by one state's laws, but the property is located in different state. It may be important to inquire of counsel in all relevant jurisdictions whether laws have changed since the closing of the loan, and whether any new laws are now applicable to loan being modified. In short, both sides may need an understanding of how laws in different jurisdictions could impact their positions, both in connection with the loan modification itself and going forward.

Conclusion

For a loan modification, both parties must understand that the loan modification process may involve much more than a change to the interest rate or an extension of the loan term. Indeed, the parties may need to come to an understanding regarding a number of material issues before a commercial mortgage loan can be modified. Prudent lenders, borrowers and guarantors, and their counsel, should pause to carefully consider the panoply of issues that not only may affect the loan modification process itself, but that also may affect the parties after the loan modification closes.

NOTE:

[1]For more on this topic, please review "*Can and Will Be Used Against You: The Importance of Pre-Negotiation Agreements for Troubled Commercial Loans*," by Arren

S. Goldman, Esq. and Jonathan P. Wolfert, Esq. (Thompson Reuters' *Real Estate Finance Journal*—Spring/Summer 2017).