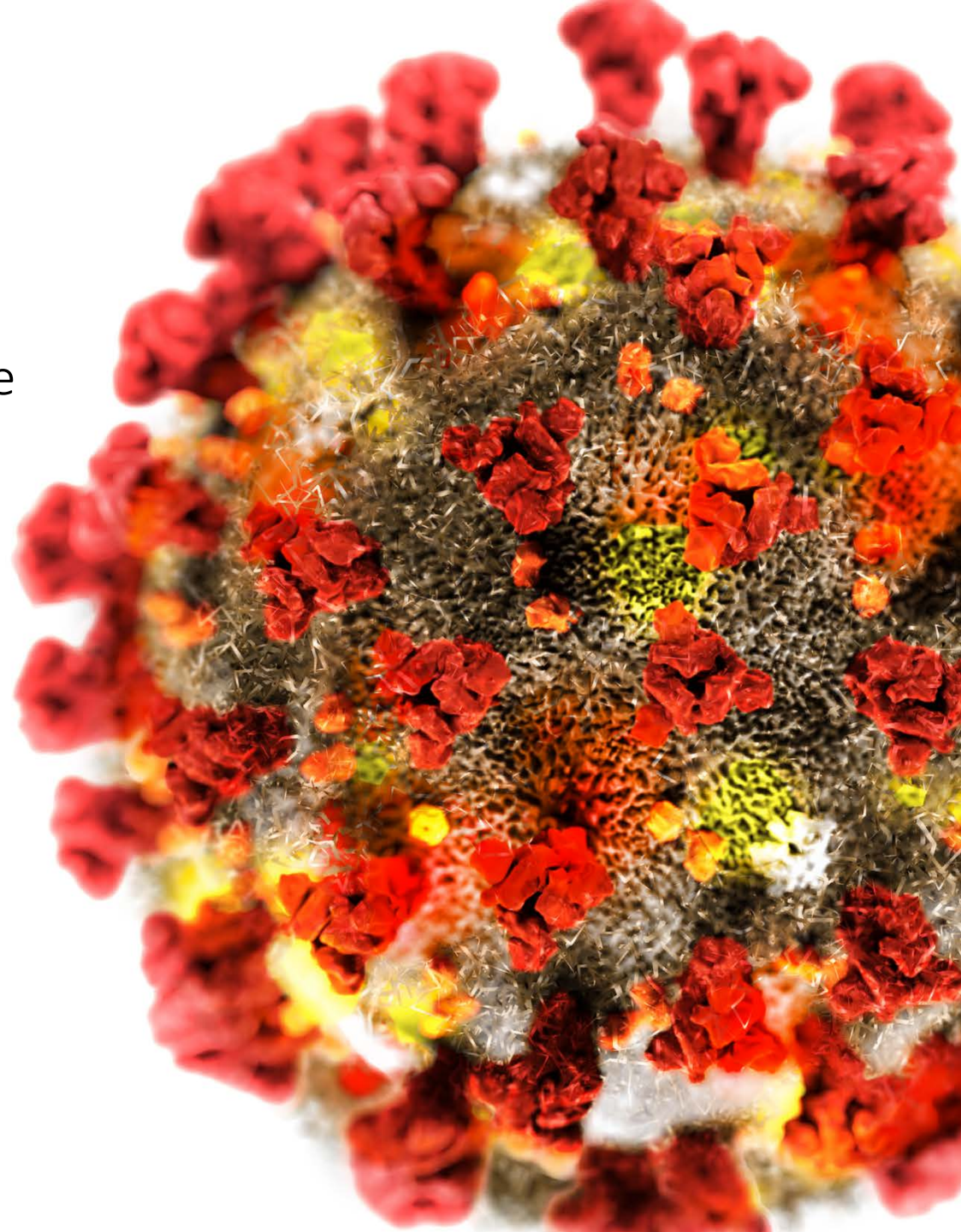


Real Assets Roundup

Assessing Default and Enforcement Dynamics in the *Real Estate*, Project and Aviation Debt Markets

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pillsbury





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Agenda

- Introduction
- Current state of affairs
- Workouts – Considerations; Pre-Negotiation and Forbearance Agreements
- “Bad-Boy” Guaranties - Considerations
- Special issues in CMBS/real estate capital markets context
- Assessing the debt stack – Intercreditor Agreements
- Creditor Rights

Current State- Closing Loans & Origination



Bob Grados

- Loans negotiated when pandemic broke out:
 - some are moving ahead, albeit with terms that reflect spread movements, etc.
 - others have been shelved, either by credit committees or by Borrowers
- Origination of new loans is largely at a standstill

Current State- Issues in Construction Loans

- Delays with construction
- Supply chain interruptions
- Possible use of “force majeure” to justify extension of construction deadline covenants

Current State- Tenant Non-Payment

- Tenant nonpayment of rent and lack of hotel key revenue affecting compliance/payment in the hotel/restaurant/hospitality segments

Current State- Governmental Action

- Local/state/federal governmental actions providing limitation or slowness with ability to realize on collateral

Workouts – Considerations; Pre-Negotiation and Forbearance Agreements

Workout: Goals and Preparations

Pre-Negotiation Agreements

Forbearance Agreements



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Workouts – General - Goals

- A workout is a restructuring of a loan in default (or soon to be in default) - which occurs out of court - and by mutual agreement between a lender and a borrower.
- The parties that come together are:
 - The borrower - that remains obligated to meet its monthly debt service payment obligations, fund required reserves, operate “normally” and, often, comply with financial covenants – even in the face of the distressed nature of its property
 - The lender, faced with what it perceives as a “temporary” – and in this case “systemic” – crisis.
 - The guarantor, mindful of the guaranties
- Goals for the lender:
 - Improving the likelihood and level of repayment
 - Avoiding the exercise of remedies, such as a foreclosure, and the associated expenses
- Goals for the borrower:
 - gaining operational “breathing room” that allow it to retain control of the asset until revenue streams resume – and preserving equity

Workout Goals - General (cont'd)

- Perhaps, in consideration for the relief to be granted by the lender, the lender can:
 - Obtain additional collateral or guaranties;
 - Put in place hard cash management – revisit level of (or require) reserves
 - Improve financial reporting and increase inspection/audit rights
- Perhaps, in exchange for the relief being granted by lender, the borrower can:
 - Obtain covenant compliance waivers to avoid further loan defaults
 - Obtain use of reserves held by lender (or otherwise restricted) for operational use
 - Limit operating cash sweeps
 - Put in place pre-approved “safe harbors” for implementing modified lease or construction contract terms that give flexibility in dealing with tenants, contractors, and leasing brokers

First Steps: Prepare for the Workout

- Before talking to the Lender about any workout specifics:
 - Assemble your team and investors – Be prepared to discuss any management team changes
 - Assess the Operational Realities – Prepare updated Property reports and order title update (or do UCC search) to diligence mechanics or other liens
 - Determine what covenants have been breached (or may be in the future) - what Relief is Needed
 - Assess which Lenders/Service providers you Need to Negotiate With or Get Approval From
 - Assess your relationship to Lender and other projects that could be implicated – consider necessity for consistent positions
 - Keep Investors and JV Partners apprised of status - consent to workout terms or loan modification positions may be needed per organizational or JV agreements or to protect Property sponsors or guarantors of loan
- Before talking to the Borrower about any workout specifics:
 - Assemble your team and advisors
 - Assess the Borrower/Sponsor
 - Assess the Property – order title update (or do UCC search) to diligence other liens
 - Determine value of property – if a mezzanine lender, determine extent of value remaining in the mezzanine loan
 - Assess the Loan and the Defaults – Assess Relief requested
 - Review and Gather Property Condition and Financial Documents and Projections

Also, as a First Step, Sign a Pre-Negotiation Agreement

- The PNA allows a borrower and a lender to freely engage in discussions - and not be bound until a formal agreement is executed. A PNA is a critical table-setting exercise that help negotiations get underway.
- This is accomplished by providing, in the PNA, that:
 - Discussions are non-binding – and the parties are only bound when a final “restructuring agreement” is signed by all parties, including guarantors
 - Discussions are without prejudice to or waiver of any party’s rights – the parties maintain the status quo during the discussions
 - Discussions are confidential settlement discussions
 - The loan documents remain in full force and effect
 - Neither party waives any of its rights under the loan documents – and no party is under any duty to grant or accept concessions
 - Discussions may be terminated at any time by either party, for any reason or no reason

After the PNA, a Forbearance Agreement

- Forbearance is less than a full “workout” or restructuring – in its simplest form, it is not a loan modification.
- Essentially, the borrower is requesting a *temporary* waiver or deferment of payments (such as interest and default interest) – and the lender is agreeing to forbear from exercising remedies *for a period of time up to an outside date*.
- Usually, the agreement terminates – the forbearance ends – if there is a borrower bankruptcy or if a default occurs under the Forbearance Agreement.
- Frequently, the borrower will be asked to (i) acknowledge its defaults, (ii) ratify the loan documents and representations made in the loan documents, (iii) waive defenses, offsets and counterclaims to date and (iv) release the lender of all claims. Lenders view these provisions as essential to avoiding future allegations of lender liability if the workout fails.
- Guarantors will be expected to re-affirm their guaranties.
- Ideally, the agreement should address any liens or claims affecting lender’s security - e.g. require that borrower satisfy all contractors’ claims/liens.

Forbearance Agreements (cont'd)

- Often, although not always, the agreement will require the borrower to pay a forbearance fee as well as the expenses incurred by lender in negotiating the forbearance agreement. The agreement may also require borrower to make concessions, such as:
 - entering into a lockbox or cash management agreement, or fund reserves,
 - providing additional guarantees or collateral,
 - imposing additional financial reporting requirements, or
 - requiring borrower to solicit new financing options.
- **A Few Tips for Lenders and Borrowers:**
 - Time permitting, lenders should audit borrower and the property as there may be defaults that exist other than the inability to pay debt service or the breach of a financial covenant.
 - Specify that the forbearance is with respect to the known specified defaults - not all, possibly unknown, defaults.
 - Be sure that the borrower is represented by counsel – and so provide in the agreement.
 - Keep track of the date on which the forbearance period terminates. Use this “window of time” to prepare for next steps.

“Bad-Boy” Guaranties - Considerations

- Lenders’ Goal: Skin in the game for the principal of borrower in the event of a loan default. [Recall, many borrowers now are SPE’s]
 - Role in deterring action by borrowers. For instance, bankruptcy.
- Borrowers’/ Guarantor Concern: Preemptive demands on guarantor for recourse.
 - Can be a trap for the unwary. Lender may seek recovery over non-core breaches or assert the occurrence of a full recourse event that is an overreach.

Typical Structure of Nonrecourse Carveout Guaranties

- Defaults for which the guarantor indemnifies the lender for losses (actual loss)- “above the line.”
- Defaults upon which the loan becomes fully-recourse to guarantor (and borrower)- “below the line.”
- Financial covenants of guarantor (net worth and liquidity).
- Note = often, unavailability of operating funds may not be a defense to performance of an obligation that triggers recourse.

Guaranty Obligations- Full Recourse

- What to look for:
 - Frequent full recourse items:
 - Bankruptcy and bankruptcy-related items.
 - Involuntary bankruptcy.
 - Acquiesces, colludes in or fails to contest.
 - Breach of SPE reps that result in a consolidation.
 - Breach of due on sale clauses. (Upper tier transfers included? Involuntary transfers included?)
 - Creation of liens (voluntary or involuntary).

Guaranty Obligations- Partial Obligations

- Frequent Indemnity/ Partial Recourse Items:
 - Material misrepresentations.
 - Waste (vs. physical waste).
 - Gross negligence.
 - Single-purpose entity covenants and covenants to keep solvent.
 - Have been enforced.
 - Well-negotiated guaranties avoid this problem.
 - Failure to pay real estate taxes or insurance premiums.
 - Grace periods? Due to lack of funds?
 - Raising Frivolous Defenses to an Enforcement Action

Bottom Line = Start Evaluation/Workout Process Sooner Rather than Later

- Lenders and borrowers should start evaluating their economic and legal rights as soon as possible
- Lenders: Don't wait until your borrower comes to you with its "plan" – start to consider your options
- Borrowers: Don't wait until your resources are limited and your options have been narrowed – don't wait until the Lender defaults you.
- *The best negotiated results occur when neither party has too much leverage*

Special issues in CMBS/real estate capital markets context

Special Servicing

Margin Calls



Bob Grados

Issues/opportunities Within the Debt Stack

Assess the Capital Structure

Intercreditor Agreements



Bob Grados



Caroline Harcourt

Lenders must assess the Capital Stack

- Are there third-party Lenders
 - Have you pledged the loan on a warehouse line?
- If there are loan participants or co-lenders—
 - Review participation/co-lender agreement to determine:
 - lead lender authority - who can approve credit facility restructuring and/or exercise remedies and/or foreclose
 - voting requirements
 - options for bridge or mezzanine financing as part of restructure
- If the mortgage loan has been securitized—
 - Workout may require consultation and/or approval of master servicer, special servicer, trustee, controlling holder and/or operating advisor
 - Pooling and Servicing Agreement may restrict ability to extend maturity or modify other loan terms

Intercreditor Agreements

- If there is mezzanine debt outstanding, determine:
 - Whether the mezzanine lender has the right to cure defaults under mortgage loan
 - If so, is such right limited (to some capped number of cures)?
 - Does mezzanine lender have the ability to—
 - replace the existing manager?
 - restrict/control leasing, or alterations/improvements?
 - approve/reject the budget?

Intercreditor Agreements (cont'd)

- If there is mezzanine debt outstanding, determine if the mortgage lender can modify the loan documents without the mezzanine lender's consent.
 - Typically, during a workout, the mortgage lender can modify all provisions other than certain “key” provisions such as—
 - increasing principal amount of loan
 - shortening maturity – or changing lockout or yield maintenance periods
- If you are the mezzanine lender, can you modify the mezzanine loan documents without mortgage lender's consent?

Intercreditor Agreements (cont'd)

- What does the ICA say regarding mezzanine lender's right to foreclose?
 - ICA's will give the mezzanine Lender a set period of time in which to conduct a UCC foreclosure - during this time, senior lender will refrain from using its available foreclosure remedies. These provisions sometimes also apply to the exercise of "voting rights" by the mezzanine lender.
 - Typically, senior lender approval (or a rating agency confirmation) will be required unless
 - (1) the transferee is the mezzanine lender or a "qualified transferee" meeting certain pre-agreed upon financial (and other) requirements,
 - (2) shortly after the foreclosure, the Property will be managed by a Manager meeting certain pre-agreed upon parameters, and
 - (3) all monetary Events of Default must be cured (other than the borrower's failure to repay the senior loan in full on any accelerated maturity date)
 - Typically, the foreclosing mezzanine lender or successor will need to provide "replacement Guaranties" in connection with consummating the foreclosure sale. The scope of such guaranties – and the identity and financial profile of acceptable replacement guarantors – are often negotiated.

Intercreditor Agreements (cont'd)

- A few practical tips if you are the mezzanine lender considering foreclosure:
 - Always order a *current title report* to understand whether mechanic's or other liens/encumbrances exist – or whether real estate taxes (or water and sewer charges) are current
 - Mostly importantly, remember, if you foreclose, *you are stepping into the shoes of the Borrower* and the liabilities of that borrower (and any liens on the borrower's assets).

Intercreditor Agreements (cont'd)

- Does intercreditor agreement grant to mezzanine lender a purchase option with respect to the senior mortgage loan? If so—
 - What triggers the option? Often, an Event of Default under the senior loan, acceleration of the senior loan, senior loan being transferred to special servicer triggers the option.
 - Often, the mezzanine lender have to cure all monetary defaults upon its exercise of the option.
 - Confirm the purchase price to be paid – this is usually negotiated and may or may not include the various fees payable to the servicer (i.e. liquidation, workout, etc.) and the payment of default interest, prepayment premiums, late charges

Creditor Rights



Patrick Potter

To learn more about Pillsbury's Insolvency & Restructuring practice, please visit:

[Pillsbury's Insolvency & Restructuring Practice](#)



Real Estate Chapter 11s are Challenging

- Probably more challenging for the debtor/owner. Secured creditors have many rights and remedies under the Bankruptcy Code.
- But bankruptcies are not easy for secured lenders either. Judges usually give borrowers some leeway, which may increase if the judge is convinced the debtor's problems are largely due to CV19.

General Pre-Bankruptcy Advice

- Communication is key.
- Work hard to make peace, not war (litigation).
- Transparency and fresh data from the borrower goes a long way.
- “Shared Pain”: Common theme in real estate during CV19.
 - Value will be lost during CV19, but will come back in most cases.
 - Consider appropriate allocation for turnaround efforts and success.

Lender Pre-Bankruptcy Considerations

- Keep your best borrowers close; keep the rest closer.
- Negotiate for robust financial/accounting reporting and access.
- Keep a close, accurate and thorough eye on payables.
- A real estate borrower with no other creditors cannot cramdown a secured creditor due to the once-accepting-class voting mandate.
- Watch out for increasing A/P and unusual, new loans/financings (e.g., equipment).
- Consider obtaining a right to pay the debtor's A/P at any time.

Bankruptcy Waivers/Agreements: What Does Not Work?

- Borrower agreement to not file for bankruptcy.
- Borrower agreement to financial penalties or forfeitures triggered by bankruptcy.
- Borrower agreement to assume or not assume key (executory) contracts.
- Borrower agreement to not challenge the debt probably does not work—trustees and committees are not likely bound.
- Borrower waiving the exclusive period to file a plan probably does not work.

Bankruptcy Waivers/Agreements: What Works?

- Rights against third parties (e.g., principals) triggered by the borrower's default.
 - Some courts will consider “section 105” injunctions where the principal argues defending an action will harm the borrower's bankruptcy.
- Waivers by borrowers of the automatic stay or the right to contest lender's motion for relief from the stay have been enforced.
 - But may not be enforceable against a trustee or committee.

Borrower Bankruptcy Considerations

- Creditors to vote for a cramdown plan—as many as possible; as business “friendly” as possible; and in different priorities (unsecured, secured).
- Cash flow to operate during the chapter 11.
- Principals may need to contribute new/fresh capital to deal with the absolute priority rule.
- Planning far in advance is critical.
- Chapter 11 does not work without a business plan—e.g., sale or restructure with new funding.

Potential Sleeper Issue – New Subchapter V: Small Businesses (2020)

- New Sub-V has many benefits for debtors, including: (a) no disclosure statement; (b) no meaningful voting; (c) no unsecured creditors' committee; (d) no US trustee fees; (e) no requirement to pay administrative claims at confirmation; and (f) an absolute priority rule for unsecured creditors (which would apply to a secured creditors' deficiency).
- CARES Act just increased liquidated debt ceiling from \$2.7 million to \$7.5 million – excludes disputed and unliquidated claims.
- Excludes debtors whose primary activity is the business of owning single asset real estate – stay tuned for creative debtors.

Questions



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