

Insights

Loan Modifications in the Wake of COVID-19

Article

Lowndes

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Given the economic impact of COVID-19, both monetary and non-monetary defaults on commercial loans are likely in the next few weeks and months, if not a reality already. Both lenders and borrowers should consider initiating communication to discuss potential problems and to try to identify solutions.

In particular, lenders with borrowers in the hotel, restaurant, event, and retail industries should begin to consider which specific borrowers may be in financial distress and review their loan documents for likely events of default. Likewise, borrowers may want to get ahead of actual defaults by discussing various options with their lenders, including a possible default waiver and modification of the loan documents to avoid future defaults, or a loan workout with forbearance agreement.

One matter to consider is the impact of any force majeure provision on the non-performance by the borrower. This provision should be reviewed carefully, and both borrowers and lenders should consult their counsel before relying upon, or dismissing, a force majeure argument. To the surprise of some borrowers, the inability to make payments because of adverse effects on its business as a result of COVID-19 may not provide a defense. Further, review the loan documents for a material adverse change clause and consider what impact a such a clause could have under the current circumstances.

Another consideration is whether the loan documents include financial covenants that could trigger a default even absent a monetary default. If a lender is entitled to request and review financial statements of the borrower, the lender should seek updated financial information and determine whether any financial covenant, such as the debt service coverage ratio, is a potential problem area. Similarly, lenders should review the financial state of any guarantor, who may be subject to a minimum net worth requirement under the guaranty, particularly in light of the recent movements of the stock market.

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Remedies available to lenders in the event of such defaults will be loan-specific, and lenders should consider whether forbearance as to such defaults and loan modification, as opposed to enforcement, would be financially prudent where the borrower has a reasonable chance of getting back on track, particularly when the recoverability of the debt is uncertain. Also to be considered in this regard is the effect of applicable governmental orders purporting to stay any foreclosure actions.

If a borrower is claiming financial distress, explore alternative funding options, especially opportunities under the CARES Act. In addition, lenders and borrowers may want to review the organization documents of borrower entities to determine whether a capital call may be appropriate. If the borrower's cash flow appears to be a temporary issue, deferment of payments may be a reasonable solution.

From the lender's perspective, any agreement to forbear or modify the terms of a loan should be paired with additional or revised financial reporting requirements, a waiver of any opportunities to cure upon subsequent default, a waiver of any existing claims or defenses, including common law defenses such as impossibility of performance, bankruptcy protections, and additional guaranties or security. This is also an opportunity for the lender to correct any deficiencies that may exist with the original loan documents.

In the event that the parties decide to negotiate a forbearance agreement, lenders should require confidentiality both during negotiations and as to the final agreement. A pre-negotiation agreement that specifically includes provisions providing for confidentiality and the inadmissibility of negotiations in any future litigation (similar to a settlement discussion), may be wise, particularly when negotiating with sophisticated borrowers.

Finally, lenders should be cautious to avoid causing any waiver of its rights and remedies under the loan documents during negotiations, which is an issue that can be specifically addressed in a pre-negotiation agreement.

Prior to initiating communication with borrowers and/or lenders, we recommend reaching out to your counsel to review applicable loan documents and assist with any pre-negotiation and forbearance agreements. Please contact any member of the Lowndes Banking & Finance Group with any specific questions.