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Forbearance Agreements in the Age of COVID-19 and National Shelter-in-Place Orders

by Elizabeth Murphy and Matt Smith

The continuing economic stoppage prompted by the spread of the COVID-19 virus is likely to trigger both monetary and covenant defaults of countless obligors under CMBS, bridge, construction, and agency loans over the next several months. Property cash-flow deficits will increase due to shelter-in-place orders preventing income generation and making it more difficult, if not impossible, for borrowers to refinance. Moreover, foreclosure proceedings will be challenging due to court closures and the availability of sympathetic defenses to borrowers, such as the doctrines of contractual impossibility and force majeure. The economic effects of COVID-19 affect all property types, from hotels to retail to student housing and multifamily. With state regulatory agencies and government-sponsored entities providing guidance and mandating forbearances in residential markets, now more than ever, many lenders and servicers are interested in restructuring defaulted or soon-to-be-defaulted CRE loans in the hope that, in the not-so-distant future, these properties will rebound along with much of the rest of the economy.

The Practicalities of Forbearance over Foreclosure

On March 21, 2020, New York Governor Andrew M. Cuomo issued Executive Order 202.9, directing institutions regulated by the New York Department of Financial Services (NYDFS) to provide, under reasonable and prudent circumstances, financial relief to individuals in New York experiencing a financial hardship due to the COVID-19 pandemic. The order amends Section 39 of the Banking Law and deems it an "unsafe and unsound business practice if, in response to the COVID-19 pandemic, any bank which is subject to the jurisdiction of the [NYDFS] shall not grant a forbearance to any person or business who has a financial hardship as a result of the COVID-19 pandemic for a period of ninety days." Building on the order, the NYDFS issued an emergency set of amendments and additions to the corresponding regulations. While these emergency regulations specifically do not "apply to any commercial mortgage or any other loans not described" in the regulation, many borrowers are nonetheless expecting their commercial lenders to be amenable to similar

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relief. Additionally, the Coronavirus Aid, Relief, and Economic Security (CARES) Act mandates forbearances for certain single-family residential mortgages.

Certain federal regulators, including the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board of Governors, have also issued statements encouraging commercial real estate lenders and other financial institutions "to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the effects of COVID-19." Though those agencies go on to say that "the agencies will not criticize financial institutions that mitigate credit risk through prudent actions consistent with safe and sound practices," it is clear that there is a preference at the regulatory and executive levels of government for lenders to forbear from taking enforcement action during this unprecedented time. Courts are also closed during this time in several jurisdictions, with filing deadlines being extended until courts can operate at full capacity.

Borrowers and their tenants are also exploring common-law defenses to payment, including the doctrines of impossibility and force majeure, with many borrowers receiving notices this month from their tenants invoking force majeure and arguing that they do not owe any rent due to government-mandated closures and this unprecedented global pandemic. Though such arguments by borrowers and tenants are likely tenuous given the terms of the applicable governing documents, those arguments have been made and will continue to be made by all parties. This is not to say that commercial real estate lenders and servicers cannot foreclose, but it is to say that any foreclosure action initiated during this time will be subject to judicial delays and potential borrower pushback.

Forbearance Advantages for Lenders

Under these circumstances, if a lender decides that a restructuring of the indebtedness is more favorable than seeking a foreclosure of the collateral, a forbearance often gives lenders and servicers the best legal protection (as opposed to a mere waiver or loan modification). Forbearance means the act of "refraining from action." Under a forbearance, the lender does not forgive any payment default or other default. Instead, the lender forbears from taking any enforcement action available to it under the loan documents. Forbearance keeps the lender's remedies available because the original default is never cured or indefinitely waived. While the lender has agreed to delay the enforcement of its rights, those rights continue to exist.

In connection with the forbearance, the lender has the ability to request modifications to the loan documents. These modifications can strengthen the lender's position through cash sweeps and additional reporting and also afford all parties an opportunity to craft changes that simultaneously strengthen the value of the borrower's property and make it more attractive to other lenders and takeout financing. Lenders (or a servicer or special servicer acting on its behalf) may and usually should also include language in any forbearance requiring the borrower to consent to jurisdiction if any lawsuit or later foreclosure ensues. In most forbearances, the borrower typically agrees to waive its right to the automatic stay if it later declares bankruptcy (although that waiver may not be enforced by the bankruptcy court under its equitable powers). In addition to lender-friendly modifications, the lender can also negotiate specific conditions to the continuance of the forbearance period, which would enable the special servicer to closely monitor the borrower and property's performance. For example, the lender may negotiate specific financial or property-

level tests and covenants (such as debt service coverage ratios, occupancy tests, or franchise default triggers); the failure to satisfy such conditions will terminate the forbearance period.

Forbearance also gives the lender the opportunity to clearly identify the existing defaults. Though the forbearance has likely been initiated due to the immediate effects of COVID-19 on the economy and marketplace, there may be other defaults on the loan as well. In a forbearance, a borrower must acknowledge such defaults and certify to the lender that no other defaults are then outstanding. Accordingly, if applicable, during the continuance of the forbearance period, since the default continues uncured, funds from the property will be applied pursuant to the post-event-of-default waterfall, preventing any payments of debt service to subordinate debtholders. For securitized loans, the loan will remain subject to special servicing, the event of default will remain in continuance, and, accordingly, the loan will not return to "performing status" nor will it be subject to servicing by the master servicer.

Further Relief for Forbearances in a REMIC Structure

Reacting to these developments and responding to comments and concerns raised by commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) stakeholders, the IRS issued Revenue Procedure 2020-26 on April 13, 2020. This Revenue Procedure provides safe harbors that prevent certain adverse tax consequences for payment forbearances and "related" modifications arising from COVID-19 on mortgage loans held by real estate mortgage investment conduits (REMICs) and investment trusts. The safe harbors apply to mortgage loan payment forbearances of three to six months and related modifications requested or agreed to between March 27, 2020 and December 31, 2020. The IRS does not define related modifications but provides two examples: (1) adding deferred payments to the principal amount to be paid after what would otherwise be the final payment on the loan; or (2) reamortizing an amortizing mortgage loan at the end of the forbearance period to preserve the original maturity date. Before this latest response from the IRS, for any CMBS deal, a forbearance, even a short-term forbearance before an actual default, could be treated as a loan modification for REMIC purposes, which would subject the entire trust to taxation. To avoid such a fate, a lender would typically have to determine that it was reasonably foreseeable that the loan would default and transfer the loan to special servicing. In addition, a REMIC opinion would typically be obtained to support that the circumstances surrounding a particular forbearance, including the default determination, should be sufficient to avoid producing adverse tax consequences to the REMIC. Under this Revenue Procedure, as long as a forbearance (and related modifications) meets the applicable conditions, the safe harbors should apply and avoid producing adverse tax consequences to the REMIC. This alleviates the need for the servicer to make the reasonably foreseeable default determination for every loan in the pools it is servicing in order to enter into such forbearances from a tax perspective. Many lenders may therefore conclude that a REMIC opinion is not necessary for such forbearances (and related modifications). Of course, the servicer should review each pooling and servicing agreement to determine its obligation to obtain other consents and the need for any opinions as a condition before consenting to any forbearance or other modifications to any loan. The servicer still has to exercise the servicing standard in determining if any emergency forbearance is warranted, but the guidance does eliminate the need to make certain determinations for tax purposes and may in many instances eliminate the need for tax opinions.

The Bankruptcy Implications and Advantages of a Forbearance

Many forbearance agreements require that borrowers waive their rights to declare bankruptcy, although such provisions have been found to be unenforceable by reason of public policy. Courts, however, recognize the inevitable "tension between affording a debtor the protection to which it is entitled under the Bankruptcy Code, and furthering the legitimate public policy of encouraging out-of-court restructurings and settlements."[1] Courts have enforced waivers of bankruptcy's automatic stay to permit lenders to foreclose on their collateral. In determining whether to enforce a waiver of the automatic stay, bankruptcy courts consider factors such as: (1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the risk and length of time of the lender's forbearance; (3) the potential effects on other creditors; and (4) the feasibility of the debtor's plan. Forbearance agreements can offer lenders added protection so that if the borrower pursues bankruptcy after a forbearance period, the lender will likely not be hindered in its efforts to subsequently foreclose.

Given the general uncertainties today, it is understandable that lenders may be hesitant to immediately enforce remedies against a defaulted borrower. In many instances, a well-structured forbearance may be the best option, providing added structure and legal protections to the lender.

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[1] Katherine A. Burroughs and H. Jeffrey Schwarz, "Forbearance Agreement," *New York Law Journal – Corporate Restructuring and Bankruptcy*, Sept. 2008.

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