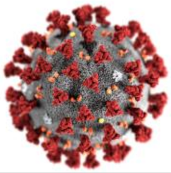

CCM **COVID-19** ALERT

April 7, 2020

Financial Covenant Considerations in Loan Documents During the COVID-19 Outbreak

The COVID-19 outbreak is not only affecting people on an individual basis, but also entire markets and industries. Reading a few headlines of newspapers indicates the industry of commercial real estate is no exception. Headlines such as: "Real-Estate Lending Funds Feeling Squeezed by Banks and Developers" in the Wall Street Journal; "Businesses Can't Pay Rent. That's a Threat to the $3 Trillion Commercial Mortgage Market" in the Wall Street Journal; and "US mortgage lenders face liquidity crunch" in the Financial Times are examples. As tenants of office buildings and retail spaces close or operate in a limited fashion, this creates a high probability of disruption to the payment of rent to commercial property owners. This disruption in the payment of rent impacts both the relationship between the tenant and commercial property owner and the relationship between the commercial property owner and the lenders that hold the mortgage loans encumbering the property. Both commercial property owner borrowers and lenders should work together to examine the documents governing their loans for any issues and strategize now on formulating solutions or options.

Financial Covenants

Financial covenants outline the financial metrics designed to measure things such as a borrower's cash flow, leverage, liquidity, or net worth. With the current market volatility, it is likely that operating income will decline for many commercial property owners who are borrowers. A decline in trending operating income may have implications under loan documents. The current economy will result in financial tests for Borrowers which most certainly will trigger financial covenant violations. The following financial covenants may be of particular concern to commercial property owner borrowers:

Debt yield is the ratio of net operating income of property to the outstanding principal balance of the loan secured by the real property. This is a financial ratio used to measure risk for a loan and is considered more stable and reliable than debt service coverage ratios and loan to value ratios. A higher debt yield means lower leverage and lower risk. If the operating income of the borrower decreases, then this will impact the debt yield in a negative way.

Debt service coverage ratio ("DSCR") is the ratio of project revenues over the sum of the borrower's total debt obligations and the costs of operating and maintaining the project. This ratio indicates the borrower's ability to pay for the costs of the project from the generated revenue. If the ratio is higher, it is less likely the borrower will default on the loans to finance the project. The DSCR is similar to the debt yield in terms of a higher number is better. Additionally, they are similar in terms of a decline in rental income directly causing a reduction in the ratio.

The ratio may also be impacted as a floating rate loan due to reductions in interest rates looking at the Federal

Reserve 10-year treasury note rates nearing zero percent. The London interbank offered rate is one of the world's most important short-term interest rates and had one of its biggest one-day drops early last month. This drop in interest rates may impact the DCSR as this drop decreases the denominator of the DCSR by decreasing the debt service payable. Meaning, while the numerator of the DCSR decreases with the decline in net operating income, the denominator also decreases with the debt service payable.

Loan to value ratio ("LTV") is the ratio of the outstanding principal balance of a loan to the appraised value of the project. The ratio is also described as the ratio of the principal amount of the debt to the value of the real property. Loans with a higher loan to value are riskier because the borrower has less equity in the project. Since the LTV incorporates an appraised value, it is likely to be indirectly impacted by the decrease in rent income. Rental stream decline is likely to impact the appraised value, but it is unclear what the extent of the impact will be due to the uncertainty surrounding COVID-19. In considering such ratio, borrowers and lenders should review loan documents to understand what rights the lender has to order or require the borrower to order new appraisals or to revalue loan collateral.

Net worth and *liquidity* requirements are also included in some loan documents as financial covenants. These require borrowers or guarantors of loans to remain above a certain net worth or level of liquidity. The equity of many borrowers, including commercial property owners and guarantors, is likely to be impacted by the COVID-19 outbreak. Lenders may want additional or replacement guarantees based upon the volatility.

What if a Covenant is Breached?

The inability of a borrower or guarantor to meet a financial covenant will have differing consequences based on the loan documents between the particular parties. These consequences need to be reviewed by all people and entities impacted by the loan. Possible results of the failure to meet a financial covenant include implementation of cash management structures, replacement of property managers, and replacement of guarantors. There are also methods available for curing a failure to meet a financial covenant such as partial repayment of the loan, posting of a letter of credit, or additional reserves.

Cash management structures can spring into place upon the occurrence of an event. The borrower and lender should review the loan document covenants to determine if failure of a financial test triggers a cash management structure. If this is triggered, all parties need to consider the procedural and mechanical implications of such a structure. Including whether such procedures are in place to facilitate the management of the structure by personnel.

Replacement of a property manager may be a step taken by the lender. A possible set up is the lender having the right to terminate a property management agreement if a financial test falls below an established threshold. Additional considerations for the lender include how the failure to maintain a financial test may not be the direct result of the management by a property manager, but rather a result of the volatility of the current market in response to COVID-19. Borrowers, lenders, and property managers should review loan documents for any subordination of management agreements and other provisions.

Replacement of a guarantor may be called for if such guarantor falls below net worth or liquidity levels. The lender might require that the borrower put up a replacement or supplemental guarantor within a specified period of time. A default may result if the borrower fails to put up such a guarantor.

Other Provisions to Consider

Material adverse change ("MAC") clauses are primarily thresholds in loan agreements or events of default concerning a material adverse change in the business, assets, properties, liabilities, operations, and the condition of the borrower taken as a whole. Though these are typically considered extremely high thresholds, they are something for the parties to consider early on since they may be triggered before other, less-subjective, provisions come into play. MAC clauses more commonly result in renegotiations of deals rather than lenders' exercise of remedies.

Capital stack refers to a financing package which means multiple levels of debt existing on the commercial real estate property. A mezzanine loan on the applicable property is secured by a pledge of equity interests in the entity which owns the mortgage borrower. The addition of a mezzanine loan complicates the calculation of the financial tests as loan documents often require the aggregating of debt in calculations. Lenders also need to review co-lender and intercreditor agreements before agreeing to or offering accommodations to the borrower. These other agreements may limit what the lender can offer and also mean additional parties are involved in the process, which may complicate the finding of a solution.

Disclosure and notification to the lender of a positive confirmed case of COVID-19 on the commercial property is an action for borrowers to consider. The answer to whether this notification is required of the borrower may be located in the environmental indemnity provision or agreement. The definition of hazardous materials in these provisions can include microbial matter and airborne pathogens. These provisions could require the borrower to notify the lender of the presence or release of hazardous materials.

Maintenance covenants need to be considered as to the standard to which the borrower is obligated to maintain the property. If such a standard is tied to similar properties in a geographic area, does the borrower need to do the same amount of disinfecting as occurring at another property?

Leasing restrictions need to be reviewed to check whether and how the borrower can accommodate desired or required short-term uses of certain properties to assist with the response to COVID-19.

Operating covenants requiring a business to remain open during certain hours are likely to be impacted by COVID-19. Certain property types are more likely to have these covenants, such as retail properties. Closures by businesses may be voluntary or involuntary.

Action Items

All parties, borrowers, lenders, guarantors, and any other impacted parties, should review all loan documents and identify provisions that may be potentially problematic. These provisions should be addressed with the other affected parties to come up with a plan of action or solution. Such solution could be a loan modification agreement or a waiver. Short-term modifications made on a good faith basis due to COVID-19 are not going to be automatically considered troubled debt restructurings by federal financial institutional regulatory agencies and the state banking regulators including the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau, and the Conference of State Bank Supervisors. Prior to such loan modification negotiations, both borrowers and lenders should consider entering into a pre-negotiation agreement for protection and to allow for the ability of an open conversation. The changing COVID-19 environment calls for borrowers and lenders to carefully consider the loan agreements entered into and will likely impact the drafting and negotiations of financial covenants in loan documents moving forward.

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