

# Tips For Prenegotiation Letter Agreements In Loan Workouts

By **Heather Horowitz, Aaron Taishoff and Shabana Baksh** (June 19, 2020)

The COVID-19 pandemic has significantly impacted the global economy. In the U.S., commercial real estate is seeing major impacts with the hospitality and retail sectors among the hardest hit. The COVID-19 pandemic has necessitated significant alterations to our way of life, including, in certain cases, the closure of nonessential businesses in response to state and local governmental guidelines enacted in response to the pandemic.



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As a result, many commercial real estate owners and operators are finding themselves under pressure with respect to existing debt service and other expenses in light of reduced or restricted operations. The cash flow crunch caused by COVID-19 closures and its related economic impacts are causing many borrowers to seek forbearance or other economic relief from their lenders.



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Forbearance or other proposed modifications in response to distress is often referred to as a workout. A loan workout is a plan of restructuring or amendment to the existing loan terms in order to address or avoid a potential or existing default or other nonperforming loan aspect. A real estate workout generally requires a reset of the borrowing relationship,<sup>[1]</sup> and a successful workout will restructure the documentation in such a way to avoid an exercise of remedies by lender parties.



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When lenders and borrowers engage in discussions around workout terms, counsel for the parties should recommend a prenegotiation letter agreement, or PNL, as the first step in the reset process. Without a PNL, loan parties may be less inclined to engage in forthcoming discussions, for fear that representations or statements made during the negotiation process may be used in future litigation.

In this article we offer an overview of the role of a PNL in workout discussions and summarize the benefits of using a PNL from the perspective of both borrowers and lenders. In addition, we include a list of key terms which any PNL should contain and propose best practice tips for counsel to borrowers and lenders.

## The Prenegotiation Letter Agreement

A PNL may take the form of a letter or more formal agreement between the parties. For the benefit of all parties, a PNL will set forth a framework for governing the related workout, modification or restructuring discussions, including an acknowledgment of the status of the existing loan documents, confidentiality obligations, a reservation of the lender's rights to pursue its remedies, and indemnity provisions.

Upon execution of a PNL, the interested parties should not be bound by any subsequent discussions, irrespective of the scope or complexity, until the terms and provisions of a proposed modification have been reduced to a formal written agreement fully approved and executed by all necessary parties, referred to as a definitive agreement. A definitive agreement may be in the form of a formal amendment to the loan documents, a

forbearance agreement or a waiver or consent document, depending upon the nature of the proposed modification.

### ***Necessary Parties to a PNL***

Obviously, a lender and its respective borrower are the essential parties to a PNL. In addition to borrowers, most lenders also seek to have the existing guarantors execute the PNL or at least sign on as a party by acknowledgment. If applicable, the PNL should also permit lenders to communicate with any other syndicate or colenders, senior or mezzanine lenders, administrative agents and other interested parties, which may include loan servicers, special servicers and within the hospitality context, franchisors or hotel managers.

In circumstances where the existing loan involves a tiered or syndicated loan structure including more than one lender, the parties may consider entering into a global or omnibus PNL signed by all of the lenders and other interested parties. If the existing loan is serviced by a servicer or if there is an administrative agent on behalf of co-lenders, the servicer or administrative agent will typically enter into the PNL on behalf of the lender group.

However, in the context of an agented loan we would recommend the PNL name each of the co-lenders, and clearly provide that the PNL runs in favor of all members of the lending group. In instances where the debt is evidenced by several tranches (such as a senior and mezzanine loan structure), typically senior lenders and mezzanine lenders will seek to enter into their own PNL with each respective borrower party, though omnibus PNLs are possible, if all parties are amenable.

The downside to an omnibus PNL in the context of a loan with a complex tranche structure is that negotiating the PNL with multiple parties may be more time consuming than having each tranche negotiate its own form.

### ***Benefits of PNLs for Loan Parties***

A PNL benefits each of lenders and borrowers in multiple ways. PNLs should be drafted to ensure that the parties do not unknowingly waive or relinquish any of their respective existing rights contained in the loan documents. Further, the PNL may help to reduce the likelihood of success on a later claim by a borrower or sponsor alleging that by taking or failing to take a particular action, the lender modified the loan documents or waived its rights.[2]

In the case of a nonperforming loan, the PNL may be entered into prior to the commencement of enforcement proceedings. In this respect, the PNL should provide that information disclosed in the Discussions shall not be admissible in litigation between the parties.

Setting these ground rules allows (1) the borrower more freedom to openly discuss what may be needed in the requested modification (i.e., the borrower may feel more comfortable admitting cash flow difficulties or inability to satisfy certain covenants) and (2) the lender more freedom to discuss what latitude it may have regarding its own optionality without fear of claims of reliance by the borrower.

### ***Advantages for Lenders***

A PNL can shield a lender from potential liability by incorporating a waiver and release of all current and future claims and defenses the borrower may have against the lender. Without

said waiver and release, a borrower may claim that the lender should be estopped from foreclosing on a loan based on assertions that during workout discussions the lender committed to extend the term of the loan or refinance the loan at maturity, or delay enforcement of remedies.

Further, the PNL may help to reduce the likelihood of success on a later claim by a borrower or sponsor alleging that by taking or failing to take a particular action, the lender modified the loan documents or waived its rights.[2] Additionally, the PNL should provide an acknowledgment by the borrower that it should, notwithstanding the discussions, contemporaneously pursue other options in the event an amicable solution is not reached.

In addition, a PNL provides comfort to the lender that the borrower will acknowledge the validity and enforceability of the secured obligations as set forth in the loan documents. The lender may also seek, among other things: (1) an advance deposit from the borrower to cover the lender's out-of-pocket expenses incurred during the negotiation process; and (2) a waiver of the borrower's defenses and counterclaims.[3]

### ***Advantages for Borrowers***

Equally important are the benefits a PNL provides a potentially distressed borrower. A PNL prevents disputes over defaults or the then-existing status of the borrower's loan obligations.[4] Traditional lenders are typically open to the idea of entertaining a mutually agreed upon discussion and a PNL can provide a pathway for a loan to remain in good standing or become performing and avoid what could be a lengthy or cumbersome enforcement or foreclosure process or potential bankruptcy.

### **Prenegotiation Letter Agreement Standard Provisions**

There are a number of provisions that borrowers and lenders should consider when drafting and negotiating a PNL. While these provisions may vary based on the intricacy of the transaction and the terms and provisions of the applicable loan documents, a typical PNL should include the following concepts:

#### ***Voluntary Termination of Discussions***

The parties to the PNL should acknowledge that the discussions are voluntary and may be terminated by either party at any time. If discussions fail to lead to a formal workout, modification or forbearance agreement, the lender may exercise its remedies and the borrower may seek bankruptcy protections or refinance options.[5]

#### ***Only Written Agreements and Amendments Shall Modify the Loan Documents***

The parties should acknowledge that preliminary discussions or agreements related to a loan workout, restructuring or modification are inadmissible by all parties in any later proceedings and further, any preliminary agreement is nonbinding (and no formal modification will be effectuated) unless the negotiations are reduced to a final, definitive written agreement executed by all parties.

#### ***Status of the Loan***

For lenders, borrower should acknowledge the status of its current obligations under the loan documents. If the borrower is unwilling to admit a default, then at minimum, borrower should provide an acknowledgement as to whether or not the lender has sent default

notices and that the borrower has received such notice.[6]

### ***Status of the Loan Documents***

The parties should acknowledge and agree that the loan documents remain in full force and effect unless and until further modifications are made pursuant to the PNL. Lenders may consider including a list of all operative loan documents and any existing modifications, or incorporate these by reference to defined terms contained within the governing loan agreement.

### ***Estoppel***

For lenders, estoppel language can be a powerful tool, if used correctly. Lenders may seek a statement from the borrower confirming the outstanding amount of the debt and/or an acknowledgment from the borrower that the lender has no further duty to fund, make advances or perform other affirmative obligations and/or that there are no offsets, abatements or other defenses of the borrower or guarantor.

Lenders should carefully consider whether to include such language as it may lead to substantial negotiation with the borrower and its counsel and delay the commencement of substantive negotiations. Further, lenders should seek to avoid incorporating any estoppel language which may hinder their own interests, such as confirming sums held in reserve, etc.

### ***No Forbearance or Modification***

The lender should not agree to forebear loan enforcement while the discussions are ongoing, nor should the lender modify any existing loan terms in the PNL itself. Instead, the lender should retain its right to exercise any available right or remedy, including, but not limited to, sending additional default notices, accelerating the loan or commencing a foreclosure action at any time during the negotiations. Any proposed loan modification should be documented separately, following conclusion of the discussions.

### ***Waivers/Strict Compliance***

The parties should acknowledge that neither waives any of their rights, remedies, or obligations under the loan documents.

### ***Release/Indemnity***

The lender may find it beneficial to include provisions wherein the borrower and any guarantors or other obligors expressly (1) agree that they will not assert any claim, action, cause of action, suit and defense against the lender as a result of the post-PNL discussions and negotiations; and (2) irrevocably and unconditionally release and discharge the lender from any claims, actions, causes of action, suits or damages caused by or arising out of the post-PNL discussions and negotiations.

The lender should avoid including overly broad release or waiver in favor of the borrower. If the lender decides to include a release or waiver in favor of the borrower, the provisions should be limited solely to the PNL discussions.

### ***Nonadmissible***

The parties should acknowledge that evidence of conduct and communications of any kind, related to and made during the course of discussions are inadmissible as evidence in judicial proceedings. However, it should be noted that the PNL itself is admissible and the PNL should state that neither party will object to the admissibility of the PNL in any legal proceeding.

### ***Consent, if Applicable***

The lender may provide an acknowledgment that the lender cannot agree to any proposed amendment that may result from the post-PNL discussions and negotiations without first obtaining the appropriate written approval of various parties — e.g., in the mezzanine loan context, consent of any senior lenders — as well as an acknowledgment that the persons who will participate in the discussions for the lender are not authorized to enter into any binding agreement unless and until they first obtain that approval.

It is important to consider the differences when representing either subordinate lenders, co-lenders or mezzanine lenders. For example, a mezzanine lender may be required to obtain approval from any and all senior lenders before discussing potential modifications to the loan, subject to rights set forth in other agreements, such as an intercreditor agreement. Therefore, a lender should be aware of all consent requirements detailed in all applicable loan documents.

### ***Authorized Representatives***

The parties should acknowledge that certain individuals in the negotiations are the authorized representative of the respective party (typically on behalf of borrower, only) and may agree to final terms on behalf of such party.

### ***Legal and Other Fees and Expenses***

Typical PNLs will provide that the borrower is required to pay and/or reimburse all of the lender's fees and expenses, including attorneys fees, in connection with the workout or modification discussions and related negotiations. The borrower's reimbursement obligations should extend to legal fees or disbursements in connection with any dispute or legal proceedings regarding the lender's enforcement of the PNL or the rights of any of the parties thereunder.

Lenders should consider specifically referencing the ability for the lender to hire third-party consultants, at the borrower's sole cost and expense, including, without limitation, appraisers, engineering, insurance and environmental consultants, and brokers. Certain lenders may wish to require an expense deposit upon the execution of the PNL, depending on the circumstances of the transaction.

As a way to curtail the lender's prospective spending, borrowers may seek to limit their costs and expenses by either (1) requesting a fee cap, (2) seeking a cross-reference to their existing fee obligations under the loan documents, or (3) applying a reasonableness, or actual or out-of-pocket qualifiers to fees which are to be reimbursed.[7]

### ***Interested Third Parties***

The lender may choose to include a provision that allows the lender to discuss and share information with: (1) other co-lenders involved in the capital structure of the project, particularly if the original financing involved subordinate debt or a mezzanine debt

structure; and (3) other interested third parties, including, administrative agents, loan servicers or special servicers, as applicable.

To preserve the unity of the lending group in connection with a PNL covering a syndicated loan, the lender may choose to include specific language that the borrower may discuss the loan only with the administrative agent or servicer.

### ***Confidentiality***

Subject to the interested third parties provision discussed above, the discussions between the parties to the PNL are required to be kept strictly confidential and may only be disclosed to a third party with express written consent of the other parties, subject to certain exceptions (e.g., to a respective party's successors and assigns, a party's legal counsel, accountants or other financial or professional advisors, by a lender to the lender's co-lender).

### ***Continuous Operations; Alternative Options***

Because the negotiation process may not produce a mutually agreeable resolution, the borrower should agree that it shall continue to operate and maintain possession of the property (or other loan collateral) in a manner they see fit and continue to assess possible alternative opportunities, including, but not limited to, refinancing, sale, lease or other disposition of the loan collateral, as permitted by the loan documents.

### **Best Practices**

The well-timed production, review and execution of a PNL is key for loan parties seeking to commence substantive workout discussions quickly.

In order to be prepared to engage in workout discussions, counsel to lenders and borrowers alike may wish to consider creating a form or template PNL, which includes the sample provisions listed above, among others which may be client specific. Retaining an up-to-date form PNL in your library can assist in assessing drafts provided by opposing counsel as well as ensure that key must-have provisions are not omitted.

Additionally, counsel may consider preparing internal, confidential forms highlighting specific revisions or fallback positions they are willing to accept if certain common comments or issues are raised by another party. As a practical matter, preparing and utilizing such forms or templates allows for greater efficiency when attempting to engage in modification or workout discussions on multiple transactions.

Borrowers and lenders alike should retain their form PNL in their workout toolkit so that the pathway to substantive discussions may be a swift one. The PNL is the gateway to a workout and all parties should be cognizant of the benefits the PNL provides.

### **Conclusion**

In light of the current economic effects of the COVID-19 pandemic, and the resultant increase in potentially distressed commercial real estate loans, borrowers and lenders may find themselves contemplating workout discussions. During this sensitive time, loan parties should make the negotiation and execution of a PNL the first step in their process.

Negotiating loan modifications without a PNL leaves both borrowers and lenders open to

exposure in the event an amicable solution is not reached. PNLs offer lenders the ability to limit their risk exposure to lender liability claims in advance of substantive discussions with borrower regarding the loan restructure or loan modification and borrowers can look to the PNL as a road to open and productive discussions in furtherance of amicable resolutions.

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[1] Michael H. Goldstein & Adam M. Starr, "Navigating the Distressed Real Estate Workout - A General Overview," 24 Prob. & Prop. 13 (2010).

[2] Commercial Real Estate Loans: Workouts available at Practical Law Real Estate, Resource ID: 7-505-9925 (last visited Jun. 13, 2020).

[3] Michael H. Goldstein & Adam M. Starr, "Navigating the Distressed Real Estate Workout - A General Overview," 24 Prob. & Prop. 13 (2010).

[4] John C. Murray, Foreclosures, Title Transfers, and Modification Structures (Part 2) (with Forms), 12 Prac. Real Est. Law. 47 (1996).

[5] Pre-Negotiation Letter for a Commercial Real Estate Loan available at Practical Law Real Estate, Resource ID: 4-507-0496 (last visited Jun. 13, 2020).

[6] Commercial Real Estate Loans: Workouts available at Practical Law Real Estate, Resource ID: 7-505-9925 (last visited Jun. 13, 2020).

[7] Pre-Negotiation Letter for a Commercial Real Estate Loan available at Practical Law Real Estate, Resource ID: 4-507-0496 (last visited Jun. 13, 2020).