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Negotiating Financial Covenants with Mortgage Lenders from a Borrower's Perspective; Practice Tips That Will Make a Difference

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Introduction

The review and evaluation of financial covenants imposed upon a borrower by its mortgage lender can be (but does not have to be) a challenging task, even between a sophisticated lender and a sophisticated borrower. The key to simplifying the process is understanding the elements used in applying the financial covenants, understanding how and when such financial covenants are tested, and understanding how to manage their application. This article will explore these concepts and offer some simple practice tips that can be used by borrowers.

Types of Financial Testing Covenants and How They Can Be Used

There are as many different variations of financial testing covenants as there are lenders. However, there are a handful of suspects that tend to be used fairly consistently amongst lenders. Some of the most commonly used financial testing covenants include what are commonly referred to as the "LTV Test," the "DSCR Test," and the "Net Worth Test." These commonly used financial covenants, and the manner in which they are used, are explored below.

LTV Test. The LTV Test is fairly straightforward and is typically expressed as a percentage — by taking the amount of the loan commitment and dividing it by the appraised value of the real property that serves as collateral for the loan. The concept is typically expressed through the lender's limiting the LTV to a maximum percentage. This LTV Test is oftentimes used as a condition to loan extensions and in connection with the release of portions of the real property collateral when there are multiple real properties involved.

DSCR Test. The DSCR Test is also fairly straightforward and is expressed through a ratio by taking the net operating income of the real property that serves as collateral for the loan, and comparing it to the debt service payable under the loan during the period used to calculate the net operating income. This concept is typically expressed through the lender's requiring the DSCR to exceed a specific ratio. The DSCR Test is used in instances similar to how the LTV Test is used, but is oftentimes also used as an ongoing, quarterly, semi-annual or annual testing covenant, and/or in connection with future loan disbursements.

Net Worth Test. Unlike the LTV Test and the DSCR Test, which are used to monitor the financial stability of the real property collateral that secures the loan, the Net Worth Test is typically imposed on the party that serves as the guarantor for the loan, requiring that such party or parties continue to maintain from time to time a minimum net worth. The Net Worth Test is typically used in approving a guarantor at the time the loan is originated, and is typically required to be complied with quarterly, semi-annually or annually, or sometimes on a continuous, every day basis.

Practice Tips

Given the limitations on the length of this article, it is impossible to set forth all of the different practice tips that may be utilized in evaluating, and negotiating, the various financial covenants eluded to above. Within such constraints, however, set forth below are some very simple, straightforward practice tips that can be instructive when negotiating these financial covenants.

Loan Extensions; Partial Releases and Future Loan Disbursements. As mentioned above, the LTV Test and the DSCR Test are utilized as conditions that need to be satisfied in connection with extensions and partial releases, and in addition, the DSCR Test is also oftentimes used in connection with future loan disbursements. Both of these financial covenants are calculated by looking at the amount of the loan commitment. Hence, it is important to be clear on whether the test is intended to include both the disbursed and any undisbursed portion of the loan. If both are intended to be used, the borrower should request the right to reduce the amount of the undisbursed commitment to enable it to satisfy the test and/or the right to pay down the outstanding balance of the loan, without the payment of any applicable prepayment penalty, in order to satisfy the applicable test.

Another element to calculating the DSCR is the net operating income generated by the real property during the testing period, as the higher the net operating income, the more likely it is that the borrower will satisfy the test. A borrower should request that the definition of net operating income take into account seasonal expenses (by annualizing them) that may be higher during the particular testing period, as well as request the right to impute rental income under leases that have free rent periods based on the rental income that is expected once the free rent period expires.

Ongoing Testing Requirements. The imposition of an ongoing minimum DSCR Test can be a very important control tool by a lender, and can impose a significant burden on a borrower to the extent that failure to satisfy the test triggers a default under its loan. There are a number of things a borrower can do to soften the impact of the test. First, the borrower can request that any remedy that the lender may have for failure to satisfy the test be limited to instances where the borrower has failed to satisfy the test for two, three or more testing periods. Second, the borrower can request that the failure to satisfy the test not trigger a default under the loan, limiting the lender's remedy to trapping a certain percentage of the real property cash flow until the test is satisfied.

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The ongoing minimum Net Worth Test that may be imposed upon a guarantor can also create problems for a borrower, as the particular real property that serves as collateral for the loan may be satisfying all financial covenants set forth in the loan documents that relate to the real property while, at the same time, the guarantor may be unable to comply with the ongoing Net Worth Test. Borrowers should be careful when agreeing to a specific minimum net worth requirement for its guarantor and should take into account potential future events that could cause a reduction in the guarantor's net worth. For example, a REIT or fund that is disposing of assets, which can result in the guarantor's net worth reducing as assets are sold. In addition, the borrower should request the right to add additional guarantors from time to time to satisfy the test.

Generally. An exercise that can be very helpful and instructive to a borrower when evaluating financial covenants being requested by a lender is to test them up front, based on specific assumptions regarding the operation of the real property to ensure that the thresholds imposed by the lender are attainable when unforeseen events occur. For example, a large tenant whose lease is scheduled to expire. Another helpful tool is to prepare a matrix of all the financial covenants being imposed by the lender and how they are being used to help better understand their relative impact.

Conclusion

Although the imposition of financial covenants upon borrowers by lenders is an important monitoring tool for lenders, it is equally important to borrowers that such financial covenants don't unnecessarily burden their operations. Use of some of the simple practice tips suggested above can help preserve the status of a borrower's loan, while still providing the necessary protections to its lender.

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