HansonBridgett

APRIL 13, 2020 | HANSON BRIDGETT CONSTRUCTION PRACTICE GROUP

Owner Alert: Recent Guidance on the CARES Act Offers Hope for Modification of Distressed Construction Loans

by Brian M. Schnarr

In passing the $2.2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES), Congress provided much-needed relief to project owners by making it easier to modify construction loans. Under the Act, an owner may qualify for a forbearance arrangement, an interest rate modification, or a repayment plan, among other options, and the modification does not adversely impact the credit of the borrower.

By relaxing certain GAAP rules related to Troubled Debt Restructurings (TDR), banks now have far greater flexibility to grant relief to project owners who find themselves at risk of default due to the impacts of COVID-19. And that risk is real: according to a recent survey performed by the Association of General Contractors, 55% of construction projects had been halted or cancelled due to COVID-19; a figure that makes sense given all “non-essential construction” has been stopped in 42 states and counting. Even projects deemed “critical,” like hospitals, are faced with significant impacts to timely completion.

Projects delays (or worse yet, abandoned projects) leave owners exposed to the obligations in their construction financing agreements. Payment in particular is based on a draw schedule built from project milestones and maturity dates often rely heavily on assumed timelines for project completion. Major delays, like those seen from the COVID-19 pandemic, turn key project financing assumptions on their head. An owner may struggle to meet its payment obligations under the loan as investment is strained, or the project may go unfunded while the construction team works to catch up. Worst case the loan matures before the project is complete, which means the collateral necessary to refinance the debt is in jeopardy, as is the expected revenue from the completed work.

The prospect of widespread default of construction loans is of particular concern to Congress. While construction loans have always been considered inherently volatile, large construction loan portfolios were a major driver of bank failures throughout the country during the Great Recession. Banks that survived the initial downfall sought to avoid defaults by offering modifications to existing loans. But a growing number of loan modifications from distressed owners raised red flags with weary regulators. As a way to prevent banks from holding a dangerous amount of toxic

debt, the Financial Accounting Standards Board (FASB) issued guidance on when a loan modification would constitute a Troubled Debt Restructuring, or TDR. (ASU no. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring.) Where a modified loan was identified as a TDR, the bank was required to report the TDR and impair the asset. These guidelines put pressure on banks to reduce their portfolio of modified loans.

However, things have changed again. Through Section 4013 of the CARES Act, as confirmed by an Interagency Statement on Loan Modifications revised on April 7, 2020, Congress has now allowed banks more flexibility to offer loan modification without classifying those debts as a TDR. Further, the borrower of a modified loan does not incur an adverse hit to their credit. The hope being that banks will be more willing to work with distressed borrowers to restructure loans (including construction loans) as one way to mitigate the impacts of COVID-19.

Eligibility under the new statute is relatively straightforward, and based on three criteria. The request must be:

1. related to COVID-19;
2. executed on a loan that was not more than 30 days past due as of December 31, 2019; and
3. executed between March 1, 2020, and the earlier of (A) 60 days after the date of termination of the National Emergency or (B) December 31, 2020 (applicable period).

The take away is this: if you are a project owner facing the potential of default on your construction loan due to COVID-19, do not overlook the benefits of Section 4013 in seeking a modification from your lender. Also be sure to consider whether the COVID-19 pandemic affords you other rights under the terms of your loan agreement.

For a more comprehensive discussion of what a construction owner can and should do in response to COVID-19, see Hanson Bridgett's helpful guide for owners.

For more information, please contact:

Brian M. Schnarr, Partner
415-995-5169
BSchnarr@hansonbridgett.com

DISCLAIMER: This publication does not constitute legal advice. Readers should consult with their own legal counsel for the most current information and to obtain professional advice before acting on any of the information presented. Copyright © Hanson Bridgett LLP