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Failure to abide by financial debt covenants can result in foreclosure, loss of personal assets

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Even commercial property owners who have structured their business to protect their personal assets may be putting them at risk by failing to comply with debt covenants in their lending contracts. That is just one reason property owners need to pay attention to debt covenants.

Until the financial crisis in 2007, banks and other lenders seldom included restrictive financial debt covenants in their commercial real estate lending agreements. Today, though, they are becoming far more commonplace in commercial mortgages. Many property owners who are refinancing mortgages that pre-date the financial crisis will be faced with debt covenants for the first time.

Two of the most common types of financial covenants are:

* Debt service coverage covenants, which require the borrower to generate enough cash flow to cover a percentage of their debt payments. Banks typically require borrowers to generate at least 125% of their debt payment annually.

* Loan-to-value covenants, which require the borrower to have at least a certain percentage of debt covered by the current fair market value of the property. If, for example, a borrower owes $75 million on a mortgage and the loan includes a 75% loan-to-value ratio, the value of the building has to be at least $100 million for the loan to be in compliance.

Failure to be in compliance with financial debt covenants by any amount, no matter how small, may technically result in a loan default, which can have serious consequences.

For example, a loan-to-value covenant of 75% with a mortgage of $75 million would require a market value of $100 million for the loan to be in compliance. If the value of the building falls to $90 million, the covenant may require the borrower to repay enough principal to bring the loan into compliance. The borrower could be required to make a $7.5 million payment to the bank to avoid defaulting.

If a borrower lacks the capital to comply, the bank could initiate foreclosure proceedings or, if a personal guarantee is in place, look to the guarantor to make good on the debt requirements. There may be no good options for the borrower, who at the least may lose his or her investment in the property. In extreme cases, filing for bankruptcy protection is the only option.

Investors in commercial property should be aware that auditors pay attention to debt covenants. If an auditor discovers that a company is not in compliance, accounting standards require that the financial statements disclose the covenant violation. The only way to avoid disclosure is for the lender to agree in writing to waive the ability to enforce the loan covenant for one year from the date of the financial statements. If the lender is unwilling to agree, the company will have no choice but to disclose noncompliance in its financial statements.

So what should property owners do if they are out of compliance? Instinctively, some choose the worst possible approach - hiding noncompliance from their lender. The "duck and cover" approach will possibly cause your bank to take action against you.

Instead, we recommend the opposite approach. At the first sign of trouble, the owner should give the lender a full account of what's happening and how the issue will be addressed. Most lenders will be flexible. They are not anxious to add to their portfolios of foreclosed property.

We have seen lenders make allowances for extenuating circumstances. They may, for example, consider one-time expenses or potential new tenants who are almost ready to enter into a lease.

New owners or would-be owners of commercial property are unlikely to be able to talk their lender out of including financial debt covenants in their lending agreement, but they may be able to negotiate more favorable terms. In another example, a client's loan included a 75% loan-to-value ratio, but the bank agreed that in case of default, a personal guaranty only had to be in place for a 50% loan-to-value ratio. Owners of properties with a small number of tenants are especially at risk, as the loss of a single, significant tenant could result in a default.

To avoid noncompliance, know the status of your covenants at all times and keep the lines of communication with your lender open. Recognize that restrictive financial covenants are here to stay, but that a savvy borrower can structure the covenants to minimize personal exposure.

Keep your accountant apprised of significant changes impacting your business and seek advice if your covenants are affected. Your accountant is your strongest ally when it comes to maintaining good banking relationships and can act as your advocate.

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