

Real Estate and Covid-19

The questions we are being asked in Italy

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KEY INFORMATION

This note discusses a number of issues and queries that are arising in the commercial real estate investing and lending markets in Italy as a result of the Covid-19 pandemic.

It is a generic discussion of those issues, but each issue discussed is usually the subject of extensive negotiation when it comes to documentation. As a result, the terms and conditions of any sale and purchase/construction/lease/finance document (as applicable) should always be considered in the context of the particular document in which they are found and the specific facts and circumstances of the relevant deal.

As such, this note provides only a general analysis of issues likely to arise and it does not provide legal advice.

1. The occupational tenant wants to terminate its lease.

- a. **If you are the landlord**, under a commercial lease agreement, the tenant may be entitled to terminate its lease for “serious reasons” according to Italian commercial tenancy laws (Section 27, paragraph 8, of Law no. 392/1978) if the lease becomes overly burdensome due to the Covid-19 pandemic and its economic impact, unless this right is contractually waived (provided that such a waiver is allowed – in relation to a “main lease”, for example, it will only be allowed if the rent is higher than €250,000).

In relation to those commercial lease agreements where the tenants cannot legitimately continue their activities due to the Covid-19 restrictions implemented by the Italian government (e.g. with some exceptions, retail activities involving sales to the public), the tenant might claim, by enforcing certain Italian law general principles and provided that these have not been expressly excluded in the relevant lease, to be entitled to terminate the agreement, maintaining, among other things, that it has lost its interest in the landlord performing its undertakings (i.e. the landlord is not able to offer the tenant a peaceful use of the premises) or, more generally, the lease. Of course, the grounds for the tenant to be able to claim this would mostly depend on the duration of the Covid-19 restrictions; in other words, the closure of the premises for just a few weeks would make the tenant's argument weaker.

An analysis of the actual situation (and thus review of the relevant lease) is therefore crucial in order to evaluate whether your tenant is entitled to terminate the lease as a result of the Covid-19 pandemic.

- b. **If you are the lender**, you will likely have limited ability to avoid termination by the tenant (if the tenant is entitled to a termination right). Your borrower will likely be under an obligation to replace the tenant under the facility agreement. Termination by the landlord is likely to be prohibited unless consented to by the lender, also considering that the lender is normally the legal owner of the claim for payment of rent as a result of a rental security assignment.

2. The occupational tenant does not want to pay rent or wants to renegotiate how it pays rent or says that it is entitled not to pay rent under its lease.

- a. **If you are the landlord**, for the time being the Italian government has not enacted any suspension of the obligation of tenants to continue paying rent. In the absence of a specific government intervention and considering the approach taken so far by case law, most tenants will not have the right to withhold rent, have their rent suspended or reduced, or alter the way in which their rent is paid as a result of the Covid-19 pandemic unless this is provided for in the relevant lease (Italian market standards mean that this is rarely the case).

The scenario could be different in relation to those commercial lease agreements where the tenants cannot legitimately continue their activities due to the Covid-19 restrictions implemented by the Italian government (e.g. with some exceptions, retail activities involving sales to the public). In respect of these agreements, the tenant might seek to enforce certain Italian law general principles and - provided that such remedies have not been expressly excluded in the relevant lease - claim for the suspension of the rent, maintaining, among other things, either that (i) the landlord has not performed its obligation under the lease to let the tenant enjoy the premises for the use agreed and expressly identified in the relevant agreement, or that (ii) the practical purpose (or '*causa concreta*') that led the parties to enter into the lease (even if not expressly set out in the agreement and consisting of the tenant using the premises for the activities restricted by the Italian government) is temporarily missing.

It is, however, worth mentioning that despite the fact that case law on lease agreements is fairly restrictive when it comes to ability of tenants to withhold rental payments, tenants who are being affected by Covid-19 related business interruption are in any case requesting free rent periods / deferrals (see section 3 below), also on the basis of commercial considerations linked to the prudent management and preservation of their business.

Again, an analysis of the actual situation is crucial in order to evaluate whether such claim has grounds, on the basis of the specific government measures and the particular provisions of your lease.

- b. **If you are the lender**, your consent to any negotiation or agreement with the tenant in respect of rent payments is likely to be required, also considering that the legal claim for payment of rent is generally assigned to the lenders. The facility agreement must be checked in order to assess

whether such consent is required in all circumstances, whether specific thresholds apply or whether the lenders have an obligation to act reasonably in giving such consent. Whether to give such consent is primarily a commercial matter and should be evaluated prudently by the lenders, taking into consideration the particular situation of the relevant asset and borrower. To date, no specific government measures have been enacted in order to relieve tenants from the payment of rent.

3. Are you seeing rent concessions in the market generally? Are there any issues with granting rent concessions to the occupational tenant? What impact does rent concessions have on financing agreements? Is there any government measure allowing landlords not to pay their lenders?

- a. If you are the landlord,** while there may not be an express right in your tenant's (or other tenants') leases to withhold rent or have rent suspended, given the extraordinary circumstances of the Covid-19 pandemic, many tenants are nonetheless requesting rent and service charge concessions. In the case of property lease agreements, we are seeing many landlords not taking major action at the moment, while others are accommodating requests from strategic tenants to agree rent deferrals (i.e. where the rent is deferred for a specified period but will ultimately still be paid to the landlord) or allowing rent to be paid monthly rather than quarterly in advance. The differing approaches are in part related to the varying impact of government measures on different market sectors (for example, the retail and hospitality sectors have experienced a major impact, while the logistics sector is experiencing a lower impact). In the case of business lease agreements, some tenants have also been requesting (and receiving) rent free periods (i.e. rent holidays). Whilst it may arguably be in the landlords' best long term interest to help keep key retail tenants solvent over the next few difficult months, agreeing to rent suspensions (especially in relation to those lease agreements where the legal right of the tenant to request and obtain a rent suspension has less grounds) may cause substantial issues for them, in particular if they have payment obligations to their lenders. Ultimately, whether landlords agree to accept such requests will also be a matter of commercial negotiation.

If you are a borrower and you are considering granting a rent concession to your tenant, you are also most likely under an obligation under your facility agreement to ask for your lender's consent before granting that rent concession, on which please see more below.

- b. If you are the lender,** your consent will likely be required for any rent concessions and we are seeing borrowers asking for waivers and consents to that effect. As mentioned above, your facility agreement will need to be reviewed to assess the requirements and procedures relating to obtaining such consent. Considering that rent concessions will most likely have an impact on interest payments and financial covenants, we are seeing waiver and consents requests relating to rent concessions also dealing with interest payments and covenant holidays.

Lenders should also be aware that a specific government measure (Article 56 of the "Cura Italia" Decree, i.e. Law Decree No. 18 of 17 March 2020) does set out the possibility for companies (including property companies) which qualify as SMEs (the company must have employees, turnover or balance sheet assets not exceeding certain thresholds in order to qualify as a SME) to

request a moratorium on principal payments (and most probably interest payments, although there is uncertainty in this respect) on amortising loans granted by banks, financial intermediaries and other entities authorised to lend in Italy and in existence as of the date of the decree. Upon notice from the borrower to the lender certifying that the relevant conditions and requirements are met, such payments will be delayed by operation of this law until 30 September 2020 (with the delay itself not construed as a delay for the purposes of the loan contract, and so not attracting penalties). Affected loans may benefit up to 33% from a guarantee from the State (of the full loan amount only in case of loans that would have matured before September 2020 and, in respect of instalments falling due prior to September 2020, for up to 33% of the delayed instalments rather than for the full loan amount). The guarantee operates through a special section of the Central Guarantee Fund (the **SME Fund**), (which has been operational since 2000 with the objective of facilitating access to sources of finance for small-and medium-sized enterprises through the granting of a public guarantee) upon application from the lender. The special section of the SME Fund has a total capacity of Euro 1,730 million. The guarantee is granted free of charge and without any evaluation of the beneficiary. On 25 March 2020, the European Commission approved the aid scheme set out in Article 56 of the “Cura Italia” Decree.

For the avoidance of doubt, the moratorium applies to borrowers incorporated as companies only (therefore it is not believed to apply to borrowers that are REIFs, SICAFs or similar financial entities).

4. Does loss of rent or business interruption insurance cover Covid-19 consequences?

- a. **If you are the landlord**, the answer will ultimately depend on the specific terms of the insurance policies, but it is unlikely that any loss of rent or business interruption insurance that you (or your tenant) have taken out will cover insurance against the impact of the Covid-19 pandemic.
- b. **If you are the lender**, the insurance requirements in your facility agreements will need to be reviewed on a case by case basis, but the expectation is that insurance cover undertaken by a borrower will not cover loss of rent resulting from the Covid-19 pandemic.

5. Are occupational tenants/landlords able to shut down their premises?

- a. **If you are a landlord**, in respect of occupational tenants, most commercial leases contain a statutory compliance clause which will require the tenants to comply with all statutes, order and notices made by any competent authority. Consequently, tenants that are not compliant with the advice of the relevant authorities in relation to the Covid-19 pandemic would be in breach of their lease.
- b. **If you are the lender**, regardless of the specific undertakings included in the facility agreement, it is believed that compliance with the restrictive measures imposed by the Italian government to deal with the Covid-19 pandemic will remain mandatory for tenants and landlords and it is likely that any possible breach of contractual provisions to keep premises open resulting from compliance with

such laws will not be attributable to, and not enforceable against, the relevant tenants or landlords.

6. A development is mid-construction and Covid-19 is going to result in delays or other issues with the contractor or construction programme

In respect of construction projects in Italy, the shutdown of worksites has been already ordered in many Italian regions by the local government. Such an order may entitle a contractor to more time to complete their works.

Construction agreements usually provide for a detailed list of events defined as “Force Majeure”, which usually includes exercise by the government, any local or public authority of statutory powers (not as a result of a contractor's actions) that directly affect the execution of the works. In any case, if a definition of force majeure is not regulated under a construction agreement, the principle of “force majeure”, regulated under Italian law, will apply. This principle also includes exercise by the government, any local or public authority of statutory powers (not as a result of a contractor's actions) that directly affect the execution of the works.

Construction agreements usually also provide for termination rights and/or other remediation clause in case the force majeure events last longer than a specified period. This could lead to renegotiation of the terms of the agreement in the future if the restrictive measures last for a long period of time.

7. Could Covid-19 consequences prevent completion of any sale and purchase agreements?

- a. **If you are a buyer**, generally speaking, most commercial property asset sale and purchase agreements incorporate the standard general commercial property conditions, which do not expressly contain a material adverse effect (MAE) clause. Under those conditions, the risk passes on exchange and, if a buyer decides to pull out of a sale and purchase agreement, it will forfeit the possible deposit paid to the seller (although, as the impact of the Covid-19 pandemic is felt in the property market, the simple retention of a deposit may not adequately compensate a seller). Whether the seller has additional rights to damages will depend on what has been negotiated in the agreement. It is worth mentioning that the buyer, by enforcing certain Italian law general principles, could request (also on the basis of commercial considerations linked to the prudent management and preservation of its business) to walk away from the sale and purchase agreement or to renegotiate the price, claiming the occurrence of a force majeure event, the absence of the practical purpose (or ‘*causa concreta*’) that led the parties to enter into the agreement or the triggering of the general bona fide undertaking of the parties. Whether the buyer would be successful in this claim will depend on a case-by-case analysis.

In Italy, some Real Estate Register Offices have stopped their activities due to the safety restriction measures imposed by the government, therefore the filing of transfer deeds of premises located in the districts of such Real Estate Register Offices may not be possible and the relevant closings may need to be postponed.

Where a corporate structure has been used to sell a commercial property, similar principles will usually apply. The share sale and purchase agreement may contain a MAE clause, but this is unlikely to be a general market MAE clause and will usually only apply if there has been a breach of the interim covenants or the warranties above a certain threshold or in relation to certain specific events (which most of the time do not include change in law or pandemic events). As such, any such MAC clause is unlikely to be triggered by the Covid-19 pandemic alone. Share sale and purchase agreements are, however, more likely to be conditional contracts and, as such, parties may look to try to ensure that the conditions are not met, either to extricate themselves from a deal during a period of uncertainty or as a means of renegotiating the price.

- b. If you are a lender.** See below in relation to conditions to drawing facilities and MAE clauses. Due consideration must also be given to the practical elements of conveyancing and closing acquisition financings. In particular, buyers and lenders should: (i) check whether the relevant land registry is operational (some offices have experienced forced closures but are gradually re-opening) as an operational land registry is key to ensure that transfer deeds can be registered and mortgages can be created (we note that absent registration, a mortgage is not enforceable); and (ii) liaise with notaries to ensure all relevant signing formalities can be carried out (notary offices are open for business but at a very reduced capacity and are often limited to dealing with “transactions that cannot be postponed”). Granting PoAs is also proving difficult unless the relevant party is equipped with a qualified electronic signature device.

8. Impact on drawing the facility.

- a.** The key Covid-19 related considerations to be looked at by both borrowers and lenders in the context of drawing new facilities are:
 - i. whether any impact on rent payments or rental concessions has triggered or may trigger a possible default under the facility agreement: any such default would likely operate as a draw-stop;
 - ii. whether the borrower is able to give the repeating representations: any such representation being incorrect may also operate as a draw-stop;
 - iii. compliance with LTV covenants: updated valuations should be carefully considered. If new valuations are required, valuers are tending to provide values which are consistent with the pre-Covid-19 environment, but such valuations are often qualified by uncertainty around the effect that the pandemic might have on valuations;
 - iv. (in development facility agreements) the impact that restrictive measures, including the forced closure of most worksites in Italy, has had or will have on project milestones (including drawing conditions), project budget and estimate timing for Practical Completion;
 - v. consideration should also be given to the ability to register mortgages and to enter into security documentation as a Condition Precedent to funding (see question 7 above).
- b.** Please see question 9 below for a discussion of potential material adverse effect draw-stops.

9. Is Covid-19 a MAE event in the facility agreements?

Lenders are generally reluctant to invoke MAE clauses given the inherent uncertainty around whether a particular circumstance is in fact producing, or has produced, a Material Adverse Effect (howsoever described in the relevant facility agreement) or not. The circumstances of Covid-19 are new and unexpected and certainly need to be assessed from a MAE perspective, however it is probably fair to expect that lenders will take a prudent approach in relation to calling a Material Adverse Effect in the current circumstances.

This expectation is based on considerations of both a legal and non-legal nature. From a legal standpoint, especially in an Italian context, lenders will likely be very cautious in taking unilateral decisions (such as calling a MAE clause) which may have the effect of irreversibly prejudicing their borrowers. Any such decision might expose lenders to being challenged and to possible liabilities for illegal interruption of credit. Similarly, it is probably reasonable to expect that banks would rather take the overall position of ensuring Italian business are supported financially as much as possible instead of invoking clauses which may give lenders an 'out' from their commitments. It should be noted in this respect that the government measures recently enacted in relation to supporting Italian businesses are in fact based on commercial banks and financial intermediaries granting extraordinary and State-aided loans to ensure sufficient levels of liquidity in the Italian economy.

Please do not hesitate to get in touch with any of the A&O contacts listed below if you have any questions on any of the matters discussed in this note

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