ALLEN & OVERY

Real Estate and Covid-19

The questions we are being asked in England

Published: 26 March 2020

KEY INFORMATION

This note discusses a number of issues and queries that are arising in the commercial real estate investing and lending markets in England 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,** unless your tenant has a contractually negotiated break right which can be exercised in the near future, it is unlikely to be able to terminate its lease as a result of the Covid-19 pandemic. It is very rare for English commercial leases to contain either a material adverse change clause or a force majeure clause and there is no common law right for tenants to terminate leases due to force majeure. Your tenant may try to claim that its lease should be frustrated as a result of the Covid-19 pandemic. However, it is unlikely that such a claim would be successful, as frustration is applied extremely narrowly by the courts. Disease and public health issues are not out of the realm of contemplation and, unless the lease has only a couple of months left to run, it seems improbable that your tenant would be successful in establishing frustration where the period during which it is unable to fully use its premises is only temporary.

b. **If you are the lender,** your borrower is most likely under an obligation under the facility agreement to ask for your consent to terminate the lease. This will not however apply if it is the tenant that terminates the lease. In that case, your borrower will most likely be under an obligation under the facility agreement to use its reasonable endeavours to find new tenants for the space.

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,** without specific government intervention most tenants will not have a right under their leases 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. Most leases will expressly prohibit the withholding of rent in any circumstances and, while rent suspension clauses are common, they are usually limited to situations where there has been damage or destruction to the property.

   The key remedy for a landlord where a tenant is in breach of its lease obligations is forfeiture of the lease. However, the government has announced that there is to be a moratorium until 30 June 2020 on the ability of landlords of all commercial properties (not just retail, hospitality, etc.) to exercise any rights of forfeiture (or continue with any existing forfeiture proceedings) for non-payment of rent (whatever the reason). Rent in this context includes service charges, insurance premiums and other sums for which the tenant is liable under the lease. The moratorium may be extended beyond 30 June 2020 without further legislation. This is not a rent holiday; landlords are still owed the rent and other sums and they will be able to bring forfeiture proceedings at the end of the moratorium where the rent and other sums have not then been paid, even if they had not sought collection during the moratorium. It also does not prevent landlords from forfeiting where a breach does not relate to non-payment, e.g. for causing wilful damage. In practice landlords may not necessarily want to forfeit in the current circumstances, as they may be concerned that they would have little prospect of re-letting in the near future. Retail, leisure and hospitality tenants also have the benefit of the business rates suspension for occupied premises for the year 2020/2021. There has so far been little government intervention assisting landlords, but this is under review.

   If you as landlord sued for the rent, your tenant may try to counter claim that you have derogated from your grant or breached the quiet enjoyment clause (by, for example, closing a shopping centre, so that the property cannot be used for the purposes for which it was demised) and use this claim as a basis for not paying rent. However, such a claim is unlikely to be successful where the landlord's actions have been caused by events outside its control, such as closure pursuant to a government requirement. Even if your tenant's counterclaim were successful, the amount of damages awarded would not necessarily equate to the amount of rent paid whilst your tenant was unable to use the premises. Your tenant would need to show actual loss, which may be less than the rent if, for example, there were already very limited footfall and sales before the closure.

b. **If you are the lender,** your borrower is most likely under an obligation under the facility agreement to ask for your consent to the changes to the lease payment terms requested by the tenant. Your consent may be subject to a requirement that you must not unreasonably withhold or delay it. Even if not, you may still be subject at law to a general requirement not to act irrationally. In the context of the current Covid-19 pandemic and its economic consequences, a prudent lender should exercise caution before considering refusing consent to any such changes, unless it is evident beyond doubt that the changes requested by the tenant are themselves unreasonable in the current circumstances. However, in contrast with some other jurisdictions, there is currently no government proposal to grant any relief on interest payments for commercial mortgage loans.

3. Are you seeing rent concessions in the market generally? Are there any issues with granting rent concessions to the occupational tenant?

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 (particularly in the retail and hospitality space) are nonetheless requesting rent and service charge concessions. We are seeing many landlords accommodating requests by tenants to pay rent monthly rather than quarterly in advance in order to preserve cash flows. Some tenants have also been requesting (and receiving) rent free periods (i.e. rent holidays) of up to three months and/or rent deferrals (i.e. where the rent is deferred for a specified period but will ultimately still be paid to the landlord). Landlords should be clear as to whether they are agreeing a rent deferral or they are actually foregoing rent. Landlords are facing unenviable commercial decisions as to how best to proceed. 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 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 be a matter of commercial negotiation. The British Property Federation issued a statement on behalf of the commercial property industry on 20 March 2020 confirming that the industry was committed to supporting its customers who were concerned about rent liabilities due to the Covid-19 pandemic, but also recognising that property owners were similarly facing the impact of the pandemic on their businesses and would need further government interventions to help them. 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 borrower is most likely under an obligation under the facility agreement to ask for your consent before granting the rent concession to the tenant. Your consent may, under the facility agreement, be subject to a requirement that you must not unreasonably withhold or delay it. Even if not, you may still be subject at law to a general requirement not to act irrationally. In the context of the current Covid-19 pandemic and its economic consequences, a prudent lender should exercise caution before considering refusing consent to the rent concession, unless it is evident beyond doubt that the rent concession proposed by your borrower is itself unreasonable in the current circumstances.

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. This is because (i) it is very uncommon for loss of rent or business interruption insurance to cover infectious diseases at all; and (ii) even if you (or your tenant) have taken out insurance that covers infectious disease, that cover will only be limited to a list of known notifiable diseases at the time the insurance was taken out and the insurance is therefore unlikely to cover Covid-19. In respect of loss of rent, this is usually linked to a loss of rent arising as a result of physical damage to the property (as per the rent suspension clause in the lease). Rent guarantee insurance (which is designed to protect landlords against rent arrears and rent defaults) may assist you if you are a residential landlord – but this is very rare in the context of commercial real estate.

b. **If you are the lender**, your facility agreement will inevitably include an extensive insurance undertaking. However, for the reasons set out above, it is unfortunately very unlikely that any insurance undertaking will cover insurance against the impact of 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 will largely be required to follow the advice of the relevant authorities in relation to the Covid-19 pandemic, otherwise they will be in breach of their lease. The advice is continually evolving but, as at 25 March 2020, all non-essential shops, gyms, pubs, restaurants, cinemas, theatres, hotels and leisure venues have been required by the government to shut down. Retail and hospitality leases may contain keep open clauses, requiring tenants to continue operating from their premises, but we do not believe that landlords would stand any chance of enforcing such clauses in light of the current enforced lockdown.

b. **If you are the lender,** if your borrower threatens to suspend, or does suspend, carrying on its business, this may technically be a cessation of business event of default under the facility agreement. Some facility agreements will also have a specific "keep open" covenant (for example, on a hotel financing). However, in the context of the current Covid-19 pandemic and its economic consequences (and especially if your borrower is obliged to suspend its business), any suspension or cessation of business is unlikely to trigger a default under that provision as the suspension or cessation is forced and hopefully temporary. Moreover, most facility agreements will also include a general compliance with laws covenant and, if the relevant action is required by law, your borrower will need to comply with the law rather than any other contractual term of the facility agreement that would otherwise mean it is in breach of law.

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 the UK, specifically those which utilise the JCT forms of contract (as is the case in most real estate related projects), certain potentially Covid-19 related events may entitle a contractor to more time to complete their works. Principally, these events are the following, but others may apply depending on the circumstances:

- exercise by the UK government, any local or public authority of statutory powers (not as a result of a contractor's actions) that directly affects the execution of the works; and
- force majeure (small "f", small "m").

Where "force majeure" is defined, the definition will determine the circumstances that could give rise to an entitlement to more time. However, where it is not defined (as is the case in the JCT forms of contract), it will be necessary to analyse and assess each relevant circumstance. It seems that the Covid-19 pandemic may well be covered by the concept of force majeure, being an event that is outside of the control of the parties; but there could be debate around knowledge and foreseeability of events in more recent contracts. To avoid uncertainty, we are likely to see parties seeking to specifically address the Covid-19 pandemic in their contracts going forward and we have seen this being done in agreements for lease already. This will be another element of the overall negotiation and allocation of risk as between employers and contractors and it will inevitably be the subject of some considerable negotiation.

In any event, if the UK government used any newly enacted powers relating to the Covid-19 pandemic and the exercise of such powers directly affected the execution of the works, i.e. by requiring construction sites to close, this would constitute an event that potentially entitled contractors to more time in its own right.

At the most basic level, delays to works caused by the Covid-19 pandemic are therefore likely to be an employer risk in terms of time in most JCT-based contracts; although this will ultimately depend on the specific contract terms, facts and circumstances in each case. Even if the Covid-19 pandemic had been anticipated, it is unlikely that the position would be any different in most English construction contracts. Such construction contracts, particularly where they are based on the JCT forms of contract, commonly allow contractors more time for other "non-fault' events, such as exceptionally adverse weather, storms, civil commotion, strikes, etc. However, contractors will usually have a duty to warn employers about delays and potential delays and contractors are generally required use their best endeavours to prevent delays. They will also need to substantiate any claims.

It is uncertain, at the time of writing this note, whether employers or contractors will be responsible for any contractors' losses and expenses arising from delays caused by the above events.

The types of practical issues resulting from the Covid-19 pandemic that could arise on construction projects include the following:

- factories closing and materials not being available. The usual questions will need to be asked here, e.g. why did the factory close? Can the materials be sourced from elsewhere? Can

alternative materials be used? Are the materials on the critical path? Can the works be re-sequenced to avoid/minimise the consequences of any potential delay? Etc.;

- restrictions on imports. We are not aware that such restrictions have been imposed just yet but, if they are, similar questions to those above will apply;
- construction workers having to self-isolate. Unless there are significant numbers of employees self-isolating, this may be something that contractors can deal with, as they would ordinarily have some employees off sick at any given time; and
- construction workers now being required to implement social distancing. This is a grey area as employees will be following government restrictions, but they will not actually off work sick. Initially contractors may have to bear the risk of this, as it would be a situation arising from their staff, for whom they are ultimately responsible. But, if it caused significant impact on site, contractors may begin to seek to claim more time to complete their works citing force majeure and the impact of the Covid-19 pandemic as the reason; and
- sites having to shut down because the government imposes a lock-down. This may of itself be an event that entitles contractors to more time.

Additionally, the following matters should be considered, and they may become more relevant as the full effects of the Covid-19 pandemic are felt:

- contractors having solvency issues because they cannot cope with the financial consequences of the impact of the Covid-19 pandemic. The usual considerations will apply here in terms of available security, status of the works and how and when they are completed. There may of course be knock-on effects under agreements for lease and other relevant documents; and
- if works are suspended (whether by employers or by other events, including force majeure actions by the government), the contractual provisions around how long works can be suspended for before either party can terminate will kick in. In many contracts, the period of suspension is only two months. However, it may be that, in the circumstances, neither party actually wants to terminate.

At some point it may be necessary to ask whether contracts have been frustrated, but we do not think that the Covid-19 pandemic has led to that point yet – at the moment it seems that we are very much in the realms of some delays and how these can reasonably be prevented and mitigated.

Specialist advice should be sought on insurance, but it seems highly unlikely that any policy of insurance will respond to cover the financial consequences of the Covid-19 pandemic. Even delay in start-up insurance, if taken out, is likely to exclude pandemics such as the Covid-19 pandemic or, at the very least, have stringent limits on any recovery. Put simply, insurance is unlikely to provide relief.

If the construction works feed in to an agreement for lease, or agreements for lease, it will also be important to consider the consequences of delays to the works on any target completion dates and long stop dates and any other potential consequences on the agreed arrangements, as well as on each lease. As mentioned above, we have seen landlords seek to include clauses which expressly push out target completion and long stop dates where delays to the works are a result of the Covid-19 pandemic. It may be that the events under the relevant building contract (discussed above) would have the same effect in any case, but parties are likely to want to make the position clear.

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

a. **If you are a buyer,** most commercial property asset sale and purchase agreements incorporate the standard general commercial property conditions, which do not contain either a material adverse effect (MAE) clause or a force majeure clause. Under those conditions, the risk passes on exchange and, if a buyer decides to pull out of a sale and purchase, it will forfeit the deposit paid to the seller (although, as the impact of the Covid-19 pandemic is felt on 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.

   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. 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. **For both buyers and acquisition lenders,** in respect of the Covid-19 pandemic potentially preventing funding by lenders at completion, unless the facility is being provided on a certain funds basis, please see answers to questions 8 and 9 below. If the facility agreement has an on-going certain funds obligation, it is unlikely that the Covid-19 pandemic will relieve a lender of its obligation to fund the acquisition, but every facility agreement should be carefully considered on a transaction by transaction basis.

8. Impact on drawing the facility.

a. **In general,** in REF facility agreements the conditions that regulate the drawstop mechanism are the following:

   i. no default is continuing or would result from the proposed loan;

   ii. the repeating representations are true in all material respects;

   iii. (in investment facility agreements) loan to value not exceeding[, and debt yield/interest cover being at least,] a certain specified percentage immediately after the making of the loan;

   iv. (in development facility agreements)[loan to value and] loan to cost not exceeding a certain specified percentage immediately after the making of the loan; and

   v. (in development facility agreements) a certificate of the project monitor confirming such matters as, for example, that the proposed loan has been requested in respect of a cost which is included in the budgeted costs or that the remaining project costs to project completion are less than the available commitments.

Drawstops are more likely to be an issue on investment deals that have not yet completed (and on which the final initial valuation has not yet been issued) and on development deals (which by their nature contemplate drawdowns throughout their life).

b. **If you are a lender,** on investment deals that have not yet completed we have started seeing valuers qualifying their valuations by reference to the Covid-19 pandemic. While any such qualification would need to be reviewed on a transaction by transaction basis, a prudent lender should consider the circumstances carefully before drawstopping a facility on the basis of a valuation qualification, given how uncertain, volatile and politically sensitive the current circumstances are.

c. **If you are a borrower,** and your deal is a development deal, you will need to carry out an analysis of the impact of the Covid-19 pandemic on the time and cost of your development in order to determine whether a drawstop might apply. A prudent borrower will also do well to ensure it is currently compliant with any non-Covid-19-impacted obligations, to avoid inadvertently giving rise to potential hair-trigger drawstops.

d. **Please see question 9 below** for a discussion of potential material adverse effect drawstops.

9. Is Covid-19 a MAE event?

a. **For both landlords/borrowers and lenders,** except in the case of deals featuring very strong sponsors, REF facility agreements usually include a MAE event of default.

The definition of MAE is usually negotiated extensively and can therefore vary considerably. The definition of MAE in the currently published version of the LMA REF facility agreements (which is acknowledged as being quite wide) is:

"Material Adverse Effect means a material adverse effect on:

i. [the business, operations, property, condition (financial or otherwise) or prospects of an Obligor; or

ii. the ability of an Obligor to perform its obligations under the Finance Documents; or

iii. the validity or enforceability of, or the effectiveness or ranking of any Security granted or purported to be granted pursuant to any of, the Finance Documents; or

iv. the rights or remedies of any Finance Party under any of the Finance Documents.]".

Although every MAE provision will need to be interpreted in the context of its facility agreement and the specific facts and circumstances of the relevant deal, the impact of the Covid-19 pandemic on deals (which is likely to be on the timing, cost and value of deals) may be expressly covered by other specific events of default.

Indeed, the usually generic nature of MAE provisions means that it is rare to be able to conclude with absolute certainty that an event or circumstance has occurred which has had a MAE. As a result, MAE events of default are rarely invoked in practice. However, every MAE provision and every transaction will be different and the circumstances of Covid-19 are new; therefore, borrowers should consider any MAE provisions, particularly in the context of drawstop situations, carefully.

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.

Your Real Estate Team

Simon Roberts | Partner
UK - London
Tel +44 20 3088 2524
simon.roberts@allenovery.com

Mark Manson-Bahr | Partner
UK - London
Tel +44 20 3088 2906
mark.manson-bahr@allenovery.com

Paul Flanagan | Partner
UK - London
Tel +44 20 3088 2571
paul.flanagan@allenovery.com

Arthur Dyson | Partner
UK - London
Tel +44 20 3088 2134
arthur.dyson@allenovery.com

David Oppenheimer | Partner
UK - London
Tel +44 20 3088 3593
david.oppenheimer@allenovery.com

Peter Mailer | Partner
UK - London
Tel +44 203 088 1415
peter.mailer@allenovery.com

Imogen Moss | Partner
UK - London
Tel +44 20 3088 4924
imogen.moss@allenovery.com

Nick Saner | Partner
UK - London
Tel +44 20 3088 3226
nick.saner@allenovery.com

Christopher Woolf | Partner
UK - London
Tel +44 20 3088 3866
christopher.Woolf@allenovery.com

Daniel McKimm | Partner
UK - London
Tel +44 20 3088 4821
daniel.mckimm@allenovery.com

Jane Fox-Edwards | Litigation Consultant
UK - London
Tel +44 20 3088 6819
jane.fox-edwards@allenovery.com

Emma Perrin | Construction Counsel
UK - London
Tel +44 20 3088 6888
emma.perrin@allenovery.com

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