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REF news and views

COVID-19 Update: Immediate Considerations

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As the world enters into lockdown and the economy braces for impact, we plan to publish special *REF News and Views* alerts with insights into how the market is responding and guidance on some of the actions lenders and borrowers may wish to consider in these unprecedented times of uncertainty.

Let's begin with some of the immediate effects and potential responses in this ever-changing situation from a European perspective. For real estate lenders and borrowers, as well as their servicers and investors, there are (notwithstanding national economic rescue/stimulation programs) highly likely to be matters which will require urgent immediate assessment and will require consents, concessions and negotiations within their equity and debt structures.

At the time of writing, we are still in a period of considerable flux and uncertainty. In particular, the market is waiting to see what, if anything, the Government will do through legislation and/or bailout to assist the commercial property lending market. Due to the unprecedented state of affairs, we have also included an analysis of Material Adverse Change provisions as this has become a topic of much discussion.

Immediate issues resulting from lockdown and impaired business activity

With the blanket lockdowns across the board (save for essential services), industries which traditionally operate with a physical presence have had their cash inflow cut off with immediate effect. Worst affected are the food & beverage, leisure and travel industries. Tenants in various subsectors are likely to request renegotiation of rents, rent holidays, deferrals and the like very quickly. As of the time of writing, retail giant John Lewis has requested various landlords to apply a 20% discount on services charges. The cessation of trading will have flow-on effects on immediate cash flow, debt service covenants and general compliance under Finance Documents, which include:

1. Finance Documents contain cessation of business representations. Any suspension of activity within the Borrower/Obligor Group itself needs to be considered in light of the drafting of the Finance Documents to avoid defaults;
2. Breach of financial covenants – as cessation continues, it is a matter of time before the cash flow position and/or covenant forecasting will cause the financial covenant breaches. The testing period will make a significant difference. For example, an interest cover ratio tested on a rolling 12-month period is likely to deteriorate at a much slower pace than a quarterly test due to the fact that cash earned in previous quarters may provide some buffer against the current situation;
3. In addition, testing of loan-to-value covenants might also present its own set of challenges. Firstly, as a practical matter, valuations will require physical inspection and attendance on the site, which in this current environment would prove difficult (if not impossible); and secondly, as valuations slow down across the board in the current climate, there may be a lack of comparable sites to conduct the analysis. Both lenders and borrowers will need to give consideration to these factors when requesting a valuation;
4. Cash trap mechanisms – in deals where cash traps were negotiated, these will kick in. However, this may be of limited effect in structures where the income is closely tied with revenue/sales (in the case of hotels) due to the nature of the closure as there will be minimal cash coming in (if at all);
5. Exercise of cure rights – borrowers who have the backing of sponsors with a favourable cash position may use cure provisions. There are a variety of cure rights in the market, but cure provisions, which may be of use for a dip in valuation and therefore useful in an LTV breach, may not necessarily be a good tool to address debt yield or interest cover if the underlying issue is due to lost income;
6. Even without mandated closures, some industries, such as the Hotel/Leisure sector, are likely to be affected given the drop in occupancy being witnessed as travel has slowed dramatically. Drops in Key Performance Indicators give rise to breaches of Franchise Agreements in addition to Finance Document breaches and may give rise to termination of the brand licence – care must be taken when liaising with the franchisor in maintaining the exclusive licence in place;
7. Certain actions with respect to Occupational Tenants (cessation of business, as a result of being required to shut their premises by law to prevent COVID-19) or insolvency of such Occupational Tenants may trigger breaches in Finance Documents (in particular, anchor tenants and materiality thresholds);
8. Be mindful of litigation reporting requirements and representations. It is quite conceivable that disgruntled Occupational Tenants could bring health and safety claims against Landlords in respect of common parts;
9. Negotiations of rent needs to be considered carefully. It is highly likely some occupational tenants and/or the property managers will look to switch to monthly rent payments to avoid cash flow issues around quarterly rent payment obligations. Material amendments to occupational leases are likely to require the consent of Lenders depending on how they are agreed, notwithstanding that debt service is maintained;
10. KPIs under Franchise Agreements could be breached (such as occupancy levels) which means Non Disturbance Agreement rights should be considered carefully by Lenders so as not to prejudice their rights. In

particular, Lenders will need to be careful not to prejudice their positions where they enter into Forbearance Agreements and or standstills; and

11. General concession arrangements may also require consent, depending on baskets and thresholds. In addition, when granting consent/waiver, care should be taken by lenders that such concession/waiver is sufficiently confined to ensure it does not undermine any future rights of enforcing their rights over other breaches or consequential breaches under the facility. With respect to documentation, it may be more appropriate to adopt standstill/suspension arrangements such as forbearance agreements or standstill agreements, given the temporary nature of the situation, until things settle. Standstill agreements would prevent lenders from taking enforcement action for an agreed limited period of time, buying some time for the borrower to see things through in such period. On the other hand, the lenders also reserve their rights to take action once the standstill period is over. Moreover, on Saturday 21 March 2020, the State of New York passed emergency legislation ordering all banks regulated by the state's Department of Financial Services to provide 90 days of forbearance to "any person or business who has a financial hardship as a result of the COVID-19 pandemic." Although it remains to be seen whether this would be adopted in other countries/cities, there is certainly a movement towards these discussions.

Can a MAC clause be triggered?

One of the other key considerations in the current climate is whether Material Adverse Change ("MAC") clauses could be used to trigger refinancing negotiation. MAC clauses are often heavily negotiated and so there are many formulations in the market, ranging from ones that are very narrow and confined to only Obligor's ability to perform its obligations under the Finance Documents and lenders to act reasonably in determining whether a change is materially adverse, to those which are wider in scope that cover business operations and prospects of the Obligors, and determined by the lenders. Suffice to say, it is very important to familiarise your MAC clauses now.

In unprecedented times like these, a question at the forefront of lenders' minds would be whether the COVID-19 pandemic is a trigger for these clauses. Historically, MAC clauses, although heavily negotiated, are rarely called by lenders as there are severe implications if the basis for calling a MAC proves to be unfounded; namely, the lender being liable to pay the borrower damages to put the borrower in the position it would have been in if the lender hadn't called the MAC. This can prove to be serious if the MAC triggers a draw stop and/or cross-defaults Borrower's other facilities and/or results in Borrower becoming insolvent. In addition, the party calling a MAC is the party which has the onus of proof to show that the deterioration of circumstances has materially and adversely affected the Borrower's ability to perform its obligations under the loan. Therefore, even during the financial crisis, often lenders would use other triggers to call default and MAC has been used to serve as a catch-all provision.

In addition, guidance from the courts on what constitutes a MAC is limited and often heavily dependent on the particular facts of the circumstances and also the negotiated language. A leading judgment on this matter is *Grupo Hotelero Urvasco v Carey Value Added SL and Another [2013] EWHC (Comm) 1039* (*Grupo*

Hotelero). Justice Blaire outlined some useful interpretation of MAC clauses generally:

- There must be a change – this test is quite clear. If at the time of the loan, the lender is aware of the particular circumstances, they cannot claim there is a MAC as the status quo remains the same. Suffice to say, new loans that are written after lockdown measures have been introduced can rely on COVID-19 as a reason to trigger MAC clause.

- The change is considered "material" if it affects Obligor's ability to perform its obligations. In *Hotelero*, this was considered to be affecting the ability to repay the loan. In the circumstances surrounding COVID-19, one could argue that store closure is effectively cessation of business and will inevitably lead to non-payment as a result given there is no income. That said, one should also consider the cash position and strength of balance sheet of the borrower against the timeframe in which suspended trading is likely to last.

- The change must be "significant" given the lender's ability to call a draw stop and accelerate the loan would impose serious implications and can push the borrower towards insolvency.

- The adverse change must not be temporary in nature – this is a key point in this particular outbreak. As it is uncertain as to how the pandemic develops, no one knows for sure how long the lockdown measures will last, and, therefore, whether business can recommence trading and pick up lost revenue. The secondary question to this is whether the adverse event has a lasting impact on the business which then renders it unlikely for the business to recover.

- General external economic or market changes alone would not constitute a MAC and the borrower's particular position and performance should be looked at individually.

It follows to say that, with regards to MAC clauses, one should review the negotiated MAC clause carefully and when considering calling a MAC, but the position taken by the court is that the MAC must be so materially adverse and significant and it is apparent the borrower is unlikely to meet its obligations under the loan. What this means in practice is that if the borrower is in such a precarious position, it is unlikely that the MAC will serve much of a purpose in allowing the lender to call a MAC default before any other default provisions. In particular, in the case of cessation of trading due to COVID-19, other triggers such as financial covenants which are linked to income (*i.e.*, debt yield, interest cover and EBITDA tests) are likely to present themselves as key covenants which will show first signs of deterioration on the financial condition of the borrower, and therefore serve as much more reliable measures as default triggers.

In the days and weeks to come, we will cover some of the more substantive issues and longer-term potential consequences relating to the real estate industry from this crisis.