



Finance ADVISORY ■

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COVID-19: What It May Mean for Landlords and Lenders Under Their CRE Facility Agreements

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The consequences of the ongoing COVID-19 pandemic are too numerous to quantify and almost no market, industry, or geography will come through the other side unscathed. Businesses of all kinds are suffering. Governments around the world have been implementing various forms of state aid to businesses and individuals alike on an unprecedented scale whilst at the same time limiting and, in some cases, prohibiting trading for a variety of business sectors in an attempt to help stop the spread of the virus.

Many businesses, particularly those in the aviation, travel, hospitality (including student accommodation and campuses relying on conference revenue), leisure, and retail sectors, have seen very significant and immediate falls in revenue on the back of countries shutting their borders, restricting all but essential travel within their borders, and in many jurisdictions preventing them from trading. The UK government, after initially closing all pubs, clubs, theatres, restaurants, cinemas, gyms, and other leisure providers, has now placed the country in effective lockdown with the forced closure of all but essential retailers.

For the UK real estate industry, landlords are facing tenant insolvencies and tenants are requesting (or in some cases self-imposing) rent-free periods, and accordingly this is likely to impact the market value of the properties and impact landlords' ability to meet their ongoing payment and other obligations under their financing arrangements. For the construction industry, the government is poised to enforce a closure of all construction sites in the face of practical challenges of workers maintaining social-distancing guidelines.

Accordingly, during these challenging times, lenders and their property-owning borrowers will need to address defaults and other issues that are likely to arise under their loan facilities. It will be of paramount importance for borrowers to start speaking to their lenders as early as possible about actual defaults and potential defaults they see on the horizon; lenders equally should check in with their customers; and lenders and borrowers should keep an open dialogue, be cognisant of the difficulties faced by all parties involved, and be realistic (and pragmatic) of what can and can't be achieved under current market conditions.

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Defaults

A quick note on force majeure

A borrower's obligations under their financing arrangements will not benefit from any force majeure carve-out or limitation – such provisions simply don't feature in the UK lending market. Therefore, breaches arising from the coronavirus pandemic will, in legal terms, be a breach like any other breach and thus will enable lenders to exercise their various rights and remedies.

Nonpayment

With loss of revenue comes an increased risk of borrowers being unable to meet their ongoing principal and interest payment obligations. Borrowers will typically fall into an immediate event of default for nonpayment. Borrowers that are likely to struggle to meet their debt service obligations should speak to their lenders to discuss what options might be available – those might include a temporary relaxation of any scheduled amortisation obligations or possibly the capitalisation of any interest that can't be paid on its due date. Alternatively, absent formal amendments or waivers, lenders might be prepared to grant temporary standstills that allow borrowers a degree of certainty that the subject default won't be enforced (subject to certain conditions) whilst allowing lenders to preserve their rights and remedies. If borrowers are able to make claims under their insurance policies for business interruption or loss of rent, any successful claims may provide a crucial lifeline to assist borrowers making their debt service obligations; but the ability to make claims may prove challenging, and the timing of receipt for successful claims will be anything but quick. Borrowers that are successful in claiming under their policies will usually be required by the terms of their financing arrangements to ensure that the proceeds of such claims are paid into the relevant blocked account and applied in the same way that rental income would otherwise be applied. Lenders should spend this time undertaking an insurance diligence exercise to ensure that the relevant insurance remains in place and that premiums continue to be paid.

Financial covenant breach

Degradation of cashflows is most likely to also translate into stresses to financial covenants – particularly (in the short term at least) forward-looking ICR and/or DSCR covenants, debt-yield covenants, and (if new valuations are being obtained) possibly also LTV breaches. Over time, forward-looking covenant breaches are likely to translate into historic or backward-looking covenant breaches too. Many borrowers have cure rights (usually in the form of prepayment or placing cash on deposit), but in these times, borrowers may not want to deploy additional equity that may be better served sustaining their overall business. Thus, borrowers may look to lenders to waive financial covenant breaches, grant temporary covenant compliance holidays, or in some cases amend the financial covenant package altogether. When waivers or amendments aren't on the table, temporary standstills may again be more appropriate, at least providing sponsors with a degree of certainty that lenders won't accelerate, demand, or enforce against these defaults.

Insolvency

Hopefully, landlords themselves won't become insolvent during these times, but it remains possible they will be under an insolvency event of default if they are unable to pay their own liabilities as they fall due. For single-tenant deals or even multiple-tenant deals where there are one or two tenants that provide a significant portion of the overall rental income, it is likely that the facility agreements will have events of default linked to the insolvency of these major tenants.

Cessation of business

At a time when the government has imposed business closures and is otherwise requiring individuals to only travel to work if their jobs can't be performed from home, lenders may have an argument that there is an event of default arising under the cessation of business event of default if borrowers suspend all or a material part of their business.

Material adverse change

There could be an argument that the repercussions of the COVID-19 virus have or may have a material adverse effect on a borrower's ability to perform its payment obligations under its financing arrangements, which may give lenders the ability to call for a material adverse change event of default. Material adverse change is an event of default provision that is infrequently called (at least on its own) and, at a time of financial distress for many, lenders should be well advised before calling such defaults in isolation.

Development facilities: practical completion and milestones

For development financings, many transactions will impose deadlines for reaching practical completion and for reaching certain other stages during the development. With the current state of lockdown, these milestones will in many cases now need to be pushed out to avoid defaults.

Prudent practice; reservation of rights

During this time, lenders will need to strike a balance between protecting their own interests and rights with being as flexible and as accommodating to their borrowers as possible. When defaults arise and when it's not viable for waivers or amendments to be made, prudent lenders would look to give borrowers notice of the default and reserve their rights and remedies for that default, regardless of whether they intend to enforce against that default. Furthermore, when it's possible for lenders to provide accommodation through the provision of a temporary standstill, those can be readily documented subject to conditions as appropriate.

Cash Traps

Many transactions will be subject to cash trap or cash sweep mechanisms that typically kick in before the financial covenants are breached with the consequence that surplus cash that would otherwise go to the borrower is either trapped into a blocked account or swept into the immediate prepayment of the loan. During these times, those surplus funds may be of paramount importance to sponsors to keep their own businesses trading, and so it may be necessary for borrowers to discuss with their lenders to what extent such mechanisms can be disappplied or varied to allow the borrower access to any necessary amounts it needs to maintain its business.

Occupational Lease Dealings

Many borrowers are bound by restrictions on dealing with their tenants without lender consent. These provisions will be particularly relevant as landlords and tenants across the country are engaged in discussions about the implementation of rent-free periods, rent payment holidays, and other payment-easing measures. Even if tenants have already failed to meet their lease payment obligations or gone insolvent, landlords' usual right of forfeiture has been suspended for three months by the UK government, and this will need to be borne in mind by lenders when assessing if borrowers have discharged their obligation to exercise their rights under occupational leases and to use reasonable endeavours to ensure their tenants comply with their lease obligations.

Drawstops

For those borrowers with any ongoing drawing requirements, such as those with working capital revolving facilities or for development borrowers still needing to draw for construction costs, ongoing defaults will enable lenders to refuse to make further funds available. Such borrowers may need to discuss with their lenders the extent to which they might still be willing to advance funds.

Refinances

Some borrowers may be approaching the end of an existing term-loan facility and in the process of negotiating refinancing terms with new lenders. If those refinancing terms have not yet become legally binding, borrowers may be facing the reality that their refinancing lender is either unable to provide refinancing on the agreed – but usually nonbinding – heads of terms or unwilling to proceed to execution and funding during these uncertain times. In those instances, borrowers will need to speak to their existing lenders as soon as possible to see to what extent an extension to their financing might be available (and on what terms). Any term sheets or offers of financing should now also contain the necessary protection wording that we can supply that affords lenders protection during and after the ongoing transition of GBP Libor to the risk-free rate of SONIA. The FCA have stated that the transition timetable remains the same despite the COVID-19 pandemic.

Our team has a strong track record of advising lenders and borrowers on stressed and defaulted loan situations before, during, and since the global financial crisis and are well placed to help clients navigate through their contractual rights and obligations during what will be a defining era for the global economy. Use this period wisely!

Alston & Bird has formed a multidisciplinary [task force](#) to advise clients on the business and legal implications of the coronavirus (COVID-19). You can [view all our work](#) on the coronavirus across industries and [subscribe](#) to our future webinars and advisories.

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