CADWALADER

Continuing Considerations

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MAEbe So, MAEbe Not

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As COVID-19 continues to cause wholesale disturbance of numerous industries, lenders and borrowers will equally need to comprehend the potential consequences of their particular rights and obligations under their loan documents. While the crisis plays out, and as it becomes more apparent that the effects of COVID-19 will be enduring, lenders and borrowers may seek to implement material adverse effect (an "MAE") clauses contained within documents. Ultimately, the issue they will face is whether COVID-19 is considered an MAE under their respective loan documents.

A "Material Adverse Effect" is a term of art used as a threshold to measure the effect of an event. MAE provisions protect both the lender and the borrower by codifying changed or unpredictable circumstances in the market, relating to the borrower or the real estate collateral. The language in MAE definitions may either be very broad or list specific items that would be considered an MAE. In general, a material adverse effect clause applies to circumstances that affect (i) the property, (ii) the use, operation or value of the property, (iii) the net operating income of the property, (iv) the business operations or financial conditions of the borrower, (v) the ability of the borrower to repay the principal and interest of the loan as it becomes due or to otherwise satisfy the borrower's obligations under the loan documents, and/or (vi) the enforceability of the loan documents.

In financing transactions, a typical definition of a "Material Adverse Effect" includes any condition that has a material adverse effect on the capacity of the borrower to make payments under the loan documents, perform its construction and maintenance obligations, maintain insurance, and pay all taxes and other charges necessary to protect and operate the property. Additionally, typical language will cover circumstances that cause a material adverse effect on the ability to enforce the loan documents, the lien of a mortgage, or the remedies of an agent and lender under such documents. Standard MAE provisions may also cover situations which affect a guarantor's ability to perform its obligations under a guaranty, the mortgaged property, or any collateral for the loan.

A sample definition of an MAE is as follows: "Material Adverse Effect" shall mean a material adverse effect on (a) the ability of Borrower to perform its payment obligations under the Loan Documents to which it is a party, maintenance of the Property or the maintenance of insurance or the payment of Property Taxes and Other Charges in respect of the Property, (b) the validity or enforceability of any of the Loan Documents, the Lien of the Mortgage or the rights and remedies of Agent and/or Lenders under any of the Loan Documents (except to the extent caused solely by an act or omission of Agent or the Lenders, respectively), (c) the ability of Guarantor to perform its obligations under the Guaranty or (d) the Property or any other collateral for the Loan.

MAE clauses are used in a number of ways depending on the type of document. Generally, there are four primary instances where MAEs are used. First, an MAE can modify a representation or warranty in a loan agreement. An MAE in this instance is used to qualify the extent to which the borrower's representation is accurate or not. For example, a borrower will often make a representation in a loan document that there is no current litigation that does or would reasonably be likely to have a "material adverse effect."

Second, an MAE can modify a borrower's covenant in a loan agreement to act in the future. The MAE would qualify the degree to which the borrower is obligated to perform an obligation under a loan document. In theory, an MAE provision in this scenario allows the borrower to act or refrain from acting as long as there is no material adverse effect.

Third, while not universal, an MAE clause is sometimes used to constitute or codify an Event of Default if an MAE affecting the borrower occurs. While MAE provisions constituting an Event of Default were historically common, they are now less common.

Lastly, but nevertheless important to note, is a situation in which an MAE is used in a loan commitment. A commitment to lend is a contractual obligation where the lender is bound to lend money on specific terms. An MAE provision in a commitment letter is often used as a condition precedent to funding. Since the lender is bound by the commitment, an MAE provision would give the lender some flexibility in its obligation to fund if there has been an MAE with respect to the operations of the borrower or the property, or generally with respect to market conditions. Essentially, an MAE provision in a commitment could enable the lender to terminate its obligations under such commitment. When a commitment is issued in conjunction with the borrower acquiring the property pursuant to a purchase and sale agreement or a merger or public company transaction, an MAE provision will most likely track the language contained in such acquisition document so there is consistency between the obligation to close the acquisition and the obligation to fund the financing. Over the years, there have been times when the market dictates that an MAE in these contexts would not relieve a lender of its obligation pursuant to a commitment but, instead, would trigger the ability of a lender to

increase its interest rate to compensate for the change in circumstances. This language is referred to as a “flex” provision since the interest rate is “flexible.”

While it remains a significant concern for parties to a financing today whether the COVID-19 crisis constitutes an MAE, there is no clear answer to this question. Whether COVID-19 should be considered an MAE will be determined on a case-by-case basis by the courts. There is no recognized bright-line test to establish whether the effect of COVID-19 will constitute an MAE. However, a court may analyze whether there is an MAE based on the totality of the circumstances by considering the following:

- What is the specific language of the MAE provision?
- What is the temporal effect of the event? Are the consequences temporary or long-term?

Nevertheless, since there is very little precedent regarding interpretation of MAEs in real estate financing transactions and even less in evaluating a pandemic such as the current COVID-19 outbreak, it is very difficult to determine what constitutes a material adverse effect. The court’s analysis is likely to rely heavily on the specific facts of the transaction, the circumstances applicable to the properties and the specific contractual language.

Although it is not common to have a “pandemic” carveout in MAE provisions, the current crisis, at a minimum, will trigger negotiations and discussions regarding this occurrence.

COVID-19 Update: Three Months into Lockdown

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In this market update, we discuss below some of the developments we have seen in the real estate financing sector for the last three months, and what's likely to come.

What's happened to date

With the lockdown officially happening on 23 March, all businesses faced a hard disruption and sudden drop of business and revenue. This led to a series of discussions/negotiations between tenants and landlords regarding rent reduction or, in some cases, suspension of payment of rent and service charges.

For borrowers who had their first quarter interest payment date falling end of March or mid-April, as the lockdown occurred towards the end of March, many had sufficient headroom to wear the decrease in income and still remain in compliance with the financial covenants for that quarter and so didn't need to seek waivers from lenders. This may be a result from recent lending policies in the REF market which, of late, has leaned slightly more towards the conservative side. Additionally, whilst negotiations were commencing through April and May with many tenants having little prospect of paying rent, the forward-looking financial covenant projections in many loan agreements (being generally drafted such that a tenant's rental income for assessment purposes is not deemed to be in arrears unless the rent remains unpaid for at least three months) meant that financial covenants remained largely in compliance.

Many borrowers sought consent from lenders to permit temporary changes to lease arrangement/rent collection, and deferral of amortisation (if applicable) to preserve cash throughout this period of uncertainty. Lenders have generally been accommodating on these requests to assist the borrowers during this time until there is further clarity.

For some hard-hit industries, such as hotel and retail, the discussions have generally been a little more forward-looking. Even where the financial covenants are still being maintained, there have been many discussions with lenders revolving around unlocking cash reserves, and banks also asking for cash sweep to be turned on, or surplus cash to be left in the structure, in preparation for further suspension of activity/downturn. In some instances, borrowers and lenders have entered into standstill arrangements to disable financial covenants for an agreed period.

We have also received numerous enquiries from private equity funds setting up new opportunity funds to take advantage of buying up distressed assets once the dust settles. Some of the enquiries we have been receiving are funds looking to buy up retail assets and repurposed for other uses such as for logistics, warehouses or other types of accommodation.

What hasn't (yet) but may happen next

As the July interest payment date quarter looms and there is no end in sight for the lockdown, no doubt there will be some financial covenant defaults starting to come through from the reduced rents/reduced income. This will start off with yield to debt and interest cover covenants.

The temporary waiver/consents sought back in April will now lead to more permanent discussions with lenders, possibly leading to standstill arrangements or, in some cases depending on the outlook, restructuring the facility.

We are also of the view that, in these discussions, it wouldn't be surprising to introduce liquidity covenants as part of the amendment/restructure of the facility in order to ensure there's sufficient cash to maintain the property for a specific period of time.

COVID-19 Update: Ban on Forfeiture, and Government Issues Best Practice Guidelines for the Industry

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The Government passed the *Coronavirus Act 2020* in March 2020 which provides various emergency measures. Amongst these, a ban on forfeiture of lease was imposed from 25 March 2020 to originally 30 June 2020 so that landlords may not forfeit a lease where it is due to non-payment of rent during this period. Please refer to our **earlier article** for more in-depth discussion on this piece of legislation.

The Government has since extended this ban on forfeiture to 30 September 2020. This extension is made by *The Business Tenancies (Protection) from Forfeiture: Relevant Period (Coronavirus) (England) Regulations* 2020, which came into force on 29 June 2020.

In addition, The Code of Practice for commercial property relationships during the COVID-19 pandemic was published on 19 June 2020. This is a voluntary code and does not change the underlying legal relationship or lease agreements. It outlines what the Government (having consulted with industry bodies) recommends to be best practice guidelines to be considered (and possibly adhered to) by the players in the commercial property industry.

The full guideline can be accessed **here.**

A few of the key points to note include:

- when tenants are seeking concessions, they should provide transparent explanations, supported by financial information of their business. The same principle of transparency and explanation should be provided by landlords when rejecting the tenant's request for concession;
- in considering tenant's request for renegotiation of rent, landlords may wish to consider factors such as duration of closure period, effect on trading extra costs to adhere to social distancing requirements, any government support available and tenant's past track record;
- the code also provides some examples of arrangements which can be entered into between the landlord and the tenant. It is important to note that these are merely suggestions and, therefore, the parties are not obliged to follow these:

    1. rent-free period;
    2. deferral of rent;
    3. rent variations to reflect current market rate, or rent adjusted to align with turnover;
    4. landlords accessing the rent deposit during periods where the tenant requires a rent reduction, to be topped up later on; and
    5. disapply default interest, and others

- service charge to reduce to align with the lack of use of the premises. It is encouraged that landlords pass on any savings to the tenants, and any solution the parties reach in relation to a service charge should take account of the RICS Professional Statement Service Charges in Commercial Property, 1st edition, and of all RICS guidance in relation to service charges and COVID-19.

Securitizing Loans with Future Advance Obligations

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As the real estate industry continues to navigate the COVID-19 pandemic, lenders and borrowers have been forced to confront many new challenges. Simultaneously, the pandemic has heightened the importance of certain issues that are ever-present in the lending market – namely, the borrower's desire to minimize costs and maximize repayment flexibility, and the lender's desire for liquidity in the secondary markets. One loan feature which is emblematic of these somewhat conflicting considerations is a loan term for a lender to make future advances.

Putting aside construction loans, which are outside the scope of this discussion, the borrower may want a financing to include a commitment from the lender to make future advances for any number of reasons, such as future capital expenditures or leasing costs, additional acquisitions which will be added as new collateral to the loan facility, or to obtain additional loan proceeds upon the achievement of one or more financial tests typically called "earn-out" conditions. Irrespective of the purpose, a commitment from the lender to make future advances gives the borrower flexibility to increase the outstanding principal balance of the loan, and, unlike having a portion of the loan proceeds reserved at closing, structuring a loan with future advances allows the borrower to exercise its discretion as to the timing of the advances without paying interest on such un-advanced amount until the loan proceeds are actually required.

While frequently seen in the traditional syndicated loan markets, in a financing intended for a securitization, the commitment to make future advances may limit the liquidity of the loan since a securitization trust is not capable of funding such advances. If the loan is structured carefully, however, the lender can preserve its ability to securitize the portion of the loan that is fully funded, while maintaining the future advance portion outside of the securitization trust.

In order to securitize the fully funded portion of the loan, the fully funded portion of the loan and the un-advanced portion of the loan should be structured as separate components and must be evidenced by separate promissory notes. This allows the role of "lender" to be bifurcated between the lender which has made the fully funded initial advance (the "Initial Advance Lender," who will hold the note evidencing such fully funded component) and the lender responsible for funding future advances (the "Future Advance Lender," who will hold the note evidencing such un-advanced component), notwithstanding that the two lenders will likely be the same entity at closing. This bifurcation also establishes the ability of the originating lender to transfer the fully funded component to the securitization trust while retaining the un-advanced component (and corresponding obligation to fund) outside of the trust structure.

The rating agencies will also require that the loan agreement contain an acknowledgement and agreement by the borrower that the borrower (i) will look only to the Future Advance Lender for such future advances, (ii) has exculpated all other noteholders (including the securitization trust) from any future advance obligations and (iii) waives any right of offset or other claim against the Initial Advance Lender with respect to any future advance obligations. Additionally, the Initial Advance Lender and the Future Advance Lender would enter into a co-lender agreement in which, among other things discussed in more detail below, the Future Advance Lender will be required to indemnify the other lenders for the failure to satisfy its obligation to fund.

While relatively straightforward in theory, the bifurcated structure creates numerous complexities that must be addressed in the loan documents. There are three issues in particular that warrant additional discussion in the context of a securitization:

1. Controlling Lender; Consents

First, as with any loan with multiple lenders, the bifurcation introduces the question of which lender will be the "controlling" lender and responsible for the administration of the loan. While the Initial Advance Lender (in this case, the servicer on behalf of the securitization trust) will be the controlling lender for all intents and purposes (including the right to call a default and to grant or withhold consent wherever required pursuant to the loan documents with respect to leasing, alterations, transfers, etc.), the Future Advance Lender should have the sole right to determine whether the applicable conditions to the borrower receiving an advance have been satisfied, and the Future Advance Lender should also retain a joint consent right with respect to any decisions only affecting the future advance component (*e.g.,* approval of the budget related to a capital expenditure to be funded or reimbursed by future advances). Further, because the future advances will be unique to each deal, there may also be specific consent or approval rights that indirectly relate to the obligation to advance funds, or, that the Future Advance Lender otherwise has a vested interest in, which will need to be negotiated between the borrower, on one hand, and the lenders, on the other hand, in the loan agreement and/or separately negotiated between the Initial Advance Lender and the Future Advance Lender in the co-lender agreement.

Additionally, the rating agencies will likely require a right for the servicer to (i) make certain decisions on behalf of the Future Advance Lender if the Future Advance Lender fails to act in a timely manner or (ii) override certain decisions made by the Future Advance Lender if the Future Advance Lender acts in a manner that violates customary servicing standards. This right prevents the Future Advance Lender from wrongfully denying a future advance request, which could negatively impact the collateral and the portion of the loan held by the securitization trust. Although this may seem onerous, the Future Advance Lender can rely on the fact that the servicer is independent and is required to adhere to industry-wide servicing standards that require the servicer to administer the loan in an objective manner that maximizes the realization of the total debt for the benefit of all of the lenders.

2. Application of Payments

Second, the lenders must determine how unscheduled prepayments of principal (both voluntary and mandatory) are applied between the two components (*e.g.*, pari passu or sequentially) both prior to and after an event of default. Additionally, the lenders must consider whether prepayments of principal will reduce the amount of the future advance component. In general, if the prepayment is made in connection with a release of collateral or to cure an event of default, the amount of additional proceeds available to the borrower should be reduced proportionately. Special attention should be paid to ensure that the prepayment provisions account for all possible prepayment scenarios and that the allocation of such prepayment between the components matches the parties' expectations.

3. Additional Restrictions on the Future Advance Component

Lastly, while the loan documents may have restrictions between the borrower and the lender as to who the future advance portion of the loan can be transferred to, in the context of a securitization, the co-lender agreement will likely have even more burdensome requirements as to who the future advance note(s) can be transferred to in order to protect against the risk of the collateral being negatively impacted by the Future Advance Lender's inability to fund or conflicting objectives of lenders. These requirements may include specific ratings requirements, higher asset tests and/or a rating agency confirmation.

An originating lender will need to determine whether or not the additional time and effort necessary to implement this structure is appropriate based on the lender's exit strategy. Of course, this would not be a worthwhile exercise if the lender plans to hold the entire loan for the full term of the loan, but borrowers and lenders should both be aware that if structured and drafted properly, it is possible for the lender to retain the ability to securitize the fully funded portion of a loan that includes future advance obligations.

Recent Transactions

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- Represented the administrative agent and lender in connection with the amendment of a $145 million financing of a property located in the Upper East Side neighborhood of Manhattan, New York.
- Represented the administrative agent and lender in connection with a forbearance agreement related to a Miami, Florida hotel and a PPP Waiver Letter with respect to a related hotel property in Washington, D.C.
- Represented the administrative agent and lender in an $87.9 million pre-development loan, comprised of a senior loan, building loan and project loan, in connection with the acquisition of a significant development site on the Williamsburg waterfront with a phased land acquisition. This transaction has been reported in the news to be the largest land transaction in New York City since the outbreak of the coronavirus pandemic.
- Represented the agency lender in connection with advances in the aggregate amount of $74.5 million to refinance two multifamily properties located in Port Saint Lucie and Port Charlotte, Florida, under a revolving credit facility in the maximum principal amount of up to $400 million, and the addition of such properties to the collateral pool for the revolving credit facility.
- Represented the agency lender in connection with advances in the aggregate amount of $141.6 million to refinance two multifamily properties located in Las Vegas and Henderson, Nevada, under a revolving credit facility in the maximum principal amount of up to $200 million, and the addition of such properties to the collateral pool for the revolving credit facility.
- Represented the agency lender in connection with advances in the aggregate amount of $26.3 million to refinance two multifamily properties located in Phoenix and Tempe, Arizona, under a revolving credit facility in the initial principal amount of up to $100 million, and the addition of such properties to the collateral pool for the revolving credit facility.
- Represented the lender on a $250 million loan financing the sale and leaseback of two distribution centers by a major retail chain.
- Represented a hedge fund in connection with a $300 million mezzanine credit facility secured by a pledge of equity interests in various entities which own single-family residential properties.
- Acting for AEW UK REIT PLC (LSE: AEWU, a commercial real estate fund) with respect to term and revolving loan facilities with The Royal Bank of Scotland International.