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Client Alert

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Real Estate Practice Group

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Commercial Real Estate Finance Considerations in the COVID-19 Era

Just as the world continues to adjust to the new reality brought on by the COVID-19 coronavirus outbreak, many commercial real estate lenders and borrowers are beginning to contemplate what COVID-19 means for them. Several states and local governments have issued shelter-in-place or stay-at-home orders and shut down non-essential businesses. In some jurisdictions, including New Jersey and New York, construction jobs have been determined to be essential; in Pennsylvania and the City of Philadelphia, construction has been deemed non-essential, except for a few cases (such as construction at hospitals or other healthcare facilities, essential infrastructure, affordable housing or emergency building repairs).

This temporary new reality – which, hopefully, is more short-term – could have lingering effects on the commercial real estate market, particularly inasmuch as financing is concerned. Commercial real estate lenders and borrowers should review their loan documents and consider the following issues in preparing for the new reality.

- **MAC Clauses:** Many loan agreements include events of default for the occurrence of a "Material Adverse Change" or "Material Adverse Effect." While courts may be loathe to enforce a lender's remedies based on such an event of default, lenders and borrowers should review the particular language in their loan documents to determine whether COVID-19, construction shutdowns and/or any lasting effects thereof (such as a slowdown in leasing or sales activity) could constitute a Material Adverse Effect.

  Even if a lender would, could or should not exercise remedies upon the occurrence of a Material Adverse Effect, loan agreements usually require that no such Material Adverse Effect shall have occurred as a condition to further draws. In addition, as a condition to any construction advance, a borrower may be required to make a representation that no such Material Adverse Effect has occurred. Borrowers should carefully consider whether these draw conditions have been satisfied. Likewise, lenders may consider these conditions in determining whether to advance additional monies at this time.

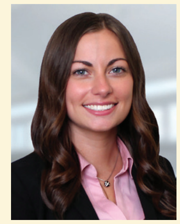
- **Force Majeure Clauses:** Construction loan agreements often will permit construction and completion delays arising out of certain "Force Majeure" events. Force Majeure events typically include acts of God, severe weather events, labor shortages and other like events not within the borrower's control. Courts interpret these clauses very narrowly, giving effect to the express language of the clause. In our experience, most Force Majeure clauses have not included epidemics or pandemics, and it is questionable whether the COVID-19 outbreak would constitute an "act of God", which is reserved for casualty events due to severe weather or natural events like earthquakes, tornadoes and such. Lenders and borrowers should review their loan documents to determine whether delays due to COVID-19 would be permissible. Note, also, that some loan agreements limit a delay due to Force Majeure events, so even if a loan agreement excuses a delay arising from COVID-19, the length of the permitted delay may be limited.

- **Loan Balancing Conditions:** Lenders and borrowers should consider whether deposits may be required (for borrowers) or appropriate (for lenders) in order to maintain minimum equity requirements. Many construction loan agreements enable a lender to require a borrower to deposit additional funds if the lender determines that the remaining funds available under the loan would be insufficient to complete a project. COVID-19 has resulted in construction delays due to shutdowns, and remobilization may lead to further delays. Significant delays, constrained supply chains for materials or a reduced workforce could lead to cost overruns, which may trigger deposit requirements.

- **Representations and Warranties:** In most construction loan agreements, as a condition to further advances, the borrower re-makes, or is deemed to re-make, all of the representations and warranties in the loan agreement as of the date of the draw. Representations and warranties generally relate to, among other things, compliance with laws and regulations, no material adverse effect (as discussed above), maintenance of the mortgaged property in accordance with applicable laws and other like matters. Lenders, but especially borrowers, should review these representations and warranties to ensure they continue to be true and correct in light of COVID-19 and/or any related shutdown orders.

- **Financial / Performance Covenants:** Lenders and borrowers who have included financial covenants – such as a debt service coverage ratio – in their loan documents should consider whether relief from such covenants will be necessary in light of the economic effects of COVID-19 and related shutdowns. Additionally, if borrowers own properties whose tenants will be abating, or attempting to abate, rent, they should consider the impact on any financial covenants.

  Construction loan agreements may also include covenants regarding sales pace, leasing or other metrics ensuring that the project is proceeding as expected. One can expect that these covenants will be impacted by COVID-19, not only because of shutdown orders in effect in various states but also due to the economic impact of job loss and a severe economic contraction.



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- **Perfection of Liens:** Lenders should review their loans to ensure they have received recorded copies of mortgages or deeds of trust, assignments of leases and UCC financing statements, as well as final title policies. To the extent applicable, lenders should also confirm they have received fully-executed cash management and/or deposit account control agreements.

- **Adherence to Loan Documents:** Lenders should review whether their practices and procedures in administering particular loans adhere to the stated requirements in the related loan documents. Construction lenders should also ensure the satisfaction of all conditions to advances, including receiving mechanics lien waivers.

- **Maturity / Completion:** Of course, COVID-19, the related shutdowns and overall economic impact of the same may affect, among other things, a borrower's ability to refinance or payoff its loan at maturity or its ability to complete a project in accordance with the original project schedule. Lenders and borrowers should review their loan documents to determine what, if any, relief may be appropriate under the circumstances.

The foregoing represents a small portion of the inevitable issues in the commercial loan portfolio of any lender as a result of the COVID-19 outbreak. We think it is important for lenders and borrowers to have open lines of communication at this time and to anticipate these issues now, rather than waiting for them to arise later.

Should you have any questions regarding the foregoing, or any other potential impacts of COVID-19 on commercial real estate, please do not hesitate to contact Stradley's Real Estate Practice Group.