The COVID-19 Pandemic: Impacts on Real Estate Transactions

March 23, 2020

KEY POINTS

Katten's Real Estate Group has been closely monitoring developments with respect to the spread of the novel coronavirus (COVID-19) and related economic, legal and public policy developments. We have also been in conversations with our clients and other leaders in the field with respect to the impact of COVID-19 on their businesses and in our industry. Many in the industry are grappling with the following issues in this rapidly evolving situation:

- Construction contractors, landlords, tenants and borrowers need to assess the impact of relevant provisions or clauses related to "Force Majeure" or "Unavoidable Delays" on construction contracts, leases and loan documents that may extend times for covenant performance.
- Real estate borrowers and lenders need to assess the potential application of "material adverse change" or "material adverse effect" provision (MAC Clause) on existing credit facilities and term sheets for new facilities.
- Property managers and owners must determine and follow best practices for what to do if a person has or may have COVID-19 in their building, including requesting that tenants notify landlords of any known or suspected COVID-19 cases among their employees or people who have been in their space, disclosing all known or suspected cases of COVID-19 to tenants and appropriate mitigation measures.
- Landlords and lenders must determine how to respond to anticipated requests to provide relief to tenants and borrowers negatively impacted economically by COVID-19. All parties involved in real estate transactions must consider solutions to logistical issues that arise from conducting real estate closings while working remotely, such as use of electronic signatures, remote online notarizations and recording digitized documents.

Force Majeure

As the effects of the COVID-19 pandemic spread to every sector of the US economy, construction contractors, landlords, tenants and borrowers are examining their construction contracts, leases and loan documents for provisions that extend times for covenant performance for delays that result from extraordinary or unforeseeable

events, often referred to as “Force Majeure” (from the French, “superior strength”) or “Unavoidable Delays.” Events defined as Force Majeure, or Unavoidable Delay, typically include war, “acts of God,” fire or other casualty, strikes, unavailability or shortages of labor, or materials and government orders or actions. After the 9/11 terrorist attacks, many parties added “acts of terrorism” to these events. Some clauses also specify a “national emergency” or even “disease.” In the real estate context, these clauses most commonly apply to (1) construction contracts to address the inability of a construction contractor to complete construction within the required schedule because the construction contractor is unable to get materials or workers to the job site due to shortages of delivery or job site personnel, (2) construction loan agreements to address the same issues precluding a borrower from completing construction within the required schedule, and (3) leases to address the same or similar issues precluding either the landlord or tenant from completing improvements or making repairs within the required time periods. If a contractor, landlord, tenant or borrower believes that his or her ability to perform a covenant is being negatively impacted by COVID-19 related issues, the party should review the relevant provisions of the contract or lease, including:

- **The definition of “Force Majeure” or “Unavoidable Delay.”** Does the definition include events such as a government order or action, a national emergency or emergency, or shortages of, or inability to, obtain labor or material? If the definition clearly refers to national emergency, government order or government action, then the definition may be applicable, particularly in states in which the state or local government has issued an order closing “non-essential” businesses. If the definition has more general language, such as “events beyond the control of [the party],” then a review of relevant case law or statutes may be necessary.
- **The contractual obligations for which an extension of time for performance is available.** Obligations to complete construction, or to install or make required improvements or repairs, are often subject to such extensions of time. Payment obligations are rarely subject to extensions of time. Indeed, “Force Majeure” provisions do not typically apply to payment obligations, and definitions of Force Majeure or Unavoidable Delay frequently exclude a party’s financial inability to perform. If an event has occurred that qualifies as a Force Majeure or Unavoidable Delay under the applicable contract, and the contract provides for an extension of time for performance should such a performance be delayed as a result of such an event, then the party will need to demonstrate that (1) it is in fact delayed in its performance, (2) the party’s inability to perform, or delay in performing, its contractual obligation was a direct result of an event of Force Majeure or Unavoidable Delay, and (3) delay cannot be avoided by alternative means that are contractually permissible (*e.g.*, a supply chain disruption, for which alternative sources are available). The occurrence of a Force Majeure or Unavoidable Delay will not relieve the performing party from the performance of obligations that are not affected by the Force Majeure or Unavoidable Delay.
- **Notice requirements.** Contracts that provide for extensions of time to perform often require the party sustaining the delay to provide written notice to the other party of the contract (*e.g.*, the owner under a construction contract, the lender under a construction loan agreement or a tenant or landlord under a lease) within a specified period of time after the affected party sustains or anticipates sustaining a delay. Failure to provide the required notice could result in a loss or reduction of the extended time to perform.
- **Caps on time extensions**. Contracts that provide for extensions of time to perform also commonly cap the extensions to perform with an aggregate number of days of extension, sometimes for all extensions of time (usually in a construction contract or a construction loan agreement regarding extensions of time for the completion or substantial completion of the construction) or for specific actions (for example, completing tenant improvements or repairs under a lease). There is some question as to whether these types of cap would be enforceable — *i.e.*, could a counterparty really call a default or breach if the other party was unavoidably delayed or the delay continued but the cap on the extension had past?

For the party to whom a request for a Force Majeure extension is being made, the best approach may be to require the notifying party to provide detailed information supporting the claim for time extension and to document

the date on which the event first occurred, so as to track the time extension against any applicable cap on such extension.

Ultimately, whether a contractor, borrower, landlord or tenant is entitled to extended time to perform its obligations under a contract is a case-by-case analysis that depends on the nature of the obligation, the language of the applicable clause and the specific nature of the delay caused by the COVID-19 pandemic.

MAC Clauses

In our current environment, many borrowers and lenders are reviewing their term sheets, commitments and loan agreements to see if they contain a "material adverse change" or "material adverse effect" provision (MAC Clause). In the real estate context, MAC Clauses are most commonly seen in loan term sheets, advance conditions in loans with future advances and in loan extension conditions. MAC Clauses typically provide that a lender will have no obligation to (1) close a loan, (2) disburse additional funds under an existing credit facility, or (3) extend the term of a loan under an existing credit facility. Additionally, some loan documents also include provisions such that the material adverse change of a borrower, guarantor or property will trigger a default, allowing a lender to exercise its remedies.

Traditionally, a MAC Clause in the real estate context can be triggered by the following: (1) material adverse changes to the condition of the property or to the business, assets, financial condition, performance or prospects of the borrower or the guarantor; (2) any material adverse change or disruption occurring in the bank loan syndication market or capital markets; (3) litigation or other action (pending or threatened) seeking an injunction, damages or other relief; and (4) a governmental regulation or policy that materially adversely affects the borrower, guarantor, property or lender. MAC Clauses vary significantly, and many sophisticated borrowers, since the Great Recession, have negotiated such clauses out of their loan documents or limited their scope significantly. It is likely that most MAC Clauses will not specifically address a pandemic or a national emergency, but some of them may or may otherwise be broad enough and encompass "systemic risks" caused by our current public health crisis. Accordingly, a careful review of the provisions of the MAC Clause and other related provisions is necessary to determine if a MAC Clause can be invoked.

Additionally, since most agreements do not include objective benchmarks or a definition for "material" as used in the MAC Clause, the determination of materiality will be left to the courts. While exact standards in case law can vary across jurisdictions, the case law generally makes it clear that a "heavy burden" falls on the party invoking the MAC Clause to show that a material adverse change has occurred and that such party invoking the MAC Clause must demonstrate that the impact will "persist significantly into the future." At present, since we do not know the duration of either the coronavirus pandemic or its economic impact on different types of properties, it is too early to tell whether the pandemic itself, the various legal order and restrictions to which properties have been subjected or the resulting economic effect will constitute a "material adverse effect" on any particular property (although many hospitality properties and retail properties are likely to sustain such effects). It is unclear if an invoking party can successfully invoke an MAC Clause.

Furthermore, the context of the overall transaction must be taken into consideration. The consequences of invoking the MAC Clause early in the term sheet phase may create significantly less exposure to lender liability (especially since most term sheets already contain ample language clearly setting forth that they are non-binding, subject to internal credit or investment committee approval, etc.) than invoking it to deny a borrower's request for an advance under an existing credit facility in order to fund an imminent acquisition or payoff of an existing loan or for a construction draw to pay its contractors on an ongoing project.

Moreover, even if it is clear that a material adverse change has occurred under the particular agreement, there are still other issues to consider. Each party must assess how mandatory building closures, construction site closures, governmental orders limiting congregations, requirements for individuals to shelter in place, moratoriums on

construction and other prohibitions are impacting the borrower, guarantor and property (and the ability of a lender to take over a project). In some of these cases, the borrower and guarantor may be complying with applicable law/orders and, therefore, is unable to continue business and strict performance of all obligations under its agreements.

Finally, it is important to monitor the evolving legal landscape in real time. Executive orders and emergency laws and regulations may temporarily limit the ability of lenders to enforce MAC Clauses to either foreclose a mortgage and take over a project or effectively deny an extension of maturity based on the occurrence of a MAC event (if the non-existence of a MAC event is a condition to the extension of maturity).

Disclosure and Mitigation

Property owners and managers are already grappling with the issues of what they must/can disclose and what they must do when they become aware that a person that has or may have COVID-19 has been in their building. Limitations on testing and delays in getting test results have complicated the issue. However, there are best practices emerging in the industry. They include:

- Requesting that tenants notify landlords if there is any known or suspected case of COVID-19 among their employees or people who have been in their space; and
- Disclosing all known or suspected cases of COVID-19 to tenants.

The need to disclose "suspected" cases arises because of testing delays and insufficiencies. Within the category of suspected, we would include people who have been tested but results are pending, and people who have sought medical attention for symptoms and have not been tested but have been directed by a physician to self-isolate. There is less consensus in the situation in which a person was exposed to someone with the disease but has not been tested and is not symptomatic. Hopefully, some of these uncertainties will be reduced once testing is more widely available and results are rendered more quickly.

Once a property owner determines to disclose, it must then take care to comply with various federal, state and local privacy laws. While many of these laws (particularly at the Federal level) may apply to only certain covered entities involved in the health care industry, others may effectively prohibit a property owner from disclosing the identity of the person who has, or is suspected to have, COVID-19 or providing any readily identifiable information that would allow the recipient of the disclosure to conclude who the affected person is. There is consensus that an owner/manager can identify the floor the person worked on (since that does not divulge the person's identity or the means to infer it) and should be able to give general information regarding the situation — for example, the person is awaiting test results vs. the person tested positive. An employer is subject to additional privacy restrictions (and counsel should be consulted), if he or she became aware of the situation through a benefits claim or HR interaction.

Once a property owner/manager becomes aware that a person who has or is suspected to have the COVID-19 virus has been in their building, what must he or she do to mitigate the situation? The CDC and New York City have published guidelines for cleaning commercial and multifamily spaces.[1] Two important takeaways:

1. The CDC guidelines do not require that the entire building be shut down for cleaning but only that access be restricted to the affected areas (which may be of limited practical benefit, if those areas include lobbies and elevators); and
2. The CDC guidelines explicitly reference "suspected" cases. For so long as testing is limited and results are slow, owners will be placed in the unenviable position of either proceeding with an expensive cleaning or risking exposure by waiting days for test results to come in. Owners may, however, be able to pass through the costs of these cleanings through operating expense clauses but leases will need to be reviewed on a case-by-case basis.

[1] See, https://www.cdc.gov/coronavirus/2019-ncov/prepare/disinfecting-building-facility.html

Disclosure to Lenders: Many lenders include a covenant in their loan documents that require the borrower to notify the lender of "any change in the condition, financial or otherwise" of the borrower or guarantor that is reasonably likely to have a material adverse effect on the business or operations of the borrower or guarantor or its financial condition, or that would impair the ability of the borrower or guarantor to comply with any of its obligations under the loan documents. Borrowers should review their loan documents to determine if such a covenant is included, the required time in which the borrower is so required to notify the lender and if a MAC event constitutes a default or otherwise limits any rights of borrower. If a borrower believes that the COVID-19 virus (either directly or as a result of government orders) will result in a MAC event, then in order to avoid a default for failure to send timely notice of a MAC event, the borrower may want to send a short letter to the lender stating that the COVID-19 virus and/or any resulting government order may cause a MAC event. However, if a MAC event is itself a default or limits any right (*e.g.*, the right to a loan advance or an extension of a maturity date), a borrower may want to defer sending notice until the borrower is able to assess the full effect of the MAC event on the borrower, guarantor or property.

Tenant and Borrower Relief

Tenant Relief. Restrictions on movement, government ordered shut down of businesses and the general economic impact of the coronavirus pandemic are dealing a very harsh blow to tenants of all types. Most landlords are expecting to receive all manner of requests for rent abatements, forbearances and deferrals. While the decision to grant relief of any kind is a commercial decision for landlords to make, there are legal issues to consider. Rent relief, for example, could violate mortgage loan documents, if it was granted without the consent of the Lender. Temporary relief, like a rent deferral, must be carefully documented so as to not permanently modify the terms of the Lease. Moreover, forbearance and other temporary relief will need to be consistent with the expanding set of applicable emergency laws, regulations and orders.

Borrower Relief. On March 23, the Federal Reserve and other national financial institution and state bank regulatory agencies issued a joint press release signaling to regulated lenders that "working with borrowers" negatively affected by COVID-19 would not necessarily have adverse regulatory consequences on the lender.[2] In essence, the agencies are encouraging financial institutions to work with affected borrowers by reducing the concern that any accommodation granted by the lender would be characterized as a troubled debt restructuring (TDR). The statement specifically states (as an example) that short-term modifications made on a good faith basis in response to COVID-19 to borrowers, who were current prior to any relief, would not be considered a TDR. The statement also indicates that examiners will not automatically adversely risk rate loans that are restructured, even if the restructuring is a TDR. In addition, Governor Cuomo's Executive Order No. 202.9 provides that the failure by any bank subject to the jurisdiction of the Department of Financial Services to grant a ninety day forbearance "to any person or business" who has a financial hardship as a result of COVID-19 is deemed an unsafe and unsound business practice. This Executive Order will effectively require 90-day forbearance.[3] It is not, as of this writing, clear whether the Order is intended to apply beyond "consumers" or "consumers and small businesses." The first part of the Order refers to forbearance with respect to "any person or business who has financial hardship" as a result of the COVID-19 pandemic, but the second part of the order refers to "consumers." The guidance from the New York Department of Financial Services suggests that the focus of the relief is "consumers and small businesses" but contains the following statement: "Finally, the Department urges all regulated financial institutions, in their capacity as creditors to businesses of all sizes, to work with and provide accommodations to their borrowers during this unprecedented global emergency to the extent reasonable and prudent, including refraining from exercising rights and remedies based on potential technical defaults under material adverse change and other contractual provisions that might be triggered by the COVID-19 pandemic."[4] In any event, both the statement and the Order indicate strong signals to lenders to work with their borrowers to avoid widespread default.

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[2] See https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200322a.htm

[3] See https://www.governor.ny.gov/news/no-2029-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency

[4] See https://www.dfs.ny.gov/industry_guidance/industry_letters/il20200319_consumer_support_coronavirus

Business Interruption Insurance

Tenants whose premises are being closed by governmental order (whether mandatory or strongly requested) are wondering whether they might be able to look to business interruption insurance to recover some of their losses. Unfortunately, that seems less than likely for a number of reasons. Typically, recovery under business interruption insurance is triggered by some physical damage to the place of business. Some policies may include civil authority interruption coverage, which would be triggered if access to the premises is prohibited by order of a civil authority. While that avenue might seem useful if applicable (*i.e.*, the tenant had that coverage and closed pursuant to a mandatory order), after the SARS outbreak, many insurers started including a standard endorsement excluding coverage for virus outbreaks and communicable diseases. While each tenant should carefully review its policy, business interruption insurance would not appear to be a generally applicable means for tenants to defray the costs of having their places of business closed because of the coronavirus pandemic.

Closing Logistics

The realities of working remotely has raised significant logistical issues in conducting closings. Some of the possible solutions include:

Electronic Signatures: Electronic signatures (*e.g.*, PDF copies of signatures or digital signatures using services such as DocuSign) can been utilized in many commercial real estate transactions. The legality of electronic signatures and records in the United States is generally governed by the Electronic Signature in Global and National Commerce Act (ESIGN) and the Uniform Electronic Transactions Act (UETA), as adopted by the states (or by different statutes). ESIGN and UETA generally provide that a signature or document cannot be denied legal effect or enforceability solely because it is in electronic form, as long as all parties agree to use electronic signatures. UETA has been adopted (with or without amendments) by 47 states, Washington, DC and the U.S. Virgin Islands. Illinois, New York and Washington have not adopted UETA, but each has adopted its own laws governing electronic signatures and records that are generally consistent with UETA in their effect. Most types of documents and transactions are covered under UETA and ESIGN, but the majority of transactions governed by the Uniform Commercial Code (UCC) and certain other types of transactions and documents (including the creation and execution of wills, notices of termination of utility services, notices of default, acceleration, repossession, foreclosure, or eviction, and the right to cure) under a credit agreement secured by a primary residence of an individual have been expressly excluded. The UCC itself, however, provides for the enforceability of electronic signatures and records for certain transactions. Although documents signed electronically may be legally enforceable between the applicable parties under ESIGN and UETA, many jurisdictions require that recordable documents include “wet ink” signatures or be in paper form (as further discussed below). We can assist you to determine if electronic or digital signatures can be utilized in your transactions and provide applicable provisions to include in contracts.

Remote Online Notarizations (RON): With the challenges of notarizing documents in person while practicing social distancing, many transaction parties have been hoping to utilize “Remote Online Notarizations” (RONs). Twenty-three states have adopted RON laws that generally permit parties to notarize a document without the notary and signer being physically present in the same place or, in some cases, even the same state by using a process that includes the signer signing the document and the notary electronically notarizing the document while participating in a recorded two-way audio and video conference. California, Illinois and many other states have not yet passed legislation. While New York has not passed legislation authorizing RON, Governor Cuomo did sign emergency Executive Order 202.7 that permits RON, so long as the following conditions are met:

- The person seeking the notary’s services, if not personally known to the notary, must present valid photo ID to the notary during the video conference, rather than merely transmit it prior to or after;
- The video conference must allow for direct interaction between the person and the notary (e.g. no pre-recorded videos of the person signing);

- The person must affirmatively represent that he or she is physically situated in the State of New York;
- The person must transmit by fax or electronic means a legible copy of the signed document directly to the notary on the same date it was signed;
- The notary may notarize the transmitted copy of the document and transmit the same back to the person; and
- The notary may repeat the notarization of the original signed document, as of the date of execution, provided the notary receives such original signed document together with the electronically notarized copy within 30 days after the date of execution.

An emergency Federal law with respect to remote online notarization, the Securing and Enabling Commerce Using Remote and Electronic (SECURE) Notarization Act of 2020, was introduced to the US Senate by US Senators Kevin Kramer (R-ND.) and Mark Warner (D-VA.) on March 18 and has been endorsed by the American Land Title Association (ALTA), the Mortgage Bankers Association (MBA) and the National Association of Realtors (NAR). The proposed legislation, among other things, would authorize every notary in the United States to perform remote online notarizations and establish minimum standards for electronic and remote notarizations (including requiring tamper-evident technology in electronic notarizations and fraud prevention through the use of multifactor authentication).

We will endeavor to make remote online notarial services of our notaries available to clients, where they are permitted, under applicable law or executive order to provide this service.

Recording: Many states (and the Washington, DC) have adopted legislation like or derived from the Uniform Real Property Electronic Recording Act that authorizes the recording of digitized documents (including digitized signatures and digitized notarizations). However, this legislation is often permissive rather than mandatory in nature, so it may not be the case that a particular recording office can or will accept electronic recording of documents. A number of the national title insurance companies have compiled and circulated information about the availability of electronic recording in recording offices nationwide, and we are available to assist clients in determining whether electronic recording is available for a particular transaction.

Title Insurance and Gap Indemnities: Although recording offices throughout the country continue to close physical locations, many continue to accept documents for electronic recording. Where electronic recording is not available, title insurance companies have agreed in certain transactions to insure title over the gap created between closing and eventual recording of the applicable deed or mortgage. Some title companies have been requiring expanded, more robust "gap" indemnities as a condition to issuance of title insurance in that circumstance. Persons requested to sign such expanded indemnities should take care that they are not too broad or overly vague creating potential unintended exposures.

Moratoriums

A number of jurisdictions and agencies have issued orders that impact the exercise of remedies. For example, the Governor of New York has issued an executive order mandating a moratorium on foreclosures with respect to residential and commercial mortgages and evictions of commercial and residential tenants (Executive Order 202.8) and another executive order mandating temporary loan forbearance for "consumers." The Federal government through HUD has mandated a moratorium on foreclosures and evictions with respect to FHA-insured mortgages. In addition, the exercise of judicial remedies may be impacted by court closures across the country.

Katten's Real Estate attorneys continue to monitor legal and commercial developments in response to the COVID-19 pandemic and are available to help you navigate through this rapidly evolving landscape. We share your hope for a return to normal in the not too distant future.

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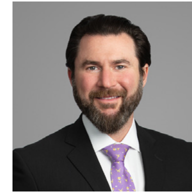

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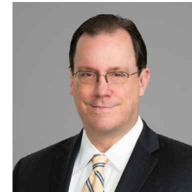

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