Schulte Roth&Zabel

Alert

Real Estate Deals and Leases — COVID-19 Considerations

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The continuing spread of COVID-19 across the United States has compelled businesses to grapple with weakened financial markets, legal restrictions hindering the mobility of people and goods and disruption to daily workplace operations stemming from, among other things, compliance with CDC guidelines.

While we are closely monitoring the impact of COVID-19 on the U.S. commercial real estate market and the business operations of our clients, we are also advising clients on numerous legal issues that directly impact ongoing transaction negotiations. This *Alert* focuses on contractual provisions in existing documents that should be examined in light of concerns raised by the COVID-19 outbreak. As parties negotiate and litigate these provisions, future provisions will become more tailored to address considerations presented by COVID-19.

Parties to purchase and sale agreements, lease agreements and loan documents should strongly consider how they are affected by COVID-19 and its adverse impacts. Many contracts contain provisions to address unexpected events and disasters, such as the provisions discussed below, but many are not drafted to contemplate a scenario similar to the COVID-19 outbreak:

- *Force Majeure*. Many real estate contracts contain a "force majeure" clause excusing a party's non-performance when "acts of God" or other improbable events beyond a party's control prevent a party from performing its obligations under the contract. Though force majeure clauses vary in scope and detail, rarely do they expressly list "epidemic" or "pandemic" as a force majeure event. Some force majeure provisions also provide that the delay may only be excused for a finite period of time, while others are narrowly drafted to apply only to events that make it "impossible" for a party to perform under the contract. Borrowers, developers and landlords, for example, will have to assess whether the force majeure provisions in their existing contracts will be triggered by anticipated COVID-19 impacts such as financial uncertainty affecting lenders, the impact of domestic and international travel restrictions on building material availability, the adverse effect of mandated quarantines on the availability of labor, and delays in obtaining necessary construction approvals caused by the closure of governmental agencies. On a prospective basis, parties that are required to perform should seek to negotiate broad force majeure clauses that are inclusive of delays due to a pandemic (and perhaps reference COVID-19 specifically), that provide flexibility for predictable delays, and that are not limited to a very brief time period.
- *Go-Dark Provisions*. Many leases contain a "go-dark" provision that permits a tenant to discontinue its business operations for such time as the tenant continues to pay rent under the lease, but different parties to a real estate transaction will have different concerns to address with a go-dark provision:

- A *landlord*, particularly in retail leases or with respect to major tenants, generally seeks to negotiate a covenant that requires a tenant to continuously operate its business during the term of its lease. Landlords may also negotiate a recapture right that permits the landlord to terminate the lease after the tenant has gone dark, without either party being in default.
- A *lender* providing financing secured by a retail or single-tenant asset may provide that the failure of a tenant to continuously occupy its leased premises will trigger a cash management event under the loan documents.
- *Tenants and borrowers* should negotiate for a flexible go-dark covenant so that a tenant discontinuing its operations due to COVID-19 concerns will not trigger a default under its lease or a cash management event under the loan documents; examples include (i) an extensive time period during which tenant may vacate the premises without triggering a recapture right or a cash management event (e.g., at least 180 days); (ii) carving out a temporary cessation of business activities due to force majeure; and/or (iii) for new leases, a "one-day covenant" that requires the tenant to be in occupancy for one day before a cessation of business activities will trigger a default under the lease.

- *Material Adverse Effect Provisions.* The definition of material adverse effect ("MAE") should be carefully considered. In real estate transactions, an MAE is generally defined as any condition that has, or can reasonably be expected to have, a material adverse effect on the property, business or financial makeup of a party:
  - In real estate-focused *purchase and sale agreements* and M&A transactions, it is typically a condition precedent to a party's obligation to close that there be no MAE to the property, seller and/or target company, as applicable, as of the closing date.
  - Many real estate *loan agreements* provide for an immediate event of default if an MAE occurs, giving lenders the ability to exercise their acceleration rights. In a debt financing that provides for future advances, lenders will require that there be no MAE as a condition to making any advance.
  - Buyers looking to terminate a *purchase transaction* may argue that the effects of COVID-19 constitute an MAE.

  Although the economic and human costs of the coronavirus pandemic are great, it remains to be seen whether the impact of the COVID-19 pandemic will rise to the level of a MAE; parties negotiating contracts should be mindful of the ever-changing market conditions when negotiating this definition.

- *Compliance with Applicable Law*. Congress, as well as state and city officials, are debating new legislation on a daily basis in an effort to slow the COVID-19 virus and, aside from any regulations that have been passed into law, the CDC is constantly releasing recommendations for maintaining the safety of the population.

  Depending on the applicable provisions of a lease, new legislation and/or CDC recommendations could trigger either a tenant's covenant to comply with additional laws or a landlord's covenant to provide additional services to its tenants, which could depend on a number of factors; for example, the obligations of a landlord of a net leased property are significantly different from those of a landlord of an office building with multiple tenants. The parties should also consider

the service charge provision or adjusting the definition of "Operating Expenses" to determine whether a landlord can pass costs incurred in connection with its compliance of COVID-19 legislation to the tenant. (Many lease provisions contain a generic clause allowing the landlord to recover reasonable costs incurred in connection with commercially reasonable property management.) The parties to a lease negotiation should be conscious of the heightened costs and obligations attributable to COVID-19 regulations and be mindful to draft the lease accordingly.

The impact of COVID-19 is continually evolving, but it is becoming clear that COVID-19 will change the way parties view many of the standard provisions of real estate contracts in the future. Much in the way the tragic events of 9/11 influenced the thinking of real estate professionals and introduced provisions into contracts protecting against the risks of terrorism, the provisions addressed in this *Alert*, among others, will likely be revised significantly in the coming months and years in response to the challenges posed by the COVID-19 outbreak.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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