COVID-19

Issues Facing the Real Estate Industry

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Agenda

- Contract Provisions
  - Force Majeure
  - Material Adverse Change
- Common Law Doctrines
  - Impossibility
  - Frustration of Purpose
  - Breach of the Implied Covenant of Good Faith and Fair Dealing
- Common Questions

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Contract Provisions

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Force Majeure – What is it?

- A contractual provision that allows one of the parties to the contract to suspend or terminate its performance when certain circumstances beyond its control arise
  - If there is no contractual provision, there is no defense
- Clause typically provides a list of specific events that constitute Force Majeure events
  - Narrowly construed and generally limited to enumerated events
  - Specific language of provision is determinative
- Force Majeure events that are relevant in the context of COVID-19:
  - Pandemic, disease, infection
  - Controls in connection with a national/state emergency
  - “Acts of God”
  - Any other act that is outside of the control of the parties, whether similar or dissimilar to the foregoing
- Note: Courts may impose a requirement that the event be unanticipated

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Force Majeure – Implications & Applications

- If there is a Force Majeure, the relief that is afforded to a party also depends on the terms of the provision in question
  - Often clauses specify that payment obligations are not excused by the occurrence of a force majeure event
  - If an agreement provides that a Force Majeure excuses or suspends certain obligations and does not state that it excuses or extends others, that difference will be given effect
- In development, construction, or building loan agreements, it is common that a borrower will be given relief from deadlines for performing work (generally up to a capped time period) if there are delays as a result of a Force Majeure
  - However, generally does not extend maturity date even if completion deadlines are extended
- Landlord performance of certain tasks or provision of certain services may be excused in the event of a Force Majeure
- If you are intending to invoke a Force Majeure provision, pay attention to notice requirements

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Material Adverse Change – What is it?

- Material Adverse Change ("MAC") clauses are another risk-allocation device used in contracts
  - Used by lenders to protect themselves from material adverse changes affecting the borrower, the guarantor, or the property
  - Used by buyers in purchase and sale agreements to protect themselves from material adverse changes affecting the property
- There is no standard MAC event – it is whatever the contract defines it to be
  - However, it is typical that general macro-economic conditions or events are excluded from the definition of a MAC
- In the context of corporate transactions, the Delaware Court of Chancery has long held that a MAC clause can be triggered only if the matter at issue is "significant," "long term," "durational," and that it "must be expected to persist significantly into the future" or "substantially threaten the overall earnings potential."

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Material Adverse Change – Implications & Applications

- The party invoking the clause faces a heavy burden to show that a MAC has occurred
  - Courts have generally declined to find that a MAC has occurred
  - Impending bankruptcy did not constitute a MAC
- In 2018, a Delaware court found, for the first time, that a material adverse change had occurred in the context of a merger transaction
  - Key factor was that the issues were company-specific, not industry-wide
- Cautionary tale: Do not invoke a MAC clause lightly, as you may be held liable for punitive damages
  - California case where lender asserted that there had been a MAC in the borrower's financial condition, and therefore a default under the loan documents, based on a material decline in value of mortgaged property, decline in rental rates, and the fact that property's income was insufficient to cover debt service
  - Jury awarded $33 million in punitive damages to borrower

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Common Law Doctrines

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Impossibility – What is it?

- Generally, a party will not be excused from performing its obligations under a contract, even when unforeseen circumstances make performance burdensome or difficult
  - However, a narrow exception exists where one party's performance becomes objectively impossible due to an unanticipated event that could not have been foreseen or guarded against in the contract
  - Generally, this requires the destruction of the subject matter of the contract or the means of performance
- Under New York law, a mere inability to pay an obligation or economic hardship – even to the extent of insolvency or bankruptcy – does not excuse performance under the doctrine of impossibility
- The impossibility doctrine "never justifies a failure to make a payment"
- A financial crisis is not unforeseeable, even if the circumstances that cause it may be, particularly where sophisticated commercial parties are involved

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Impossibility – Implications & Applications

- Given these principles, New York courts have universally held that a financial crisis will not give rise to a defense of impossibility
  - Tenant who signed a lease for a store in Manhattan in which it planned to sell upscale decorative items was not excused from performance due to 2007/08 financial crisis
  - Borrower's payment obligations under a real estate financing agreement were not rendered impossible due to 2007/08 financial crisis
  - Impossibility not a defense to foreclosure where borrower was unable to procure a construction loan to take out acquisition financing due to 2007/08 financial crisis

- Application to COVID-19
  - Financial difficulties as a result of COVID-19 will likely not give rise to an impossibility defense
  - Impossibility may be applicable where performance of a contract has been prevented by governmental regulation
    - However, impossibility needs to be complete

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Frustration of Purpose – What is it?

- Frustration of purpose occurs where an unforeseen event has occurred, which, in the context of the entire transaction, destroys the underlying reasons for performing the contract, even though performance is possible
  - Does not apply unless the frustration is substantial
  - Not sufficient that the transaction/performance has become less profitable
- The purpose of the contract is key to determining whether frustration of purpose applies

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Frustration of Purpose – Implications & Applications

- Borrowers have tried to invoke the frustration of purpose doctrine to avoid repayment obligations where the purpose for which the money was borrowed has been frustrated
  - Courts have generally rejected these efforts
  - The purpose of the agreement is to borrow money and the purpose is fulfilled when the borrower receives the loan proceeds, even if the intended use of the proceeds is thereafter frustrated
- Like with the impossibility defense, frustration of purpose may have more application in the leasing context
  - Fact specific determination based on the lease terms, the level and length of governmental restriction, etc.

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Breach of the Implied Covenant – What is it?

- Under New York law, all contracts include an implied covenant of good faith and fair dealing which imposes an unwritten obligation upon the parties to deal with each other in good faith
- A claim for breach of the implied covenant arises where a party has acted in a way to prevent the performance or frustrate the purpose of a contract
  - The implied covenant cannot be used to create an independent contractual right that was not bargained for by the parties
  - The implied covenant cannot be used to contradict the express terms of an agreement
  - The implied covenant cannot be used to penalize a party for exercising rights under an agreement

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Breach of the Implied Covenant – Implications & Applications

- Parties have attempted to use the implied covenant to impose an obligation on a counterparty to renegotiate the terms of an agreement that has become less beneficial
- Following 2007/08 financial crisis, borrowers commonly asserted that the implied covenant required lenders to negotiate or consummate a restructuring due to the decline in the markets
  - Claims were rejected by courts
  - Sophisticated business entity could not be justified in presuming that, in the event of a default, the lender would be obligated to restructure the obligations
  - Lender was contractually entitled to exercise remedies, and that contractual entitlement cannot be negated by the implied covenant

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Common Questions

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What is happening with the courts?

- Each jurisdiction has different policies and procedures in place
- New York State Courts
  - Moratorium on evictions
  - Foreclosure auctions postponed
  - Gov. Cuomo announced that mortgage payments and foreclosures in New York will be suspended for a 90-day period
  - State court only performing essential functions
  - Can still commence cases, but they will not progress
  - In person arguments and conferences have been cancelled
- New York Federal Courts
  - Have cancelled non-case related activities
  - Restricted access to the courthouses
  - Still holding appearances, but individual judges may have different procedures

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Can we commence the process for a UCC foreclosure?

- UCC foreclosure is non-judicial, so not affected by court closings
- A UCC foreclosure sale must be commercially reasonable in every respect
  - Method
  - Manner
  - Time
  - Place
  - Other terms
- Fact-specific analysis
  - Will depend on how the pandemic evolves, and what the circumstances are throughout the marketing and sales process
  - At minimum, atmospherically, the pandemic will provide circumstances ripe for a challenge

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Is insurance coverage available for the COVID-19 pandemic?

- It depends on the specific terms of the policy
- Some business interruption policies may provide coverage
  - Civil authority coverage which may apply to government-mandated closures
  - Ingress/egress coverage may apply when customers/suppliers can't access your business
- However, a lot of policies contain exclusions for losses caused by communicable diseases and/or only apply if there is property damage
  - Case in New Orleans has been filed alleging that the contamination of surfaces by COVID-19 constitutes property damage
- If you have coverage related questions, our Insurance Recovery Practice Group can help
  - Leslie Thorne: (212) 835-4848, leslie.thorne@haynesboone.com
  - Ernest Martin: (214) 651-5641, ernest.martin@haynesboone.com

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What do I do about property taxes?

- Thus far, there has been no government action to defer payment of property taxes
- If you are a borrower that is not going to be able to pay real estate taxes, carefully examine your loan documents so that you are aware of the consequences
  - Often payment of property taxes is subject to cash flow availability

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Before entering into negotiations with my counterparty, is there anything I should do?

- YES! Enter into a pre-negotiation agreement
- The purpose of a PNA is to encourage frank and open communication by setting the ground rules for negotiations, and protecting the parties from subsequent claims of waiver, estoppel, and/or modification
- Key provisions:
  - Confidentiality and inadmissibility of discussions and documents exchanged during discussions
  - No agreement unless it is in writing and duly executed and delivered by both parties
    - Be specific that emails do not constitute a writing signed by the parties
  - Discussions can be terminated by any party, at any time, for any reason

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Presenter Bio

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PRACTICES AND INDUSTRIES

- Litigation
- Real Estate Litigation
- Real Estate
- Hospitality

EDUCATION AND CLERKSHIPS

- J.D., Georgetown University Law Center, 2004*, cum laude;* Symposium Editor, *Georgetown Immigration Law Journal*
- B.Soc.Sci., University of Ottawa, 2001*, magna cum laude;* Dean's List

BAR ADMISSIONS

- New York, 2005

COURT ADMISSIONS

- United States Supreme Court
- U.S. Court of Appeals for the Second Circuit
- U.S. District Court for the Southern District of New York
- U.S. District Court for the Eastern District of New York

Emilie Cooper is an accomplished litigator with significant experience handing disputes in the real estate and hospitality arenas. She has successfully represented companies and individuals, including real estate and hotel investors, developers, lenders, owners, managers, and operators, in a wide variety of matters and through all stages of complex litigation and arbitration, including in breach of contract, fraud, breach of fiduciary duty and commercial tort suits, and securities and foreclosure actions.

Emilie's knowledge of the real estate and hotel industries, particularly in New York, has been invaluable to her clients, and enables her to better understand their business goals and how best to achieve them, through litigation or otherwise.

Emilie works hand-in-hand with her transactional colleagues to advise clients concerning the potential litigation implications of their agreements and transactions, providing a unique litigator's point of view in a transactional context.

Professional Recognition

- New York Metro Super Lawyers Rising Stars, Thomson Reuters, Business Litigation and Real Estate: Business, 2015-2019
- Recognized as a Leading Lady in Real Estate by *Real Estate Weekly*, 2019

Articles & Presentations

- Lexis Practice Advisor, New York Commercial Real Estate Foreclosures
- PLI, Commercial Real Estate Financing 2018 & 2019, Recent Litigation in Commercial Real Estate Financing
- N.Y. State Bar Association, 2019 Advanced Real Estate Topics CLE, Real Estate Litigation

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