COVID-19
UK: REAL ESTATE FUNDS ISSUES

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FOCUS ON LIQUIDITY

Given the unprecedented social and economic implications of COVID-19, liquidity will be a key consideration and, in some cases, issue, for investors. This means that investors with capital to spend are likely to be highly selective as to the opportunities that they will consider (although capital is certainly available for the right strategies), and investors with existing undrawn commitments are likely to be particularly sensitive around timing and quantum of capital calls.

In this context, and depending on the stage of the fund lifecycle and drawdown pipeline, closed-ended fund managers may wish to give their limited partners (LPs) enhanced transparency on projected drawdown schedules and consider their options regarding additional financing options (for instance, extending the use of a credit subscription line or obtaining alternative finance), and also ascertain whether they are able to extend or suspend investment periods (with appropriate consents) if deemed desirable.

Clear and proactive communication is key, both to manage the heat of the crisis and to make and implement plans for when fundraising and capital deployment can return to normality. In situations where a fund's pipeline commitments necessitate drawdowns without compromise, it will be important to consider LP default provisions – these often include a penal rate of interest on the default amount, and the GP's right to pursue other remedies (such as forced sale of the defaulting LP's interest, at a reduced sum, to other LPs or a third party; forfeiting the defaulting LP's commitment and/or suspending their right to vote and receive distributions). Often these provisions are given only passing attention on fund establishment, on the basis that they are 'standard' provisions that are unlikely to be tested in practice. However, both fund managers building strategic relationships with their investor base, and investors who expect difficulties in honouring their contractual commitments, would be well-advised to familiarise themselves with the LP default provisions, GP remedies available and consequences that flow from these provisions being employed on their respective funds.

AUTHORISED FUNDS SUSPENSIONS

Authorised fund managers (AFMs) have been facing considerable pressure to consider suspending dealings or to take other measures to protect fund liquidity in light of the current difficulties determining value. The FCA recently issued guidance over property fund suspensions, which is in line with the new rules for NURS that are due to come into force in September 2020 requiring mandatory suspensions where there is material uncertainty about the valuation of at least 20% of the scheme property. As a result of this guidance most authorised funds have now suspended dealings.

Edwin Schooling Latter, FCA Director of Markets and Wholesale Policy, confirmed in his 19 March 2020 speech on open-ended funds investing in less liquid assets that the FCA is asking for industry input on the response to liquidity issues within funds. Whilst not aimed specifically at the COVID-19 pandemic, the speech is nonetheless very pertinent to the issues that AFMs are experiencing. In particular, it highlights the importance of treating all investors fairly. It also serves as a timely reminder both that the SMCR is now in force for FCA solo-authorised firms, and of the responsibility of senior management and AFM boards to ensure compliance with firms' regulatory requirements.

The FCA has been looking closely at fund liquidity for some time and is likely to be paying close attention to the actions of fund managers in response to the COVID-19 pandemic. As such, the mandatory suspension rules provide a useful reference point for all AFMs when deciding how best to manage their funds at this time.

CONTRACTUAL ISSUES SUCH AS FORCE MAJEURE AND FRUSTRATION

Due to the COVID-19 pandemic the material uncertainty around valuations is having a significant impact on fund managers of both unregulated and authorised funds, and their investors.

In such circumstances you may be questioning whether the English law doctrine of frustration is worth pursuing as one of a number of legal means to navigate the commercial problems arising.

Frustration is a common law concept that addresses whether events that occur after conclusion of a contract may allow a party to treat the contract as being discharged. The concept is very narrow and historically UK courts have been reluctant to find a contract is frustrated, as it conflicts with the idea that in normal circumstances the parties have allocated risk as they see fit. Essentially, the event must change the nature of the contractual performance so that there is a radical or fundamental change from the original obligation. An example of a situation that might give rise to frustration arguments (and which may be relevant in light of the COVID-19 pandemic) would be a change in the law which makes it illegal to perform the obligations in a contract.

If frustration can be proved, the contract will be automatically terminated from the time it has shown to be frustrated. However, generally you can only argue frustration where the contract does not already contain a force majeure provision (where parties have explicitly provided for remedies if a specified supervening event occurs). Other clauses that provide for what may happen in the event of a delay or cancellation might also restrict or undermine the opportunity of relying on frustration.

The question as to whether the doctrine of frustration may be relied on is fact specific and will depend on a number of different factors, such as the contract terms generally, the parties' assumptions and expectations, the nature of the supervening event and the parties' intentions in the new circumstances. In some contracts both parties might be in agreement that the contract should be discharged. But in other scenarios the parties will be at odds. Each contract needs unique analysis, and whilst frustration might be arguable, and COVID-19 might be the time to see a development in the English law of frustration, it should probably be used alongside other arguments for discharge.

DIRECTORS OF NON-UK COMPANIES CONDUCTING MEETINGS FROM THE UK

Non-UK vehicles are frequently used in fund structures. In order to maintain non-UK tax resident status and treatment/ tax analysis, it is essential that a vehicle's 'central management and control' is located in its country of incorporation (for instance, Jersey for the trustee/Jersey manager of a JPUT) and not in the UK. Typically an entity is 'centrally managed and controlled' by its board of directors. It is, therefore, important to ensure that a majority of directors (or equivalents) are non-UK tax residents and that the board takes strategic decisions at board meetings in the relevant non-UK jurisdiction.

If you are a director of a non-UK company and are self-isolating in the UK in accordance with government guidance, or are unable to leave the UK due to travel restrictions, you may end up having to take part in board meetings or make decisions in relation to the company's business while you are in the UK. This on its own may not risk the non-UK resident status of the vehicle, provided that its business is otherwise managed and controlled outside the UK. This should be clear looking at the long-term picture both before and after the COVID-19 restrictions.

However, if possible it would be better to avoid having directors who are confined to the UK making key and/or strategic decisions in relation to the company's business.

An alternative might be for the powers of the board to be delegated to committees made up of individuals who are outside the UK for the duration of the COVID-19 restrictions, provided the company's articles of association allow for this. The delegation must be a true delegation of power rather than a mere 'rubber-stamping' of a decision already taken in the UK. If a director who is physically in the UK attends the meeting virtually, or by telephone, HMRC may treat the meeting as having taken place in the UK.

POWERS OF ATTORNEY

A power of attorney (PoA) is a document under which one person (the principal/donor) appoints another (the attorney) to act on their behalf and in their name. By contrast, an agent acts in their own name, and not in the name of the principal. A principal may appoint an agent orally or in writing, but an agent who is not an attorney has no authority to execute deeds on behalf of the principal. Individuals and companies (as well as partnerships that have legal personality) can be attorneys. To be valid, the document creating the power of attorney must be executed by the principal as a deed.

In term of execution of documents, some documents must be deeds (ie transfers of shares and dispositions of interest in land), and therefore, if they are to be executed by an agent, the agent must be appointed as an attorney under a power of attorney.

As a general rule, persons may do by means of an agent (including an attorney) whatever they have power to do themselves. There are, however, a number of exceptions to the general rule. For example, individual directors generally cannot delegate their functions, and attorneys themselves generally cannot grant PoAs of their functions.

It would be wise to consider situations where it would be useful to appoint an attorney now, so as to ensure day-to-day business continuity of fund operations. This can be done using electronic signatures. For a power of attorney that is being signed by an overseas company/entity, it is vital to check that using an electronic signature is within the scope of authority of the signatory (as a matter of the laws of the territory in which the company is established) and is otherwise valid.

ELECTRONIC-SIGNATURES AND DUE EXECUTION

With social distancing and self-isolation, it has become more difficult to obtain wet-ink signatures, so an alternative, where possible, is for documents to be signed electronically. E-signatures are a reliable form of execution in England & Wales, for both contracts and deeds (although they are not currently accepted for documents that need to be registered at the Land Registry).

Companies House accepts electronic signatures on all documents to be filed with it, and HMRC has recently confirmed that during the COVID-19 outbreak, it will accept electronic signatures on stock transfer forms, and other documents submitted to it for stamping.

For a deed to be validly executed (in person or digitally) it has to be to be signed by two directors, or a director and secretary, or by a single director in the physical presence of a witness who attests the signature – the latter method often being most practical. The witness should be an adult, of sound mind and preferably independent (however, this is not a requirement and during the current exceptional circumstances of COVID-19, it may well be that a family member is the only person available to witness).

Many other jurisdictions also allow the use of e-signatures. If non-English parties are also signing a document, it is usual for a local legal opinion to be obtained, to expressly confirm the validity of e-signatures in that jurisdiction.

AUTOMATIC EXTENSION TO DEADLINES FOR FILING ACCOUNTS

From 25 March 2020, businesses will be able to apply for a 3-month extension for filing their accounts because of an event that is outside their control, for example because of unexpected illness. If the application cites COVID-19 as a reason the accounts will be late, and the filing deadline has not yet passed, the application will be granted the 3-month extension automatically and without penalty.

W&I INSURANCE

Despite the drop off in deal volume, the M&A insurance market continues to operate, with pricing in the short term likely to remain competitive as the same number of insurers vie for a smaller pool of business. This may change in the medium term with the number of claims likely to increase and as insurers become more conservative with respect to the maximum policy limits and more selective regarding jurisdiction and sector exposures. For distressed deals, we expect to see higher premiums and/or deductibles than pre COVID-19.

The most obvious impact on policy terms will be the introduction of a COVID-19 exclusion for at-risk businesses or transactions (whereby if COVID-19 is a known risk to the target, any related losses will be excluded from cover). Insurers are also likely to require robust diligence into the impact of COVID-19, for example on financial forecasts, valuation, supply chain management, potential material contract dispute and employment matters. Standard warranties for which cover had previously been readily available, such as compliance with health and safety regulations and no material changes since the accounts date, are now under scrutiny - with insurers in some cases seeking to water-down warranties and/or insert exclusions.

If there is a short-term buyer's market signalled by COVID-19, buyers may begin to require sellers to stand behind their warranties, either entirely or to a more meaningful extent than is customary (eg under a £1 cap). This could lead to higher levels of deductibles under buy-side W&I policies or even a demand for sell-side policies. With a stronger buyers' market, it is also anticipated that, in addition to repetition of business warranties, MAC (material adverse change) termination clauses will feature more commonly in sale and purchase agreements. From a policy standpoint, it will then be important to ensure that policies remain in force even if the parties agree to close following a MAC event (albeit any loss flowing from the matter which gave rise to the MAC event will not be covered under the policy) and securing "new breach" cover in relation to repeated warranties will be more challenging in the current climate.

UK REAL ESTATE MARKET OBSERVATIONS

The UK government has brought in temporary measures to protect both residential and commercial/ business tenants. For instance, landlords will not be able to evict tenants from private rented accommodation or commercial premises for non-payment of rent for at least a 3 month period (until 30 June 2020) even if the non-payment of rent is unconnected to COVID-19. Tenants will remain liable for the rent (unless a rent-free period is agreed between the parties) and landlords and tenants will have to agree a schedule for payment of any arrears. Landlords and lenders alike are also very conscious of the reputational impact stemming from enforcement at this present time.

We understand that the majority of landlords are agreeing the deferral of rental payments to the end of H1 (some longer) rather than agreeing rent-free periods. Also that banks will be making assessments on a case-by-case basis, but are less likely to enforce repayment and financial covenants where they are receiving some repayment. There may be scope for interest deferral with scheduled amortisation in order to reduce capital.

As a general rule, many market participants are continuing to watch events closely before deciding to take any permanent action – events are still moving very quickly and it is unclear how long the lockdown will continue. In the short term this is expected to result in decreased dealflow in H1, with extended transaction timelines and delayed launches already prevalent. However, real estate continues to offer attractive relative returns in comparison to other asset classes and as distressed deals become available and the overall position becomes clearer transactions and capital raising are expected to pick up – particularly in the sectors which offer income stability and certainty of occupancy.

Below are a few observations on the impact of COVID-19 on specific industry sectors. Overall, the situation continues to present challenges to investor due diligence; alongside this valuation uncertainty is causing disruption to the usual flow of acquisitions and disposals.

Retail

COVID-19's impact on the retail sector (leading to the closures of shops, restaurants, pubs, cinemas and gyms) has led to retailers re-assessing their financial strategies which include open discussions with landlords about rent repayments. A UK government initiative supports retail, hospitality and leisure businesses owning property with a rateable value of between £15,000 and £51,000, with funding of up to £25,000 per property.

Hotels and Leisure

This sector has arguably been impacted more than any other, as travel restrictions and closures of restaurants and other leisure spaces have been implemented. Occupancy rates have been effected as a result. The longer term impact on the sector will be primarily influenced by the duration of the crisis, but there is potential for a rapid rebound if it is contained in relatively short order.

Logistics

The logistics sector is poised to benefit as e-commerce growth accelerates. As online shopping normalises, especially for groceries, retailers are looking for additional storage and distribution space, leading to a growing demand for warehouse space. Critical logistics and data centres are seen as low risk at the present time, as they house tenants and operations that are vital to maintaining revenue and business operations.

Office

Social distancing and the resultant adoption of agile working have reduced the demand for office space and may, in the long term, accelerate the shift to greater remote working and optimisation of office space.

Build to rent

The residential sector tends to be viewed as having more defensive characteristics (partially due to its less variable contractual income) and, as such, may see an increase in investment allocation when compared to other real estate sectors. However, it is expected that investors will be looking closely at the impact on rent payment levels and how these compare to the commercial market over the coming weeks and operators are currently considering tenants with difficulties on a case by case basis. As with other sectors, communal spaces and services such as gyms are having to be closed during the crisis.

Student accommodation

Student accommodation will likely see a short term fall in occupancy and rental yields following university closures and travel restrictions. Demand for the 20/21 academic year will be determined by timeframes within which universities are able to re-open and travel restrictions are lifted (although the Government's decision to cancel rather than defer A-level exams, with student performance being assessed on alternative bases, is seen as a positive for the sector).

Development sites

The situation is still very volatile, with different contractors taking different approaches. Some developers are suspending works to protect the health of their staff as it is problematic to adequately maintain social distancing on site and some contractors are experiencing hostility from the public and employees where they are continuing. Supply lines have been disrupted by travel restrictions and border closures. Construction contracts, development milestones and loan agreements will be under close legal scrutiny.

Getting in touch

Kieran Saunders
Partner
Tel: +44 (0) 20 3400 4749
kieran.saunders@bclplaw.com

Kate Binedell
Partner
Tel: +44 (0) 20 3400 4276
kate.binedell@bclplaw.com

Antony Grossman
Partner
Tel: +44 (0) 20 3400 4320
antony.grossman@bclplaw.com

Matthew Baker
Partner
Tel: +44 (0) 20 3400 4902
matthew.baker@bclplaw.com

Simon Pollock
Partner
Tel: +44 (0) 20 3400 4710
simon.pollock@bclplaw.com

Louisa Cobbe
Partner
Tel: +44 (0) 20 3400 3247
louisa.cobbe@bclplaw.com

Chris Ormond
Associate Director - Knowledge Development Lawyer
Tel: +44 (0) 20 3400 2370
chris.ormond@bclplaw.com