

# HONG KONG REAL ESTATE FINANCE AND COVID 19

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The coronavirus that causes Covid-19 is continuing its spread globally, and while at the time of writing the infection rate in Hong Kong is declining, it seems likely that the virus will have ongoing effects on the local real estate industry. In this article, we consider some of the issues that may arise in relation to real estate financing documents and provide some practical guidance for both borrowers and the lenders that have financed their properties.

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## CONSTRUCTION COVENANTS

A construction facility agreement will invariably contain a deadline by which the proposed development works must be completed, and an occupation permit obtained. There will normally not only be an overall completion deadline, but also intermediate deadlines by which certain development milestones must be met. For example, there may be deadlines relating to when foundation or super-structure works must be started or completed. These obligations are normally supported by sponsor completion guarantees. However, the construction process may be delayed due to the unavailability of materials from mainland China, staff shortages, an inability to conduct physical site inspections, or the relevant government departments not being able to process permits or other applications. Parties should

consider the following potential issues:

- **Borrower's obligations:** Completion deadlines under the financing documentation do not generally contain exceptions, and a failure to meet them is normally an event of default. Also, construction contracts are normally the subject of security granted in favour of the lender, and the borrower will be under an obligation to enforce them against the relevant contractors. This may include making a claim on any liquidated damages clause in the relevant construction contract. Liquidated damages are pre-determined damages set at the time that a contract is entered into. They are often calculated on a daily or weekly rate and should be based on a calculation of the actual loss the borrower is likely to incur if the contractor fails to meet the completion date. Any waiver or amendment of the construction contracts will generally be subject to lender consent;

- **Force majeure:** This is not a generally applicable concept in Hong Kong contract law, and it is highly unlikely there would be a force majeure clause in any finance documentation. It is possible that construction contracts may have a force majeure clause, in which case the relevant contractor may have a way of avoiding a breach of the relevant contract. However, even if such a clause was applicable under a construction contract, it would not normally have any effect on the completion deadlines in the financing documentation;
- **Frustration:** The doctrine of frustration is distinct from force majeure and does not require the inclusion of a specific clause within a contract. Broadly speaking, the doctrine of frustration may result in a contract being discharged where due to a supervening event, performance becomes impossible or the obligation is radically different from what was undertaken at the outset. A full discussion of the doctrine is beyond the scope of this briefing, but it is worth noting that it is difficult to prove, especially in the context of a loan agreement; and
- **Utilisation request:** A utilisation request may be required to include a statement that the construction is progressing in accordance with an agreed progress schedule, and it may need to be supported by a report from a bank-appointed project monitoring surveyor. If the construction is behind schedule, then this could result in a drawstop on further tranches. A lender should keep in mind that if it does not continue to fund the borrower then that could result in the borrower breaching the terms of its construction contracts due to unavailability of funding, which could affect the development as a whole.

## LEASING

For commercial properties that have already been built and let out, there are potential issues relating to the leasing of units, especially in the case of shops and restaurants that have suffered greatly due to both the anti-government protests and the coronavirus pandemic. Income may be much lower than anticipated when the original terms of the lease were agreed, and many tenants will be looking to re-negotiate the terms of their leases to include discounts, rebates or payment holidays.

- **Amendments and waivers:** Amendments and waivers of lease terms will normally be subject to lender consent. Landlords should be especially careful not to adopt a course of conduct which could lead to a de-facto amendment or waiver. Many landlords will be sympathetic to the situation of their tenants, but depending on the circumstances, an indication of an alteration to a tenant's payment obligations through an informal phone call or e-mail may in itself result in a waiver of the lease terms and an inadvertent breach of the financing documents.
- **Other requirements:** The financing documents may also contain other relevant provisions, for example that rental shall not be less than a certain amount per square foot, that the overall rental income must exceed a certain amount, or that the departure of certain anchor tenants could be an event of default. Rental income is also commonly used to service debt (and is included in what is called a "debt service cover ratio", which forms part of the financial covenant in a loan agreement – see below). Landlords should keep these in mind when faced with any negotiation with existing or potential tenants.

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## FINANCIAL COVENANTS AND VALUATIONS

- Financial covenants are meant to be an early indicator of a borrower's (or guarantor's) ability to make its debt payments. However, in practical terms, the protection provided by them can be very much delayed. Since the coronavirus began to make its financial impact earlier this year, for a company that reports on 30 June and December 31, the financial impact would start to show in the coming June 30 accounts. Since there is usually a 90 to 180-day grace period for the delivery of financial statements, it could be that any breach is not detected until the early part of 2021. In this case, borrowers that are aware of a pending breach should take action accordingly, and possibly engage with lenders at an earlier date. Lenders can take advantage of information covenants enabling them to request financial and other information (such as monthly accounts) to get a more up-to-date sense of a borrower's position.
- The potential impact of the coronavirus on property valuations remains to be seen, though there is initial evidence that valuations are starting to slip. Valuations are crucial in a financing context due to Loan to Value ("LTV") covenants that check that the loan amount does not exceed a certain proportion of the property valuation. In most cases, LTV covenants will be agreed with some headroom for borrowers, although it is possible that breaches may start to occur if the situation worsens. Many LTV clauses require that the borrower "top up" the security package if the LTV increases beyond a certain level, so borrowers should consider how they might be able to meet such a requirement. Lenders often have rights to call for the borrower to deliver interim valuations in case the usual delivery date is too long to wait for.
- In the case of development finance, similar considerations apply, with the loan being geared to the development value of the property by what is known as the Loan to Gross Development Value (or "LtGDV") ratio. Any fall in the ultimate development value of the property will have an impact on the LtGDV ratio.

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## EVENTS OF DEFAULT

In addition to non-payment of principal or interest under the loan, the loan agreement will normally contain other events of default. These may be triggered if the issues mentioned above are not resolved, or if other events agreed between the parties take place. Parties should consider the following potential issues:

- **Event of default:** Borrowers should remember that they will normally be under an obligation to alert the lender of any default (including a potential event of default). An event of default will generally result in a drawstop, preventing the utilisation of further tranches;
- **Cross-defaults:** There can be an event of default if there is a default in relation to other financings of a borrower or related companies. Parties should pay attention to which companies are covered by the cross-default clause. In addition to covering the borrower, the clause would normally also cover the sponsor guarantor(s). In many cases, the guarantors would be guaranteeing loans under numerous other projects, and a default under one could result in a cross default under all of them;
- **Insolvency:** One of the typical APLMA events of default includes where the borrower negotiates amendments to scheduled debt repayments with its other creditors. Borrowers ought to be careful not to trigger this by asking a lender or group of lenders for an amendment to payment terms;

- **Material adverse effect (“MAE”):** The effect of an MAE event of default will depend on its negotiated terms, but the general intention would be to capture the situation where there has been a material adverse effect on the borrower but the other more specific events of default may not have been triggered. They are generally considered a last resort for a lender where it is keen to take enforcement steps, but the other events of default do not appear to have occurred. This is because such clauses are normally drafted on broad and non-specific terms and the lender would have to be quite certain that it can prove the MAE has occurred. If it starts enforcing security or withholding a drawdown this could well cause substantial loss to the borrower;
- **Reservation of rights:** If a lender becomes aware of a default, it should consider whether to issue a “reservation of rights” letter to the borrower so as to reserve its rights of enforcement under the documents. Waiting or doing nothing could be taken as a waiver;
- **Negotiation:** The occurrence of an event of default will mean that the lender would be in a position to accelerate the debt repayment and take enforcement action but does not itself mean that the borrower or the transaction is about to collapse. The onset of an event of default should mark a period of negotiation to resolve the relevant matters. Where there are multiple lenders, parties should coordinate with the agent and note the majority voting thresholds; and
- **Credit support:** Where necessary, a lender may consider asking for further credit support like guarantees or asset security in order to improve its position as against other creditors.

## EXECUTION AND CLOSING

For new financings, parties should allow extra time and plan carefully for the proposed execution of documents. This is particularly important given that many relevant persons may be working from home or be unavailable due to isolation or quarantine requirements. Parties should consult their lawyers with respect to how documents may be executed remotely where necessary. Registration of documents with the Companies Registry and the Land Registry should also be initiated well before the usual deadlines in case the registries are forced to shut or operate limited opening hours. This will ensure the intended priority of the relevant security documentation.

## NEXT STEPS

The above is not a comprehensive analysis of potential issues and parties should consider a full review of their financing documentation. They should consider the potential issues at an early stage and engage with each other and their legal advisers. Where necessary, bearing in mind the discussion on cross-default above, borrowers should consider requesting any required amendment ahead of time. Such amendments may relate to payment terms (such as a debt re-scheduling or extension) or an amendment to other terms, such as with respect to completion deadlines. It is often easier to get an approval for an amendment or waiver before a default occurs. This should avoid a cross-default situation and hopefully facilitate the smooth continuation of business and loan payments.

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