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CORPORATE REAL ESTATE: A POST-COVID-19 PERSPECTIVE

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Revival signs in real estate M&A

The Covid-19 pandemic caused a noticeable slowdown in real estate M&A activity. Despite this, there are early signs in the market of a bounce back. Opportunistic/strategic deals are still completing and many investors have capital reserves ready to be deployed. As a firm, over the last few weeks we have noticed an increase in initial real estate M&A activity. As part of this we are seeing new trends emerging specifically in response to Covid-19 (and we expect more to emerge in the short to medium term).



Covid-19 due diligence

Covid-19 due diligence is already a focus for buyers and insurers. From a legal perspective, compliance with health and safety regulations, effects on material contracts, insurance coverage and accounting impacts are likely to require attention. For operating real estate businesses, employment matters will also necessitate an additional strand of enhanced due diligence.

Whilst some buyers may be willing to forego certain aspects of such due diligence, it is important to remember that, if a warranty and indemnity (“W&I”) insurer is underwriting the deal (see more below), they will scrutinise the due diligence and expect to see all matters covered or (at the very least) for an adequate reason to be provided why the due diligence is not required.

All of this will require more due diligence information to be made available and reviewed. Buyers should also bear in mind the practicalities of conducting due diligence – site inspections, valuations and other physical forms of due diligence will be impacted. Deal timetables will need to take all of this into account and parties should engage with advisers at an early stage to ensure a managed due diligence process.



Seller business conduct in a split exchange and completion

Where there is a split between exchange and completion, the seller’s conduct regarding the asset or business is commonly restricted in this gap period. In more simple real estate businesses, sellers can often take a relaxed view here on the basis that real estate holding businesses do not tend to involve active operations on a day to day basis. In the current climate, we expect sellers to pay much more attention to the detail here to ensure that they have the necessary flexibility required to react to the uncertain circumstances of the present day.



Termination rights between exchange and completion

Due to the uncertainty in the market, we are already seeing buyers pushing for enhanced termination rights between exchange and completion (where there is a split) – a trend we predict will continue to develop. Material Adverse Change (“MAC”) clauses, which were relatively uncommon in real estate M&A at the start of this year, are increasingly featuring in negotiations.

Whether a MAC clause is acceptable and the breadth of termination scenarios that may be covered will be subject to the relative negotiating strength of the parties (and who between seller and buyer may be responsible for driving the gap between exchange and completion). More bespoke and individualised termination rights (eg specifically on a rent payment default of a major tenant) can be seen as a bridging position. Notably, MAC clauses that are Covid-19 specific are also emerging. This brings with it a challenge in defining the trigger of a second wave of Covid-19 or related matter.

On the counter side for sellers, there have been reports recently of buyers defaulting on their obligations to complete transactions. For sellers, achieving deal certainty will therefore be a key commercial imperative when exchanging an agreement. At the start of this year, we were noticing an increased number of real estate M&A deals that did not include a buyer’s exchange deposit. Although the market is expected to favour buyers in the short to mid-term, sellers will be wary of entering into sale agreements with extended gap periods (between exchange and completion) without the fall-back protection of a buyer deposit to claim on.



Distressed deals and synthetic warranties

We are already seeing distressed deals in the market and expect them to become more commonplace. These bring a very different form of real estate M&A transaction. Timetables tend to be accelerated, due diligence more focused and there will be increased scrutiny on the structuring/financing of the deal. Contractual protections are equally unlikely to be on offer from a distressed seller.

One recent market feature that may assist buyers here is the ability for M&A (or more specifically W&I) insurance to offer 'synthetic' warranty coverage whereby an insurer provides the warranty coverage (not the seller). In this instance, the warranties (and possibly tax deed) will be negotiated directly with an insurer and protection is then provided by way of the W&I policy (rather than the sale and purchase agreement). It is a neat solution in certain circumstances and something that was not available for distressed deals during the financial crisis. This is a somewhat bespoke insurance product, which will suit some deals better than others. Early discussions with lawyers on this form of insurance is key (especially on an accelerated deal timetable).



W&I insurance: shifting coverage

Whilst W&I insurance will provide some solutions in an uncertain market, insurers are also reacting to the impact of Covid-19. The insurance market is expecting an increased number of claims as a result of the pandemic, which will feed through to increased scrutiny of the coverage on offer for upcoming deals and the premiums payable. For buyers, this means greater due diligence underwriting (as mentioned above) and increased policy limitations. Many insurers are already looking to include Covid-19 general exclusions in newly incepted policies. The drafting here will be of particular interest to buyers and care should be taken to ensure that such exclusions do not provide insurers with a means to avoid wider claims. As ever, it is important to engage with lawyers here to ensure policies are subject to similar levels of scrutiny as, and work consistently with, the sale agreement.



Purchase price adjustments

Although a common feature of M&A in certain sectors, we do not expect buyers will overwhelmingly turn to deferred consideration or contingent consideration in respect of real estate holding businesses. Instead, purchase price adjustments are becoming the source of focus, and this has pushed more parties towards completion accounts over a locked box mechanism. Locked box mechanics (which tend to be viewed as seller-friendly) fix a purchase price at exchange that is payable at completion by reference to a set of pre-signing management accounts. The risk of issues arising between the date of those management accounts and completion therefore lies with the buyer. In uncertain times such as these, buyers are looking to avoid such a risk and push for a completion accounts mechanic. Where locked box is accepted by buyer and seller in name, we are generally seeing these change into complex 'hybrid' mechanics (involving elements of locked box and completion accounting) through the course of negotiations, eroding the seller friendly aspects. Where completion accounts are used, care still needs to be taken to ensure that accounting policies react as intended to events in a target business - we would therefore encourage close dialogue between lawyers, accountants and deal teams on these.



Dealing with Arrears

One area already subject to increased negotiation is the treatment of arrears. Given the reported levels of rent collection in some businesses, there may be levels of income outstanding at the time of any disposal. With this in mind, sellers will want to ensure that they have sufficient protections that pre-completion rent will be pursued and passed through. Conversely, a buyer will wish to ensure that this does not impact on any future recoverability of rents or relations with tenants. Where there are material arrears, we expect parties will wish to pay close attention to the detail of conduct rights and the apportionment of rent between seller and buyer.

If you have queries in relation to the above or would like to discuss a corporate real estate M&A transaction in more detail, please do not hesitate to get in touch with us.

Herbert Smith Freehills contacts



Paul Chases
Partner, Corporate
Real Estate
Herbert Smith Freehills
T +44 20 7466 2386
paul.chases@hsf.com



Alex Wright
Associate, Corporate
Real Estate
Herbert Smith Freehills
T +44 20 7466 7454
alex.wright@hsf.com

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