COVID-19: PRESSURE POINTS: THE IMPACT ON DEVELOPMENT FINANCE TRANSACTIONS (AUSTRALIA)

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Legal Briefings – By **Lucy McCullagh, Oanh Ho and Josh Todd**

Less than five months have passed since the existence of a new virus was reported to the World Health Organisation. The pandemic continues to expand, with confirmed cases of COVID-19, the disease caused by the coronavirus (SARS-CoV-2), soon to reach 4 million globally.

Large-scale quarantines, case isolation, travel restrictions, social distancing measures, business closures and government borrowing are creating unprecedented economic challenges. Navigating the crisis and assessing its symptoms and impact from a health, economic and public-policy perspective is becoming increasingly multifactorial and complex.

It is crucial that financiers and borrowers operating in the development and real estate sector, decode the risks and consequences the COVID-19 pandemic will have on their debt obligations, many of which will continue to exist long after the COVID-19 wards have emptied.

In this note, we offer some of our latest insights on the impact that the COVID-19 pandemic may have on development finance transactions.

FACILITY AGREEMENTS

MATERIAL ADVERSE EFFECT

Both borrowers and financiers in development finance transactions may need to consider whether the COVID-19 pandemic has resulted in a ‘Material Adverse Effect’ (**MAE**) occurring under their facility agreement.

The concept of ‘MAE’ is widespread in Australian facility agreements. Its primary purpose is to act as a catch-all description for risks that are unidentifiable or otherwise not contemplated when the parties entered into the finance documents and which has or is reasonably likely to have a material and adverse impact on the borrower and its business.

In a facility agreement, MAE is commonly used in three scenarios:

- **event of default**: to describe an event or events which will trigger an event of default, thereby permitting a financier to withhold further funds (a ‘drawstop’) or accelerate the debt;
- **representation**: as a representation, given by the borrower at regular points in time, that there is no event of default subsisting, (which would include an MAE); and
- **notice obligation**: as part of an obligation on the borrower to notify the financier if there is an event of default subsisting (which would include an MAE).

Typically, the definition of MAE is drafted in broad terms and will include a material and adverse effect occurring in relation to:

- the business, operation, property, condition (financial or otherwise) or prospects of the borrower/obligor group (taken as a whole);
- the ability of the borrower/obligor group (taken as a whole) to perform their obligations under the finance documents; or
- the validity or enforceability of the whole or any material part of any finance document or any material rights or remedies of the financier under the finance documents.

In a development financing it is common to see the definition of MAE contain further limbs such as a material adverse effect on:

- the ability of the builder, borrower and/or security providers to achieve practical completion of the development project by a specified sunset date; and
- the enforceability of a material proportion of sale contracts.

The exercise of construing MAE clauses is complicated and case specific. To determine if an MAE has occurred in relation to a particular borrower under its loan facility will be a matter of fact. Financiers and borrowers will need to consider the precise wording of the MAE clause in the relevant facility agreement. Financiers who wish to call an MAE, will have the onus of proving that an MAE has in fact occurred. The notion of 'materiality' must be determined by reference to context including the nature and extent of the borrower's obligations under the facility agreement and the consequences of a default, which include acceleration of debt and making security immediately enforceable. In order to be material, any change must not be merely temporary – courts have found that the event must affect the borrower in a 'durationally significant manner'.

In practice, it is uncommon for financiers to rely on MAE clauses, due to the difficulty in establishing that an MAE has occurred and for relationship and reputational reasons. However, given the unprecedented nature of the COVID-19 pandemic and its widespread impact, it is expected that these clauses will come under closer scrutiny by both financiers and borrowers, and they will in some cases be triggered.

CHANGES IN LAW AND INCREASED COST PROVISIONS

Parties should consider whether the emergency legislative or regulatory responses to the COVID-19 pandemic may impact their financing arrangements. The Commonwealth, Territory and State Government responses to date have included temporary amendments to legislation and regulations governing commercial leases, planning, insolvency and corporations law.

Many facility agreements contain ‘change in law’ provisions. However, whether the temporary government measures are classified as ‘law’ will depend on the specific drafting of the relevant provision. Parties should consider whether the change in law clause only applies where there is new legislation introduced or amendments made to existing legislation that is broadly drafted and extends, for example, to government orders, directives or requests. In addition, the change in law provisions may only relate to financial legislation. Some of the changes made so far have not been a result of new legislation but through the exercise of powers under existing laws.

Increased cost provisions in facility agreements are methods of allocating regulatory risks to borrowers. Through these clauses, borrowers indemnify financiers against:

- increases in the costs of lending; or
- reductions in the expected return from their participation in the facility,

due to changes in law or regulation.

Parties should engage in proactive dialogue to prepare for scenarios where increased costs may result. When these provisions are likely to be enforced, borrowers should be mindful of issues including:

- whether they have any prepayment rights;
- whether they have sufficient cash flow to cover the increased cost; and
- whether there is any risk of breaching financial covenants.

In practice, it is uncommon for financiers to rely on increased cost provisions. During previous economic downturns, financiers were reluctant to invoke these clauses due to reputational and relationship reasons.

FINANCIAL COVENANTS

All development finance facilities include financial covenants which must be tested and complied with on regular calculation dates. The potential impact of the COVID-19 pandemic on supply chains, revenue streams and asset values require borrowers and financiers alike to more closely examine the associated consequences on the financial covenant tests contained in their facility documents. These typically include:

- **loan to cost ratios**: loan to cost ratios test the ratio of the total commitments to the total project costs. It is possible that the costs of the project will have increased due to supply chain and labour disruptions;

- **loan-to-value ratios**: loan to value ratios test the ratio of the total debt commitments to the latest land valuation. Where the borrower is seeking a variation to its financing arrangements (such as an upsize to the facility) it is possible that in those circumstances the financiers may revalue the underlying asset. This may materially affect the borrower's ability to comply with its loan-to-value ratio as valuations for properties are likely to have decreased and it may be difficult for financiers to obtain reliable valuations due to market volatility; and

- **earnings cover ratios**: financial covenants that are a function of earnings, such as an interest cover ratio which tests EBITDA to interest expense or a leverage ratio which tests net debt to EBITBA, are more likely to be negatively impacted by COVID-19. However these are not common in pure limited recourse development facilities used in development financings. Parties should however consider the impacts in a financing arrangement that is cross-collateralised or otherwise more complex than a limited recourse construction facility. Where such a financial covenant is relevant, parties should consider whether once-off extraordinary expenses relating to COVID-19 are permitted as add-backs to lessen the impact on the borrower's financial results.

A financial covenant will be tested at certain specified intervals and a breach may not occur until the borrower actually delivers a pre-agreed compliance certificate (i.e. 45 days after the specified test date) or a revised valuation is completed.

It is also common for facility agreements to contain a right for the shareholders or sponsors to invest additional equity or subordinated debt into the development or the borrower group to effectively 'cure' a financial covenant breach.

PROJECT UNDERTAKINGS

Parties should consider the impact of the COVID-19 pandemic on project specific undertakings provided by borrowers under their facility agreement – in particular project document undertakings and insurance undertakings:

- **project documents / material contracts**: the construction industry has been negatively impacted by the COVID-19 pandemic and this may impede the ability of contractors to deliver projects in a cost-effective or timely manner, and may even lead to their insolvency. Where a contractor requests relief from a borrower for any of their obligations, borrowers should bear in mind common undertakings to ensure there are no defaults under project contracts (such as construction contracts) and to not grant waivers or agree to amendments under any project documents without financier consent; and

- **insurance**: parties should consider whether the borrower's current insurance policy sufficiently covers business interruptions caused by the COVID-19 pandemic and whether this impacts compliance with insurance undertakings in the facility.

EVENTS OF DEFAULT

The COVID-19 pandemic may trigger a wide range of events of default depending on an individual borrower's circumstances and the drafting of the facility agreement. For example, the following events of default may be triggered:

- **failure to pay**: failure to repay financial indebtedness, if the borrower's source of funding the repayment of the debt (such as by sale of apartments), has fallen away or decreased;

- **failure to comply**: failure to comply with financial covenants, if the borrower's property valuation drops materially;

- **material adverse effect**: the occurrence of an event which has a material adverse effect (discussed above);

- **litigation**: actual or threatened litigation, if there are claims which arise on the project and are not resolved between the parties;

- **insolvency**: insolvency related events (including voluntary administration), if the borrower forecasts it cannot pay its debts when due; and

- **business cessation**: suspension or cessation of business activities, if construction ceases and so a project is suspended or potentially abandoned.

Parties should particularly bear in mind that:

- **notice**: borrowers will typically be obliged to notify financiers of an event of default or a potential event of default and provide information about the steps being taken to remedy the event of default;
- **cure**: borrowers will generally have a cure period and specified cure right (i.e. equity injection) to remedy an event of default;
- **cross-default**: a default under one agreement can trigger a cross-default across a suite of finance documents; and
- **repeating representations**: many event of default triggers are also repeated as representations at certain intervals (i.e. each reporting period or each drawdown). For example, a borrower may repeatedly represent and warrant that no material adverse effect has occurred or that it has not ceased or changed its business.

DRAWSTOP TRIGGERS

Parties should be mindful of any facility agreement provision that allows a financier to refuse to make an advance when requested by a borrower in certain circumstances.

Typically, a financier is not obliged to make an advance where:

- **events default**: there is an event of default (and in certain circumstances, a potential event of default) or review event that is subsisting or would result from the advance being made;
- **repeating representations**: a representation when repeated as at the date of the advance, is false or misleading;
- **certifications**: the certifications are not yet received from the independent certifier, builder or borrower (as the case may be);
- **milestone and practical completion dates**: the project is not on schedule to meet the pre-agreed milestone and practical completion dates; or
- **cost to complete**: the cost to complete test has not been satisfied.

The fact that there has been a disruption to the economy as a result of the COVID-19 pandemic does not necessarily of itself impact the ability of a borrower to make the repeating representations and satisfy the conditions precedent to an advance.

CONSENTS, WAIVERS, AMENDMENTS AND STANDSTILL AGREEMENTS

CONSENTS, WAIVERS AND AMENDMENTS

Borrowers may, as a result of their particular circumstances, be looking to:

- obtain consents or waivers in respect of breaches or potential future breaches to their finance documents, such as a waiver of compliance with a particular financial covenant or a consent to amend an underlying project document to obtain an extension of time or amend a sunset date; or
- amend existing arrangements in response to financial distress, for example by extending dates for repayment of debt.

Financiers will need to observe any relevant timing or voting procedures contained in their finance arrangements when providing consents or waivers or agreement to any amendments. This is especially relevant for syndicated facilities, where financier consent thresholds are likely to be relevant. Financing arrangements may also contain 'snooze-you-lose' provisions or other mechanisms which govern scenarios where consents are not provided within the required timeframes.

INTERCREDITOR ARRANGEMENTS

Financiers and borrowers should also review intercreditor arrangements. Such arrangements often include a combination of the following terms (among others), each of which may need to be considered when understanding each party's respective notice, voting and enforcement obligations:

- **decision making and voting mechanisms**: provisions detailing what level of consent is required, typically relating to changes to finance documents, increases in commitment and approval of borrower activities;

- **security enforcement**: a mezzanine financier's right to enforce its security is commonly suspended until the senior financier has been repaid in full;

- **proceeds application following enforcement**: the order in which enforcement proceeds are applied is explicitly detailed, accounting for payment ceilings and refunds;

- **administration and information sharing**: term requiring the senior and mezzanine financiers to share information received from the borrower; and

- **buy-out right**: a pre-emptive right in favour of the mezzanine financier, pursuant to which it can purchase the senior financier's debt in certain circumstances.

STANDSTILL AGREEMENT

Parties may also want to consider entering into standstill agreements as an alternative to obtaining waivers and consents, under which financiers agree not exercise their rights following an event of default and agree not to take enforcement action during an agreed standstill period. The benefit of such an agreement includes the ability to stabilise the restructuring process, giving the borrower time to develop a plan. These agreements can include heightened information reporting, partial debt pay down, payment deferrals, processes and milestones for a sale, capital raising or refinancing and/or the provision of additional credit support.

CONSTRUCTION CONTRACTS

While the supply chain risk on projects has somewhat decreased with Chinese manufacturing output starting to return to normal, the domestic effects of the COVID-19 pandemic will continue to impact individual projects and the industry more generally for some time to come.

Issues and circumstances continue to change, but the largest impact for development finance transactions is likely to come in the form of project delays as a result of supply shortages, reduced numbers of workers or a complete shut-down of projects.

FORCE MAJEURE CLAUSES

The term ‘force majeure’ does not have a standard or exhaustive definition in Australian law. However, a force majeure clause is generally understood to be a contractual term which excuses one or both parties from non-performance or delay of contractual obligations upon the occurrence of a supervening event.

Whether the COVID-19 pandemic, or events or restrictions related to the pandemic, will fall within the scope of a force majeure clause will depend on how the particular clause is drafted. The construction of a given force majeure clause will be governed by general contractual principles.

A party seeking to rely on a force majeure clause bears the onus of proving that the clause applies, which generally involves establishing:

- **scope and non-avoidance**: that the circumstance which have occurred is within the scope of the force majeure clause and could not reasonably have been avoided;
- **effect**: that the circumstance caused an effect on performance (without any intervening voluntary act, or failure to mitigate);
- **relief**: that the clause provides relief against that performance effect; and
- **notice**: that any requisite notice has been given.

The following are specific issues that financiers and borrowers need to consider in a construction context:

- **scope**: whether the COVID-19 pandemic, or events or restrictions related to the pandemic, fall within the scope of the force majeure clause. Consideration should also be given to whether the event falls within a change in law, extension of time, variation or similar provision (some of which are discussed below);
- **effect of performance**: performance will not be beyond the control of a party to a contract merely because performance becomes uneconomic or unprofitable;
- **causation**: complex questions regarding causality may arise where there are multiple

contributing causes for a failure of performance, and only one of them is a force majeure circumstance;

- **mitigation**: if the party could have prevented or mitigated the effects of the force majeure event, but did not take all reasonable steps to do so, it may not be able to meet these requirements; and

- **notice**: ensuring all notice requirements under the contract are complied with.

DELAY, VARIATION AND CHANGE OF LAW

There are a number of additional clauses which are common in construction contracts that may affect the availability of remedies in response to the COVID-19 pandemic. Financiers and borrowers will need to be alive to each of these.

By way of example, some of the provisions that a contactor under a construction contract may consider making a claim under include:

- **allocation of 'delay' risk**: the contractor typically bears the risk that the project is completed on time and will usually be required to pay 'delay liquidated damages' if the date for completion is not met. The contractor may be required to provide a 'notice of delay' where there is a likely or probable delay. Some contracts contain an 'extension of time' clause which governs when a contractor will be entitled to additional time to complete a project, on grounds which can include force majeure, change of law and other specified risks;

- **variations**: contractors are often entitled to make claims for 'variations' under construction contracts where there is a material change to the works, the quality of any materials or where there is a change to the method, sequence or timing of the works. Where a variation is granted, contractors are typically entitled to claim additional costs and time to complete the project. A variation is also often a ground for obtaining an extension of time in an extension of time clause; and

- **change of law**: many construction contracts contain 'change of law' clauses which respond to changes in government regulation (usually broadly defined to include any legislation, ordinances, regulations and proclamations) which delay or increase the cost of performing the works. A 'change in law notice' is usually required. The clause will identify how the risk of a 'change in law' is distributed between the parties. 'Change in law' clauses are particularly relevant in the context of COVID-19 as governments are increasingly using regulation to restrict the movement of people and shipping.

Borrowers and financiers in the construction sector should consider these issues when responding to the COVID-19 pandemic, as financier consent will most often be required before a borrower can adjust its terms with its construction contractor.

CONTRACTOR OR BORROWER INSOLVENCIES

Contractor or borrower insolvency will clearly have an impact on the timeline and cost of the development project. Financiers, borrowers and contractors will need to be cognisant of their rights, obligations and timelines agreed in any contractor side agreement with the financier, including step-in and cure rights, restrictions on termination, provisions relating to the preservation of contractual terms, assignment and transfer rights, liabilities of each counterparty and payment directions.

CONSTRUCTION COVENANTS IN FACILITY AGREEMENTS

There are a number of construction specific undertakings that will be included in a development facility. Borrowers and financiers will need to be aware of the interplay between such provisions and the construction contract. In particular:

- **requirements in relation to project documents**: this clause will ensure the borrower maintains and complies with the project documents and enforces its rights under those documents. The clause typically:
    - restricts the borrower from amending or terminating such documents;
    - obliges the borrower to comply with such documents; and
    - requires the borrower to notify the financier of certain things that occur in respect of such documents (for example, any notice of default issued under such document or an event giving rise to the right of a counterparty to terminate or enforce such

document);

- **completion of the works**: this clause seeks to ensure that:
    - the works are carried out in accordance with the construction contract;
    - the works are not varied in a material respect without the approval of the financiers; and
    - the works are completed in a proper/workmanlike manner;
- **authorisations and licences**: this clause will require the borrower to maintain in full force and effect, and to comply with, the terms of any authorisation to complete the development and execute, deliver and perform the project document; and
- **insurances**: this clause will require the borrower to take out and maintain insurance over the project and the property.

Each of the above terms may be impacted by the COVID-19 pandemic and the economic consequences therefrom. Familiarisation with the drafting and scope of each provision will be key to best ensuring that the financier and the borrower are best placed to respond if such a term is enlivened or comes into question.

SALE CONTRACTS

Development facilities which finance the construction of residential apartments are repaid from the proceeds of sale under sale contracts. To ensure any settlement risk (and thereby financial default) is mitigated, borrowers will need to be proactively managing their purchasers under sale contracts and consider how market conditions impacted by the COVID-19 pandemic may affect the ability of parties to settle under sale contracts and also impact the borrower’s obligations to its financier.

SUNSET DATES AND RESCISSION RIGHTS

If a plan of subdivision for a block of residential apartments is not registered by the fixed sunset date in an off-the-plan contract, a purchaser is entitled to rescind the contract to purchase an apartment by serving a rescission notice. Accordingly, borrowers and financiers must be mindful of any need to:

- extend the sunset dates in any unsigned contracts for new sales;
- be proactive in settling and registering plans where sunset dates in contracts are fast approaching; and
- liaise with purchasers for contracts with sunset dates that are close to expiring, with a view to having them extended by agreement where necessary.

VENDOR FINANCE

A request by purchasers to extend a settlement date in difficult financial times is not unusual. It is common for vendors (borrowers) to accept such an extension instead of risking the sale falling over. Such an extension can be documented by way of a separate loan arrangement or additional fee chargers. If vendor finance is to be provided by the borrower, it must seek legal advice on whether such arrangements constitute a ‘credit contract’ under the *National Consumer Credit Protection Act 2009* (Cth) and what the implications that extend from this are. It may also require consent from its financier under its development facility.

FOREIGN INVESTMENT REVIEW BOARD

The Foreign Investment Review Board is set to run the ruler over every proposed foreign acquisition in Australia, with a temporary reduction in the screening threshold for foreign investments to $0. Under these changes, ‘foreign persons’ under the *Foreign Acquisitions and Takeovers Act 1975* (Cth) will have a higher likelihood of needing to seek approval from the Foreign Investment Review Board when purchasing a property. This temporary measure will remain in place for the duration of the COVID-19 pandemic. However, the measure is not retrospective, so will not impact purchases under sale contracts which have been entered into prior to 10:30pm AEDT on 29 March 2020.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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