Dechert LLP

COVID-19
The impact on commercial leases in the UK

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Following the introduction of a nationwide lockdown in the UK on Monday 23 March 2020, landlords and tenants have been considering the implications for commercial leases and in particular obligations relating to the payment of rent. This note looks at some issues for both parties and provides an overview of the recently introduced Coronavirus Act 2020 in the context of business leases.

Can tenants suspend payment of rent or pay a reduced rent for premises that they cannot occupy or use?

UK commercial leases generally do not permit tenants to suspend payment of rent or other sums except in circumstances where the premises are damaged or destroyed. In the case of COVID-19, the premises have not been damaged or destroyed so the rent suspension provisions in most leases will not respond. The obligation on the tenant to pay rent will continue.

Furthermore, most leases expressly require the tenant to pay the rent in full without any set-off, deduction or withholding.

The closure of premises by the UK government does not impact on the obligations owed by one party to the other under commercial leases but, as discussed later in this article, the government has recently introduced measures, under the Coronavirus Act 2020, to restrict landlords' remedies for non-payment of rent for a temporary period.

Can a tenant rely on Force Majeure or Frustration to avoid paying rent?

Force majeure clauses have the effect of suspending a party's obligations under a contract where an event has arisen which is outside the reasonable control of that party and that event has made performance by that party substantially more difficult or impossible.

In the UK, most commercial leases do not currently contain express force majeure clauses (although this may well change in the future) and it is very unlikely that a court would imply such a clause into a lease. Accordingly, force majeure is rarely going to be of assistance to tenants in the current crisis.

The common law doctrine of frustration provides that a contract may be discharged where, as a result of some supervening event, performance becomes impossible.

In the context of COVID-19, it could be argued that the pandemic is a supervening event which has had the effect of preventing tenants from occupying premises and landlords from permitting occupation of the tenant's premises. However, we think that courts are unlikely to consider COVID-19 sufficient to frustrate a lease as its effects are, we hope, relatively short term.

Currently there are no reported cases of the doctrine of frustration being successfully applied to leases in England. A case only last year attempted, unsuccessfully, to invoke the doctrine in the context of Brexit. The European Medicines Agency (EMA) argued that Brexit should have the effect of frustrating their lease of premises at Canary Wharf on the basis that, following Brexit, they would have to relocate to a member state within the EU. The High Court ruled that the test for frustration had not been met as the EMA had the ability to dispose of the premises by other means i.e. by way of assignment or underletting.

What other options do tenants have with regard to payment of rent?

On the basis that there are no legal mechanisms in commercial leases to reduce or suspend payment of rent in the current crisis, the only real option for most tenants is to try to renegotiate terms with their landlords; under English law there is no obligation on landlords to act in good faith in terms of considering such requests. The restrictions on landlords' remedies introduced in the Coronavirus Act 2020 and discussed below may provide some leverage to tenants in terms of their negotiations.

Some of the proposals currently being considered by tenants include:

- Quarterly rent payments being converted to monthly payments to help with cash flow, although, for some tenants with no operating income, it is difficult to see how this will assist in the longer term;
- A rent holiday or rent deferment with rent, plus interest, being postponed for 3 to 6 months and then possibly payable over a longer period;
- A rent reduction, so that the burden is shared between the landlord and the tenant, possibly coupled with an extended lease term or the tenant forgoing some benefit under the lease such as a break right; and
- The use of a rent deposit held by the landlord to cover the rent before a default arises. Care should be taken though to vary the usual requirement that the tenant immediately tops up the deposit account following the draw down.

Some tenants have unilaterally notified landlords that rent will not be paid at all or that they will be paying on a monthly basis going forward. It remains to be seen how landlords will react but, given the unique collective bargaining power of tenants across the country at present, landlords may have little choice but to accept the proposals. The alternative, insolvent tenants and vacant premises, is even less attractive to landlords.

Any agreement between a landlord and tenant for the temporary reduction in rent or deferment of rental payments should be properly documented to ensure that it takes effect as the parties intended. Such agreements should also take account of any government assistance provided to either party to ensure transparency and a fair outcome for both parties.

Where the landlord's interest is charged, the landlord is likely to require lender consent under the terms of its facility agreement before any proposal can be agreed with the tenant.

What about the CVA process – is that an option?

There has been much talk in the press over recent years about the use of Company Voluntary Arrangements (CVAs) by tenants, particularly in the retail sector, to restructure their lease obligations and secure a reduction in rent liability.

CVAs are a mechanism whereby a company in difficulties can put forward proposals to its unsecured creditors, which, if voted for by more than 75% of the unsecured creditors by value, will be binding on all unsecured creditors regardless of whether they voted for or against the proposals or didn't vote at all. Landlords, who anticipate bearing a large proportion of any debt write-off, often resist the CVA process proceeding.

The commencement of the CVA process is usually a trigger for forfeiture under most leases and, as was confirmed in a recent case involving Debenhams' CVA, the landlord retains its right of forfeiture, if it has not been waived, whether as part of the CVA negotiations or otherwise, throughout the CVA process. However, that may be of little comfort to landlords in the current climate given the limited scope for re-letting space in the short term.

The COVID-19 crisis will likely lead to further use of CVAs in the coming months, alongside other insolvency measures, but for now the impact of the crisis has been so sudden and sharp that for many tenants there simply hasn't been time to implement the CVA process. Instead tenants have been forced to seek immediate rental waivers and deferments. The implications for landlords of not agreeing to such requests is all too obvious even without the threat of a CVA.

Will insurance cover the rental payments?

Tenants' business interruption insurance will typically only cover situations where the business is impacted due to damage to premises. However, policies can be extended to cover the impact of notifiable diseases on the business and if this extension is in place it may provide the tenant with cover although the terms would need to be checked carefully as it may not extend to "novel pathogens" or "pandemics", such as COVID-19 and may specifically exclude virus and bacteria related claims. COVID-19 was made a notifiable disease by the UK government on 5 March 2020.

What about break clauses?

Some tenants may wish to exercise lease break rights to mitigate their liability for rental payments going forward. Most break rights require a minimum of 3 to 6 months' notice to be given to the landlord to exercise the break so the effect of such provisions will not be felt immediately.

It should be noted too that most break rights require the tenant to have paid the rent in full up to the break date and to give vacant possession on the break date. Tenants should therefore be careful to ensure that any non-payment of rent now does not prevent the operation of a break right in the future. Furthermore, the current lockdown, if it continues for longer than a few months, may impact a tenants' ability to vacate premises and deliver up vacant possession on time. These logistical matters will need some careful planning in the current climate.

What action can landlords take for non-payment of rent?

With the Coronavirus Act receiving Royal Assent on 25 March 2020, one of the main remedies that landlords have for non-payment of rent has been suspended.

The Act prevents landlords from forfeiting all business tenancies for terms exceeding 6 months for non-payment of rent between 26 March 2020 and 30 June 2020. The time period can be extend by the Secretary of State if needed, and it may well be, particularly for those leases based on modern quarter days where the next instalment of rent will not be due until 1 July. The period may also need to be extended to allow businesses time to generate cash flow once the current restrictions are lifted. So the end date of 30 June 2020 may be somewhat optimistic.

The term "rent" is widely defined in the Act to pick up all sums payable by tenants under leases, not just principal rent. It would therefore include payments such as service charge and insurance.

The Act applies not only to landlords of business tenants in occupation but also to superior landlords of head tenants who need not be in occupation, provided at least one sub-tenant is occupying for business purposes. This provision is aimed at preventing superior landlords from forfeiting head leases and thereby collapsing all the subleases below them. The Act does not apply to occupiers who are mere licensees or those occupying under a lease for a term not exceeding 6 months.

The Act also prevents landlords from opposing a tenant's application for a business lease renewal under the Landlord and Tenant Act 1954 on the basis that there has been a "persistent delay in paying rent".

Any rent that is not paid will only be deferred, not written off, so once the period covered by the Act expires the missed rental payments (plus interest calculated under the terms of the lease) will become due which could be a real problem for some tenants if they have not been trading for several months. Tenants will need to find not just the next quarter's rent but the previous quarters', plus interest, as well. As a result we are likely to see numerous forfeiture actions once the standstill period has been lifted.

It should be noted that the Act does not prevent landlords from enforcing other remedies for non-payment of rent such as a debt recovery claim, issuing a statutory demand, commercial rent arrears recovery (formerly known as distress), or claiming on a rent deposit, or parent company/bank guarantee but please see below regarding recent developments in relation to this.

Landlords also retain the right to forfeit for other breaches of the lease terms, apart from the non-payment of rent, such as insolvency (which, depending on how the term is defined in the lease, could include failure to pay sums as they fall due), repair, alienation or where the tenant failed to top up a rent deposit following draw down. In the current circumstances though we think it is likely that a court would grant relief from forfeiture at least during the standstill period and particularly where the tenant can demonstrate that the reason for the breach was connected with the pandemic.

The Act does not apply to Scottish leases although similar provisions have recently been introduced in Scotland providing a standstill period in relation to irritancy (forfeiture) proceedings.

What effect will non-payment of rent have on the relationship between landlords and their lenders?

Whilst landlords have generally been sympathetic towards tenants and the position in which they find themselves in the current crisis, they too have their own concerns in terms of debt service obligations.

Landlords may be able to absorb some of the rental losses in the short term but careful consideration will need to be given before agreeing to any medium or longer term arrangements.

It is likely that many landlords will find themselves in breach of their loan obligations as a result of the COVID-19 crisis and will need to seek waivers and concessions from their lenders. Any concession arrangement with tenants will also need to be approved by the landlord's lender.

Is the Government intending to introduce any further measures in relation to rent?

In response to the perceived loopholes in the Coronavirus Act 2020 referred to above, the Government announced on 23 April 2020 that it would be introducing further measures to protect "high street shops and other companies under strain" from "aggressive rent collection".

The guidance confirms that statutory demands (made between 1 March 2020 and 30 June 2020) and winding up petitions (presented from 27 April 2020 to 30 June 2020) will be banned where the tenant company cannot pay its bills due to coronavirus. Any winding up petition that claims the tenant company is unable to pay its debts will need to be reviewed by the court to establish whether this is as a result of COVID-19.

The Government is also intending to introduce legislation to provide tenants with additional time before landlords can use the Commercial Rent Arrears Recovery (CRAR) process to recover unpaid rent. Landlords will only be able to use CRAR where the rent is overdue by 90 days or more.

While these measures are intended to provide further assistance to tenants at this time, the Government has also indicated that it expects tenants to pay rent where they can afford it and to the extent possible so as to alleviate the effects on landlords. The guidance encourages cooperation and a spirit of fair commercial practice between landlords and tenants. Even if tenants do heed this advice it is unlikely to be of much comfort to landlords and investors who have debt obligations that still need to be met.

It remains to be seen whether the measures to be introduced will go further than outlined presently in the guidance. For instance, will "aggressive rent collection" extend to rent concession negotiations where landlords try to obtain more favourable terms in return for a rent waiver or deferment? It is also unclear currently which tenants will be able to take advantage of these new measures. "Other companies under strain" is a very broad concept and could potentially cover many different sectors.

It will also be interesting to see how the principles outlined by the Government will be implemented by the courts and what evidence tenants will need to produce to persuade the court that their inability to pay is linked to the COVID-19 crisis rather than some other underlying issue with their business.

The new legislation will remain in force until 30 June 2020 and can be extended in line with the provisions relating to the standstill on commercial lease forfeiture.

Are any other proposals being considered?

While the Government's additional measures to protect tenants have been widely welcomed by many tenant bodies, others have been calling for the Government to take a more radical approach and introduce what has been termed a "rent support furlough scheme" or a "furloughed space grant scheme".

The idea is similar to the current employee furlough scheme and would mean that the Government would pay a percentage of the rent and possibly other outgoings due on the space that has been "furloughed". The scheme is being proposed jointly by the British Retail Consortium and the British Property Federation and has been supported by Revo, the trade body representing shopping centre owners. Similar schemes have been introduced in other European countries.

One of the reasons that this type of scheme is being proposed is that many business are unlikely to be able to benefit from the Government's Coronavirus Business Interruption Loan Scheme due to lenders' reluctance to lend to the retail sector. Even for those businesses that are able to access this funding, it is unlikely to be sufficient to cover all outgoings until they are fully operational again.

The argument for such further intervention is that without it, many tenants will collapse which will in turn have serious implications for property owners and investors including pension funds.

The government is currently in detailed talks with landlords and industry leaders on the proposals. Landlords will be hopeful that a deal can be reached in good time for the June quarter day.

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