Forfeiture beyond the Covid-19 moratorium

Looking beyond the current moratorium, what place will forfeiture have in the post Covid-19 commercial real estate market?

Rob Nicholson of Ashfords LLP and Andrew Walker QC of Maitland Chambers look to the future, considering the fine balance between the interests of landlords and tenants, and how the Government or the courts might mitigate the effects of the pandemic.

The speed with which Covid-19 has hit the global economy and the extent of its impact are both staggering. Whilst the world struggles to contain the virus, the Government has launched an eye watering support and stimulus package. The recovery phase for the UK economy is some way in the distance, when that time comes consumers will, no doubt, be cautious about spending what money they have, and social distancing will leave some wary of venturing out to leisure and retail venues and destinations. So, when we do enter that phase, it will no doubt start slowly and only pick up speed over time, as consumer and business confidence returns.

A crucial, and significant part of the UK economy is the commercial property market, from retail to office space, leisure to logistics, it is a part of every economic sector.

In the post-pandemic market, landlords and tenants will face huge challenges. Both will be suffering from a lack of cash, revenue and profits, whether caused by the inability to trade or falling sales or reduced rental and other income. Both are likely to be experiencing the shock effects of insolvency – of themselves or others.

The Coronavirus Act 2020

Parliament has already stepped in to try to "pause" the possible fallout from the economic downturn by enacting section 82 of the Coronavirus Act 2020 (which places a moratorium on new forfeitures until 30 June 2020). Although this puts a pause on new forfeitures in the short term, and the period of pause can be extended, it will do nothing to prevent forfeiture as soon as the period ends. It will not help tenants in financial difficulty hold on to their leases if landlords want to forfeit. The Government's financial support package for business may be a help to some tenants – and some landlords – but more borrowing needs servicing and many landlords and tenants already have keen margins and high levels of debt finance, leaving them little room to manoeuvre.

But is there really cause for concern? In difficult times in which demand by tenants for commercial property is likely to be significantly reduced, why would landlords forfeit? Indeed why would a landlord take any action against a tenant that might push it into crisis? Many retail landlords, in particular, are likely already to have too much vacant property on their hands, and be looking for new uses and occupiers for it.

There is no doubt much truth in that, but there are two compelling reasons to suggest that at least some landlords may act. The first is self-preservation. Landlords will need income; and if they cannot get rental income, they will need to realise capital. Lender pressure and financial covenant breaches may also drive a need to sell. Buyers with cash will be looking for bargains, and many will want development and change of use opportunities, not distressed tenants in declining sectors. There may be many situations in which it makes sense to secure vacant possession.

The second is profit – maybe not immediate profit, but in the medium term, as the UK economy recovers, values will increase again. A landlord may have a flagship commercial property, or a property that is the key to unlocking a wider development, which is occupied by a long-standing tenant in a declining sector who is protected by the Landlord and Tenant Act 1954. Any "normal" action to remove the tenant – using ground (f) perhaps – would bring about a significant statutory compensation payment. The tenant may have traded well historically and always paid its rent on time. It has a viable business, and will recover from the impact of Covid-19, but perhaps for the next 18 months to 2 years it will struggle to pay its full rent quarterly, monthly or with any regularity at all. Some landlords may be tempted to risk public or market opprobrium and take the opportunity to forfeit.

Both scenarios are realistic, and the Government needs to give careful consideration to the consequences of failing to address them.

Further intervention?

What form might intervention take? The moratorium on forfeiture might be extended, and landlords may be given similar breathing space by their banks. But what about beyond perhaps another 6-month blanket forfeiture moratorium? Might we see an ongoing moratorium, or a temporary regime for relief from forfeiture, for those who satisfy some sort of Covid-19 means test? How might that work in practice?

One possibility could be to implement a two-stage test for avoiding forfeiture, or achieving relief on more flexible terms, whenever the breach is connected with the tenant's financial position. Stage (1) might involve a broad assessment of whether the tenant's business (at a single property, or overall) was viable before the Covid-19 crisis. Any test would need to be at a fairly high level, and avoid prescription: the purpose would be to filter out those businesses that were likely to fail in any event. For those tenants who satisfy that test, stage (2) could involve assessing the impact of Covid-19 on the tenant leading to a schedule for the payment of rent arrears and future rent for a set period of years, based on realistic expectations of the tenant's gradual recovery, and balancing the interests of both the tenant and the landlord. It might also take into account whether a property is over-rented: for example, if the market rent is lower than the passing rent, then this might weigh in favour of re-scheduling the arrears over a longer period. Those tenants who make it past stage (1) of the test would thereby secure a moratorium or relief, and as long as they continue to meet the terms set, will not face the threat of forfeiture. If they default on the new terms, then they will the threat will reawaken. Those who do not meet stage (1) of the test will, in what will be seen by

some as harsh, either fail, re-locate or somehow agree terms with their landlord to remain (some of which may be the many "zombie" companies that were still managing to operate before the virus struck). Would this meet the need to balance the interests of both tenants and landlords? Possibly it will, at least if landlords are similarly provided with the ability to re-schedule their financial commitments with the banks and other lenders, giving them the freedom to reach sensible accommodations, or be forced to do so by the court. It may also be beneficial to a landlord if the alternative might be a standard CVA or administration; and we should not be forcing all businesses in difficulty down an insolvency route.

Beyond forfeiture

Forfeiture is really only the beginning of the puzzle, though. If landlords cannot secure possession whilst any extended moratorium is in place, might they simply sidestep this by using debt recovery action and forced insolvency? Again, something will be needed to control what steps landlords can take, and that might again need to be based on pre-Covid-19 viability and post-Covid-19 means testing.

The interaction with the insolvency regime would clearly need to be addressed. There is already room for aligning the relief from forfeiture and insolvency jurisdictions more closely, and for reviewing the operation of the CVA regime in relation to leases, and we are also likely to need temporary insolvency measures. There are signs that temporary measures may already be in the pipeline, but it is unclear whether they will allow enough flexibility, and ensure a satisfactory balance between landlords, tenants and other creditors.

Another area that may need attention is s.30(1)(b) of the Landlord and Tenant Act 1954: the persistent arrears ground for opposing a lease renewal. We may see courts deciding that the Act already gives them sufficient flexibility to act fairly where arrears have been caused by the virus or related Government measures, but clarity would be helpful and discourage opportunism. There will no doubt also be other areas that need to be considered as the full impact of Covid-19 becomes known.

Without legislation that caters for these direct and indirect financial consequences of the pandemic, too many of the very businesses that need to recover to create jobs or to allow people to return to work and to kick the economy back into life will simply not be there.

A role for the courts?

If the Government fails to legislate, can the courts respond? Procedural powers to adjourn court proceedings have already been used extensively, but there is a limit to this. Clearly a tenant can already apply for relief from forfeiture, and the court has a degree of discretion as to the terms on which relief is granted. The courts might decide that the discretion allows them to re-schedule the payment of arrears over a lengthy period, even in cases of ongoing non-payment, but the scope for this would need to be tested, and it may not be enough to prevent abuse by a landlord deliberately using re-entry and the cost of court processes to force out a struggling tenant. Even if courts were willing and able to make such orders, landlords will also still be entitled to their costs under the terms of most modern leases, adding yet further to the burden on these tenants.

The issue of a potential "windfall" to the landlord, highlighted in cases such as *Freifeld v West Kensington Court Limited* [2015] EWCA Civ. 806, is nothing new to the courts but it is hard to see

how this could be extended in any meaningful way to cover a tenant who is simply unable to pay or fight on because of the economic impact of Covid-19, other than by giving the tenant time to seek a disposal of its interest if it has value.

We fully expect the majority of landlords to do what they can to assist viable tenants, but we fear that the worst financial impacts of the pandemic will not be avoided unless the Government acts. Unless it can provide more direct financial support to enable commercial rents to be paid when due, we will need legislation to control the excessive use of forfeiture and debt recovery by landlords against tenants while arrears are paid over time, while ensuring that landlords have breathing space to accept this. Without intervention, when normal market forces resume, we can expect a surge in forfeiture and landlord and tenant disputes – and potentially litigation – which will undermine the economy's ability to recover.

More fundamental reform?

Some predict that there will be marked differences between the pre- and post-pandemic worlds. Even if they are wrong, the controversies arising out of recent CVAs have already brought the law relating to commercial property and insolvency into the political arena. Residential property law was already there. Might a Government looking to transform and kick start the economy be willing to consider more fundamental reform of the law affecting commercial property too? Might new levels of cooperation between landlords and tenants lead to market support for this? If so, then is now the time to deal with the many historic criticisms of the law of forfeiture? Reforms intended to simplify and clarify the law, and to encourage transparency and cooperation, may well look attractive and give the UK economy a better prospect of a healthy and speedy recovery. More immediately, they could facilitate a more effective and efficient recovery programme to mitigate the impact of commercial rent arrears.

A Law Commission working party first suggested reform as long ago as 1968. Reform was formally proposed in 1985. This topic was the subject of a further Law Commission consultation in 2004, leading to a further Report in 2006. The 2006 Report recommended a new statutory regime for dealing with the termination of tenancies following tenant default. In several of the Ministry of Justice's annual Reports on the Implementation of Law Commission Proposals, the Government has repeatedly promised to reach a conclusion on these proposals, along with several other property law proposals.. Progress on some – but not forfeiture – in 2015 and 2016 was overtaken by Brexit. That, too, may soon be "done", although perhaps not as soon as some have promised. Now might finally be the time to look again at implementing these, and other, Law Commission proposals for the modernisation of property law.

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