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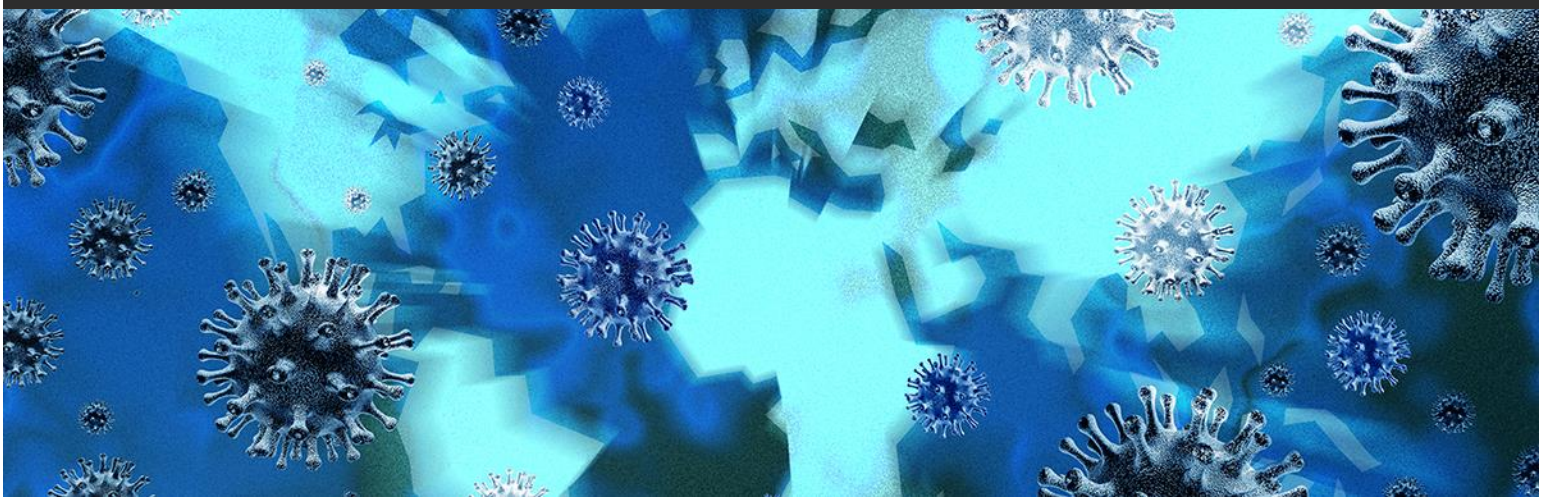
Alert | Health Emergency Preparedness Task Force: Coronavirus Disease 2019



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Lender Perspectives: UK Coronavirus Act 2020, Impact on LMA Real Estate Form Facility Agreement

During the Global Financial Crisis, borrowers who needed to refinance their maturing debts faced difficulty. Lenders had neither the appetite nor the ability to lend, save in limited circumstances. The income generated by commercial real estate assets often did not change, however. Businesses remained open and while some of them, particularly those related to the financial services sector, generated less revenue, that did not mean they were unable to pay rent to their landlords – indeed, the payment of rent was regarded by some as a more logical expense to bear in the expectation that business would normalise. Some tenants gave up surplus space by agreement with landlords, and some also sublet part of their space, but few failed to pay rent and were evicted.

Landlords and their lenders may find themselves in a different situation today.

This GT alert describes the relief given to tenants under the Coronavirus Act, 2020 (the "Act") and what that means, in certain respects, for landlords and therefore for their lenders under certain of the terms of the Loan Market Association (LMA) form of real estate facility agreement (LMA Form). In the description that follows, we use the terms "landlord" and "borrower" interchangeably.

The Coronavirus Act, 2020

The UK Government has recognised that the generation of operating revenues by businesses has been materially curtailed as a result of COVID-19 and the social distancing conditions imposed to combat the virus. Thus, Section 82 (1) of the Act provides that the right of re-entry or forfeiture, under a relevant business tenancy, for non-payment of rent may not be enforced by action or otherwise, during the relevant period. A "relevant business tenancy" is defined as one to which Part II of the Landlord and Tenant Act, 1954 applies or would have applied if any relevant occupier was the tenant. Section 23 of the Landlord and Tenant Act 1954 applies to any tenancy where the property comprised in the tenancy includes premises occupied by the tenant and are so occupied for the purposes of a business carried on by it for those and other purposes. For practical purposes this would cover the preponderance of occupational leases which are relevant in the context of a commercial real estate loan, such as occupational leases of office buildings, warehouses, shopping centres, as well as less mainstream real estate assets such as data centres and hotels. The "relevant period" begins on the date after the date the Act was passed (it received royal assent on 25 March 2020) and ends, for now, on 30 June 2020, though this may be extended.

While this rule is, consistent with the policy of the Act, designed to ensure that tenants are protected from eviction and so have the ability, at least in terms of the availability of their business premises, to continue their businesses after the current restrictions have eased, the rights of landlords are also recognised in that under Section 82 (2) of the Act, no conduct or action by the landlord during the relevant period will be construed as a waiver of their rights of re-entry or forfeiture (other than an explicit waiver).

The Act makes no reference to a tenant's ability to pay, whether by reference to the tenant's own creditworthiness or the creditworthiness of an affiliate or sponsor who is in a position to provide the tenant with credit support, however.

What this means under the LMA Form

The LMA Form recognises that a lender is one step removed from the occupational tenants of a real estate asset, and therefore imposes obligations on a borrower, enforceable by a lender against a borrower through the event of default mechanic provided by the LMA Form, to exercise rights against occupational tenants. At the same time, the LMA Form also provides a lender with some control and supervision over the actions that a borrower can take, recognising that actions taken by a borrower can have an impact on the cash flow generated by the real estate assets in a manner that could be prejudicial to the interests of the lender.

Rental collection

The first rule of note contained in the LMA Form is in the "Property Undertakings" section. Subject to amendments that may be made in the context of a particular facility agreement, this rule imposes on a borrower:

- an obligation to collect, or procure that there is collected, all "Rental Income" (a term defined in the LMA Form to cover all income generated by the occupation or use of a real estate asset);
- an obligation to exercise its rights and comply with its obligations under each relevant document relating to an occupational lease (the defined term that is used is "Lease Document"); and

- an obligation to use its reasonable endeavours to ensure that each tenant complies with its obligations under each Lease Document (which covers non-payment obligations, payment obligations having been dealt with in more absolute terms, by the obligation to collect or procure the collection of Rental Income).

While the Act negates the ability of a landlord to exercise its rights of re-entry or forfeiture during the relevant period, it does not by its terms negate the obligation of a tenant to pay rent, or the right of a landlord to require that rent be paid, other than by enforcing the right of re-entry or forfeiture (such as seeking damages against a tenant or commencing insolvency proceedings against it). Nor does the Act negate the obligation of the tenant to pay default interest on unpaid rent. Thus, if a tenant has the means to pay based on its own creditworthiness, or there is a rental deposit or a guarantee which a borrower can rely upon to obtain funds for payment of rent, the Act does not provide any protections to tenants or their guarantors. Lenders are therefore within their rights to require that payment of rent be sought by borrowers using contractual remedies or insolvency-related remedies, though borrowers may argue to the contrary. A lender may investigate with a borrower the credit position of each tenant and which of the borrower's tenants has provided a rental deposit or a guarantee which may be available for utilisation. In this regard, the LMA Form requires a borrower to provide a lender with a copy of each Lease Document.

Failure by borrowers to discharge these obligations will itself be an event of default under the rubric of the LMA Form. Even if a lender chooses not to accelerate a loan and enforce security, it may, depending on the terms of the facility agreement, be entitled to charge default interest or to transfer the loan without the restrictions that applied prior to the occurrence of an event of default.

Amendments to Lease Documents

The second rule in the LMA Form that is relevant, and which is also contained in the Property Undertakings section, is that which requires that a borrower seek the consent of the lender before entering into new occupational leases or amending the terms of existing occupational leases. While the provisions of the Act are, as described above, helpful for tenants, they are also narrow; therefore, as described above, a tenant is not relieved from its obligation to pay rent. This notwithstanding, some tenants may be approaching landlords either for deferments of the obligation to pay rent or, in more extreme situations, a cancellation of the obligation to pay rent for a period where its business has been interrupted because of COVID-19. A borrower should not be agreeing this without the consent of its lender, save for circumstances where its facility agreement specifically allows for this. During this health emergency, borrowers may be inundated with such requests and, in turn, inundate their lenders. In order to prevent this situation, particularly where the available staff of a lender are limited in number, it may be helpful for a borrower and a lender to agree parameters within which a borrower may grant relief to a tenant or a guarantor – the facility agreement may not have been prepared with a scenario such as COVID-19 in mind. This could, for example, allow a rent deferment or waiver up to a certain limit for a prescribed period of time.

Financial covenant tests

The third rule in the LMA Form that is relevant here relates to the interest coverage test, debt service coverage test or debt yield test. The numerator of all of these tests is the net rental income (or some variant of the same), and the tests are generally both backward-looking (covering a historic period and being based on rents actually paid) and forward-looking (covering a prospective period and being based

on rents expected to be paid in accordance with the terms of occupational leases). Given that the Act does not, in and of itself, grant any relief to tenants in terms of paying rent, absent a provision in a facility agreement excluding payment of rent by a tenant which is in arrears for a single rent payment period, a borrower could, with some justification, claim credit for rents that tenants are required to pay for the purposes of forward-looking tests, even though the borrower's ability to enforce such claims through the remedies of re-entry and forfeiture are compromised because of the Act. A lender may consider what the impact of rent holidays will be on these tests rather than allowing the borrower to report based on a "business as usual" situation. If the lender finds that the tests are or could become compromised, it should consider what additional means of credit support it might have access to. While a borrower may not be obliged to agree to a change which reduces the amount of credit it can claim, a lender will have some degree of leverage against a borrower given the obligation of a borrower to enforce rights under Lease Documents.

Moving forward, consideration may be given to whether the measurement of rental income for the purposes of these financial covenants should exclude rental income from tenants who have sought a rental holiday or against which rights under Lease Documents cannot be exercised.

Conclusion

Lenders and borrowers should take a practical approach to seek to manage their loan books efficiently and work with counsel to provide strategies that are realistic, both for them and for borrowers. Taking enforcement action in the strict sense may not be the best course, both in terms of managing a specific lending situation and in terms of the perception of an individual lender's franchise.

* *This GT Alert is limited to non-U.S. matters and law.*

For more information and updates on the developing COVID-19 situation, visit GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019.

Authors

This GT Alert was prepared by:

- Carol Hopper | +44 (0) 203.349.8765 | hopperc@gtlaw.com
- Ian Jack | +44 (0) 203.349.8700 | jacki@gtlaw.com
- Partha S. Pal | +44 (0) 203.349.8754 | palp@gtlaw.com
- Kady Hircock | +44 (0) 203.349.8750 | hircockk@gtlaw.com