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Alert | Real Estate

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Real Estate Debt and the UK Corporate Insolvency and Governance Act 2020 – The Moratorium

In late June 2020, the UK's Corporate Insolvency and Governance Act (the Act) became law.[1]

While the Act was passed in response to the Coronavirus Disease 2019 (COVID-19) pandemic and its economic ramifications, it represents a significant legislative step forward in promoting the "rescue culture" in respect of financially distressed business enterprises, a policy objective that goes beyond COVID-19. The rescue culture, is, in essence, the theory that it is better to provide the existing management of a distressed business enterprise the opportunity to remain in control of it without the pressure of action by creditors, so that existing management can find a solution to the distress affecting the enterprise, thus optimising the position for all business stakeholders: employees, trade creditors, financial creditors, existing management and, indeed, existing equity holders.

For those who have grown used to the UK being a "creditor-friendly" country where the rights of creditors, be they financial creditors, trade creditors or indeed landlords, are respected, the Act is a significant change, requiring reconsideration of the contractual bargain struck between the relevant parties.

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[1] *See* GT Alert, "The Corporate Insolvency and Governance Act 2020: Changes to UK Insolvency Laws," Aug. 10, 2020.

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This GT Alert relates, in the main, to the concept of the moratorium (the Moratorium), which is central to the architecture of the Act and the achievement of its policy objectives.

The Traditional Approach to Real Estate Finance in the UK

At its most elemental, a real estate finance transaction is fairly straightforward; the borrower, which is typically the owner of a commercial real estate asset, such as an office building, that generates a cash flow through tenants paying rent, borrows money from a lender - historically banks but now a variety of types - typically by way of a loan and provides the lender with security over the real estate asset being financed using the loan and the cash flow it generates, among other things.

Payment of interest and repayment of principal to the lender is made using the cash flow generated by the asset and, if there is an event of default in respect of the loan, as contractually defined in the credit agreement, the lender can enforce its security, taking control of the asset and the cash flow immediately and disposing of it, or the share capital of the entity owning it, so as to recover the amount owed to it by way of principal, interest, expenses and fees. This action may be taken through the appointment of a receiver and without a need for a lender to seek the support of the court. The receiver is empowered, both by contract and by statute, to take control of the asset on behalf of the lender and ultimately dispose of it. There are also other options, such as administration or altering the bargain between lender and borrower on a consensual basis, in the event that the borrower does not perform its side of the bargain.

There are, of course, many subtleties and nuances that supplement this relationship, but this is the "core" bargain between borrowers and lenders. Lenders have long operated within the comfort of a legal environment where security can be enforced to enable them to achieve recovery without material disruption; borrowers have equally proceeded with the understanding that if there is an event of default, security can be enforced to dispossess them of the assets being financed and, quite possibly, to deplete or destroy their "equity value" (the difference between the value of the assets and the debt secured by them) because the lender is only required to recover the "best price reasonably achievable" for the asset. In practice, lenders and borrowers recognise that the enforcement of security is not necessarily in either of their interests and a consensual resolution of an event of default, derived from an analysis of why the event of default has arisen and finding a commercially sensible solution so that the same event of default does not arise again, is the most effective way forward. However, lenders ultimately have the benefit of the security interests they have bargained for in order to recover amounts owed to them.

In recent years, there has been a trend towards real estate becoming an "operating" asset. This may be illustrated by the difference between a conventional office, where tenants occupy specific areas and pay a periodic rent, with the landlord providing maintenance services both in respect of the tenant occupied areas and the common areas such as lobbies and lifts and a co-working office, where the landlord provides a range of hospitality services (including, in some cases, restaurant quality food and beverage offerings), business services (such as access to administrative support and document production), and business development services (such as networking events or guest lectures). These services are often provided by an entity which is different from but affiliated with the entity that owns the commercial real estate asset where the co working space is housed. This is known as the "operating company – property company" or "OpCo-PropCo" model. In the OpCo-PropCo model the OpCo has a range of creditors related to the running of the business. It also has as a significant creditor, the PropCo, with which it will have a long-term lease to occupy the asset and in respect of which it pays rent to the PropCo (in a sense, like a single tenant occupying a conventional office building). The PropCo, in turn, will typically have a limited number of creditors. The most prominent of these is the lenders which have financed the acquisition and development of the property.

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There are a variety of operating asset real estate businesses. Examples include care homes and other senior residential accommodation; purpose-built student housing; and build to rent housing and co-living. While not all operating property businesses are organised using the OpCo-PropCo model, many are. Even where a single entity is used both for property ownership and the provision of services, there will be a variety of creditors because the differentiating factor between traditional commercial real estate assets and operating real estate assets is that the latter offers amenities for tenants – the industry parlance being "amenitisation" – and the provision of amenities involves third parties making supplies.

What is important to appreciate, however, is the essential linkage between the operating side of enterprises of the types described above and the property side: if there are trade creditors on the operating side of the business that are unpaid, it is open to them to enforce their claims or commence insolvency proceedings against the debtor they face. This may result in the occurrence of an event of default under the financing arrangements, either directly, where an OpCo-PropCo structure is not used or because such action against the OpCo will itself be prescribed as an event of default under the financing arrangements.

The New Approach under the Act

The Act changes the traditional approach that creditors have enjoyed in the UK through the introduction of a new kind of moratorium which will be available in broader circumstances than moratoria which might previously have been invoked by debtors or otherwise applied following commencement of formal insolvency (e.g., on administration, another more long-standing form of insolvency process available under the UK insolvency legislation).

We examine the Moratorium in more detail below but, in essence, and subject to certain limitations, in the context of a real estate financing transaction, one element of it is particularly important; the Moratorium imposes restrictions, while it is in force, on creditors taking enforcement action against debtors or commencing insolvency proceedings against them in respect of debts that have arisen before the commencement of the Moratorium. This is described in the Act as a "payment holiday" in respect of pre-moratorium debts. By providing the payment holiday, debtors are provided with "breathing space", and, acting through their existing management teams but subject to the oversight of a third party known as a "Monitor", are provided with a period of time to devise an alternative resolution strategy, designed to return them to going-concern status. The Moratorium, however, does not allow debts to be written off nor does it provide any protection in respect of payment obligations that arise after and while the Moratorium is in effect.

There are two ways in which debtors can seek a Moratorium:

1. Where a debtor is an English company (not an overseas company) which is not subject to an outstanding winding-up petition, the directors of the company can apply for a Moratorium by filing with the court certain documents. These are: a notice that the directors of the company wish to obtain a Moratorium; a statement from the Monitor that they are qualified and willing to act as the Monitor in respect of the company in accordance with the Act; a statement that the company is an "eligible company" under the terms of the Act; a statement that the company is, or is likely to become unable to pay its debts; and a statement from the Monitor that if the Moratorium came into effect it is likely that the company would be able to continue as a going concern (the "First Route"). The First Route does not involve the exercise of any judicial decision-making power by the court but rather the delivery of documents that comply with the requirements specified in the Act.

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2. Where a debtor is an English company that is subject to a winding-up petition, or is an overseas company, the directors may apply to the court for a Moratorium (the "Second Route"). The Second Route does involve the exercise of a decision-making power by the court. If it is to make an order imposing a Moratorium, the court must be satisfied that the imposition of a Moratorium would result in a better result for the creditors of the company as a whole than if the company was wound-up (i.e., liquidated and hence ceasing to trade).

Under both the First Route and the Second Route, the Moratorium will not be available to a company that is not an "eligible company" for the purposes of the Act. A company will be an eligible company, unless it is an "excluded company". An excluded company is one which has its own insolvency regime such as a bank or an insurance company. A company that has issued at least £10 million in debt capital market instruments which has certain characteristics will be treated as an excluded company, thus preserving the sanctity of capital markets funding. However, as a general statement, a company that is established for the purpose of owning and operating commercial real estate and that is financed by bank or alternative lender loans, as is the current norm in the UK real estate market, will not be an excluded company. The Moratorium may thus be thought of as a statutory standstill period; while debts will not be written off, creditors cannot, during the period of the Moratorium, initiate insolvency proceedings or take enforcement action in respect of security granted by borrowers – a fundamental change to the core contractual bargain outside of formal insolvency.

Loans, however, are given special treatment under the Act.

If a borrower under a commercial real estate loan obtains a Moratorium, it will be entitled to the protections of the Act in that the lender cannot commence enforcement or insolvency proceedings while the Moratorium is in effect. This disrupts the traditional lender-borrower bargain and prevents the lender from appointing a receiver or taking any other action that would ordinarily be open to it. However, the Act has left open a way for lenders to be able to re-assert the traditional bargain.

In commercial real estate financing arrangements, the application by a borrower for any form of debt relief or enforcement protection will generally result in the occurrence of an event of default. This allows the lender to accelerate the loan, meaning that the lender is entitled to require all amounts owed to it to be paid immediately. Thus, if a debtor who is a borrower under a typical real estate loan agreement seeks a Moratorium, it runs the risk of its loan being accelerated. The special treatment accorded by the Act to loans requires the borrower to make payment of the accelerated amount, even though the loan was entered into before the Moratorium. Unless it had the means to be able to pay the accelerated amount (for example through the committed support of a well-capitalised sponsor or other form of committed financing), the Monitor is duty bound to bring the Moratorium to an end, following which the bars on taking proceedings or enforcing security are lifted. This means that the Moratorium may only be useful in the context of a traditional real estate financing where there is a means of dealing with a lender which accelerates a loan.

Where the Act becomes more useful is in the context of operating real estate assets. The special treatment accorded to loans does not apply to trade debts. Thus, in the context of the co-working example described above, assuming its income has been reduced, the Moratorium may be effective to prevent suppliers taking enforcement action in respect of pre-moratorium debts or commencing insolvency proceedings. It may also be effective in respect of pre-moratorium debts that may have arisen in respect of development or construction work, or fixtures and fittings that have not been paid. If these debts have been incurred by the OpCo in an OpCo-PropCo arrangement or by the entity that owns the real estate itself, the Moratorium may provide breathing room. However, there will still be a need to deal with the "acceleration risk". Unless there is a source of committed liquidity, this will necessitate the implementation of

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contractual standstill arrangement with the lender. Any lender may be more willing to enter into a standstill where it is to be used in conjunction with a Moratorium, given the ongoing risk in standstills that all the good work of the lender and the borrower will be undone when a trade creditor takes hostile action, imperiling the continued operation and solvency of the debtor.

The Length of the Moratorium

The initial period prescribed under the Act for the Moratorium is short – 20 days (the "First Moratorium Period"). The Moratorium may be extended for a further period of 20 days by the directors filing certain documents (the "Second Moratorium Period"). While it would be brave to think that any situation with a degree of complexity involved could be resolved within 20 days, a combined 40-day period could, however, be more realistic in terms of at least formulation if not implementation of more involved resolution plans. There is, of course, the possibility that plans could be formulated by debtors before the First Moratorium is applied for.

The Moratorium may be further extended through agreement with creditors and, most interestingly, by way of application to the court. In considering any such application, the court is required to weigh the interests of the creditors of the company and the possibility that the company will, given the extension, once again become a going concern. This goes back to the promotion of the rescue culture.

When Can the Moratorium Actually Be Used?

We are, of course, in the world of conjecture. However, the following guiding principles are worthy of consideration:

1. The Moratorium process cannot be initiated by a debtor to frustrate the contractual bargain struck with their lenders and can only be used where an enterprise can be returned to going-concern status nor can it be used to keep "zombie" enterprises alive. The involvement of the Monitor in the process is relevant in this context.

2. The possibility of an enterprise being returned to going-concern status is greater when that enterprise faces a short term "liquidity" situation (where it cannot pay its debts immediately but will, or at least expects, to be able to pay its debts in full as its business position improves) than when it faces a "credit" situation (where it will never be able to pay its debts in full because its business situation has fundamentally changed, either for idiosyncratic reasons (i.e., factors affecting a specific debtor) or for sectoral or systemic reasons (for example, some areas of traditional retail). Thus, in the context of the co-working example, the liquidity position of the debtor would be impacted if the income of the enterprise had been affected for a temporary reason such as the impact of COVID-19 or in order to generate additional income certain investments have to be made and which the debtor has an ability to finance. In the context of a retail asset, the position may be different, as retail, as an asset class, has been subject to a fundamental business change in recent times.

3. Borrowers may be able in the time allowed to resolve short-term liquidity issues. This might typically involve a well-conceived asset management and operating plan and a source of additional capital to enable that asset management and operating plan to be achieved. There are lenders who are in the business of providing transitional capital.

4. If there is a risk of a loan being accelerated, the debtor will, unless it has committed sponsor support, need to enter into a contractual standstill arrangement in respect of the loan.

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As a further example, assume that a debtor has developed a student accommodation asset. The asset is located in a town with a high student population and with less supply for student housing than demand. However, because of classes being undertaken online for COVID-19-related reasons, uptake has been slower, and the borrower is unable to pay suppliers for fixtures, fittings and equipment. This is a liquidity situation, as contemplated above, because it is a legitimate expectation on the part of the debtor that, as COVID-19 recedes and classes revert to a conventional format, its business will normalise. It would be a credit situation if the universities in the town had been forced to close, and so the business plan on which the asset had been developed was no longer viable. If the debtor could raise some form of subordinate financing to enable it to service its existing debts and meet its operating liabilities until normality returned, it would be able to achieve going-concern status.

The Act, of course, has many other provisions which are relevant to real estate financings. However, because of the special treatment given to loans, and because of the right of lender to accelerate a loan when the Moratorium is entered into, lenders may still have the ability to re-assert the traditional lender-borrower bargain if it is in their interest to do so. However, the Moratorium may prove a useful tool for borrowers and lenders alike and serve to promote the rescue culture which is the policy behind the Act where it is used in conjunction with standstill arrangements, if needed.

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

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