Katten

HOSPITALITY ADVISORY

COVID-19: Real Estate Issues – Lease Provisions

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Katten has set out some considerations applicable to hotel or serviced apartment businesses that are held and operated by way of a lease, with the tenant as the operator.

How Should Rent Payment Problems Be Addressed?

Many tenants are experiencing severe cash flow problems and, where landlords are willing to assist or, indeed, are in a position to assist given their own cash flow pressures, we have been discussing with clients a range of ways in which assistance can be given, such as:

- allowing monthly rent payments;
- rent suspension (rent holidays) with amortisation of the suspended rent over the balance of the term;
- rent suspension with an extension of the lease term;
- rent suspension with adjustment to break dates; and
- accessing rent deposits by agreement with obligation to refund the deposit later.

Whatever is agreed, it should, of course, be clearly documented: for the landlord, so that there is no risk that the landlord's short-term conduct amounts to any kind of permanent waiver of the right to accept the rent, or a variation of the lease; and for the tenant, to help it be clear that it can keep trading (particularly in the context of directors' liabilities if a business continues trading whilst insolvent).

How this is documented depends upon what is agreed. For example:

- A simple rent holiday with future repayment can be covered by a side letter signed by the landlord and tenant — and where relevant any guarantor to the tenant.
- Changes to break dates or term extensions will need a deed of variation and, perhaps, a reversionary lease. Note that a term extension will incur a Stamp Duty Land Tax (SDLT) liability for the tenant.

Of course, for some landlords, there are other considerations to think about in deciding whether to help a tenant or, for that matter, being in a position to. For example:

- If the landlord has borrowings on the property, can it afford to let the tenant have a rent holiday unless the landlord equally has a holiday from paying interest?
- Does the business plan for the asset mean that it would help the landlord if the landlord regained possession of the premises (i.e., should the landlord seek a surrender (or even let the tenant fail))? This might be opportunistic in a situation where the landlord could take over, for example, a hotel business or opportunistic where a redevelopment opportunity could be accelerated by obtaining early vacant possession.
- Does the landlord need the tenant's income to support its wider group position?
- If the landlord does not help the tenant get through and ultimately gets possession of the property back through insolvency or forfeiture, what void costs will be inherited? (E.g., the rates liability.)
- Some tenants may try to use coronavirus as an excuse for a business already failing in any event.

And, of course, the landlord should consider that if the tenant has multiple rented properties, and only a few landlords give a `*rent holiday*', is there any point in these few landlords doing so if, overall, the tenant will go under because it cannot secure rent holidays across the board?

What Are the Landlord's Remedies for Non-Payment of Rent by Commercial Tenants?

Leaving aside any sensitivities around taking action against non-paying tenants in the current environment, which would need to be judged on the specifics of the landlord/the property, a landlord's rights to pursue non-payment of rent by, forfeiture, statutory demand, issuing proceedings or through the Commercial Rent Arrears Recovery regulations (which replaced distraint), are to a greater or lesser extent impacted at the moment by the following:

- **Forfeiture:** The UK Government enacted emergency legislation (the Coronavirus Act 2020) on 25 March 2020 that, amongst other things, creates a three-month moratorium on landlords' ability to forfeit most commercial property leases (but not most leases for terms of less than six months) for non-payment of rents or other sums, including service charges and insurance rent in England, Wales and Northern Ireland. These measures will last until 30 June, with an option for the Government to extend if needed. This does not suspend the right to rent or other payments, just the landlord's right to forfeit the lease for non-payment until the moratorium ends.
- **Commence court action:** As its stands, the Courts are open at the moment, so proceedings can be issued and hearings can take place by telephone and even, in some cases, by video. But, in practice, these could be limiting if, for example, parties are unavailable due to the current situation, even illness. The realities are that no proceedings issued at the moment are likely to achieve a hearing date before several months' time in any event.

Business Rates

For some businesses, there is help in terms of business rates. From 1 April 2020, there will be a 12-month rate-free period for all hotels, guest and boarding premises and self-catering accommodation. There is no Rateable Value limit, however, the relief will be applied to occupied properties only.

Break Options

- **Landlord breaks:** The recent emergency legislation relating to the prevention of forfeiture, does not, as far as we are aware, prevent a landlord from exercising a break during the three-month forfeiture suspension window.
- **Tenant breaks:** Tenants will have a number of considerations, and the question of what conditions (if any) need to be complied with in order to successfully operate a break clause could be a problem. Two obvious conditions, which may be a problem to comply with at this moment, may be:
  - Payment of rent – does the tenant have the cash flow to make payments?
  - Vacant possession – this not only means free from occupiers, but also free from any fit out and fittings. Given the current difficulty in attending places of work, or obtaining contractors or workmen to undertake works, this might be difficult for tenants to comply with.

Coronavirus Clauses

These are starting to appear. We have seen them in draft leases covering rent suspension whilst a property is closed during pandemics, epidemics and other national health emergencies. Whether landlords will be willing to accept them, or lenders willing to fund properties where leases have them, may well depend on whether the insurance industry starts to insure the risk.

COVID-19 Operational Contract Issues

Hotels and serviced apartments are often individual operating businesses with many stakeholders including investors, lenders, third party operators and franchisors, as well as many issues to consider concerning licences, permits, vendor relationships, marketing programmes and so on. The various stakeholders and their varied interests make for complex solutions following the effect on the business of a global pandemic. Any stakeholder taking a unilateral approach, without considering the effect on the other stakeholders, may find the business's value quickly evaporate. For instance,

what value would the underlying real estate have to a lender if in enforcing its security it loses the property's brand and professional management (which by some estimations can raise or lower the nominal value of a hotel by 25 percent or more)?

A couple of relevant provisions from long-term hotel management agreements/franchise agreements are explored below, which could assist in keeping the business afloat during the pandemic.

Force Majeure

The question of whether any lease or operational contract can rely on the concept of *force majeure* (i.e., unforeseen circumstances which prevent performance of a contract) has been widely debated recently in the legal industry. The position is that unless a contract contains provisions which allow some adjustment due to force majeure, it will not, as the law currently stands, be implied.

You do not typically see force majeure provisions in sale contracts or leases — although leases and other documents, in particular services documents, may contain caveats in relation to the performance of services or some other obligation where prevented by '*circumstances outside [a party's] control*'.

However hotel management and franchise agreements usually expressly include force majeure provisions. The effect of force majeure would be the grant of an extension of time to the parties to perform their obligations, equal to the period of delay caused by the disruptive event. Firstly in the light of the coronavirus, please check that 'pandemics' or 'epidemics' are included in the definition of 'force majeure' in your management/franchise agreement. If so, COVID-19 would probably be captured and, therefore, afford the party/parties claiming force majeure, the requisite extension in time. The performance test provisions of hotel management agreements usually deem an event of force majeure to be an 'intervening event' in the assessment of the hotel's performance, and in any such year in which performance is materially and adversely affected by such an event, the performance test for the applicable year would be deemed to have been passed. The operator should check the provisions of their management agreement to check that this useful provision is in place, which would offer them protection from owner termination. Owners and franchisees should also be aware that some hotel management agreements may indicate that force majeure does not affect the obligation of the parties to make payments of money — therefore even if the hotel temporarily closes due to the effects of the coronavirus, the hotel manager's/franchisors' fees will still need to be paid (giving rise to an insurance consideration, as examined below). If the hotel is still under development, it is probable that the technical services agreement would allow for similar force majeure provisions to those above, allowing an extension of time during the construction and fitting out period. However, the management agreement may specify an ultimate backstop date beyond which the operator would be entitled to terminate the agreement, to prevent force majeure indefinitely prolonging the development stage — again the appropriate provisions of the contract should be reviewed on a case by case basis.

In England and Wales, the concept of force majeure is not defined in statute or case law and will not, consequently, be implied into a lease. If the practical effect of COVID-19 is to prevent performance of a contract, then it probably is a *force majeure* event. However, in order to rely upon 'force majeure', a party must be able to demonstrate that it was otherwise willing and ready to perform/continue to perform its obligations under the relevant agreement, had it not been for COVID-19.

Frustration

The possibility in terms of the status of a contract, including a lease is that a party could assert that COVID-19 has '*frustrated*' the contract, and therefore the contract should be repudiated. Frustration is an English law concept, which (unlike force majeure) **can** be implied into contracts. A contract would be deemed frustrated if something occurs after it has been entered into, which:

- is not the fault of either party;
- has not been expressly provided for in the contract; and
- would render further performance of the contract either impossible to fulfil, illegal, or the contractual obligations become something radically different.

Frustration has a narrow application however, and, although each case would be assessed on its facts, it is unlikely the English courts would rule in favor of a party claiming frustration due to COVID-19, unless time was so '*of the essence*' that the obligations could never be performed at a later date. Indeed there are no reported cases of frustration applying to leases. Where force majeure provisions are included in the contract (as set out above in respect of hotel management and franchise agreements), the contracting parties should use the certainty of these provisions over frustration.

Insurance

The government-enforced lockdown has given rise to a number of considerations in respect of the insurance provisions of business leases and operational contracts:

Business interruption policies

- Firstly, tenants (under leases) and owners/franchisees (under hotel management/franchise contracts) may have procured business interruption policies, but successful claims under these are usually linked to actual property damage. The specific wording of insurance policies will need to be checked to ascertain whether parties can claim under them.
- Landlords also will need to review their insurance policies to ascertain whether loss of rents/business interruption losses will be recoverable, notwithstanding, that it may be difficult to evidence physical damage to the property. Hotel management agreements will usually oblige the owner to place business interruption insurance for all risk perils as reasonably determined by the operator, to cover at least two years' loss of profits and expenses for interruption to the hotel. Given the effect of the current pandemic, going forward, operators should specify that such business interruption insurance should pay-out further to similar epidemics. Compulsory closure of the property, further to the government-induced shut-down, is likely to constitute an insurance trigger.
- Since COVID-19 has been declared a "*notifiable disease*", the Association of British Insurers (ABI) has commented that it may be possible to buy consequential business interruption cover for '*notifiable diseases*' as an extension to a business insurance policy. This formal classification required by many insurance policies may enable those tenants and hotel owners (as applicable) with business interruption cover to make a claim under the insurance policy.

Unoccupied premises

Tenants of '*non-essential*' businesses have closed and in most cases vacated their properties given the current trading climate/government direction. Hotel owners and operators (and franchisees/franchisors, as the case may be) have also come to the decision to temporarily close their properties given the effect that international quarantine has had on hotel occupancy figures. In such instances, landlords (and owners/operators, franchisees/franchisors) should consider the security and safety of the property, firstly to protect the asset from deterioration whilst being closed, and secondly especially since building insurance policies typically specify security and inspection conditions where properties are long-term unoccupied (typically 30 days, but can vary).

Landlords and hotel owners/franchisees should contact their insurers as soon as they close the hotel, or become aware of a tenant vacating the property (as applicable) and in particular, check their security/inspection obligations.

In respect of properties that have been left unoccupied, landlords of leases (and hotel owners) should limit the likelihood of damage by implementing some practical measures (e.g., unplugging unnecessary electrical equipment, ensuring there is no post accumulation from street facing letter boxes which could be a fire hazard, securing the property and any outside bins, avoiding external accumulation of combustible materials near buildings, employ security companies or a slimmed down asset management team) to ensure the preservation of the hotel's quality and safety.

Conclusion

Given the multiple problems and issues which could arise if a large number of stakeholders were to try to immediately protect their own interests further to a COVID-19 induced hotel/serviced apartment business casualty, it would arguably be far more beneficial for all concerned to protect the longevity of the business by allowing it to be temporarily parked and to limit its operating costs and expenditures using some of the ways discussed above. The contracting parties

should (1) agree to make a claim of force majeure; (2) notify insurers and proceed to make claims after checking the details of their policies; and (3) arrange appropriate security measures to ensure the safety and preservation of the hotel/serviced apartment asset whilst operations remain paused throughout the pandemic.

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