Property / Landlord & tenant

Landlords beware

Mark Leonard on how landlords should deal with struggling tenants

IN BRIEF
- Occupational tenants are increasingly likely to encounter financial difficulties.
- A landlord may wish to employ a variety of strategies when such situations arise.

As the credit crunch enters its next phase and the recession begins to bite, landlords are likely to find an increasing number of their occupational tenants getting into financial difficulties. The nature of these difficulties and/or the manner in which they can be resolved will have an impact upon and be affected by the terms of any banking documents into which the landlord entered in order to finance its purchase of the property.

Delayed or non-payment of rent

The clearest sign of a tenant’s financial difficulties is the non-payment or delayed payment of rent. At its extreme, this could result in the landlord being unable to service its debt, thereby entitling the bank to accelerate the loan and enforce its security over the property. In practice, in relation to multi-let properties, unless a large tenant or several smaller tenants have failed to pay their rent, the landlord will usually have sufficient income from its remaining tenants to service its debt. If a substantial amount of rent is delayed only by a few weeks, the landlord may still find that this does not impact upon the servicing of his bank debt, on the basis that the next interest payment date could be as much as one month after the relevant rental payment date.

Breaching banking documentation

Interest cover covenant

Even if non-payment of rent by tenants does not impact upon the landlord’s ability to service its debt, it may result in the landlord being in breach of his financial covenants under the banking documents. Invariably, the loan agreement will contain an interest cover covenant, whereby the landlord is obliged to confirm, usually every quarter, that the net rental income received or receivable in respect of the property for a particular period has not or will not fall below a certain percentage of the interest payable for that period under the banking documents. The test can be historic, eg by reference to the last 12 months of rent/interest, and/or prospective, eg by reference to the next 12 months of rent/interest. Where the test is prospective, an estimate will need to be made of the net rental income likely to be received during the forthcoming period. In making this estimate, certain adjustments would be made.

For example, the loan agreement would often exclude any net rental income payable by a tenant which is already in arrears on its rent on the basis that it is reasonable to conclude that no rent is likely to be paid by that tenant under that lease for the forthcoming period. However, a borrower-friendly loan agreement might purport to “add back” such rent even if the tenant is in arrears, provided that, for example, it continues to be paid by a guarantor or is payable under a loss of rent insurance policy or if the landlord has the benefit of a rent deposit which he can apply for that year.

In addition, prospective net rental income would often be reduced by the amount of any ground rent, rates, service charges, insurance premium and maintenance costs which have not been fully funded by the tenant to the extent required under the lease documents.

So, the fact that one or more tenants is in administration, liquidation or financial difficulties may result in the landlord being in breach of his interest cover covenant. Could the bank then immediately accelerate the loan and enforce its security over the property? Not necessarily, on the basis that the agreement may entitle the landlord to cure the breach by, for example, depositing monies with the bank within a specified time following the breach.

Assuming that the landlord can find the requisite funds within the time-period, how much will he need to deposit to cure the breach? Ultimately, the devil is in the drafting. A borrower-friendly loan agreement would typically provide that such funds are deemed to comprise “net rental income” for the purposes of complying with the covenant but a less borrower-friendly agreement would provide that the funds are deemed to reduce the underlying loan, thereby requiring a greater amount of cash to be deposited in order to cure the breach.

If the landlord cures the breach and then finds that he is in compliance with the interest cover test on the next test date, is he entitled to the return of the funds which he deposited to cure the previous breach? Alternatively, if the landlord is still in breach of the same covenant on the following test date, can he cure...
that breach again and, if so, can he take into account the money which he had deposited to cure the previous breach or will he need to inject fresh funds? Ideally, the banking documentation should address these issues but in practice many agreements will be silent.

**Loan to value covenant**

The liquidation or administration of a tenant may also fundamentally affect the value of the property and could lead to a breach of the loan to value threshold in the loan agreement, entitling the bank to accelerate the loan and enforce its security, subject, again, to any cure right which the landlord may have. Any cure right would typically entitle the landlord to deposit monies into a blocked account but these would usually be deemed to reduce the loan so as to comply with the loan to value covenant and could require a substantial injection of funds in order to ensure that the breach was cured.

**Dealing with a struggling tenant**

If a tenant gets into financial difficulties, a landlord may wish to employ a variety of strategies. For example, it may wish to forfeit the lease at the first sign of a breach by the tenant. This may be desirable where:

- the landlord believes that there is a reasonable prospect that the tenant will go into administration, following which the landlord would be barred from forfeiting the lease in the absence of approval from the court or the administrator;
- the landlord has an alternative tenant ready to move in (unlikely in the current market); or
- the rent payable under the applicable lease is below the market rate and the landlord believes that it will be relatively easy to find a replacement tenant (again, unlikely).

Alternatively, a landlord may prefer to strike a deal with its tenant in order to keep it in occupation. This approach may be desirable where it would be difficult to find a replacement tenant and where the landlord believes that the nature of any deal struck with the existing tenant would prevent it from going into administration. Deals could include:

- accepting rent on a monthly, not quarterly, basis so as to enable the tenant to manage its cash-flow;
- accepting reduced—or, indeed, no rent for a limited period;
- agreeing that part of the rent be based upon the tenant’s turnover thereby falling during the recession but increasing when business improves;
- surrendering the lease and granting a new one to a third party;
- relaxing the provisions relating to assignment, under-letting or sharing possession; or
- agreeing not to provide service charge services which the tenant no longer regards as essential.

**Is the bank’s consent required?**

The landlord may find that the terms of his banking documentation will prevent or restrict him from carrying out his preferred or, indeed, any strategy with the occupational tenant.

The landlord should check his banking documentation to find out whether bank consent is required. It is not unusual for the banking documentation to prohibit or restrict the grant of new leases, the forfeiting of existing ones, the grant of surrenders/ waivers or amendments to leases, the assignment of a lease or reductions in the rent. However, some loan agreements may water down these restrictions such that they may not apply to, for example, leases with an annual rental income below a specified amount. Ultimately, whether consent is required will depend upon the underlying documentation. For example, a landlord, whose tenant has asked to pay rent on a monthly basis may find that his banking documents only prevent the reduction in the amount of the annual rent payable. If that is the case, he may still need to ensure that he receives three months’ worth of rent between each interest payment date under the loan agreement in order to ensure that sufficient rental income reaches him in time to meet his quarterly interest bill.

If bank consent is required, from whom must it be obtained? The landlord may find that the loan has been transferred, possibly without his knowledge, to one or more lenders, including hedge or vulture funds, with whom he has little or no working relationship. Alternatively, the loan may have been securitised such that, whilst the landlord is dealing directly with a loan-servicer in relation to consents, the servicer may ultimately need to obtain the consent of a percentage of bondholders whose underlying identity is unknown.

If the loan agreement has been syndicated, it may provide that the consent of all lenders is required or, perhaps, just the consent of the agent. Even if the agreement appears to require only the consent of the agent (with whom the landlord may have the best working relationship), the agency provisions of the agreement would typically require the agent to act in accordance with the instructions of the majority lenders. Majority would typically mean those banks who hold two thirds of the loan/commitments.

Either way, the landlord may find that he needs to persuade more than one entity to consent to the arrangements—and those entities may see this as an opportunity to extract fees as a condition to their consent.

If consent is required, must the bank act reasonably? As a matter of English law, there is no overriding principle that persons must act reasonably (or not act unreasonably) in exercising their discretion under contracts. However, it does at least appear that judges are leaning towards finding the equivalent of a “good-faith” clause in many more contracts than in the past and the requirement that any discretion shouldn’t be exercised whimsically.

In *Gan Insurance v Tai Ping Insurance* [2001] EWCA Civ 1047 Lord Justice Mance said in relation to Gan’s contractual right to refuse its approval under a reinsurance contract, that withholding approval should only be “exercised in good faith after consideration of and on the basis of the facts giving rise to the particular claim and not...with reference to considerations wholly extraneous to the subject matter of the particular reinsurance or arbitrarily”.

The loan agreement itself may require the bank to act reasonably (or not act unreasonably) in exercising its discretion whether or not to grant consent. Moreover, the loan agreement may contain a “snooze and lose” clause whereby, if any bank within a syndicate does not grant or refuse consent within a specified time-period, its participation in the loan will not be counted in determining whether the requisite majority of banks had consented to the proposed action.

While a landlord may believe that both his and the bank’s priorities should be aligned in taking whatever action best preserves the value of the property, it may be that the bank has a different perspective. In today’s climate, a sensible landlord will need to keep one eye on his tenants and one eye on his bank. Knowing what is in his banking documentation will enable the landlord to understand the full impact on him of the financial difficulties of the tenant, to ensure that he is not caught by surprise by his bank and to develop a strategy which is more likely to lead to a satisfactory outcome in the long term.

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