TENANT DEFAULT

By Simon Hardwick, Head of the London Real Estate Team and
Paul Marco, National Head of Property Litigation at Halliwells LLP

The dire forecasts of retailers' blood on the High Street may have receded with positive trading statements from some of the major multiples. Nonetheless, landlords are bracing themselves for more bad news after the pre-Christmas collapse of Unwins and last week's failure of Sock Shop (again!). Rumours of difficulties at discount furniture retailers are continuing to spook the market. Against this background, institutional and private investors with retail property in their portfolios have to confront the question of what to do if their tenant goes bust.

Avoiding Trouble

Despite the strong performance of property as an asset class in the past few years, it involves risk, which needs to be evaluated and managed. One of the most significant and obvious risks is the loss of the tenant. It is therefore essential for investors to carry out, prior to purchase, the same level of due diligence on the tenant's financial standing as a prospective landlord would when granting a new lease. This basic precaution should minimise the risk of investors ending up in the same position as some of the purchasers of the freeholds of Unwins' stores, who bought properties only days before the company went into administration.

The Warning Signs

It is unusual for the insolvency of a retail tenant to be wholly unexpected. The warning signs often include one or more of these features:

- Delay in filing accounts;
- A deteriorating picture shown by the publicly available financial information;
- Low stock levels as suppliers' credit begins to dry up;
- Deeply discounted sales, which may be a pointer that a company's profit is being sacrificed for cash flow;
- Delay in paying rent;
- A tenant requesting concessionary rental arrangements – such as an arrangement to pay rent monthly, instead of quarterly.

Possession of this information will not enable the landlord to change the destiny of the tenant's business – that is in the hands of others – but it does allow the landlord to make informed choices with, hopefully, sufficient time to implement appropriate action.

Landlord's Options

There are several options for landlords when faced with a troubled tenant. However, it is essential to bear in mind the inter-relationship of the potential remedies and to recognise that one route will frequently bar another. Issues for a landlord to consider include:

- Whether there are sufficient goods at the premises to warrant appointing a bailiff to seize goods to pay rent arrears;
- What are the likely consequences and outcome of an insolvency process? For example, the appointment of an administrator to a company tenant could, in effect, "freeze" the property.
- Who else is liable for the tenant covenants in the lease and can they be forced to take a new lease if the tenant becomes insolvent?;
- What is the effect of the loss of the tenant on the value of the property? Is the impact wholly detrimental or could there be a beneficial outcome where there is redevelopment potential or the chance of achieving a more valuable letting to a new tenant? A positive conclusion may encourage the landlord to promptly forfeit the lease if the chance to do so arises.
- Is there a chance that the administrator might sell all or some parts of the business (including the lease), which may protect the value of the landlord's investment?

It is, however, inevitable that in many cases the landlord will not have the option of pre-emptive action and will have no choice but to deal with the situation after the tenant has gone bust. What then are the implications and what should the landlord do?

Insolvency Procedure. If the tenant is a company and becomes insolvent, the landlord's remedies depend on which of the following procedures affect the company:

- Receivership. If a receiver/administrative receiver is appointed, the landlord can forfeit the lease in the usual way and claim arrears of rent.
- Administration. The landlord cannot forfeit the lease nor issue court proceedings without permission from the court or the administrator.
- Liquidation. The liquidator has the power to disclaim the lease. The effect of disclaimer is that it brings the lease to an end, leaving the landlord to make a claim as an unsecured creditor in the liquidation.

Liability of Third Parties. It is important for the landlord to determine who, in addition to the insolvent tenant, may be liable for the tenant covenants in the lease. This will be influenced by whether the lease is "old" or "new" for the purpose of the Landlord and Tenant (Covenants) Act 1995. Where the lease is an "old" one (i.e. entered into before 1 January

1996), the original tenant and, probably, any other previous tenants will be liable to the landlord. However, for "new" leases, former tenants are automatically released from liability – with the exception of the immediate predecessor tenant if it entered into an authorised guarantee agreement.

The landlord should also consider if there are any other tenant guarantors and, if so, the nature of their obligations. It is important to establish if, as is often the case, the guarantor can be forced to take a new lease if the current lease is disclaimed by a liquidator.

Where there are third parties to whom the landlord intends to look to pay rent, it is vital to remember that liability notices must be served on them within six months of the debt becoming due. It should also be noted that a former tenant or guarantor who pays rent in these circumstances is entitled to require the landlord to grant them an overriding lease.

Forfeiture. Most modern leases allow the landlord to forfeit the lease if the tenant becomes insolvent. It must, however, be borne in mind that this remedy cannot be exercised without permission from the court or the administrator where a company tenant is in administration. More importantly, forfeiture of the lease brings to an end all future tenant liabilities. This remedy should therefore be avoided if the landlord wishes to look to previous tenants or guarantors to continue to pay the rents or, possibly, to take a new lease following disclaimer.

Sub-tenants. An option that is sometimes overlooked is the right for a landlord who is owed rent by its immediate tenant to serve notice on any sub-tenant requiring them to pay rent directly to the landlord. This is a particularly useful remedy where the tenant has sublet all or a substantial part of the property.

Wait and See. It is possible that the landlord's only available option is to await the outcome of the tenant insolvency process. There is a chance things will turn out satisfactorily if an administrator is able to find a buyer for the tenant's business, who is willing to take an assignment of the lease. In reality, however, this is an infrequent outcome. All too often, the landlord will face a period of uncertainty, followed by the termination of the lease with little chance of recovery as an unsecured creditor.

Conclusion

It is inevitable that whatever the coming year holds for the UK economy, some tenants will become insolvent – with potentially serious consequences for the investors who are their landlords. Thorough due diligence and monitoring the early warning signs of tenant distress have an important role to play in managing landlords' risk, but cannot eliminate it. A landlord facing a tenant insolvency must act quickly to evaluate its options and implement its decision.

A clear, well executed strategy is the best way to lower the risk of a landlord's valuable investment turning into an expensive liability.

__________________ Article Ends __________________

Insert Box

Dos and Don'ts of Tenant Default	
Do:	Check out the tenant thoroughly.
Do:	Watch for early warning signs.
Do:	Consider your options and plan accordingly.
Do:	Act promptly.
Don't:	Forget the inter-relationship between remedies. One route will frequently bar another.
Don't:	Give in without a fight!