REAL ESTATE DISPUTES
LANDLORDS' REMEDIES FOR TENANT DEFAULT (SEPTEMBER 2020)

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We set out below a menu of possible options available to landlords whose tenants already have, or likely will, default on rent payments and other lease obligations, with some practical tips. Before taking any action in response to a tenant default, landlords should first consider whether their priority is to get paid or get the premises back, and ensure that they don't prejudice their ability to achieve this.
*Landlords' remedies have been impacted by measures/legislation implemented in response to the COVID-19 pandemic. These measures are indicated in red in the note below.

RENT DEPOSIT DRAW DOWN

- The rent deposit deed, made between the landlord and tenant (and sometimes the guarantor), will set out the circumstances under which the landlord can draw against the deposit funds during or after the term of the lease, and the conditions that must be fulfilled for the deposit to be repaid or topped up by the tenant.
- Any rent deferrals or waivers agreed with a tenant would need to be factored in when determining whether the rent is in arrears for the purpose of any draw down from the deposit.
- If the arrears of rent are an isolated incident, and the tenant is able to top up the rent deposit in the future, drawing down on the rent deposit is a quick, simple and inexpensive method of recovering the debt, with minimal impact on the landlord and tenant relationship and a very low risk of reputational damage.
- If the tenant is unlikely to be able to top up the deposit and there are other methods to recover the debt (e.g. pursuing any guarantors or former tenants – see below), it might be best to utilise them in the first instance and maintain the rent deposit for any future arrears.
- In the current climate, in the event of draw down from a rent deposit, we would expect a tenant not to top up the deposit account immediately. If a tenant fails to top up the deposit on demand, this would usually constitute a breach of the rent deposit deed, and generally any rights of re-entry contained in the lease will also apply to any breach of the rent deposit deed (although there are currently restrictions on forfeiture and possession proceedings, which may be applicable here – see below).
- Where there is a loan in place, landlords should consider whether bank consent is required to draw down from the rent deposit.
- Certain types of rent deposit may be protected from drawdown where a tenant is subject to the new "statutory moratorium" introduced under the Corporate Insolvency &

Governance Act 2020 (CIG Act 2020). Deposits held on trust or absolutely by the landlord should be a "financial collateral arrangement", so expressly unaffected by the moratorium. Deposits held by the tenant or by landlord as stakeholder are not financial collateral arrangements, so will be affected.

Practical tips (rent deposit drawdown)

- In the current climate, a tenant is unlikely to top up the deposit following a draw down and, even if a landlord wanted to use that failure as a ground to forfeit the lease, the legal moratorium on forfeiture that is currently in place until 31 December could prevent landlords from enforcing this remedy.
- We therefore recommend that, if there is an alternative way to recover rent arrears (e.g. pursuing a guarantor or former tenant), landlords should consider these alternatives and preserve the rent deposit for as long as possible.

FORMER TENANT, FORMER GUARANTOR & EXISTING GUARANTOR

→ A landlord may be able to recover rent arrears and other sums due under the lease from a former tenant, former tenant's guarantor or an existing guarantor under the lease.

FORMER TENANT & FORMER GUARANTOR

→ The range of parties a landlord may pursue for rent arrears will depend largely on whether the lease was entered into before or after 1 January 1996.

→ In any event, to pursue a claim for a "fixed charge" under a lease (including rent, service charge and any liquidated sums payable for breach of tenant covenants) from a former tenant or former guarantor who is still liable (whether by statute or because they entered into an Authorised Guarantee Agreement), the landlord must have served a notice under section 17 of the Landlord and Tenant (Covenants) Act 1995 on the former tenant/guarantor not later than 6 months after the fixed sum had fallen due under the lease. Failure to do so would prevent the landlord from claiming the relevant fixed charge from the former tenant/guarantor. The landlord would not, however, be prevented from serving new section 17 notices on former tenants/guarantors in respect of any further fixed sums that fell due (provided they were served within 6 months of the sum falling due).

→ If a former tenant/guarantor pays the arrears pursuant to a section 17 notice, it is entitled to ask the landlord for an overriding lease. This is a new leasehold interest which sits between the interests of the landlord and the defaulting tenant (so the current lease becomes a sublease, sitting below the overriding lease). By taking an overriding lease, the former tenant or guarantor acquires the ability to take direct enforcement action against the defaulting tenant or regain control of the premises (e.g. by accepting a surrender or by forfeiture of the defaulting tenant's lease).

→ If the landlord wants to recover sums from a former tenant or guarantor that fall outside the definition of "fixed charge", there is no need to serve a section 17 notice.

EXISTING GUARANTOR

→ In the case of an existing guarantor (who is not a "former tenant" or assignor who entered into an authorised guarantee agreement), the extent or scope of their liability to the landlord will depend on the wording of the lease. Usually, the guarantor promises to ensure that the tenant will fulfil its obligations under the lease, and is required to fulfil those obligations if the tenant fails to do so. So, there is no liability on the guarantor unless and until the tenant has failed to perform.

The landlord need not serve any statutory notices on a guarantor in order to preserve a claim against them.

Practical tips

- If a landlord is able to pursue a former tenant/guarantor for a fixed sum due under a lease, it must serve a section 17 notice on the former tenant/guarantor well within the requisite 6 month period, beginning with the date when the arrears first fell due. In the current financial climate, it would be prudent for landlords to diarise to review rent payments every 2-3 months.
- There are statutory requirements concerning the form, contents and service of a section 17 notice; landlords would be well advised to instruct solicitors to prepare and serve these notices on their behalf.
- Landlords should keep in mind that service of a section 17 notice may operate as a waiver of the right to forfeit the lease.
- Serving a section 17 notice is effectively an invitation to the recipient to become the landlord's direct tenant (if they pay the sums claimed in the notice). Landlords should ensure that they are happy with this, including investigating the financial strength of the former tenant, before deciding whether to serve a section 17 notice and who to serve it on.

COURT PROCEEDINGS

→ Landlords can issue court proceedings against a tenant to recover rent or other sums due under the lease.

→ Assuming the tenant cannot defend the claim and judgment for the arrears is obtained, the landlord must then take steps to enforce the judgment and recover the arrears. If the tenant has no funds, income or assets to enforce against, there is little point in obtaining a judgment.

→ Where a tenant, former tenant or guarantor is subject to the new CIG Act 2020 statutory moratorium, there are limitations on bringing court proceedings to recover arrears.

Practical tips

- This method of recovery is usually not a "quick fix" remedy. Court proceedings can be expensive and protracted, many of the courts are currently closed and the processing/service of claims is taking longer than usual. There are pre-action protocols that should be complied with, and once issued, the proceedings may not move quickly, as the court may be inclined to allow the tenant extensions of time to comply with directions, particularly in the current circumstances. A court hearing may not be set for several months and the tenant may not feel any impetus to pay the arrears while the proceedings are ongoing.
- On the other hand, if the landlord wants to give the tenant time to get its financial affairs in order and pay the arrears, then court proceedings may be a good way of taking action to obtain the unpaid rent. However, if a landlord subsequently decides to discontinue its claim, it may have to pay the tenant's costs.
- Good practice before issuing proceedings is to investigate the financial standing of the potential defendant. There is no point suing a tenant who does not have the means to pay in the event of a judgment.

INSOLVENCY*

→ Often, just the threat of insolvency proceedings can prompt payment of any rent or other arrears, due to the serious consequences of a winding up or bankruptcy petition (e.g. advertisement of a winding up petition can lead to frozen bank accounts, adverse impact on trading relationships, reduced access to credit).

→ Where there is no dispute as to the amount due, landlords can serve a statutory demand on the tenant. If this debt remains unpaid after 21 days, then this gives grounds for landlords to present a bankruptcy or winding up petition. The minimum threshold for serving a statutory demand is a debt of £750 for a company and £5,000 for an individual.

→ Where the debt is disputed, the debtor will have to satisfy the court that there is a genuine dispute founded on substantial grounds. If this is the case, then the appropriate forum for the resolution of the dispute will be debt recovery proceedings rather than via a statutory demand.

→ In the case of an individual, landlords must serve a statutory demand before commencing bankruptcy proceedings. This is not the case with a company: if the arrears are not in dispute, a letter to the tenant threatening winding up proceedings if the arrears aren't paid in a set time (e.g. 7 days) would usually suffice.

→ The CIG Act 2020 introduced a new temporary measure that provides that, on or after 27 April 2020, no winding up petition can be presented on the basis of:

- A statutory demand served during the period beginning on 1 March 2020 and ending on 31 December 2020; and/or
- Other evidence of an inability to pay debts, unless the creditor has reasonable grounds for believing that the coronavirus has not had a financial effect (by worsening the financial position) on the company or that the debt issues would have arisen anyway.

The above restrictions only apply to the service of winding up petitions on registered and unregistered companies, not bankruptcy petitions. This means that landlords may continue to serve statutory demands on individuals (including sole traders - potentially the most vulnerable), and then go on to present a bankruptcy petition.

Practical tips

- Serving a statutory demand is not in itself a method of debt recovery; it is only a precursor to pursuing insolvency proceedings, however it can be effective to produce payment at relatively low cost.
- Serving a statutory demand may have a negative impact on an ongoing landlord/tenant relationship, as it may be perceived as an aggressive step.
- Where the debt is disputed, serving a statutory demand can lead to costly court proceedings (e.g. an application by the tenant to set aside the statutory demand), and the courts' sympathy may well be with tenants during the COVID-19 pandemic.
- Forcing an otherwise solvent individual or company into insolvency, where they might have survived if they had been given time, may reduce landlords' chances of recovering the debt due to the restrictions on recovery under the insolvency regime in England and Wales.

CRAR*

→ CRAR is a statutory regime which allows a landlord of commercial premises to recover rent arrears (where at least 7 days' worth of rent is outstanding) by taking control of tenant's goods at the leased premises and, if the arrears are not paid, selling them.

→ CRAR requires 7 days' notice to be given, informing the tenant that a certified enforcement agent will attend the premises to take control of the tenant's goods if the arrears aren't paid.

→ Once a CRAR notice has been served, the tenant cannot dispose of the goods for 12 months.

→ For the purposes of CRAR, "rent" is limited to the amount payable under the lease for the possession and use of the premises. It does not include any sum in respect of rates, council tax, services, repairs, maintenance, insurance or other ancillary charges, even if those amounts are reserved as "rent" in the lease.

→ As part of the government's implementation of measures to safeguard against aggressive rent collection tactics as a consequence of COVID-19, temporary Regulations have been passed which increase the minimum net unpaid rent that must be outstanding before CRAR can be exercised, to an amount equivalent to **276 days' rent** where CRAR is exercised between 29 September 2020 and 24 December 2020, and **366 days' rent** where CRAR is exercised between 25 December 2020 and 31 December 2020.

Practical tips

- For CRAR to be effective, the tenant would need to have some assets of value situated at the premises. However, seizing and selling the tenant's valuable assets will affect its profitability, making it harder for the tenant to survive in the long run.
- In some cases, the mere threat of CRAR could encourage some tenants to settle arrears.
- Although some commercial premises are locked/unoccupied during the current lockdown period, enforcement agents may use reasonable force to enter the premises. That said, in the current climate, from a reputational perspective, you may not want to be seen to be taking such forcible action.
- Using CRAR when the tenant is in arrears with rent (and the landlord's right to forfeit the lease has arisen) will waive the right to forfeit.

NOTICE ON SUBTENANT TO PAY RENT TO SUPERIOR LANDLORD*

→ The CRAR procedure also enables a landlord to require the defaulting tenant's sub-tenant to pay rent directly to the landlord until the defaulting tenant's arrears have been cleared. If the sub-tenant then fails to pay, the landlord can exercise the CRAR procedure against the sub-tenant.

→ Exercising the right to require a subtenant to pay the rent that it owes directly to the landlord is achieved by the service of a "section 81 notice" on the subtenant.

→ All of the provisions concerning CRAR, including the type of rent and the amount of rent outstanding, apply to a section 81 notice.

→ The temporary restrictions on exercising CRAR (set out above) are also applicable to section 81 notices i.e. to serve a section 81 notice on a subtenant, the superior landlord's immediate tenant must be in arrears of **276 days' rent** where notice is served between 29 September 2020 and 24th December 2020, and **366 days' rent** where notice is served between 25th December 2020 and 31st December 2020.

FORFEITURE*

→ Forfeiture or "re-entry" is a landlord's right to terminate a lease (during the term) and take back possession of the premises.

→ A landlord may only forfeit a lease if there is a provision in the lease entitling the landlord to do so, usually on certain specified grounds and after a specified time.

→ The effect of forfeiture is to bring the lease to an end, including any sublease granted out of the forfeited lease, allowing the landlord to take back possession of the premises and grant a new lease to a stronger covenant, potentially for a premium.

→ Tenants, subtenants and mortgagees have a statutory right to apply for "relief" from forfeiture, conditional on suitable terms (usually remedying the breach). The effect of a successful relief application is to reinstate the lease, as if the forfeiture never occurred.

→ A landlord can forfeit a lease either by changing the locks (known as peaceable re-entry), or by the service of court proceedings seeking a court order for possession of the premises on the grounds of forfeiture.

→ The Coronavirus Act 2020 imposed a suspension on the forfeiture of most business tenancies on the grounds of non-payment of rent (defined as all sums due under a relevant lease), between 26 March 2020 and 30 June 2020. That period has now been extended to 31 December 2020. This means that a landlord cannot exercise a right to forfeit a lease on the basis of a tenant's non-payment of rent until 1 January 2021.

→ As this suspension only applies to forfeiture on the basis of non-payment of rent, if a landlord has a right of forfeiture on any other grounds, it could still forfeit a business lease (subject to compliance with section 146 of the Law of Property Act 1925). It can do so by peaceable re-entry or by the issue and service of court proceedings for possession.

Practical tips

- A landlord can waive (compromise) a right to forfeit a lease by unequivocally confirming the existence of the lease once the right to forfeit has arisen, and communicating this to the tenant.
- So, once the right to forfeit has arisen (e.g. if the tenant fails to pay rent), it is important that landlords and their agents do not inadvertently waive the right to forfeit (e.g. by continuing to demand/accept rent or entering into surrender discussions).
- It is worth noting that during the period of suspension of the right to forfeit (until 31 December 2020), a landlord will not be regarded as waiving its right to forfeit for non-payment of rent *unless it expressly confirms such a waiver in writing*. As a result, once the suspension period has expired, a landlord could still forfeit the lease on the basis of the tenant's non-payment of the rent which accrued during the suspension period if this remains unpaid, even if the landlord demanded that rent or discussed payment terms etc.
- Note also that a new Practice Direction 55C (of the Civil Procedure Rules), in force from 20 September 2020 (when the stay on all possession proceedings ended), sets out the steps required to reactivate stayed possession claims, as well as procedural changes applying to both existing possession claims and the issue of new claims, including forfeiture proceedings.

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