

The Pubs Code and the Crisis in the Hospitality Industry

Jonathan Karas Q.C., Adam Rosenthal Q.C. and Toby Boncey take stock of the Pubs Code and possible measures that might be taken in the wake of the Covid Crisis.

As Samuel Johnson put it: “No Sir! There is nothing which has yet been contrived by man by which so much happiness has been produced, as by a good Tavern.”

Unfortunately, for both pub tenants and pub landlords, under regulation 4 of the Health Protection (Coronavirus, Restrictions) (England) Regulations 2020 (“the Emergency Regulations”), a person responsible for running a pub (amongst various other types of business) must close any premises (or part thereof) in which food and drink are sold for consumption on those premises during the emergency period defined in regulation 3. Any customers would also breach regulation 6 by leaving the place they were living without reasonable excuse¹.

The forced closure of businesses under reg. 4 has had, and will continue to have, an unprecedented effect on all pubs. The focus of this article is tied pubs which are subject to the Pubs Code Etc. Regulations 2016 (“the Pubs Code”), enacted under s.42 of the Small Business, Enterprise and Employment Act 2015 (“the 2015 Act”).

Now might be a good time to take stock and consider whether the existing regulatory framework offers sufficient protection to pub tenants, or whether an unintended consequence of the substantial separation of the retail side of the industry from the manufacturing side may be that pub tenants are now facing disaster.

The Regulatory Framework

In 1986 the Monopolies and Mergers Commission, at the request of the Director General of Fair Trading, investigated the UK beer market. As a result of this investigation, the Supply of Beer (Tied Estate) Order 1989 sought to address a perceived monopoly in favour of six national brewers who, between them, owned more than half of the 60,000 tied pubs by, among other things, requiring all brewers who owned over 2,000 pubs either to sell their breweries or release half of the pubs over the 2,000 threshold from their ties by November 1992. As a consequence of these reforms, the “Pubco” was created, a company set up to own pub premises and act as a middleman between brewers and individual licensees.

The unintended consequence of the 1989 reforms was that a new imbalance was thought to have been created. While Parliament recognised that the free market forces supposedly unleashed by the 1989 reforms incentivised Pubcos to support their tenants up to a point (since “Pubcos which not only benefit themselves but support their lessees are likely to stay in business”²), tenants were thought to be at a disadvantage. Consultations led to the eventual enactment of the Pubs Code which was brought into force on 21 July 2016. The Pubs Code regulates “pub-owning businesses” (“POBs”) which, under s.69(1) of the 2015 Act, are those businesses which are the landlords of 500 or more tied pubs. This applies to the tied tenants

¹ A visit to a pub would not fall within the exception to the prohibition in reg. 6(1) for “obtaining basic necessities”.

² House of Commons Business and Enterprise Committee, Seventh Report of Session 2008/9 – Vol 12 para 193.

of pubs held from six major Pubcos: Ei Plc (Enterprise Inns), Marston's, Greene King, Star Pubs & Bars, Admiral Taverns and Punch Taverns. The Pubs Code does not therefore apply to all businesses operating tied pubs and is instead focused only on the largest operators.

S.42(3) of the 2015 Act provides that the Pubs Code must be consistent with two broad principles:

- (a) the principle of fair and lawful dealing by pub-owning businesses in relation to their tied pub tenants; and
- (b) the principle that tied pub tenants should not be worse off than they would be if they were not subject to any product or service tie.

The Pubs Code, among other things, imposes various duties on POBs in their dealings with their tied pub tenants, gives the tied tenant the ability to request a rent assessment every five years, and enables the tied tenant to request a 'market rent only option', i.e. to obtain a new free-of-tie (FOT) agreement on reasonable terms, if certain events occur, most notably following a rent assessment or a renewal of the lease under the Landlord and Tenant Act 1954. A Pubs Code Adjudicator resolves disputes under the Code by arbitration and can impose financial penalties on POBs.

Problems likely to be encountered as a result of COVID-19

The pandemic is likely to affect pubs significantly. The "Emergency Period" under the Emergency Regulations has no specified end date but rather may be brought to an end at different times in relation to each restriction or requirement under the Emergency Regulations (reg. 3(1)). Recent statements by Ministers suggest that the hospitality industry is likely to be "locked down" longer than most other sectors. Although this is a fast-moving situation, this suggests that current thinking envisages a prolonged period in which pubs will remain closed.

We consider, below, some of the issues which will be faced by both tenants and Pubcos, with particular reference to those pubs which are subject to the Pubs Code.

(1) Financial Difficulties Faced By Tenants

Tenants may find themselves unable to meet ongoing rent liabilities with no trading profits or cashflow. Although such tenants are protected from the enforcement of a right of re-entry for non-payment of rent (including any sum the tenant is liable to pay under the tenancy) until 30 June 2020 by s.82 of the Coronavirus Act 2020, the liability still exists.

Some tenants will become insolvent and / or decide not to re-open. If tenants do leave, landlords may find it difficult to find replacement tenants, and may find themselves subject to the financial burden of dealing with dilapidations if their tenant is insolvent.

Tenants who re-open their pubs may find trading difficult for various reasons, especially if they have let staff go during the outbreak or are short of cash to re-stock.

Pub Companies are already coming under pressure to waive rent or take other steps to protect their tied tenants. The Pubs Code Adjudicator ("PCA") announced on 6 April 2020 that he is exploring with the Pubcos ways for the Pubcos to support their tied tenants. However, as at 6 April 2020, only one of the six large Pubcos had agreed to waive rent. Any assistance will of course come at a direct cost to the POB, which will have its shareholders' interests to

consider. Moreover, the pressure applied by the PCA will apply only in relation to tied tenants (as tenants who do not occupy their pubs under tied tenancies are not subject to the regime of the Pubs Code or the control of the PCA). Tied tenants are likely to be given assistance at the expense of free-of-tie tenants because the levels of support generally are higher for tied tenants with the Pubcos being more heavily invested in the tenant's business where the tenant is purchasing products under a tied agreement.

(2) Rents After the Crisis

The current crisis may result in pubs being substantially over-rentalised or under-rentalised, depending upon the date of the rent being set. Tenants who have recently fixed a rent may find that, in the current market, that rent is at too high a level. Others may use the immediate aftermath of the crisis to obtain a rent which may prove to be too low in a recovered market. For tied tenants this might lead to more attempts to trigger a rent assessment under reg. 19 of the Pubs Code.

(3) Exercising Rights under the Pubs Code

POBs have now signed up to a declaration which stops the clock on certain time limits under the Pubs Code from 16 March 2020 (when the Prime Minister advised the public to stop visiting pubs) until 30 June 2020 (subject to review), to protect the interests of tenants. However, there will inevitably be a backlog of MRO cases under the Pubs Code to be dealt with at the end of the crisis. Dealing with MRO requests and Pubs Code litigation is likely to add (substantially in the case of Pubcos who have to deal with such requests and litigation across their portfolio) to the administrative burden on all parties emerging from the crisis and seeking a return to profitability.

Although Covid-19 itself is not a trigger event for MRO purposes, it is likely that, as the Pubs Code is presently drafted, the secondary effects of COVID-19 disruption (for instance, factory closures which might affect all pubs in a particular local area) might give rise to a greater number of events triggering MRO options than anticipated by the draftsman. Whether the MRO option remains as attractive to tied tenants in a post-Covid world remains to be seen.

Legislative Intervention?

Landlords will in many cases be economically incentivised to take steps to support individual tenants through the crisis, since it is in no Pubco's interest for all its pubs to stand empty or for the pub industry to collapse. As can be seen from the declaration above, and certain rent waivers, Pubcos are already taking steps in this direction. However, precisely what assistance will be considered appropriate by particular landlords in respect of particular tenants, and whether this will prove sufficient to keep their pubs open for business after the crisis, remain to be seen.

Under regulation 68 of the Pubs Code, the Secretary of State was to carry out a review of certain parts of the Pubs Code by 31 March 2019 and thereafter, such reviews are to be carried out every three years. Although the 2019 review was undertaken, no substantive changes have been made to the Pubs Code, notwithstanding a number of suggested deficiencies in its operation (which were identified by Pubcos and tenants alike as well as in a submission from the PCA himself).

Nevertheless, the current situation is likely to require more fundamental legislative intervention outside of this review process to offer some protection to the pub industry. Given that the perils are faced by tied and FOT tenants alike, any such legislation will need to address both sectors of the market. It will also be important that any legislation avoids a knee-jerk reaction in favour of pub tenants. POBs' income comprises principally rent and sales of beverages. The latter income stream has been closed off completely by the Emergency Regulations and the former will, in practice, be reduced considerably given the inability of tenants to fund the ongoing rental liability. This, in turn, will hinder the assistance that Pubcos can provide to their tenants as well as returns to their shareholders.

Parliament might consider a number of ways in which the sector might be relieved.

First, consideration might be given to expanded use of the existing mechanism to provide tenants with MROs. For instance, under s.43(9) of the 2015 Act, the Pubs Code must provide for the MRO option to be available to a tenant where a "trigger event" has occurred. This is an event which is beyond the control of the tenant, was not reasonably foreseeable when the tenancy was granted, has had a significant impact on trade and is of a description specified in the Pubs Code. This seems apt to apply to the Covid 19 Crisis. However, reg. 7 of the Code contains a number of restrictions which would preclude tenants from relying on this trigger event.

- (1) Under "Condition A", the effect of the event must be to decrease the level of trade over a continuous 12-month period.
- (2) The "event" must either be peculiar to the particular tied pub (which will not be the case) or it be limited to the locality in which the pub is based. In other words, the trigger event will not cater for a national emergency in which all pubs suffer from the decrease in trade.

Although prospectively, Condition A could well be satisfied, it is unclear whether a tenant can rely on this trigger for the MRO option until that 12-month period has elapsed. .

One solution might be to expand the scope of the unforeseeable trigger event under s.43(9) of the 2015 Act. This would enable tied tenants to rely on the wholly unforeseen predicament they find themselves in to opt to take a MRO tenancy. However, this risks increasing an already significant burden on Pubcos and as suggested above it is far from clear that MRO is the answer for tenants.

Secondly, it might be thought that existing mechanisms will allow rents to become more affordable. In practice, it is likely in time that there will be a recalibration of the rental market for pubs. For tied tenants, this could be achieved using the rent assessment process. Many tenants will not be entitled to rent assessments under reg. 19 until their next contractual rent review. Given the severity of the financial crisis which will be hitting tenants, the recalibration might well be forced on the parties (by the need to make allowances to tenants to avoid tenants becoming insolvent and pubs being vacated with no market for new tenants). The larger Pubcos might find themselves expanding their own managed divisions but they will, no doubt, also wish to ensure that their tied houses are sustainable. It might therefore be necessary to look at expanding the triggers for rent assessments. However, this would then have the effect of increasing the scope for MRO claims which might not be the best way of

assisting tied tenants, and may increase the administrative burden on parties seeking to emerge profitably from the crisis.

Thirdly, depending on how long the “emergency period” under the Emergency Regulations is to last for the hospitality industry, emergency funds might be required to enable pubs to re-stock. It is likely that long before the lifting of the measures under regulation 4 of the Emergency Regulations, stock in most pubs will be unusable and will have to be replaced and emergency funding might be required to assist tenants of pubs to do so. Landlords of tied pubs might be more ready to assist their tenants with short- or long-term loans for this purpose. But the financial difficulties will not end there. It is likely that pubs will see a prolonged period of reduced trade when eventually permitted to reopen, either because of enforced social distancing or because social attitudes to public gatherings mean sales take time to return to pre-crisis levels.

More generally, landlords are likely to encounter many pleas for time to pay debts accrued during the emergency period and indeed thereafter. Where rent arrears and other debts are not waived, it will be necessary to provide assistance to enable a pub tenant’s cashflow to facilitate trading. This is unlikely to be a matter for the Pubs Code. Although the PCA, via the press release referred to above, has signalled an intention to take steps to protect tied tenants, the Pubs Code is not drafted in a way which will enable to PCA to impose obligations on the Pubcos to provide the levels of financial assistance and forbearance that will be required.

Looking outside of the pub industry at other commercial sectors which are also heavily impacted by the Emergency Regulations, although there are broad measures to prevent creditors from taking immediate action (e.g. the general stay on non-trespass possession proceedings, including where tenants are unable to pay rent, under the Civil Procedure Rules Practice Direction 51Z), debts will continue to accrue during the emergency period. There may come a time where the enforcement of those debts, in whatever manner, is prohibited, but no doubt it is hoped that market forces will pave their own solution, albeit one which will be less than perfect.

So far as the pubs industry is concerned, what form any emergency legislation might take remains to be seen, but if the industry is to survive in a recognisable form, any emergency legislation will need to strike an appropriate balance between the interests of pub tenants and their landlords. What seems like a short-term fix to a serious problem could have long-term consequences for the hospitality industry.