Hicks Baker
Commercial Property Consultants

BUSINESS SPACE

Seven things Tenants should understand about Lease Break Clauses

Most longer-term commercial leases give landlords the right to review the rent at fixed intervals to ensure it is in line with prevailing values. And of course, there may be an opportunity to revise the rent at the end of the term, if a tenant renews its lease.

Rent reviews are an invaluable mechanism to help landlords ensure they are maximising returns, but there's always a need to balance the possible costs of managing the process against any potential additional revenue.

The terms and assumptions that govern rent reviews are contained within the lease agreement, whereas the terms relating to renewals of are contained in the Landlord and Tenant Act 1954 (unless of course the lease has been 'contracted out' in which case the bargaining power of the parties is the driving force). These processes can therefore produce a very different outcome than might be achieved on a brand new letting.

Here are seven key aspects of both processes that landlords need to understand and ensure that the process works in their favour as far as is possible.

1 Floor Areas

The floor areas used to calculate rental values are frequently inaccurate. The RICS Code of Measuring Practice provides precise definitions appropriate for different property types from Gross External Area to Net Internal Area, identifying which structures should be disregarded and which included. It is not a case of one size fits all and therefore a misunderstanding as to whether a staircase, a partition or a heating unit should be included or excluded can lead to very different outcomes.

It is not however, just the metrics and calculations which need checking, but the usage and accessibility of different spaces can also have a significant impact on value and should be considered in the context of the wording of the lease.

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2 Lease Terms and Assumptions

The lease is the most important influencer on value and no two leases are the same.

The lease will tell you if a tenant's alterations be valued or disregarded? It can tell you to assume black is white, it can place a limit on the rent and it could tell you that a shop in the middle of the West End be valued as a factory. It can therefore defy logic and give rise to outcomes which seem unfair or absurd, but it cannot be ignored.

They therefore need careful reading and interpreting. Sometimes clauses that were never intended to be restrictive become so because of casual or naďve drafting. A clause which limits the use of a property will generally result in a lower value that one which is wider. On occasion there are conflicting terms – which one takes priority?

Sometimes the market changes and what may have been considered advantageous becomes the opposite. Forty years ago, for example an assumed lease term of 15 years, would have been viewed positively. Today this would be considered a burden on the tenant requiring a discount.

3 Valuation Date - Reviews and Lease Renewals

Rental values fluctuate, which makes the definition of the valuation date a crucial concern. For rent reviews it is straightforward - it is virtually always the review date – fixed and immutable. For renewals it is fluid and is effectively the date the agreement completes, or becomes unconditional or is determined by the court.

The process can therefore be influenced by the actions of the parties and given that the process can take years, it is likely the market and values will change over the time. For example, in early 2007 the market was arguably at its peak and even in summer 2008, it was generally in reasonable shape. After the demise of Lehman Brothers in September 2008 the market collapsed immediately. A lease therefore which may have expired at the height of the market, may not have been renewed until the depths of the market at a significantly lower rent and possibly significantly softer terms.

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4 Evidence

The benchmark for valuation is the rent being paid on recent transactions or settlements for similar properties close by.

In evidential terms, the courts place highest emphasis on open market lettings. In some locations there may have been no activity and even where there has been interpreting letting evidence can be complex. A property that may look the same as yours may be held on very different terms.

Most often the evidence is very different and requires detailed analysis and adjustment to equate it with the property being valued.

Finding the evidence is arguably the hardest part however, and employing agents who are active in the market and have access to extensive sources of data is to be advised.

5 Dispute Resolution

If negotiation is unsuccessful, the lease will usually provide for the appointment of a third-party or in the case of a lease renewal it is the court.

On rent review the third party generally either acts as an Arbitrator or an Independent Valuer whose roles are distinct and have different powers with regard the awarding of costs. In some leases (the landlord usually) can choose.

It is important to remember that these people are human and that in the way judges in the criminal and other courts make odd decisions as we hear in the media, so can these third parties. Their award is final (save mainly for procedural misdemeanors) and notwithstanding the costs the process should not be undertaken lightly.

The total costs of the parties including the 3rd party are unlikely to be less that £10,000 excluding VAT and usually much more particularly on lease renewals where legal costs need also to be factored in. For many properties therefore at the smaller end of the rental market the process may just not be viable.

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6 Timing

A landlord's ability to exercise a rent review cannot be abandoned unless the lease states otherwise. It is possible therefore to implement this many years after the date has passed. It will usually be backdated to the review date and therefore additional rent payable for that period plus possibly interest will become due as a lump sum. This can place a significant burden on a tenant.

It is sensible for tenants to provide for an increase or ensure that each review is addressed, even if it is considered there should be no increase.

Usually timing provisions in leases are for guidance and are not to be construed strictly. There are occasions however where they must be and therefore this needs to be checked.

For lease renewals however, timings need to be observed more closely especially once the termination process has started.

It is advisable for all parties to prepare well in advance for rent reviews, but particularly lease expiries if relocation is required and especially for tenants who leases may not be protected, as they will have no right to occupy after the end date. It is not uncommon in these circumstances for tenants to be held to ransom and pay a premium rent if they choose to stay. We advise clients to try and agree terms with their landlords at least 6 months before the lease end and have a plan B. Larger organisations should prepare sooner as much will depend upon the availability of alternative premises and the time it takes to fit out and relocate.

7 Cost

We have referred above to the potential cost of the dispute resolution process, in the relatively few cases that are not settled by agreement.

The cost of a employing a surveyor should be considered in the context of the lease period/rent review period of usually five years and for landlords the potential impact on capital value. A rental increase of £1,000 per annum is therefore £5,000 over five years (more on a long lease).

In many cases tenants think too short term, by choosing not to seek professional representation and agree deals which they think are acceptable oblivious to the true cost to themselves or their business.

If you are a tenant, you want to understand and manage your commercial risk in relation to rent reviews and lease renewals the Hicks Baker team will be able to give you the advice you need.

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