

When the going gets tough it pays to talk lease options

As economic tensions in landlord-tenant relations look set to remain, many business tenants have struggled on, giving little thought to restructuring their leases and reducing operating costs. Tim Clark, Head of Commercial Property at Black Country corporate law firm Hawkins Hatton, considers some of the options which could provide an opportunity for both landlords and tenants to mutually benefit.

So some economists believe the austerity measures facing Britain could even trigger a dreaded “double-dip.” From a tenant’s perspective, premises will still be “over rented,” where cost per square footage is too high. For the landlord, there will be lingering fears over tenant insolvency with little chance of rental growth at the next review date.

There could however be a golden opportunity for parties to sort out their differences, begin with a clean slate, and modernise their leases so that they truly reflect market conditions. Taking a conciliatory approach could well be far more prudent than getting embroiled in litigation over unpaid rent!

“Re-Gearing” Leases

A “re-gearing” arrangement could fit where sub-letting or assignment is simply not an option. In a typical scenario, the tenant would surrender the break clause, but the existing rent would be reduced. By removing the break clause, the landlord guarantees income for the remainder of the term and, by substituting an open market rent review for a fixed/index-linked formula, improves the prospects of an uplift in rent at the next review. The landlord may also want to extend the term of the lease.

There are several mechanisms by which this can be achieved. A deed of variation is required solely to remove the break clause, revise the rent and alter any other terms of the existing lease. If the term of the lease is to be extended, there are two options. The existing lease may be surrendered and replaced by a new lease (incorporating new rent, review provisions and the longer term.) Alternatively, and in addition to the deed of variation, the parties will enter into a future lease (called a reversionary lease,) that will come into effect when the existing lease expires.

From the tenant’s perspective, replicating the old lease with the new would probably be a tactical disadvantage, as a more favourable outcome is likely to be achieved in a tenant orientated environment. As for the landlord, if the lease was an “old tenancy” (granted before 1 January 1996,) the tenant is already “on the hook” for the full duration of the term, and by surrendering the existing lease a valuable covenant may be lost.

That said, all current disputes in the new lease can be “put to bed,” or at least regularised. What about removing that worrying personal guarantee clause (agreed to innocently when the market was buoyant,) or dealing with the timing of reinstatement of alterations, the terms of future underletting, and maybe a “deal” over dilapidations?

Assignment and Subletting

It is a well-rehearsed ground that a landlord will usually be required to grant consent, not to be unreasonably withheld. However this potential tenant “exit strategy” has lost much of its appeal today due to the lack of supply of potential assignees/sub-tenants. In either scenario, it is important to remember that the tenant is going to remain liable to the landlord in the event of transferee default, at least for a limited duration.

Moreover, existing leases often contain provisions preventing sub-letting at a lower rental level than that provided in the existing lease, the landlord not wanting other tenants using the sub-tenants low rental as a comparable in open market rent reviews. By adopting the strategy of “re-gearing” leases, above, and converting an existing open market review into a fixed/index-linked formula, there may be scope for the new lease to allow subletting at lower rents, thereby increasing the flow of potential sub-tenant, and making sub-letting a more marketable option to the tenant.

Virtual Assignment

A modern “arrangement” whereby there is no actual assignment of the lease or change in occupancy, but a tenant transfers the economic obligations and benefits under a lease to a third party. As for the tenant, the premises no longer appear on the balance sheet, and the need to gain landlords consent to an assignment is successfully circumvented.

On the other hand, landlords are likely to be very wary, as they know nothing of the covenant strength of the additional party. Watch this space – alienation provisions may be tightened up to prevent such arrangements!

“Going Dark”

As a “last gasp” interim strategy, the tenant shuts down operations but continues to honour the rent. The tenant sheds operating costs, but may face a landlord’s action to forfeit if the lease contains a “keep open” clause, although in today’s market forcing the tenant out is likely to be pointless.

Again adopting the alternative strategy of “re-gearing,” above, is likely to be a more attractive proposition than “going dark,” giving parties a wonderful opportunity to reconfigure their relations in a truly modern lease.

With sensible negotiation by your advisors, you’d be surprised how accommodating those tenant and landlord discussions can be.

For further information please contact Tim Clark at Hawkins Hatton on 01384 216840