Balancing risk between landlords and tenants in leases

The ongoing pandemic crisis is having far-reaching consequences across the commercial property sector. Landlords and tenants are seeking to address a fair balance of risk between themselves, not only to facilitate ongoing business and trade, but also to balance the books. It is hard to imagine a situation where a landlord would be expected to step in following a government mandated closure or a tenant would be obliged to continue to pay full rent when they are unable to occupy and trade from their premises.

So, what is the solution? How is the risk allocated between landlord and tenant? In an effort to share the financial loss, some parties are introducing rent concession provisions into new leases or by way of a side letter. This paper considers different options currently being negotiated and agreed in the market.

Rent reductions and restructured rental payments

Rent reduction provisions recognise that neither party is at fault and demonstrate parties' genuine desire to invest in their long-term relationship and to assist the recovery of both. Often, we have seen that a 50% reduction in rent is agreeable to the parties but applies only to the market rent and not turnover. The insurance and service charge rents remain payable, though the landlord will often agree to use reasonable endeavours to mitigate service costs during periods of closure.

Alternatively, the parties might agree that the rent payable is restructured. Instead of a rent that remains the same throughout the first five years of the term, the lease provides for stepped rental payments over the same period for the same overall rental value to reflect the "return to normal" as trade/business increases. Some occupiers might consider this a fairer approach.

In the case of retail leases, switching to a turnover-based rental model can work for both parties. Landlords retain a minimum base rent based on a high percentage of the market rent. The pressure on retailers is eased as a proportion of the rent reflect the financial performance of their business. The exact mix of market and turnover rent can be tailored to suit both parties by negotiation.

Key considerations

- Landlords and tenants can negotiate flexible terms to suit their changing needs, to help balance the risks and to preserve the landlord and tenant relationship longer term.
- Parties should properly document any alternative arrangements they agree to avoid unintended consequences.
- A turnover-based rental model can work for both landlords and tenants, particularly in the case of retail leases.
- Deferral arrangements should protect landlords' rights against any guarantors.
- Some commonly agreed landlord and tenant lease concessions should be carefully assessed in the context of VAT rules even though HMRC has indicated a more relaxed approach.

Rent deferrals and payment plans

Another option is to allow the tenant to defer the payment of rent, where the landlord recognises that cashflow may be an issue during a period of forced closure or reduction in opening hours. When business and trade pick up, the tenant should be in a better position and therefore will be obliged to start to repay the deferred rent in manageable instalments.

This might be agreed as a simple deferral of rent where an agreed sum is deferred and repaid as a lump sum, or in monthly or quarterly instalments. Alternatively, it might be a more bespoke payment plan that is agreed with an occupier based on their financial situation, available financing and/or the changing regulations mandated by the government.

Whilst this option does mean that the landlord will often be waiting a while for the deferred rent to be paid in full (and with the risk that depending on circumstances it may not be paid on the later dates), it can make the difference between the tenant being able to continue to trade or not. The risk is balanced between the landlord's interest in not having vacant premises and the tenant's interest in keeping the business operational from the premises.

Landlords need to ensure that deferral arrangements protect their rights against any guarantors and that any required notices under section 17 of the Landlord and Tenant (Covenants) Act 1995 are served on relevant guarantors.

Rent free periods and term extensions

Periods of mandated closure and rent concessions pose an obvious financial loss to both parties. Landlords may be more amenable to a rent free period during a period of closure, in exchange for an extended term. An example of the commercial terms of which we are aware, is extending the term by two months for every one month of closure. A reversionary lease will be entered into when the period of closure is known, to cover the new (additional) term.

This gives the landlord a degree of comfort that the loss sustained can be recovered through the rent received for the additional period. This recognises that the landlord is operating a business too and needs the income. This option provides the parties with some certainty, which in challenging economic times is in short supply.

Some tenants are seeking to introduce a suspension of rent for a variety of circumstances linked to current or future pandemics. Whether or not such a suspension is agreed will reflect the respective negotiating strengths of the landlord and the tenant. Some landlords will refuse to agree this and will instead offer what for them is a more certain solution in the form of a rent free for a specific period or another precisely defined rent concession.

If rent suspension drafting is agreed, there will be a number of contentious negotiating points. Is it to be a personal arrangement? Does it apply only to the current pandemic or to a particular wave of the current pandemic? In what circumstances does it apply, for example, is it limited to when the tenant is prohibited from keeping its premises open for business or trade because of a mandatory measure imposed by COVID related legislation? Is only a proportion of the rent to be suspended?

Other measures

As well as rent negotiations, a landlord and tenant can agree on other measures to help balance the risks between them depending on what their objectives are. For example, measures to help ease financial pressure on tenants in terms of their cashflow might include agreeing monthly as opposed to quarterly rent payments or payments in arrears.

Where the landlord requires additional security such as a rent deposit, they might agree for the rent deposit to be paid in regular instalments, rather than as a lump sum.

If an extension of the term is not an agreeable option for the parties as compensation for a rent free period or other rent concession, another option may be to vary the lease to remove or change a tenant's break date to give the landlord more certainty. HMRC has recently released helpful guidance indicating a more relaxed approach to a number of commonly agreed landlord and tenant lease concessions (such as varying a lease to remove a break in exchange for a rent free) which may have previously been considered barter transactions for VAT purposes. A word of caution, however. Whilst HMRC has responded to the changing market and the commercial challenges faced by landlords and tenants in a COVID-19 world, they have not done away with the concept of barter transactions altogether. You should seek legal advice before agreeing heads of terms.

Going forward

Going forward both landlords and tenants will continue to negotiate flexible terms to suit their changing needs and regular and open communications between the parties can help balance the risks between the parties to preserve the landlord and tenant relationship longer term.

Where alternative arrangements are agreed, it is important for both parties to ensure that these arrangements are properly documented (to avoid unintended consequences) and accurately reflect what has been agreed. The Government introduced a voluntary Code of Practice, which lasts until 24 June 2021 and is intended to assist landlords and tenants to agree mutually beneficial arrangements to overcome the consequences of the pandemic.

Conclusion

By incorporating the provisions, or a combination of the provisions above, the parties set out their expectations at the outset. Should the worst happen, they at least have a fair starting point and a platform from which they can have further discussion if needed. This approach should cut down negotiation time, reduce uncertainty and achieve a fair balance of risk between the parties who unwittingly find themselves trying to navigate unknown waters. Given the continued impact of COVID on both landlords and tenants, it continues to be important for landlords and tenants to try and agree practical and commercial solutions that take into account the impact the pandemic has had on both parties and ensuring that a balanced approach is taken going forward.

Coralie McKeivor
Senior Associate
T +44 20 7067 2444
E coralie.mckeivor@cms-cmno.com

Sophie-Jennifer Pyle
Associate
T +44 20 7367 3712
E sophie-jennifer.pyle@cms-cmno.com

Further information, including a list of our offices, can be found at **cms.law**