



COMMERCIAL PROPERTY LEASES - DETERRING OR OUTLAWING UPWARD ONLY RENT REVIEW CLAUSES

July 2004

- The Government has published a consultation document setting out options for legislating to ban upward only rent review (UORR) clauses from commercial property leases. The document has arisen as a result of an interim review of the impact of the property industry's Code of Practice on Commercial Leases, adopted in 2002.
- The Government is concerned that businesses sometimes have little choice over the terms they are offered; that UORRs can result in the risk of holding property falling disproportionately on small tenants; and that there are significant disadvantages to UORRs in falling markets. It has therefore set out a range of options designed to promote greater choice and flexibility in commercial property leasing.
- This paper provides an overview of the 6 main options put forward by the Government, setting out the implications for pub and bar operators and assessing the pros and cons of each. It concludes by addressing the most likely next steps

Overview

- Concern about commercial lease terms has been growing since 1995 when the property industry introduced the first code of practice in this area. This issue was highlighted by the Labour Party in its 2001 Manifesto and, once in power, Ministers stressed that they would monitor the impact of the 2002 revised code against choice and flexibility for tenants.
- The interim review of the Code reported towards the end of last year and a final report is scheduled for the end of 2004. Although it found that there was increased scope for tenants to negotiate individual terms of leases, there were few signs of landlords offering alternative packages. In particular, the interim report has found that the use of UORR clauses remains entrenched and is the predominant pattern of review among longer leases.
- The document acknowledges that there are benefits as well as problems associated with the use of UORR clauses. There are clear disadvantages to tenants in falling markets, but the document also highlights the fact that many tenants overlook the potential implications when taking out a lease. The advantages include a cheaper initial rent, the facilitation of sale and leaseback deals and the fact that they provide a basis against which to raise cash and invest in the property.
- The document appears to suggest that UORR clauses in themselves are not inherently wrong – provided that they are entered into freely and with a full understanding of the risks. It suggests that legislation would be targeted at the problem use of UORR – where no other terms are offered or where the landlord overstates the relative risk of non-UORR options.
- It sets out 6 possible options for promoting greater choice and flexibility and addresses these concerns. However, it is clear that the preferred Government



options do not involve outlawing only the unacceptable uses of UORRs, but rather banning all UORR clauses.

- The consultation seeks to understand the effectiveness of each option in promoting greater flexibility and the impact on the market. The proposals would apply to all types of commercial lease and are not specific to the pub sector.

Option 1 – Do nothing

- The first option would focus on promotion of the existing or a more robust voluntary code and ensuring that it is adhered to. This is not a realistic option for government given that there have already been 2 voluntary codes and the initial assessment suggests that the last one has had a limited effect – it has been included more as a matter of form rather than a serious option for addressing genuine concerns.

Option 2 & 3 – Total or Partial Ban UORR Clauses

- These two options are similar and have therefore been discussed together. Primary legislation would be introduced requiring any periodic rent review to be on an open market basis. Any lease containing a review term other than on an up/down basis or permitting only the landlord to initiate a review would be deemed to be an unfair contract.
- Option 3 introduces a slight variation insofar as it allows the parties to agree a minimum rent at the outset of the lease. Even if the open market review suggests that the rent should be below this level, the tenant would still be obliged to honour this commitment.
- A total ban on UORR clauses seems somewhat heavy-handed, particularly given that the document acknowledges that such leases may have advantages and the Government's stated objective of promoting choice in lease terms. Nevertheless, this option is politically attractive since it would be self-policing as all UORR clauses would be challengeable
- The Government is clear that if the law was changed in this way it would only apply to new leases issued after the change in the law took effect, not leases already in existence. Uncertainty and protracted political debate may have an impact on business planning, however. It is also not clear what impact this would have on renewals.
- Rent reviews may become more sporadic in these circumstances as landlords would be unlikely to initiate a review in an obviously falling market. The costs and difficulties for an individual tenant in pursuing this may be something of a deterrent.
- The suggestion of a floor on the level below rent cannot fall may be appealing to landlords as this would provide some certainty against which to raise or structure finance. However, the Government is concerned that there may be problems in defining the initial rent as the landlord may offer rent free periods or reduced rental periods.



Option 4 – break clause

- A new right would be introduced allowing tenants to break their lease if the UORR produced a rent which was above open market levels. The onus would fall on the tenant to demonstrate that this was indeed the case. Leases without an operable break clause would be deemed to be unfair and there would also be a statutory override of lease terms permitting only the landlord to initiate a review.
- This is a much more limited response to tenants' concerns than either of the above two options. The Government describes it as providing an 'escape route' but in reality it could only be used in emergency as the break would involve the tenant moving premises. In the pub sector, that is arguably no choice at all.

Option 5 – limit lease length

- By introducing a statutory maximum length of lease, the Government argues that it may be able to neutralize or limit the impact of UORR clauses. The document suggests, by way of example, that a lease with a term of more than 5 or 10 years would be deemed unfair.
- This sits uneasily with the desire to provide security of tenure for smaller businesses and ignores the very valid reasons that many businesses, particularly in the pub sector, seek longer leases. It is also entirely inconsistent with the stated objective of promoting choice and flexibility in lease terms. It is, however, superficially attractive in political terms.

Option 6 – Requirement to provide priced options

- Legislation would require landlords to provide prospective tenants with a range of alternative options, which may include UORRs. Landlords would also be required to offer pricing schedules using a standard format to provide risk-adjusted pricing of the options. Little additional information is provided, largely because this does not appear to be a serious option, despite the fact that this most closely meets the Government's objectives.
- The document notes that officials have yet to determine whether it would be workable; that it would be very difficult to police since it would apply at a point before a contract was in place; and landlords may simply offer a 'sham' choice by either going through the motions or pricing non-UORR options at too high a level.

Likely next Steps

- Whilst the document ostensibly offers 6 options for reform – and specifically notes that other non-legislative options will be considered – it is clear that the Government has a preferred route. The fact that reference to commercial leases was included in the 2001 Labour Manifesto means that legislation is almost certain and we can expect a speedy announcement on this in the Autumn to enable action to be taken before the next Election.
- The phrasing used in the document suggests that Ministers prefer Option 2 – with all other options, drawbacks are highlighted but none are referred to in this context. It



could easily be presented as a quick win and tough action being taken to protect small businesses. It also suggests that Ministers are not looking at issues outside UORR eg review panels, arbitration

ALMR Action

- The deadline for comment is 30th September and the *ALMR* will be seeking to submit a response. This will be factual and objective, reflecting the fact that we have both tenants and landlords in membership, but seeking to highlight the impact of the proposed changes on the pub sector and drawing attention to the specific requirements of the industry.
- The consultation document is somewhat simplistic and fails to take into account the range of factors considered in setting a rent eg the balance between rent and the scope of the tie, length of lease and repairing conditions. A one-size fits all approach will inevitably mean higher initial rents which may not suit all tenants. A ban on long leases must be resisted. Whilst option 6 appears attractive, we would need to demonstrate it was workable and the costs of choice would need to be addressed.