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# Lease terms — an update

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## Introduction

The government is pointing to “green shoots of recovery”, but the commercial property market remains subdued. So how has the sector responded to the prolonged downturn?

### Shorter leases and other signs of flexibility

Many practitioners will recognise the trend towards shorter lease terms. Ten and even five-year terms are becoming the norm, and break rights are now (if not standard) certainly much more common than they used to be – with a break at five years typical and occasionally breaks at four and eight years being seen.

There has been no wholesale change from rent being paid quarterly in advance, which remains the norm. However monthly payments have been agreed quite commonly by landlords faced with tenants with cash flow issues, especially in the retail sector and secondary property markets. In this recession, landlords have been very keen to keep tenants in occupation to maintain occupancy levels and defray rates and other bills.

### Guarantors

The decisions in *Good Harvest* and *K/S Victoria Street* continue to creep into drafting discussions and during applications for assignment where a guarantor is involved. Landlords are now exceptionally sensitive to the issue of enforceability of guarantors, and often uneasy about the consequences of losing a direct guarantor on assignment, in favour of the solution implied by *K/S Victoria Street*, being an authorised guarantee agreement (AGA) backed-up by a sub-guarantee (known as a GAGA).

In the light of these cases, tenants’ solicitors are heavily amending standard alienation provisions, and giving careful thought to the structure

of a guarantee arrangement. This is particularly true where parent company guarantees are being offered. In many instances, large group company occupiers should try to resist offering the ultimate parent as guarantor (in view of the enforceability problem raised by *K/S Victoria Street*), and should consider offering a guarantor lower down the financial pecking order, which might make a future intra-group assignment much less contentious.

### Break clauses

As ever, break clause disputes continue to occupy the courts’ time, and remain the subject of hot dispute between lawyers acting for landlord and tenant.

The traditional break clause, which is dependent on unqualified compliance with the tenant covenants is becoming more of a rarity. Certainly tenants’ lawyers typically resist this type of wording out of hand. Landlords’ lawyers still try to get qualified compliance obligations as well as other conditions such as payment of rent up to the break date or giving vacant possession. However, the problems thrown up by these seemingly innocuous conditions are now well known.

For example, in *Quirko Investments Limited v Aspray Transport Limited* [2011] EWHC 3060 (Ch), the landlord successfully argued that a clause stating that a break notice shall only be effective if at the time of the expiry of the notice “there are no arrears of rent reserved or any other sums due”. In that case, arrears of insurance rent by the tenant were sufficient to invalidate the break.

That strict approach was dramatically echoed in *Avocet Industrial Estates LLP v Merol* and another [2011] EWHC 3422 (Ch), where the High Court held that a tenant's failure to pay default interest of about £130 (even though interest had not been demanded) meant that it failed to comply with the strict conditions of the break notice, and the break was held to be ineffective.

As a result, well-advised tenants resist even these conditions, preferring to offer a break premium which at least gives certainty. If the landlord is insistent, tenants should revise the wording to ensure that arrears must be clear (e.g. have been demanded within a minimum time before the break), that rent can be apportioned and that no reinstatement type work is required to get the break.

Faced with a difficult letting market, landlords are keen to keep a tenant on the hook. The flipside of this coin is that landlords are also keen to "re-gear" leases to remove breaks and this is now a standard feature of investment property portfolio management. Institutional landlords (who are especially sensitive to reversionary values and certainty of long term income) will offer substantial rent holidays or premiums to achieve this.

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### **Out of hours service charges as a way of smuggling extra income?**

Landlords have long included a provision for charging an additional amount if they are obliged to provide "services" outside normal working hours – but in the past, many tenants assumed (rightly) that this would rarely be enforced. We have noticed

that landlords are now more likely to enforce this, which can come as a surprise to a tenant, who might expect access at all times and at no extra cost.

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### **"Green" leases**

The idea of a "green lease" has been around for some time, but the issue has only recently become active.

Local Authorities now have to make a presumption in favour of sustainable development, and so routinely impose "green" requirements on developers as a condition of the grant of planning permission. Planning conditions can take a number of forms, but they typically impose requirements to demonstrate that the fabric and fittings of a building comply with a minimum set of environmental credentials, and obligations to ensure that any commercial leases contain suitable "sustainable" provisions.

Some landlords have struggled with these requirements, particularly where their target tenant market consists of smaller-end commercial operations, which might not have the resources or expertise to comply with complicated sustainability obligations. Unsurprisingly, this can damage the marketability of commercial premises, and we are noticing that some landlords will take steps to "hand hold" tenants through the process.

Another principal reason for the sudden rush of interest in green leases concerns the impending arrival of the first payment date under the Carbon Reduction Commitment Scheme – due in June 2012. The Scheme controversially imposes a tradable tariff based on energy consumption (no

longer intended to be revenue-neutral), so there is now a clear financial incentive to improve energy efficiency in commercial properties. Tenants and landlords often try to bat-away the obligation to meet the costs of the Scheme, but on the whole, landlords do appear to be passing the cost onto tenants, although tenants with particularly strong covenant strength are occasionally able to resist cost.

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### **Avoiding disputes**

Sophisticated landlords and tenants are avoiding costly and lengthy disputes by engaging with each other closely at the Heads of Terms (HoTs) stage. This tends to make lease negotiation a much smoother process, and should save clients money in terms of legal spend. Solicitors advising either party can win brownie points by offering early involvement at the HoTs stage, and should at least offer comments on the HoTs before they are signed off.

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### **Dilapidations**

Recessions have typically always been good for the dilapidations industry and this one is no different. This is an area where considerable friction can arise between former landlords and tenants. The temptation is for landlords to exaggerate claims (e.g. requiring improvements going beyond repairs or claiming for work which they have no intention of doing). The temptation is for tenants to do no work and then haggle ill-advisedly about whether the landlord has suffered any loss. These sorts of arguments can be particularly heated where the premises are older and tired and needs a substantial overhaul to be put back on the market.

These arguments were aired in the infamous PGF case in 2010.

The number of claims actually getting to court is small because most settle, but the industry is well aware of the tensions and in recent years has sought to minimise this by requiring greater openness and transparency in the negotiation. This has led to the formal adoption of the Dilapidations Pre-action Protocol under the Civil Procedure Rules and it will be interesting to see how effective this will be.

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