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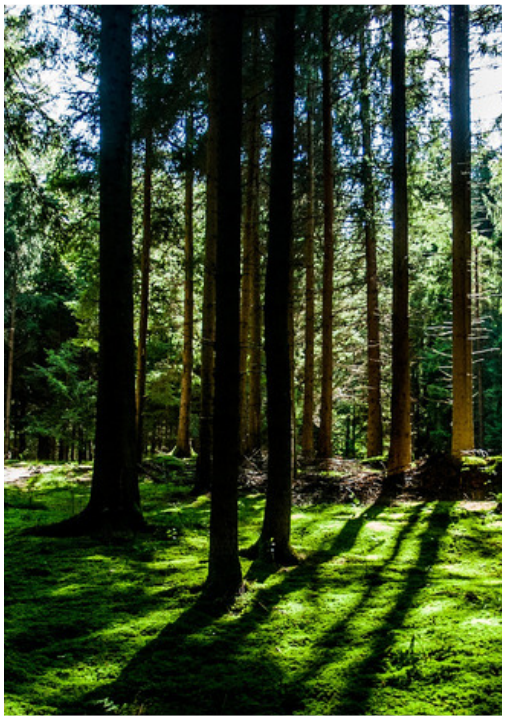
Commercial Leases: Heads of Terms



Part 1:

What are heads of terms ("HOTs") and why are they important? Who should the tenant be?

Heads of terms are the main terms of a commercial transaction put together by an agent, usually a commercial agent, to set out what has been agreed between the parties. They are important because they set out to the parties and the professionals advising them what has been agreed.

It is not just the rent and the length of a lease which are referred to in a commercial agents HOT's. Most importantly several key points are referred to here also and a tenant needs to be informed what these other points are, such as, break clauses, rent free period, fit out works and approval, signage, whether the lease is within the Landlord and Tenant Act 1954 and so on.

Commercial Property agents are incredibly important in this role. They are the glue that can keep the deal together but also ensure that all the parties have agreed terms set out before solicitors are instructed.

Must always be SUBJECT TO CONTRACT. Sometimes it is difficult to have client who has agreed HOTs without taking a solicitors' advice and doesn't fully appreciate the implications of what they have agreed to, either from a landlord's or a tenant's point of view.

Relied upon as evidence of agreement – important because both sides can become intransigent and stubborn if things are not agreed before HOTs issuedThe first important point to focus on is the parties provision. This is, in essence, who is going to be the tenant and the landlord.

The landlord obviously cannot change its structure once the property is owned in a particular format. So, if the landlord is an individual and holds the property as an investor, then the landlord will be granting the lease personally. The focus here is always on the tenant and the legal entity the tenant will have.

So what should you consider and why?

The landlord will want security. It's a simple fact so having the Individual as tenant best suits the landlord because that individual is bound by all the terms. It means the Tenant is held responsible for all liabilities under the lease personally. The tenant, however, needs to make careful consideration as to what entity they wish to take the lease in.

Obviously, taking a lease in your personal name makes you personally liable for all of the obligations under the lease. It is amazing how many times as a solicitor we see this and the tenant has gone from bank manager, to accountant, to agent and then to us and the deal has been 'agreed'. Your solicitor should be involved at the outset and explain the implications of why taking a lease personally will not always be beneficial.

Another option is for the Tenant to be an incorporated limited company. A limited company has legal capacity as an entity and once it has entered into a contract (a lease in this instance) is the responsible party. It is always better for a tenant as the company is responsible and not the individual director and person of significant control of the company. This is very important to note. The landlord therefore often wants additional security and therefore requests a personal guarantee for the tenant company or even a tenant in an individual capacity. A person should avoid this unless they are fully aware of the risk of a guarantee and what they are guaranteeing. It means the Landlord has ultimate protection against not only the Tenant but also a guarantor.

A guarantor may limit their liability (if it's absolutely required) by asking for a financial cap on the guarantee. It is fundamentally important to remember that a lease isn't just an obligation to pay rent. The personal guarantee can bankrupt the guarantor of a tenant.

We have seen situations where, under a personal guarantee scenario with an uncapped liability, a guarantor was forced to pay £100,000 for repair to the structure of the building including the roof, scaffolding, repairs, repointing, and other items for the maintenance of the building once the tenant company had failed. So, do not give a guarantee uncapped, or at least try to negotiate this with the landlord in an amicable way.

Why else should a tenant not take a lease in a personal capacity or limit a guarantee? One of the particular provisions in a lease which is often ignored, **is the general form of indemnity in the lease**. An indemnity is effectively an uncapped guarantee given by the person promising to indemnify the other, that if anything happens, which the other party suffers loss for, they will pay for that loss.
This should at least be attempted to be removed from the lease but discussed at the point of negotiating the HOTs.

Tenants who take leases in their individual names and agree to that full indemnity are putting themselves at risk of potentially having a personal claim, not only under provisions in the lease, but also the indemnity.

Tenants who give guarantees and landlords should also look at capping this. **The key here is therefore that the landlord want to make sure they have a tenant as long as possible and if that tenant fails they have a way to continue getting rent / payments. Tenant's need to ensure they are not putting their personal assets, home and potentially a third-party guarantor on potentially crippling financial liability indefinitely and uncapped.**

The key is to try and find a balance! But also speak to your solicitor before agreeing who the tenant will be!

What is the tenant's favoured position?

So, what kind of entity can the tenant be and what are the implications of that?

The main one will be a limited company. From a landlord's point of view, rather understandably, a newly incorporated limited company is not an attractive proposition as a tenant, but actually there are reasons for a tenant to take a lease in the name of a limited company and if the landlord has adequate protection, either in the form of a deposit or a personal guarantee from the tenant (see above) then a limited company has very attractive qualities.

1. The first of these are tax implications. We are not tax specialists so you must speak to your accountant. Two such tax saving schemes are The Seed Enterprise Investment Scheme (SEIS) and the Enterprise Investment Scheme which are both significant tax factors for a tenant. The SEIS, in particular, provides the rebate of income tax paid by the investor if they hold less than 30% of the company shares and the company is less than two years old.

For example, if somebody is setting up a restaurant and they want to take the lease, they could have an investor giving £50,000 and if that investor then holds less than 30%, they will get £25,000 back from the government against previous tax paid on their income. It's a very important incentive. Landlords should appreciate that tenants would want to be able to succeed in the business and this obviously allows them to limit the start-up cost by 50%, assuming they've paid tax previously. It will help the business to grow and to flourish. Landlords should be looking to help the tenant at the start.

2. Transferability of a company is much more straightforward than an assignment where the landlord controls every aspect. You can as accompany owner, transfer your shares in the company when selling the business or if you wish to retire and transfer the lease This means you don't have to go through a potentially difficult assignment procedure under the lease terms which allows the landlord to ask for a guarantor, have his fees paid and verify and approve the incoming tenant.

3. Rates and Small business Rates relief – a very useful aspect of having a tenant company is of course business rates, and in particular, small business rates relief. If you have more than one property, you will lose small business rates relief unless both properties have a rateable value of less than £2,600, which is effectively a shed!

For business rates a company is also responsible (and any guarantee must be within a separate document). The local authority can only ever ask that company to be responsible for the rates and not any individual. Business rates can cripple a business and if that business fails, like the landlord, the local authority will request rent until the end of the lease regardless of occupation. Therefore a company with no assets or money will continue to be responsible until it is dissolved or liquidated or the landlord agrees to transfer liability or bring the lease to an end.

Landlord protections against a limited company as tenant

In order for the limited company to be agreed, therefore, what kind of protections can the landlord obtain?

- The first of these, of course, is the deposit. Now, a deposit shouldn't be seen as a guaranteed amount of cash for the landlord, as actually it's held on trust for the tenant. A landlord should be looking at a deposit as a suitable and adequate protection for the tenant that is taking the lease. From a landlord's point of view, if you have a newly incorporated limited company, asking for a 6 month deposit is not uncommon. The landlord therefore has a 6-month cushion to be able to find a new tenant and let the property out. Each case and property will be different and of course the landlord must be happy with the proposal and the incoming tenant's business plan but 6 months rent being held as a deposit can be considered reasonable security for the landlord, rather than the personal guarantee.

- Landlord's need to also understand that a tenant company gives significant tax breaks to the tenant allowing them more financial security and gives the tenant the best chance for success (see above). The message here is, therefore, do not be scared of tenant companies as there are significant reasons why a tenant would want to do this and also with the adequate security of a deposit and in addition or in addition or substitution of, a personal guarantee (capped, of course) the landlord can rest assured that they are covered in case of a tenant insolvency.

- To recap, from a landlord's point of view, obviously having a tenant as an individual as well as a deposit is the best form of security. It will of course, depend on the strength of covenant of that individual as if they have no assets, then it makes no difference whether they are a company or not. From a tenant's point of view, a company with no guarantee and a deposit would be best. It's a balance but the word of warning here is do not agree to just take the lease in your name without speaking to a solicitor. There are a lot of factors and an agent will ask you who the tenant will be and you will need to consider all the options before confirming.

Part 2:

Negotiating Heads of Terms

In this part we will look at the Landlord & Tenant Act 1954 and its impact on a lease. The question is with the Act, is the lease within the security of tenure provisions, or out?

The 1954 Act was a piece of legislation the government at the time enacted to support tenants in post-world war Britain. Scrupulous landlords were signing leases with tenants on a short term basis and due in no part to the sheer limitation of commercial property in the UK due to the bombing of industrial and commercial property, the tenants would have to leave after a short time and the landlord would have a new tenant paying significantly more rent.

This situation was changed by the 1954 Act which, amongst other things, provided that, should a tenant have a lease granted within the act, then the tenant could at the end of the lease remain at the property subject to the landlord's right to obtain possession by a Court Order on seven grounds, all contained within the Act itself. These grounds make it difficult for a landlord to remove a tenant. We are not here to give a full breakdown of the grounds but, for example, the grounds can be such examples:

- The tenant is consistently late with rent. This is a protection for a landlord that the tenant is a bad payer and therefore the landlord shouldn't have to endure a tenant who is inconsistent in paying rent. There is however an issue with this in that case law has suggested that if the tenant at the court date to decide on a new lease or not, is not in arrears, this ground cannot be relied upon and it is not mandatory on a judge to grant possession.

- The landlord wants to develop the property. To use this argument and ground the landlord cannot just say they want to develop, they need to have gone some way with that, such as obtaining planning permission.

Just these two examples of grounds can show how difficult it can be for a landlord to obtain possession. The landlord must also go through a Court process, serve notice on the tenant and pay the fees of going to court. This is not an ideal scenario.

The process of renewal also favours a tenant, allowing a tenant to effectively serve notice before the landlord has an opportunity to do so, confirming that, pursuant to the 1954 Act, they want a new lease and suggest their terms first. If the tenant doesn't serve a notice, the landlord is able to do so and a tenant, very important to remember, will inadvertently lose their right to a new lease if they fail to respond within strict time limits. Please remember this.

The 1954 Act is therefore important for a tenant to instruct the agent upon and state that the lease must be within the 1954 Act and its protection.

Landlord's will sometimes not like the lease to be within the Act and reasons for that could include:

1. They want control so that a tenant must leave or agree a new lease at the end of the term.

2. They can control the rent. If the lease is renewable under the 1954 Act then without agreement between the parties on renewal, a Court will set the rent. Why would a landlord want to put that in the hands of a Court?

3. They can re-take and do what they wish with the property at the end. The asset isn't potentially indefinitely leased to a tenant under the original lease.

The security of tenure provided by the 1954 act is great for a tenant. The Act itself also provides for compensation if the tenant has to leave but doesn't want to. It is therefore a negotiable point in heads of terms and both landlords and tenants must understand the implications of a lease being within or outside the Act. For a lease to be outside the tenant must make a declaration in front of an independent third party solicitor.

Think carefully before what you agree is set in the Heads of Terms as your solicitor will then have to renegotiate either way and it is likely to be disagreed or become an issue with the other side.

Part 3:

Alienation and Transferability of the Lease

What is alienation?

Alienation is the general term for the tenant's ability to deal with the lease. Most commonly this will refer to the tenant's ability to either;

1. transfer the lease to a third party;
2. underlet the whole or part of the premises; or
3. share occupation of the premises.

It is equally important for both a tenant and a landlord that the agreement in relation to alienation is clearly set out in the heads of terms and followed through in the lease. Failure to consider these terms could result in the landlord giving the tenant complete freedom to deal with the premises however they wish, or could result in the tenant not having the flexibility to assign the lease when circumstances change.

Assignment
Assignment involves the transfer of the whole, or part of, the lease to a third party. The assignee becomes responsible for rent and other obligations under the lease, and so the landlord will want to ensure that it is of good financial standing. Without an express restriction on assignment, the tenant's benefit in the lease can be freely transferred to another party. For this reason, commercial leases will often contain restrictions on the tenant's ability to do this. These terms should be clearly defined and agreed in the heads of terms so that there is no dispute when drafting the lease.

Under-letting
Under-letting, or subletting, is where the tenant retains its own lease, but a new lease is granted to a third party from the tenant's own lease. There are several situations where this arrangement is appropriate (for example where there is an area of the premises which is surplus to the business requirements), however Landlords will want to retain a degree of control over any subletting, as there are circumstances where the sub-tenant can become the immediate tenant of the landlord.

Sharing Occupation
Covenants that prohibit a tenant from sharing occupation, prevent them from granting a licence to third parties for use of part of the premises, and therefore sharing occupation of the premises. It can also prevent sharing with companies from within the same group. Therefore, tenants should resist an absolute bar against this type of restriction, unless they can be sure that they will not require to share possession of the premises in the future.

Restrictions on Alienation

As you can see these provisions have the potential to cause dispute given the differing requirements of the landlord and tenant. Heads of terms should therefore record what restrictions have been agreed on the tenant's ability to deal with the lease.

An absolute covenant against dealings would be unusual in a business lease, because a tenant is unlikely to agree a complete bar on their ability to deal with the lease. A tenant should resist any such restriction except in very short business leases.

A common compromise is for the lease to prohibit assignment of part of the premises, but allow the tenant to assign the whole of the lease with the landlord's consent. Where a lease does permit assignment with the landlord's consent, it is implied by Section 19(1) LTA 1927 that such consent cannot be unreasonably withheld. This should still be expressed in the lease. As a tenant you must remember that the requirement for the Landlord to act reasonably does not prevent them from requesting that the tenant pays their reasonable legal, or other, expenses in connection with the consent.

It is usual for assignment of part to be restricted in the lease as this would raise issues to do with apportionment of rent and service charge which could be a complication. However, the wording must be carefully considered as a simple covenant not to assign or underlet any part of the premises could result in a complete restriction of assignment of the whole of the premises (Field v Barkworth [1986] 1.E.G.L.R. 1).

As a result of the LT(C)A 1995, s19(1A) was inserted into the LTA1927, whereby the Landlord can stipulate certain conditions that must be met if they are to grant their consent to any assignment. The landlord can withhold its consent on one of the agreed grounds without acting unreasonably. The type of conditions that can be imposed are left to the parties to decide, and should be recorded in the heads of terms.

One of the conditions that is most onerous for the tenant is that they may be asked to provide an Authorised Guarantee Agreement (AGA) on any assignment. This is where the outgoing tenant is required to guarantee the assignees obligations under the lease, and is one of the most common restrictions that a Landlord may request. The AGA itself must comply with the requirements of S.16(2) LCTA1995, and importantly will only apply for as long as the assignee is liable. Tenants should consider whether it is appropriate in the circumstances for them to provide an AGA, particularly if it is likely that they will assign to someone in a better position. It is also important for corporate tenant to always ensure that any director of the company is not required to provide an AGA for any incoming tenant on assignment, otherwise this could result in them becoming personally liable for the lease obligations, including payment of the rent.

Another common condition that can be imposed by the landlord in the lease is that a person of standing acceptable to the Landlord, acting reasonably, enters into a guarantee and indemnity of the tenant covenants of this lease. A tenant must consider each of the conditions carefully and decide whether in the circumstances it is appropriate. From the landlord's point of view, extensive restrictions on alienation are not always a sensible idea as they can have a downward effect on rent at rent review as it can result in the lease being less marketable.

Certain restrictions may also apply to subletting. For landlords they should consider whether they should require that the sub-lease contains provisions that require the subtenant to enter into direct covenants with them, prohibit any further dealings of the sublease or require the subtenant to comply with all covenants with the headlease. Tenants should consider each restriction carefully as they can restrict the pool of tenants that can be let to. For example, where there is a provision preventing the tenant from subletting at less rent than currently payable under the headlease, if rents have fallen since the latest rent review then it may prove difficult to sublet.

You can see that it is therefore key for landlords and tenants to agree all aspects of alienation during negotiations for the lease and ensure that the heads of terms reflect the agreement. This guarantees that the lease does not become a burden to the tenant if they are not able to dispose of it, but allows the landlord to keep control over dealings with the lease to ensure that any incoming tenant is of good financial standing, and will not have a detrimental effect on the landlord's other existing tenants.

Part 4:

Rent Free Periods and Break Clauses

Rent free period – What is it and why use it?

A rent free period is given at the beginning of a tenancy during which no rent is payable by the tenant for a set period of time. It is given:

- As an inducement to the tenant to enter into the lease which does not affect the headline rent; or
- Recognition of the fact that until the property is in a bad state of repair and the tenant's fitting out works are complete, it cannot use the premises for its business, or
- For the landlord to get a tenant induced into entering a lease and then having the property put into a state of repair which is better than at the start without having to do that work at the landlord's cost (effectively using the tenant's resources to do this).

However, one should be aware that a tenant is usually still obliged to pay "additional rent" or "maintenance charges" during the rent free period and these can include charges such as operating expenses, costs related to common area maintenance, utilities, electricity, insurance and all common items for services to the building or the estate the property forms part of.

Rent free periods should always be requested – if you don't try you won't get the concession. Empty properties most commonly mean a business rates liability for a landlord so they want a tenant in occupation and are likely to offer such incentives.

What is the most effective method to persuade your Landlord to agree a rent free period?

1. If there is any disrepair at the property, the tenant would usually seek to have this rectified before the lease is completed. More often, this does not happen as it is not practical due to time constraints. Therefore, this is usually a good time to request a rent free period to cover the extra costs incurred in carrying out the works instead of the landlord. Again, a surveyor is best placed to address the repair works that are required and potential costs. This will place the tenant in a better negotiating position with the landlord.

2. A similar principle can be applied when it comes to works that are required to comply with statutory requirements – fire safety, asbestos regulations, EPC regulations or any other statutory controls. It is reasonable to suggest that the tenant shouldn't be out of pocket so the property can be compliant with the current regulations. For example, if the property needs new fire exit doors and the cost of this is £6,000, and the lease rent is £2,000 per month, a rent free period of 3 months could be requested. Landlords do at times however have a 'take it or leave it attitude' so a Tenant needs to offer some justification for their request.

3. The landlord may use a rent free period as a way to encourage the tenant to take the rent. This is typically the case where they have a property that is difficult to rent. This is why it is useful to get in touch with a surveyor or specialist who arranges rent free periods for comparative properties in the area. The tenant may think they have found an attractive lease with a competitive rent free period. However if potential tenants are avoiding the property then you know that the landlord is just using this as a means to cover up potential issues.

4. In most cases, tenants will have plans to complete fit out works towards the beginning of the lease in preparation for whatever their business may be. The tenant may think that it is unlikely that the landlord would essentially cover the cost of this by giving a rent free period. However, whether it is just applying a coat of paint or just basic home improvements the landlord will be more likely to agree to this if the works will generally upgrade the estimation of their property.

5. One of the most obvious reasons for requesting the rent free period is that whilst the above is being carried out it's unlikely that the tenant will be doing any business. Therefore, the rent free period somewhat compensates for their loss of business during this time as well as improving the landlord's property. It would be unreasonable to request that the rent is paid whilst the property is unusable. Even in the early days of the business, this time would allow the tenant to develop it and take the weight off what otherwise may be some rough circumstances.

If a landlord can avoid giving a tenant a rent free period it will of course do so. Therefore, it lies with the tenant to negotiate one. The tenant has nothing to lose and in the worse scenario the landlord would just reject – but best case could leave the Tenant with a respectable rent payment period taken off its lease.
Break clauses – why and when?

Break clauses can be included in a fixed-term lease allowing either the tenant or landlord to terminate the lease early. Some leases can include break clauses for both the landlord and the tenant. Exercising the break clause brings the lease to an end.

Depending on how the lease has been drafted, the right to break the lease may arise on one or more specified dates or be exercisable at any time during the term of the lease on a rolling basis. However, a formal notice is normally required to exercise a break clause.

A break clause may only be exercised if any conditions attached to it have been satisfied. The lease will outline these conditions, for example it may specify that the tenant must give vacant possession of the property at the date when the lease is to come to an end. A break clause will be strictly construed by the courts and any conditions must be strictly performed. Therefore, it is crucial that the tenants pay particular attention to this.

The 2007 Lease Code recommends that: "The only pre-conditions to tenants exercising any break clauses should be that they are up to date with the main rent, give up occupation and leave behind no continuing sub-leases. Disputes about the state of the premises or what has been left behind or removed, should be settled later (like with normal lease expiry)."

Although it sounds simple enough, but in practice a tenant wishing to exercise a break clause which is subject to pre-conditions may find it anything but straightforward.

Practical issues for tenants to consider when exercising a break clause

- Once a notice exercising the break clause has been served, it cannot be withdrawn. Therefore, the tenant must be sure that they want to end the lease early before serving the notice triggering the break right.
- Tenants should comply with all the relevant requirements in the break clause and keep evidence of their compliance to help protect their position.
- Serve the break notice in good time and strictly in accordance with the terms of the lease – the lease may contain provisions relating to serving the break notice that are not in the break clause itself. If the lease says 6 months' written notice you must give a full 6 months in accordance with the notice and service provisions of the lease. Do not miss your date!
- Pay any outstanding sums due, even if these are in dispute. Payment can be made on a "without prejudice" basis and discussed later. Again, this is particularly important where such payment is a condition of the break clause.
- The tenant might not be aware of all the money it owes. The lease may oblige the tenant to pay interest in respect of late payments, so check if any such interest is due in respect of arrears in the past. The tenant may owe interest on historic arrears, even if the arrears have been cleared and the landlord has not requested the interest. Unless the tenant has received a demand for such interest, it may have difficulty knowing precisely how much interest is due, but the landlord has no obligation to tell the tenant how much interest is owed. The tenant should try to estimate the amount due and err on the safe side when paying. The cost of over-estimating the amount due for interest is likely to be far less than the cost of remaining bound under the lease. The exact amounts owed can be settled later.
- Ask the landlord for confirmation of the steps required to comply with any conditions in the break clause. In particular, the tenant may want to be sure that it has complied with its repairing obligations under the lease. In order to do this, the tenant may ask the landlord to prepare a list of items that are in need of repair, and for which the tenant is responsible under the lease. This list is known as a schedule of dilapidations.
- If a tenant agrees to carry out works to the property before the break date, be careful to ensure that the works are completed and vacant possession is given by the break date.
- Remember that there may be general obligations that apply at the end of the term of the lease, which will need to be complied with before the break date. For example, the lease may require the tenant to remove signage, reinstate alterations and redecorate the property. You should also check supplemental documents, such as any licences granted for works to the property, in case these contain obligations that are relevant to the break.
- Consider asking the landlord to accept the break notice on payment of an agreed amount as liquidated damages for any outstanding breaches of covenant. Liquidated damages are a fixed or determined sum agreed by the parties to a contract to be payable on breach by one of the parties.

Practical issues for tenants to consider when exercising a break clause

- Ensure that any waiver of a break clause condition by the landlord is not made “without prejudice” and that it is clear to which condition(s) the waiver applies.
- Do not assume that the tenant is only obliged to pay an apportioned part of sums due under the lease, for the period up to the break date. The lease may require full payment.
- If the tenant is obliged to pay any sums in advance, such as rent, service charge or insurance rent, check to see if the landlord is obliged to refund any part of those sums that can be attributed to the time after the lease ends. The tenant will not normally be entitled to a refund of rent paid in advance, unless there is an express provision in the lease to the contrary.

Landlords looking to protect their reversion and to keep their options open could also request a break clause. This suits the landlord because it can retain control of a valuable property in a shorter period of time. Importantly, any lease with a landlord’s break must be excluded from the Landlord and Tenant Act 1954 (see series 3)

Having seen from the above, a break clause is an important provision of a lease. At the head of terms stage, the tenant should not be prevented by breaches of covenant or other conditions attached to the break clause. This is why it is vital that tenants take expert legal advice before agreeing to the heads of terms with the landlord and should also insist that the exercise of the break clause not be subject to the pre-conditions

Part 5:

Service Charge and Insurance Provisions

Service charge and insurance provisions are potentially one of the most misunderstood areas when considering a commercial lease, but also one of the most crucial because of the opposing positions of the landlord and tenant.

What is a service charge?
The service charge is the mechanism within the lease allowing the landlord to recover its service and maintenance costs from the tenants. Where there is a multi-let building or series of buildings in an estate, the landlord will wish to ensure that it is able to recover the service charge from the whole area from the different tenants. For the landlord, this is known as achieving a “clear rent”, as they do not then need to spend any of the rent money on maintenance expenses.

The tenant’s point of view is more balanced. Whilst they want to limit their liability to pay for works to other parts of the building or estate, they would also wish to maintain the overall appearance and condition of the building. The important point for the tenant is to remove from the service charge any items that it thinks should be supplied and paid for by the landlord, or for which other tenants should be responsible. As there are limited statutory restrictions on the service charges in commercial leases, the parties are free to negotiate whatever provisions they would like. The final service charge and insurance provisions will therefore largely depend on the bargaining power of the parties.

What is covered by the lease provisions?

Let’s look at the main elements of what should be included in the service charge clause:

1. Firstly, the clause must contain a list of the services for which the landlord can charge the tenant. These will usually include a number of matters which the landlord is obliged to provide by covenant, and a number of matters which the landlord is not obliged to provide, but for which the tenant must contribute if they are provided. Despite the tenant being required to pay for these, the landlord is not necessarily required to provide them (Russell v Laimond Properties (1984) 269 E.G. 947). As the tenant, these are the items for which you will be responsible for contributing the agreed proportion. You must remember that this relates to the whole of the building or estate, and not just the lease of your part. The obligation to insure can also be included here as one of the services, or can be included separately within the lease.

This important point is that if included here the remaining provisions will apply to insurance charges. Another point to consider is management costs. These are often included in the service charge if the Landlord employs a managing agent. The tenant may wish to impose a cap on what can be charged here, whilst the landlord will wish to recover as much as possible from the tenants.

2. Secondly, the clause will place an obligation on the tenant by a covenant to contribute towards the total service charge cost for the building or estate. In a larger estate or even in a multi-let building, it is important for the landlord that the service charge provisions of each lease are exactly the same. It can therefore be difficult for a tenant to negotiate the standard provisions in these circumstances. The exact proportion that an individual tenant will pay can be fixed in the lease by a percentage, but whilst this provides certainty, it can also result in an unfair result if there are any changes in the future. The other common option is for the proportion to be based on a fair proportion. This method is more flexible when there are changes to the building or estate, but can also lead to disputes over what constitutes a fair proportion.

3. The Third element of the service charge provisions is an obligation on the landlord to provide the services, which usually forms part of the Landlord's covenants. From the tenant's point of view, they will want to ensure that the covenant is a full obligation on the landlord to provide the services, whereas the landlord is likely to try to limit their obligation by stating they must only use their 'reasonable' or 'best' endeavours to provide the services.

4. The final key part of the service charge provisions are the operative parts e.g. how the mechanism for payment will work. The service charge will usually be calculation by reference to a given service charge year. There must also be a provision for a statement of account to be prepared and this should then be certified independently. Importantly, there must also be a timescale for preparation of the service charge accounts, which should occur promptly after the end of the Service Charge Year. If there is any delay, there may be problems for the tenant on assignment as there could be sums outstanding after the assignment. The Landlord may also validly be able to reject an application for a licence to assign if such sums are outstanding. This ties in with the matters discussed in Part 3 of this series on alienation.

What should the landlord consider?

There are some important issues that the landlord should consider when negotiating a new lease:

1. It is a common for the lease to provide for advance payment of service charge, usually paid monthly or quarterly, to allow the landlord to have sufficient cash flow to undertake the services for which they are obliged. It is important in this situation for there to be provisions dealing with the any overpayment or underpayment when the service charge accounts are finalised. From the Landlord's point of view, any excess service charge payments should be set off against future service charge costs.

2. It may be useful for the Landlord to be able to vary the services that they are to provide. Particularly in larger developments, circumstances may change and so there could be a need to alter the services that are provided at any given time under the service charge provisions. Tenants may be reluctant to agree to this, but without such a right in the lease the landlord would not be able to vary the services that they are obliged to provide should the need arise.

3. Again, there may be a need for a provision providing for provision and maintenance of a sinking or reserve fund. Given the complex tax issues, and the burden of administering these funds, they have become a less popular option, however the landlord should consider if this is required.

4. The landlord may wish to make the provision of the services conditional on payment of the service charge. In smaller multi-let developments, or in single let properties, this can be an effective method for the landlord to ensure that they do have to outlay substantial funds in order to provide the services without receiving the advance service charge payment tenants. In a large multi-let development, this can be less effective as it would be unlikely that all tenants would be in arrears of service charge, and as such the landlord would still be obliged to provide the services for those tenants who are up to date with their payments.

5. Where some parts of a multi-let development are vacant, the landlord will want to consider how payment of that portion of the service charge is covered. The tenant will be keen to ensure that they are not responsible for excess payment here, but where the service charge is by reference to a fair proportion, this will be of the whole of the service charge for the premises, and will oblige the tenant to contribute.

What should the tenant consider?

Likewise, the tenants can be heavily impacted by the service charge provisions, and such they should be carefully considered. In particular the following should be discussed

1. The service charge may be capped, and this is something the tenant should consider negotiating with the landlord to provide them with certainty of their expenses. This restricts the amount that can be charged by the landlord in each service charge year. Whether this is acceptable will largely depend on the bargaining strength of the parties. If an outright cap is not accepted, then the landlord may accept a cap that has an increase linked to the Retail Price Index, or other mechanism allowing proportionate increases.

2. The landlord may try to negotiate a ‘catch-all’ clause that allows them to include additional items that they decide to provide within the service charge. Although this is not objectionable in principle for the tenant, it gives the landlord wide scope for provision of services, and so the tenant should insist that the clause is limited so that the landlord is acting reasonably at all times. In Fluor Daniel Properties Ltd v Shortlands Investments Ltd [2001] EWHC 705 (Ch), the court said that the landlord must consider the length of a lease when acting reasonably.

3. Where statements of account are prepared, the tenant should insist that the person who prepares them is fully qualified to do so, and independent from the landlord. This can add extra cost, however where the statement is to be final, it is key for the tenant to be comfortable that this accurately reflects the correct position.

4. Any guarantor of the tenant will also be providing a guarantee of payment of the service charge. For this reason, they should be aware of the costs and requirements of this. Similarly if the tenant forfeits the lease the guarantor could be asked to take a lease in the same format, and so they would take liability for the payments.

Insurance Provisions

Commonly, the landlord will insure the building or development as a whole, and then recover the cost of this from the tenants. This insurance would be in the landlord's name and the tenant would want to make sure that it is to the full reinstatement value. From the landlord's point of view, this should also include cover for loss of rent for a specified period. The tenant will be prohibited from doing anything that may vitiate the landlord's insurance.

The insurance provisions will then usually provide that the tenant is liable for repair and upkeep of the property, except where damage is caused by an insured risk. In this situation, the landlord becomes liable to claim under the policy, and to apply the proceeds for reinstatement of the property as a whole.
The tenant should insist that if the property has been damaged or destroyed by an insured risk so as it so that it is no longer able to be occupied for the permitted use, that the annual rent is suspended for a set period of time.

Some important points to consider in relation to insurance provisions:

1. The landlord's obligation to insure should not be linked to the tenants payment of the insurance rent or service charge. This should be separate with separate remedies for breach of covenant if left unpaid. This is particularly key in multi-let buildings and developments.

2. The landlord should not accept a complete liability for insurance. Where the policy has been vitiated by an act of the tenant, or where the policy itself limits cover the landlord's solicitor should ensure that there is no liability on the landlord for insurance not being in place. From the tenant's point of view it is important that they include in the lease an obligation on the landlord to provided copies of the relevant document on them so that they are aware of all the restrictions.

3. There can be disagreements between parties over what should be covered by the 'insured risks'. The normal position is that cover is provided for usual risks by reference to a list of insured risks in the definition section. Special consideration should be given in the circumstances of each lease to ensure that all necessary risks are covered.

A final important point to make for both landlords and tenants is how the payment is defined in the lease.

Often the landlord's starting position is to reserve the actual rent, insurance, service charge and interest owing as 'rent'. A tenant should reject this because the payment of 'rent', or in actual fact, the non-payment of 'rent' can lead to forfeiture provisions being instigated. A landlord is able to forfeit the lease if a tenant has not paid 'rent' within say 14 or 21 days of demand. If service charge and insurance are classed as 'rent' the tenant must pay or risk forfeiture. This means a tenant who disputes the payment of a service charge or insurance must first pay to avoid forfeiture and only have the right to contest. We advise that only the actual rent is reserved as such and other payments are separated as other payments.

Part 6:

The Tenant's Covenant to Repair

Tenant's covenant to repair – What is it and what is a Full Repairing and Insuring Lease?
Full Repairing and Insuring lease ("FRI Lease")

When there is a lease of whole or part, a reference to a "full repairing and Insuring lease" means that the tenant has full responsibility for the repair of the property, building contribution by way of service charge (if lease of part) and to pay towards part or the total cost of building insurance for the Business. They will be responsible for carrying out the repairs and bearing the cost of these repairs if it is a lease of whole for the whole building (roof, structure, foundations etc unless specifically excluded) and if a lease of part, for their part of the Building and then the remainder by way of a service charge.

As stated, if the property is part of a larger premises, an FRI Lease places responsibility for repairing the property, as well as being responsible for the repair of the external parts and communal areas by way of service charge. For information on service charges, please see part 5 of our Head of Terms series.

Repair
The lease will usually require the tenant to keep the property in "repair". A common misconception in commercial property is that a tenant believes their obligation extends to what they received the property in. This is incorrect. The repairing obligation is based on the wording of the lease. So the words 'good and substantial repair and condition' mean that the tenant is required to keep the property and structure in that level of repair and condition (more later) Therefore, this would include an obligation to put the property into repair if it is in disrepair at the start of the lease. This would be because the tenant cannot comply with their obligation under the repairing covenant unless the tenant first puts the property into the level of repair required by their covenant.

It is vitally important that before taking the lease the tenant inspects the property (and the building if part of the property) for any disrepair – a building and structural survey is always recommended. At this stage it is important to note the potential repair costs – either directly by the tenant or by way of the service charge.

A tenant should consider restricting its obligation to simply keeping the property "in repair" to avoid assuming a more onerous standard of repair in the wording (such as 'good repair') – in most instances the Landlord will require the tenant to keep the property in "good repair" or "good repair and condition".

The above should be considered in detail as the state of repair of a property can cause disputes at the end of the lease term, when the tenant must return the property to the landlord. This is known as dilapidations and is a very difficult area for tenants at the end of the term. There will also be issues if the lease is renewed under the Landlord and Tenant Act 1954 as the landlord can as a condition of agreeing to renewal ask for the covenants in the lease (including the repairing covenant) to be complied with fully.

Meaning of repair

The standard and nature of the work that the tenant has to carry out depends on the age and nature of the property at the date of the grant of the lease (Lister v Lane [1893] 2 QB 212). Therefore, in principle (but case by case can be different) if the property is old and dilapidated, a covenant to repair it will not require the tenant to modernise it.

Woodfall: Landlord and Tenant (at paragraph 13.032) advises that the correct approach to assess whether works go beyond repair is to:

- Look at the particular building.
- Look at the state which it was in at the date of the lease.
- Look at the precise terms of the lease.

Conclude whether, on a fair interpretation of those terms in relation to that state, the requisite works can fairly be termed repair.

Tenant's should be aware that some leases use alternative or additional words and phrases besides the word "repair" to impose a repairing obligation on a tenant. For example, a covenant that requires the tenant to keep the property "in good repair and condition" is more onerous than one that specifies "good repair" alone.

If the lease states that the property must be kept in "good condition", this means that the Landlord can require works to be carried out, also to the structure perhaps, even if there is no disrepair.

In a lease of part, a detailed definition of the premises should be included which specifies exactly which parts of the building are included and are therefore the tenant's responsibility under its repairing covenant. A poorly defined repairing clause can cause disputes between the landlord and tenant.

How may a tenant limit their obligation?

Schedule of condition
The tenant's responsibility to repair is as required by the wording of the lease, not the actual condition they take it in. The schedule of condition reverses that and so it is vital that there is one negotiated at the outset. A photographic schedule is preferred with adjoining notes.

A tenant will want to limit its repairing obligation to keeping the property in the same state as when the lease was granted. In particular, when the property is already in a poor state of repair, as a covenant "to repair" would require the tenant to put the premises into repair.

If the parties agree that the repairing obligation will be limited in this way, a schedule of condition should be prepared to show the state of the premises at the date of the grant of the lease. The schedule should include photographs and a detailed description of the condition of the property, and should be signed by the parties to the lease. It is important that the schedule of condition is kept with the lease for future reference and that the covenant in the lease expressly refers to the schedule.

Difficulties may arise later if a schedule of condition was prepared when the lease was granted, but was not referred to in the lease – the tenant will not be able to rely on this. Importantly, any schedule must be agreed by BOTH Parties. It makes no difference if the tenant decides to take the photographs if the landlord has rejected the schedule of condition. Any additional notes should also be included at this stage.

Insured risks

It is usual for the tenant's repairing obligation to exclude damage caused by an insured risk. However, the tenant will normally be responsible for repairing damage caused by an insured risk if the insurance monies cannot be recovered because of an act or omission of the tenant. Make sure the Lease states you must knowingly omit or have a copy of any requirements of the insurers before

Dilapidations

Dilapidations refer to items of disrepair that are covered by the repairing covenants contained in a lease. The term is used to cover breaches of the tenant's covenants relating to the physical state of the premises when the lease ends. Therefore, they are the tenant's requirements to put the property in the repair as required by the lease at the end of the term.

Dilapidations are usually produced by a surveyor and the tenant is normally required by the Lease to bear the cost. This can be upwards of £1,500-£2,500 plus VAT and so it is essential to limit the costs of this. The tenant should also request that the landlord provides this within 2 months of the end of the lease in line with the Dilapidations Protocol. Otherwise the landlord can do so months and months after the end of the term.

The process is that a landlord will appoint a dilapidations surveyor to prepare a detailed schedule of dilapidations. This is then served on the tenant by the landlord or their solicitor and usually costed – at this point the tenant will usually instruct a surveyor to validate the claim. It is then up to the tenant to decide whether to undertake the works, during the lease, or agree a financial settlement with the landlord, after lease end. It can often be financially advantageous for the tenant to undertake some or all of the works, but once the lease has expired, the tenant loses the right to do so and negotiating a claim for damages becomes the only solution. It is therefore important to attend to this before the end of the term and months before at that.
Otherwise the landlord will carry out the works with his own builders and workmen at considerably higher cost than a tenant could have negotiated. The landlord cannot however charge more than the loss of value of its reversion – so therefore only the amount of diminution in the value of the property because of the disrepair.

Practical steps for tenants to take to limit dilapidations liability:

- In initial negotiations for a new lease, particularly with short leases, the tenant may insist that the repairing liability be restricted to leaving the building in no worse condition than at the start of the lease, as an alternative to accepting full liability (as explained above). This can be done by way of a photographic schedule of condition.
- A survey should be carried out as it is an ideal tool for understanding the condition of the property and the risks from the outset. The advice in a survey report can substantially assist a tenant in new lease negotiations
- To limit any repairing liability a Chartered Building Surveyor should be instructed by the tenant to produce a Schedule of Condition, recording the state of decoration and any pre-existing items of disrepair.
- These precautions also apply on assignment of a lease, where a new tenant takes on the obligations of an existing tenant. Here alterations and disrepair must also be considered carefully by the tenant considering the purchase (assignment) of another tenant's lease. It can make the lease more valuable to know the repairing obligation is not overly onerous.
- If breaches and alterations are identified prior to the purchase of the lease, the tenant may be in a position to negotiate for a reverse premium from the outgoing tenant.
- Think about also who the tenant is as in our part 1 and what liability will pass on to individuals under a guarantee.

It is important for landlords to note that agreement of a financial settlement must only relate to actual loss incurred as a result of the tenant's failure to comply with their lease. It is a common misconception that landlords can therefore profit from a dilapidations claim. It is also important to note that landlords cannot expect a building to be returned to 'as new' condition, only the condition dictated by the lease covenants.

Part 7:

Making Alterations to the Property

Why is it important to deal with alterations in the lease?

A commercial lease must deal with the tenant's ability to make alterations to the property because without any restrictions on the tenant, they are free to carry out any alterations that they choose. This freedom for the tenant is subject to the boundaries of the property that is demised, meaning that the tenant cannot make any alterations to structures beyond the demise. There is also an implied obligation on the tenant not to commit waste, where waste is defined as "a spoil or destruction to houses, gardens, trees, or other corporeal hereditaments, to the injury of the reversion of inheritance" (Mancetter Developments Ltd v Garmanson Ltd & Anor [1985] EWCA Civ 2).

For this reason, most commercial leases will contain tenant covenants that restrict what alterations can be carried out at the property. Consideration must be given to the type of alterations that will be permitted, and this will largely depend on the nature of the property, and the degree of control that the landlord desires. The priority for the landlord is usually to protect the value of their interest in the property and to prevent alterations which could make the property difficult to let in the future. On the other hand, the tenant will be wishing to ensure that they have the flexibility in the lease to make alterations to the demised property to ensure that it can meet future needs. It is common for the tenant to undertake "fitting-out works" which would need to be in line with the terms of the lease. The tenant will also want to consider that it may wish to assign or sublet the lease in the future and it may restrict the marketability of the premises if certain alterations are restricted.

In negotiating the covenants for alterations, the following points should be considered:

- The length of the term – where the term that the premises are demised for is short, then the covenants for alterations are likely to be more restrictive.
- The nature of the particular property, for example the property's age, method of construction, use and location.
- The extent of the demise. If the tenant only has an internal demise, the alterations clause will naturally be more restrictive.

How can the Landlord control alterations to the demised premises?

The most common position in the lease, is to restrict or prohibit alterations to the exterior of the demised premises, and to the structure of the demised premises. Non-structural alterations to the interior of the demised premises are usually allowed subject to the landlord's consent. It is common to include a provision that such consent is not to be unreasonably withheld, however even without a specific provision to this effect, there is an implied obligation on the Landlord not to unreasonably withhold consent for an improvement under s.19 LTA1927. As above, the tenant may not make any alterations outside its demise.

The Landlord should also consider further restrictions on how any alterations are carried out by the tenant. It is common for a lease to require the tenant to carry out any permitted alterations using good quality materials which are fit for the purpose, and in a good and workmanlike manner. The landlord may also include a provision that the alterations must be to the reasonable satisfaction of the landlord. It is also important for the lease to restrict the tenant's ability to alter the service media serving the property, as this can have impact on neighbouring premises and the reversionary interest.

Even where consent is not necessary, the lease should require the tenant to notify the landlord of any alterations carried out. The landlord may even go as far as to include a covenant requiring the tenant to provide plans and any other information that could be useful for management purposes. Indeed, such information may be required under the insurance , which is usually the landlords responsibility.

How can the tenant retain flexibility in the lease?

From the tenant's point of view, they may wish to insist that the lease expressly states that consent should not be unreasonably withheld, because not all alterations will qualify as improvements for the purposes of the LTA27. The tenant may also wish to provide that the consent cannot be unreasonably delayed.
It is particularly important for the tenant to consider the alterations for which consent is not required, and to ensure that any works that are proposed either do not require consent under the lease, or are subject to a licence for alterations. The tenant may wish to have the ability to carry out certain non-permanent alterations, such as erecting demountable partitioning, without having to obtain landlord's consent. As above, where the landlord does agree this, they may insist on further restrictions on how the works are carried out.

The tenant may wish to consider conceding certain covenants in the lease in order to retain the overall flexibility to make alterations. For example, the tenant may wish to consider accepting covenants require them to:

- Carry out any alterations in a specified manner
- Make good any damage to the property or the common parts as a result of the alterations
- Provide plans and specifications for the alterations to the landlord after they have been completed.

Where the tenant agrees to covenants such as these, the landlord may be more likely to give the tenant a wider scope to make alterations.

How can the alteration provisions interact with other lease clauses?

1. Rent review provisions
A commercial lease will usually contain a market rent review, and in that case the effect of alterations carried out by the tenant on the rent should be disregarded for the purposes of calculating the market rent. It is important for the tenant's solicitor to ensure that this is the case as otherwise, the tenant will not only have paid for the costs to undertake the work, but could also be liable for an increased rent because the premises are now in an improved state, and are therefore more marketable and can attract a higher hypothetical rent.

2. Signage clause
It is common for a tenant to erect a sign at the premises advertising their business, but they should be careful as to any requirements under the lease. They may not expect to have to obtain permission from the Landlord for this. Provisions relating to signage may be included within the alterations clause or dealt with separately, but the obligations should be clearly understood and negotiated if necessary.

3. Compliance with laws
We have so far only considered the lease implications regarding alterations, but there are of course regulatory matters to also deal with, depending on the specific work being undertaken. Commercial leases usually contain a clause dealing with the tenant's compliance with laws. This is relevant to the alterations where

- the tenant is required by statute to carry out certain alterations, include building regulations and fire safety legislation; or
- planning permission is required in relation to the works, and this requires landlord's consent.

4. Yield up clause
It is important for the Landlord to insist on an obligation on the tenant in the lease to reinstate alterations when they yield up the lease. Without this, the landlord may have to pay compensation to the tenant for alterations that amount to "improvements" under the LTA 1927, and this sum could be a substantial amount depending on the works undertaken.

5. Insurance obligations
It is also common for a commercial lease to include a provision requiring the tenant to adhere to the requirements and recommendations of the insurers that relate to the premises. In the context of alterations, this could mean that before starting certain types of works at the property, the insurer may need to receive details of the works and provide their consent. If the tenant fails to notify the insurer in these circumstances it could result in a breach of the insurance policy, and an issue if there is subsequent damage to the property whilst carrying out the works.

Licence for Alterations

Whilst most commercial leases will contain a provision requiring the Tenant to obtain consent from the Landlord before making any alterations to the property, the lease should be considered to see whether consent is required. Where a Licence for Alterations is required under the lease, it is likely that the tenant will need to pay the Landlord's legal fees in connection with this. The licence records the works that the tenant proposes to undertake that will alter the property. This protects the tenant's position in relation to the works, but allows the landlord an element of control.

Part 8:

Final Boilerplate Provisions in a Commercial Lease

In this final section, we look at the final boilerplate provisions – provisions which are considered 'standard' in leases. Here we explain why they are not always the best thing for a tenant to agree certain aspects and why, as with the rest of the top tips, it's important to take into account all the necessary considerations such as, who is the tenant, guarantor, limited company, repairing obligation and other factors.

The main provisions to consider are

Indemnity – There will usually be a clause in the lease that the Tenant must keep the Landlord fully indemnified against all losses arising directly or indirectly from any act, omission or negligence of the Tenant. The Landlord would also usually seek to extend to any persons under the authorisation of the Tenant. A potential tenant should avoid entering into such indemnities as a general indemnity such as this is too wide, particularly if the lease is guaranteed or take in a personal name. It is in essence a 'catch all provision' which should be rejected. The tenant can argue that the lease itself (forfeiture and claims for non-payment or non-performance) as well as the common law and statute adequately deal with any loss or damage that a Landlord can recover requires and an indemnity clause such as this goes what a tenant should accept. Indemnities should be resisted and the tenant should fully appreciate the consequences of agreeing to such a clause. One possible compromise as a last resort is to limit the indemnity to losses arising from a breach of covenant by the tenant or asking the landlord to provide a mirror indemnity for any of their breaches – something they will almost certainly reject!.

Insurance – There should be a provision in the lease that the Landlord is required to provide a copy of the insurance policy and recommendations of the insurers to the Tenant. This is because there will usually be a clause that the tenant must comply with the terms of the insurance, by act or omission, at all times. This is again particularly important as the lease will usually state that the Tenant must not do or omit anything that could cause any insurance policy to be become wholly or partially void. It is important here to limit this provision to the Tenant must not "knowingly" do or omit anything that may void the insurance. This small amendment imparts the pressure of knowledge to ensure that the tenant is not strictly liable for an event or occurrence of which he is not aware.

Many tenants do not like the standard lease provision requiring the tenant to comply with all insurers' requirements as a tenant would then be bound to carry out any works that the insurers may require, even if unreasonable, or, most importantly, inadvertently vitiate the insurance policy by not complying with terms that they had no idea existed! Ignorance is not a defence and a scenario that could arise is that the tenant fails to have adequate firefighting equipment on the property which was required by insurers (or specific equipment) and the building burns down. The insurers wills take the insurance is vitiated and invalid. The landlord will move to say the tenant is personally liable for failure to comply. The implications can be huge! However, from a landlord's point of view, it cannot have one tenant of a development or a building refusing to comply with insurers' requirements and therefore invalidating the landlord's insurance policy as a whole. The parties must get a balance here.

Rent review

Rent review is the most common method of increasing the rent during the term of a lease. It is usually based on a hypothetical lease scenario with an open market valuation of the rent. Most rent reviews are on an upwards only basis and this is not preferable for a tenant. The rent is increased to the higher of the basic rent, then payable under the lease at the time of review and the open market rent. Therefore the basic rent cannot go down if market rents are in decline, and will not be set at less than the then current rent – a guaranteed increase even in depressed times. That is not to say that upwards and downwards rent reviews do not exist but they are very rare. If ever agreed by the landlord, there would be some cost involved for the tenant such as an initially high rent or some other compensation due to the landlord.

From a tenant's perspective It would be sensible to negotiate a right to terminate the lease once the revised rent is known and the rent review is settled, so that if the rent is set too high on review there is an exit and any such break would also give the tenant a substantial bargaining position in any rent review, as the landlord will be aware that if he seeks too high a rent the tenant will terminate the lease.

However, for the exact same reasons the landlord will resist this. The rent review is essentially the valuation of a hypothetical lease in the open market at the review date, but assuming and disregarding certain things about the lease. The dates in negotiation of break and when rent review needs to be initiated and discussed are very important therefore. The basic starting point is that the rent review provisions should reflect reality and should not assume or disregard any matters to create an artificial position in the hypothetical lease position.

Common assumptions are:

- That the premises are let on the open market without a fine or premium. This means that the lease is valued in the open market and without any capital sum being paid by either the landlord to the tenant or the tenant to the landlord as this would distort rental levels.
- With vacant possession. It is only reasonable that the premises being let are assumed to be empty, as otherwise it could be assumed the tenant or any subtenant or other party is in occupation which could either have the effect of driving down the rent (to the landlord's detriment) or the landlord could contend the tenant who is already in occupation would pay far more for the premises than any other party, therefore driving up the rent (to the tenant's detriment).
- By a willing landlord to a willing tenant.
- For a term commencing on the relevant Review Date and either equal to the unexpired residue of the term or perhaps 10 or 15 years (depending on the actual length of the term- the hypothetical term should never be assumed to be longer). The tenant will want to ensure that the term deemed to be remaining is the shortest possible and the landlord will want to assume the longest possible term remains. The reason behind this is that the basic principle is that the shorter the assumed term the lower the rent that can be demanded because of the certainty of rental income a longer term provides. In reality this will actually depend on a number of factors, including the type of property (retail, restaurant, office etc).

- That the letting is of the premises as a whole. This could be for both parties benefit as it is conceivable that splitting the premises into parts and letting to a number of different tenants could either increase or decrease the rent compared to letting the premises as a whole.
- On the same terms and conditions as are contained in this lease. The tenant would want all onerous terms and all obligations contained in the lease to be assumed to be in the hypothetical lease being valued as without them, the value of the rent could be higher than would otherwise be achieved.
- That the premises are ready for immediate occupation and use ready to receive the incoming Tenant's fitting out works. The point here is that the premises should not be deemed to be fitted out before the tenant takes the lease as fitting out works are time consuming and costly. It would be very valuable to a tenant (in terms of both time and capital outlay saved) if those works had already been carried out for the tenant, which would therefore drive up the rent on rent review.
- That the premises may lawfully be used for the use permitted by the lease. This essentially assumes that all necessary statutory consents for the use of the premise are in place. Therefore, if the parties know that this is not actually correct then this should be deleted especially if the tenant needs specialist consent or is under a permitted development use.
- That the tenant has complied with all his covenants and obligations under this lease. Some leases assume that the landlord has complied with all of its lease obligations but this should be resisted. It is not reasonable, if a landlord has allowed the building to fall into disrepair for example, that this is ignored when valuing the premises and the lease on rent review.
- That, if any part of the premises or any amenity serving it shall have been damaged or destroyed, they have been repaired and reinstated. Leases will usually contain rent suspension provisions in the event of damage so no rent is payable during periods of damage, but the landlord will require that once the damage is made good, and the rent becomes payable again, that this is at the full rate due on review. Therefore it is only reasonable to ignore any damage upon valuation.
- That no works have been carried out to the premises by the tenant during the Term which would diminish the rental value of the premises.
- That the hypothetical tenant will have had the benefit of such period (commencing on the grant of the hypothetical lease) free of rent or at a concessionary rent as he might be expected to negotiate in the open market for fitting out, so that any such rent period will have expired. There are three related points here:

  1. It is common for tenant's to be granted a rent free period or other concession at the commencement of the term. Some landlords seek to exclude the whole of any such concession and therefore reserve a "headline" rent. Effectively by ignoring any concession, the aggregate rent across the term will not be reduced by any rent free period and so the corresponding annual rent payable will be higher than would otherwise have been achieved on review. This is unreasonable as the tenant will be penalised for something common in the market which should be a benefit.

2. Only rent free periods for the "period" of fitting out should be disregarded and not rent free periods or concessions for the "purposes of fitting out". The point here is that fitting out is thought on average to take about three months and so three months' worth of rent free period will be disregarded. However, rent free periods or concessions given for the "purposes" of fitting out could be huge. Fitting out is expensive and time consuming and so any rent free period or concession equivalent to that cost is likely to be large and disregarding such large rent free periods offered in the market (which would otherwise have had the effect of reducing the rent) would cause the rent to be higher than that which would otherwise be obtained on review.

3. A similar point arises in respect of disregarding rent free periods for the period of fitting out. Fitting out usually takes around three months and so it is fair to disregard three months of rent free period. However, disregarding anything in excess of that period is likely to increase the rent on review as landlords can sometimes offer extended rent free periods described as for fitting out when in fact they are for a combination of the fitting out period with a large element as an incentive. Disregarding any such large incentive offered in the market would cause the rent to be higher on review. Therefore, the length of fitting out periods disregarded should be limited to three months.

Common disregards are:

- The fact that the tenant, their sub-tenant or their respective predecessors in title have been in occupation of the premises. This is for the tenant's benefit as this discounts a special bid that would be made by the tenant or their subtenant in order to remain in occupation, which would drive up the rent on review.
- Any goodwill attached to the premises by reason of the carrying on at the premises of the business of the tenant, their sub-tenants or their predecessors in title in their respective businesses. This is a variation on the same point as above.
- Any improvement, alteration or addition carried out by the tenant, his sub-tenant or their respective predecessors in title, at their own cost, with the written consent of the landlord (where required) and otherwise than in pursuance of an obligation to the landlord. Essentially, if the tenant has paid for, and carries out, works to the premises he should not be penalised on review by the tenant's own works increasing the rental value. However, if the landlord paid for the works, or the tenant had a contractual obligation to the landlord to carry them out, it is not unreasonable for their value to be taken into account. Similarly, if the works required the landlord's consent under the lease and this was not obtained, and therefore the works were carried out in breach of the lease, it is not an unreasonable penalty for their value to be taken into account on review.
- Works carried out by the tenant to comply with statute. The issue with taking into account the value of tenant's works carried out pursuant to an obligation to the landlord (as explained above) is the lease will require the tenant to comply with statutory requirements. Therefore, any works the tenant caries out to comply with statute will be taken into account on review and could increase the rent by quite a margin. For example, disabled accesses, fire safety systems, works to comply with health and safety legislation and various other works required as a result of statute could all add up to a significant value. This would be unreasonable where the tenant has paid for these works already. However, a landlord would want a reciprocal assumption that where such works are to be disregarded the premises are still assumed to be compliant with statutory requirements, as otherwise this would reduce the value of the premises and drive down the rent.

On a final point, rent reviews quite often provide that the rent on review must be the “best” rent obtainable in the market. This should not be agreed as the word “best” would take account of any special over bidder who may pay an unusually high price. This should be excluded.

These provisions are vitally important to get right as well as the other provisions we have advised on in the rest of the Top Tip series.

For any information on any aspects of this Heads of Terms Series please contact our experienced Commercial Team on 01323 407555 or Head of Commercial Legal Services Hamed Ovaisi on hovaisi@solegal.co.uk