Restrictions on Lease Obligations in the UK: Negotiating Revised Lease Terms

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In our article “Implications of COVID-19 Restrictions on Lease Obligations: The Legal Position,” we looked at some of the statutory protections for restaurant tenants during the COVID-19 period. Those protections are limited both in scope and duration. For the longer term, a negotiation between landlords and tenants is required underpinned by a need for all parties to be prepared to collaborate, co-operate and compromise with one another to achieve mutually agreeable solutions. In this article, we will look at some of the drivers for those negotiations and possible outcomes.

The vast majority of restaurant leases will reflect the institutional landlords’ preferred leasing model: fixed duration; fixed rent with upward only rent reviews; and rents payable quarterly in advance. The stresses on the restaurant market caused by the COVID-19 lockdown have caused many stakeholders to question whether this model is sustainable and how it might be varied.

THE TENANT’S POSITION

Even if the tenant has complete confidence in its business model (perhaps the restaurant has been operating for some time and so has a proven track record), the upward-only open market rent review mechanism imposes an element of uncertainty, putting the tenant’s business model at the risk (but not benefit) of rental market fluctuations. But even the most astute of restaurant operators could not have modelled for the impact of COVID-19.

Restaurant operators face a long road back to full recovery. After food and salaries, rent is one of the biggest expenses for a restaurant business. Whilst COVID-19 restrictions remain in place and during the recovery period, fixed rental liabilities have potential to cause the collapse of many restaurants.

THE LANDLORD’S POSITION

Many landlords with large portfolios will be funds of one type or another with duties to investors or shareholders to show prudent management and to maximise returns, making it harder to justify variations from the market norm position. The majority of landlords will also have bank debt in one form or another which creates two issues: first, the need to service the bank debt potentially leaves landlords exposed if rental income is reduced; and second, the loan terms may well prevent the landlord from agreeing to vary terms of existing leases or place constraints on the terms that can be offered to new tenants. So far there is no Coronavirus-related legislation protecting landlords from enforcement by lenders if landlords cannot service debt due to defaults by tenants – landlords risk losing their whole property in such a scenario.

Landlords are not, however, insensitive to the impact of the COVID-19 crisis on tenants. Vacant restaurant units are not good for landlords. Terminating an existing restaurant lease means the landlord takes on additional costs (reletting fees, insurance, rates, service charges, etc.) and uncertainties regarding re-letting risks -- something landlords would prefer to avoid, especially in the current climate. A well-performing restaurant unit can enhance a mixed-use scheme making it more attractive to other tenants and helping to drive rent levels. There are incentives for landlords to negotiate with struggling restaurant tenants.

FRAMEWORK FOR NEGOTIATION – *COLLABORATION, CO-OPERATION AND COMPROMISE*

Inevitably it will fall to the tenants to start negotiations; it is, after all, the tenant who is asking for a change from the status quo. Tenants need to position themselves to engage with landlords in a co-operative and collaborative manner in order to arrive at a compromise position that works for both landlord and tenant. Most landlords will have a representative responsible for each property, an internal or external asset manager, for example and this person will already be known to the tenant from day-to-day property management. An approach at this level is likely to be the best starting point.

Tenants should enter into negotiations being clear what they are seeking by way of concessions, but also with an idea of what they might offer in return. The fact that the tenant's business may not survive without the variation is unlikely to be enough in itself to persuade the landlord to offer a long-term variation. Landlords, in turn, should enter into negotiations with a willingness to co-operate and collaborate to find workable compromises, recognising that losing a tenant, with the additional costs and uncertainties this invites, is also a bad result for landlords.

Whilst landlords might provide property information as part of a marketing exercise and tenants may share initial business plans with landlords to secure the letting, most leases will not provide for further, on-going information sharing. This should change in the current environment. A tenant who can present to its landlord historic and projected data on restaurant performance, show long-term sustainability and rent affordability will be better positioned to engage in negotiations. Equally, if landlords share data such as shopping centre footfall trends with their tenant, this will help with business modelling.

POSSIBLE NEGOTIATED OUTCOMES – *COLLABORATION, CO-OPERATION AND COMPROMISE*

Rent holiday: It is too early to tell when and how restaurants will be able to re-open for dine-in customers, but it is likely to be many months before they are able to operate at anywhere near full, pre-COVID-19 capacity. Income will remain, at best, depressed, and in some cases non-existent. Ideally for restaurant operators, rent would be reduced to zero for the period their income is lost. However, such a request places all of the COVID-19 losses with the landlord. Many landlords will not be able to accept this. Where landlords are able to agree on rent holidays they may require an equivalent extension to the lease duration as compensation. Landlords may alternatively agree on a reduced rental payment for a period as a way of sharing pain between the parties.

Rent frequency: Even prior to COVID-19, the model of quarterly rental payments was being questioned by tenants, particularly those in the retail sector. Moving rents to monthly rather than quarterly cycles does not reduce the overall liability but can aid with tenant cash flow. As we approach the next quarterly payment date at the end of June, many restaurant operators will struggle to fund three months of rent in advance from their reduced income. Some landlords had already agreed to move to monthly rental payments, and this is one of the easier requests for a landlord to agree to, whether on a short-term or permanent basis.

Longer Term Rent Reductions: Even when restaurants are allowed to re-open, it cannot be assumed that customers will return immediately. The long-term viability of some restaurants will be in doubt unless they can reduce operating expenses, including rents. Landlords will need to assess whether conditions are bespoke to the specific operator or a wider issue for the sector and/or location when deciding whether to agree longer-term rent reductions. If the request is refused, the tenant defaults on rent and so the lease is terminated. How easy will it be to re-let the space and what lease terms will be achievable? A new tenant taking over space post-COVID-19 will be unwilling to sign on to the same terms the landlord achieved beforehand. It may be better to keep the existing tenant at a lower rent.

Inclusive Rents/Service Charge Caps: Leases in multi-let buildings will typically see tenants paying a variable service charge in addition to their principal rent – broadly speaking, the tenants cover the running costs of the building regardless of what those may be. Tenants have little control over the level of such cost and so they present an additional, fluctuating expense to be factored in. If rents are inclusive of service charge or if service charge levels are capped, this removes the element of uncertainty for the tenant and allows better business planning. This does, however, place the risk of cost variations on the landlord despite the fact services generally benefit the tenants, rather than the landlord.

Turnover Rents**:** Turnover rents are not a new concept though have been out of favour in English leases in recent years. The concept sees tenants paying a percentage of turnover to the landlord rather than a fixed rent. If turnover is down, the landlord shares the tenant's pain, and if turnover increases the landlord shares in the up-side. Turnover rents can be paired with a minimum or base rent (providing the landlord with a fixed minimum rental payment) with turnover being used as a top-up. Turnover mechanics can be complex (and costly) to negotiate. Issues include: What is included in income? Are on-line sales receipts included or only sales on-site? What expenses can be deducted before the landlord's percentage is calculated? What monitoring and review rights does the landlord have? Turnover rents require landlords to take more direct risk in the performance of a business over which they have no control or input and require greater administration on the landlord's part.

Increased Lease Duration**:** Security of income is important for landlords. Longer lease durations mean lower asset management costs. In return for compromises tenants are seeking from landlords, one of the benefits they can offer is an increased lease term. This may be particularly attractive where existing leases are due to expire in the near future when landlords may struggle to re-let. Tenants can agree to extend lease terms to provide security of income – so long as they can also show long-term viability of their business.

CONCLUSIONS

Whilst negotiations to vary existing lease terms would seem primarily to benefit tenants, the opportunity should not be dismissed by landlords. Voids are not in any landlord's interests and the ability to re-let in the current market is uncertain. There are a number of ways rents could be restructured in order to assist restaurant tenants in both the short and long term, and reduced rental income is better than no income. However, tenants need to be realistic in their expectations – landlords have been impacted by COVID-19, too, and may be constrained in negotiations by fund or loan terms. Tenants should think through carefully which concessions they request, how they can support those, and what they can offer in return. A well -presented and supported package will be better received than a unilateral notice refusing to pay rent. Again, landlords and tenants should collaborate, co-operate and compromise with one another to find mutually agreeable solutions in this unprecedented moment for the restaurant sector.

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