AVOIDING CONFLICT

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The implications of the credit crunch are still not fully apparent. Nor is the extent of the action needed to deal with it. What can the property industry do to ease the problems? What can we do at least to lessen the problems which undoubtedly exist?

These problems do not just extend to small retailers on the high street. The larger retailers are not immune. Indeed they arguably have the potential for even greater difficulties, like an oil tanker, being unable to change course or stop quickly. It is the sheer speed of the recession which has caused some of these issues. Retailers themselves as a group are also not the only ones.

With asset values having crumbled, property owners have their own issues. These include breach of loan to value covenants with their lenders as well as an inability to fund development. A sudden lack of potential occupiers is another concern, either for what new development there is, or on an existing property, where the current tenant does not want to continue, or has gone out of business.

While there may come a time when the weakness of sterling makes property investment especially attractive to foreign investors, with the equivalent of the Channel shopping trip good news for retailers, with greater business from euro zone or US visitors, we are not there yet. If ever there was a time for the property industry to work together, now is that time. By property industry, I mean property owners, occupiers, and their advisors, the latter including agents, surveyors and lawyers.

There have been improvements of owner/occupier relations in recent years. The BPF declaration on underletting, the Service Charge Code and the Lease Code are evidence of this. The British Retail Consortium and the British Property Federation (BPF) have continued to work closely in certain areas – both are firm opponents of the current empty rates regime. The BPF have set up the Commercial Landlord's Accreditation Scheme (CLAS). These are initiatives at a higher level. On the less positive side, the Business Vantage research "Equal Partners" into owner/occupier relations, found that while there is often a good understanding at say Director level, between owners and occupiers, the same cannot be said either at day to day management level, or at advisor level.

Having started with that preamble, I set out in this article what can be done within the industry to improve the individual transaction. There are fewer of these than there were. It seems to me more important than ever for the client experience on both sides to be enhanced. Later, I will also look at some of the issues for the existing relationship.

Let us assume that owner and occupier have negotiated their deal. Heads of terms are agreed (again see below) and lawyers instructed. In normal circumstances both parties will want exchange/completion sooner than later. The owner will then start receiving rent, and the occupier can begin trading. There is no conflict between those positions, indeed it is in both parties' interests. What neither want, nor wish to pay for, is a protracted, adversarial transaction delivered "late" and with the prospect of lawyers seeking extra payment for their work/time involved. In practice, with both lawyers probably on a fixed fee, it is not in their interest either for the deal to take too long. That is not an argument for cutting corners, but one for working together to avoid unnecessary conflict.

Traditionally, the owner's lawyers draft a lease in tough terms. The assumption is that that is what their client wants. Alternatively, that happens because they do not perhaps understand their client's ethos. Possibly owner and lawyer have not sat down to consider that ethos. Maybe the heads of terms were insufficiently detailed, and a significant element of guesswork is involved in the drafting process. The ever cautious lawyer will inevitably err on the side of too much drafting, or tough drafting, rather than run the risk of criticism, or worse still, a claim. There is a fear factor.

What then happens (with the tough draft) is that trust quickly disappears. The occupier's lawyer will report this to the client. The high level good relations will not filter through to operational level. Conflict, delay, and frustration result. This is just as likely to happen at the stage of negotiating heads of terms.

What needs to happen is: -

1 The owner must ensure that its lawyers understand its ethos.

2 A vital part of this is that that ethos must filter through all parts of the owner's organisation.

3 The agents and lawyers must then translate that both into the heads of terms, and then into their drafting.

Arguably drafting a fair document (one which the owner could reasonably expect a prospective occupier to sign without significant amendment) requires a far greater skill than the mere pressing of buttons on the word processing system. That drafting also needs to take account of the likely attitude of a prospective buyer of the investment. It is a fine balance. In theory, if the agents follow the model Heads of Terms from the Lease Code, and the lawyers follow the Lease Code itself, they should not go wrong. The opposite side of that coin is the need for the occupier's lawyer to avoid amendments which go too far in the other direction.

The exercise of that skill might reasonably be reflected in the fees charged. In other words, early engagement/involvement will pay dividends, reduce conflict, and speed up the deal. In those circumstances, the reward would be for a professional job, well done, on time, rather than a mechanical weighing of the file.

What does all this mean in practice?

I have split what follows into 3 sections: -

A To cover those elements of drafting which if properly covered, will reduce scope for argument;

B To cover those elements which should be considered at heads of terms stage,

C To cover areas of the existing relationship where continued dialogue is important.

<u>A Drafting</u>

1 The Lease should require the landlord to provide insurance details on request.

2 The Lease should not require the tenant to get the consent of the owner's lender before doing anything for which consent is required under the Lease. This is true whether or not there is an existing lender. Where pre-existing, the lender has the chance to approve the deal at the outset. The same applies to superior landlords where there is not already an existing headlease.

3 The Lease should not contain any obligation to comply with recommendations in energy performance certificates. These are split into short, medium and long term suggestions. Many of these may not be appropriate, for instance to a short term Lease. If there is to be any requirement to comply with EPC recommendations, this is an item for heads of terms. The energy performance certificate should be produced, in the normal way, as an integral part of the negotiations, and at the outset of them.

4 The tenant should not be required to comply with insurer's recommendations. Requirements are different. The latter would result in the insurance being vitiated. Failure to comply with recommendations may result in a higher premium, but not no insurance.

5 Where the tenant occupies part of a building, the landlord's obligation should be to insure and reinstate the whole building, not just the property being let. The same applies to rent suspension, where rent should be suspended where damage to the building makes the property unfit. An example of the reason for this is that an upper floor of an office building may become unusable not because of damage to that floor, but because damage to a lower floor may make the structure unsafe.

6 Heads of terms should confirm what rights are needed e.g. for means of escape and ducting. The latter is especially important for restaurant premises, where high level ducting/roof plant may be essential. The Lease then needs to reflect that.

7 If there is a tenant break option, it should be drafted to be Lease Code compliant (or better!). It should not oblige the tenant to give vacant possession. Those words have a technical meaning. The break should not be lost due to arguments about what are landlord's fixtures (and so should have been left), and what are tenant's fixtures (and so should have been removed). Also, the landlord should be obliged to refund the tenant will a proportion of any sums paid for a period beyond the break date. The break date itself should be the day before a quarter day (assuming quarterly payment). This avoids the need for the tenant to have paid the full quarter's rent.

8 The landlord's lawyer needs to avoid drafting which produces a headline rent. In other words, it is acceptable to assume a rent free period or inducement which covers the <u>period</u> of initial fit out, but nothing beyond that.

9 The Lease should be consistent with the BPF Declaration on Underletting (as also the Lease Code). It should not contain drafting which undermines the principle of either. The requirement here is to give the occupier flexibility. It should not seek to avoid, or push under the carpet, any decline in market rents, or prevent the tenant from making best use of the property to reduce its loss if for any reason it is not in occupation itself. Judicious use of excluded leases will produce the desired result. It is equally important for the tenant to understand the legitimate fear of the owner of being saddled with an occupier on "soft" terms.

## B Items for Heads of Terms

1 Service charges. If these terms could be drafted simply to say that the landlord should treat everything as if all items were its responsibility, in other words as if service charge monies were its own, then life would be easy! Ideally, a detailed list of items included or excluded should be covered. This should take the Service Charge Code into account e.g. the cost of promotions. Car parking is also an issue. There should be an explanation about any car parking charges (existing or proposed). This needs to be combined also with a clear understanding as to where car park income is to be paid (to the landlord or to the service charge fund) with this also being combined with a similar understanding as to who picks up the cost of repairs to the car park area. If the historic position for the property is that the local authority receives the car park income, with the tenants paying the cost of repairs etc through the service charge, there may be nothing to be done about that situation in legal terms. But at the very least, the position should be understood.

The position on service charges undoubtedly remains a minefield. The forthcoming carbon reduction commitment is a further likely area for problems.

2 Capital contributions/inducements. Where this is part of the deal, the timing of payment is also relevant. Where payment is after occupation e.g. on the tenant starting trading, then it is legitimate for the tenant to expect some security in case of landlord default. That is a sign of the times. A cash-strapped landlord may resist lodging money in advance. However, lodging/paying it as a precondition to access may be fair, as also the ability of the tenant to charge interest and deduct from rent if the landlord does not pay.

Undoubtedly, this is a novel point. Owners may resist, based on the traditional lease drafting which usually forbids deductions or set off from rent. The counter-argument is that if the landlord does not default in these initial payments, then there will be no ability to deduct. Inducements can be substantial, and form an integral part of the transaction. The failure to receive the payment in some way could be catastrophic for the tenant.

On the other hand, the giving of a significant inducement and/or lengthy rent free period may cause problems for a landlord if, shortly after the rent free period expires, the tenant goes out of business.

3 Monthly rent. While not necessarily top of the tenant's agenda, it is becoming an important and definitely topical point. There are cash flow issues for both parties. However, if the rent is at the right level, cash flow benefit to the tenant may outweigh any other considerations.

4 Basis of rent review – Is the market ready to consider up/down reviews, or at least a threshold review? In the latter case, if the landlord is fortunate enough to have negotiated a lease with more than one rent review, e.g. 15 years, with reviews after 5 and 10 years, then the rent might be fixed at a figure of no less than say £50,000, so that on the first review, the rent could only stay the same or go up, but on the second review, the rent could reduce, but never less than the initial £50,000.

If an RPI increase is relevant, should this allow for the possibility of deflation? But how relevant is RPI in today's trading environment? If turnover is a consideration, what percentage of the market rent should be the baseline. In the past, some turnover rents were negotiated on the basis of an initial 100% of market rent (or something close to it), resulting in a win/win for the landlord, with, in effect, no sharing of any pain on the downside.

C The Existing Relationship

1 Service charges. In the current market, it is vital that owner and occupier work together. The BPF is looking to its members to do just this with its occupiers, trying to reduce the burden, or at least to avoid increases. Owners need to work on the basis that each extra £1 of service charge is £1 less for tenants to afford on rent. A similar point can be made about the professional costs (and delay) incurred in tenants getting consent for alterations e.g. to install a new facia sign.

2 Monthly rents. This has been a more controversial topic for owners. Naturally, in many cases, owners have been reluctant to change existing contractual arrangements. However, the severity and suddenness of the credit crunch may force a new dialogue. Owners and their lenders are likely to prefer a tenant paying monthly or at worst at a reduced rate monthly, than to receive no income at all. Oddly, the bank may even prefer rent paid monthly. Inevitably, they do business with owners and occupiers. I have come across at least one story of a significant sized retailer having a facility for the quarterly rent spike being withdrawn at short notice. In those circumstances, faced with the prospect of an insolvent tenant, the enlightened landlord readily agreed to accept monthly rent.

If the tenant does seek monthly rent payments, it must be sensible about the basis. In other words, electronic payment is fair, to reduce landlord's administration costs. Also, the tenant should not expect any significant grace period. While a short period for monthly payment (e.g. one year) may be better than nothing, the tenant needs to be aware that at the end of that year, it will need to have geared up to resume the more onerous obligation.

Conclusion

If landlord and tenant work together to avoid conflict, there is a better chance of getting through the recession. That requires an understanding of each other's position, and a willingness to compromise. Those who do that already are well placed. Lawyers and agents can do much to help that process. Those who take proactive steps may even prosper.