

Top Tips for Commercial Tenants when Negotiating Heads of Terms



James Clellow

Managing Partner
Head of Real Estate
01403 831 229
jclellow@pdt.co.uk



Craig Burton

Partner
Real Estate
01403 831 259
cburton@pdt.co.uk



Elise Sherwell OLY

Senior Associate
Real Estate
01403 831 210
esherwell@pdt.co.uk

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We needed to find a first-class real estate solicitor at very short notice to assist us in completing our tenancy on our new office space. Craig and his team responded swiftly and professionally. Right from the start, we were impressed with their attention to detail, clear line of response and ability to be robust and thorough in dealing with our Landlord’s legal team. I would recommend them wholeheartedly.

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Jeremy Brown, Company Management Executive, Heart of London Business Alliance

Top Tips for Commercial Tenants when Negotiating Heads of Terms

As a result of heads of terms often being negotiated and agreed prior to solicitor instruction, it is not uncommon for a tenant to be asked to negotiate and make decisions on the headline terms for a lease without the benefit of properly understanding the legal and practical implications of the same or whether any alternative options or compromise positions are available.

To assist and to give tenants in such situation a better understanding of the key terms / framework, we set out below a summary of the headline terms commonly negotiated as part of the heads of terms process together with explanation on the legal and practical implications and considerations on each.

1. Length of the Lease Term and Break Options

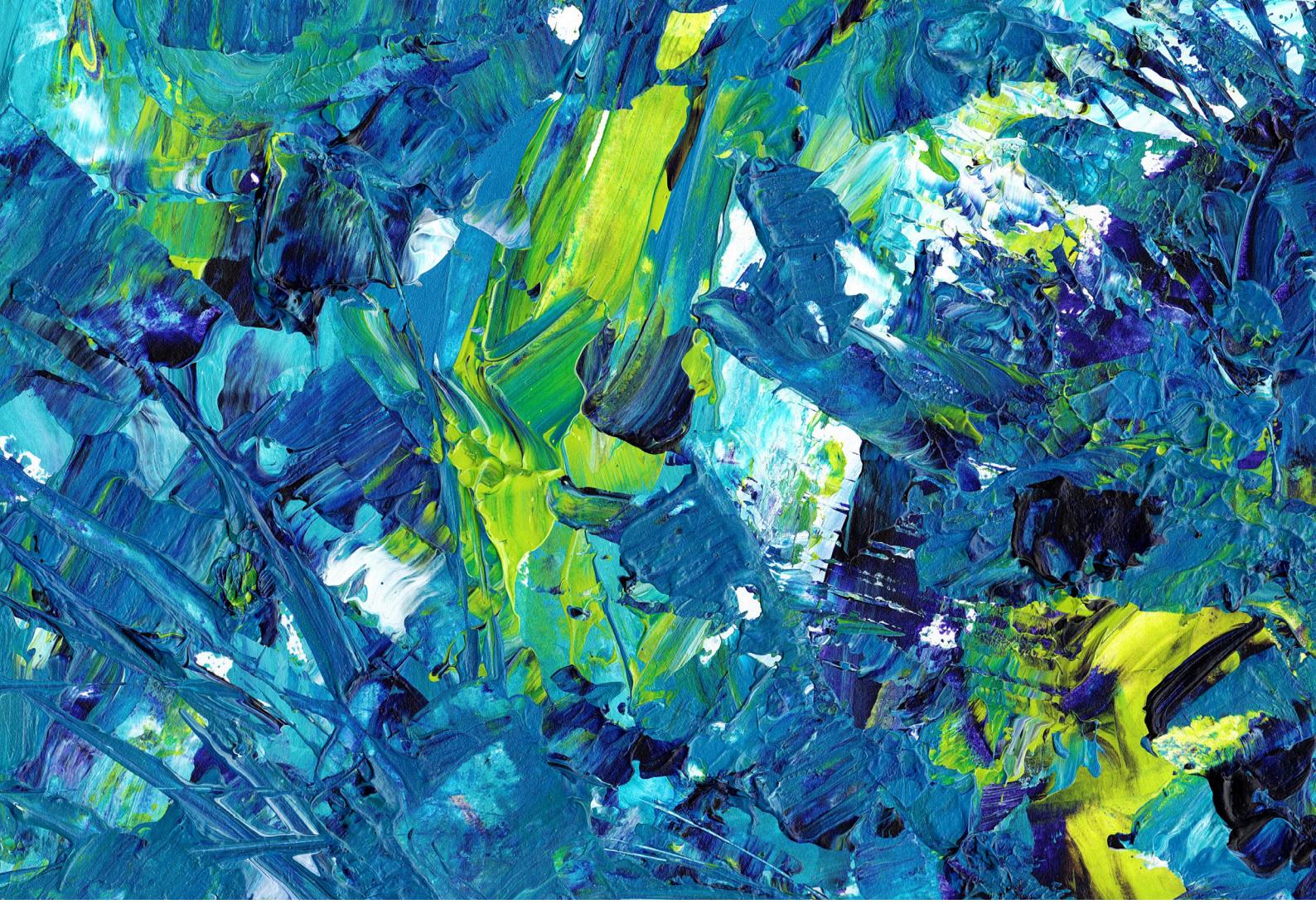
Whilst the heads of terms will set out the proposed lease term (i.e. 5 years, 10 years etc), it is important to make sure you are comfortable with your business being tied into the property for the full duration of this period. Where you wish to retain some flexibility for your business moving forward, you should consider whether any break options can be agreed whereby you are permitted to terminate the lease early either on an agreed set date or on a rolling basis after a set date has passed. Break options are common on 5 year leases (usually set at 3 years) and 10 year leases (usually set at 5 years) but can be applied or negotiated in respect of any length of term. It is also possible to have multiple break options set at different points (i.e. after 2, 3 and 4 years for example). Unless agreed at the outset, once the lease is completed you will have no option or ability to terminate the lease term early so the above is an important point in terms of the commitment being made.

2. Break Options

Whilst a break option is advantageous to a tenant in terms of giving them the flexibility to bring a lease to an end early, as break clauses will always be conditional on various matters it is important to carefully read through the heads of terms to see what conditions are stipulated or to ensure there is a statement confirming no conditions or no conditions above those listed will be imposed. It is common for break options to be conditional on a set fixed length of notice being given (usually 6 months), payment of the annual rent under the lease being up to date and possession of the premises being returned free from third party occupation. Whilst additional conditions are often sought (for example the giving of "vacant possession", material compliance with all lease covenants or payment of all sums due under the lease, these should be resisted where possible to ensure the break option is exercisable in practice and cannot be frustrated by a landlord claiming the conditions have not been satisfied. It is also important to note that break options may be mutual (i.e. can be exercised by either the landlord or the tenant) or can be included separately for the landlord to break early. Where this is the case, you will need to be comfortable that you may be required to vacate the premises on the break date irrespective of whether you have secured new premises and that any notice period attaching to the mutual or landlord break option is considered sufficient to enable you to locate and secure alternative premises if necessary.

3. Repairs

Be prepared! As a starting point a landlord will often market premises on an "FRI" basis. This means the lease is "full repairing and insuring" and means you, as tenant, will be responsible for repairing the premises and also meeting the cost of the landlord's buildings insurance. Where you are taking a lease of whole, this will mean you are responsible for the full extent of the premises including the structure, foundations and roof. Where you are taking part only of a larger premises,



this is often termed as "effective FRI" as the obligation to repair is limited to the internal non-structural elements with the cost of any structural works for example being recovered by the landlord under a service charge. If you are taking a lease on an "FRI" or "Effective FRI" basis, you will need to be aware that where the premises are currently in disrepair or in poor condition generally, this will mean you will inherit liability to bring the premises up to the required state.

Where the premises are in disrepair or in poor condition, you should consider limiting your obligations in this regard (either through identifying and excluding known issues (i.e. damp etc) or from limiting your obligations in line with a schedule of condition). Where a schedule of condition is agreed, the effect of this is that your obligations are limited to returning the premises to the landlord in the state you find or take them – as is evidenced by a photographic schedule which then acts as the benchmark for any repairs required. As a law firm we are unable to advise on the current state of the premises generally or the likely cost of any works required to the premises and, if this is of concern to you, would recommend you instruct a surveyor to undertake a formal survey of the premises to give comfort on this point.

4. Landlord and Tenant Act 1954 (LTA 54)

In short, any commercial lease for a term of 6 months or more automatically takes the benefit of certain protections under the LTA 54, the effect of which is that a tenant can remain post expiry of a lease until certain notices have been served and/or can seek to (periodically) renew the lease – on the same terms as originally granted save for reasonable modernisation and a new open market rent – with a landlord only able to oppose renewal on limited statutory grounds. As this impacts on a landlord's flexibility both in terms of future lettings and any potential redevelopment etc, landlords often seek to have this excluded on short to medium term leases (as a standing requirement) or where they consider there is the possibility of redevelopment in the foreseeable future. Discussions on the LTA 54 are often framed in phrases such as whether the lease is "inside or outside the Act" or "whether you have the right to renew". In short, both are references to the above. If these rights are excluded, you will need to be comfortable that you will have no such rights to renew and could be required to vacate the premises on expiry of the lease unless terms are agreed in advance for any continuation.

5. Annual Rent and Rent Free

The initial annual rent set out in the heads of terms, is generally a fixed sum and is something you will need to be comfortable your business can service. It is possible for landlords (or tenants) to seek to link the annual rent to turnover (i.e. the rent is a set percentage of the monthly or quarterly revenue of the business or that the tenant pays a (low) base rent with an additional turnover element to supplement), however, this is rare as the mechanics for accounts and assessment of the sums due can be fairly complex. The annual rent is usually paid in advance (without the right to set off) either quarterly on 25 March, 24 June, 29 September and 25 December or monthly (usually on the first of each month). Whilst historically payments have been required quarterly, it is now much more common for payments to be agreed monthly to assist tenants in terms of pressures on cashflow. It is also common on new leases for tenants to be afforded a rent free period at the start of the lease to reflect the need for the tenant to refit the premises or to reflect the need for certain works to be undertaken (for example where the premises are in disrepair). Whilst every letting and premises are different in this regard, this tends to be between 3 – 6 months in length where being given purely for fit out works to be undertaken. Where the rent free is being given as compensation for works required (i.e. the lease is being given on an "FRI" basis but the tenant is being given a rent free to reflect the current level of disrepair) it is important that the agreed period is reflective of the cost of the works to be undertaken.

6. Rent Reviews

Whilst the annual rent under short term leases (3-5 years) will almost always be fixed for the duration of the term, as every lease (and indeed every landlord) is different it is important to check the heads of terms for any references to this being reviewed at any set point. Under longer term leases (10 years and over) the rent will almost certainly be subject to some form of review. In practice, there are a number of different ways in which the rent can be reviewed – the only common denominator is that all will resist any reduction in the rent (i.e. the rent will either stay the same or increase).

The main types of review are as follows;

- Stepped Rent – This is more common on short to medium term leases where the parties agree to fixed increases in the rent – usually on an annual basis (i.e. in year 1 the tenant will be £[x], in year 2 £[y] and years 3-5 £[z] for example. Where this is the case, a tenant will need to be comfortable the business will be able to meet the increasing obligations (or possibly seek to negotiate appropriate break options linked to any specific increases to ensure an exit strategy if required);
- Open Market – This is effectively a reassessment of the rent to what would be payable if the premises were re-let on the relevant review date. In general terms, the open market rent can either be agreed between the parties or, in the absence of agreement, will be determined by an independent surveyor. Where a lease includes an open market rent review this will generally only be once every 5 years, however, a tenant will need to be comfortable that the rent could increase significantly where the market is buoyant in that area at the relevant time;
- RPI / CPI – This is where the rent is increased proportionately to any increase in the retail prices index (RPI) or consumer prices index (CPI) and is, effectively, a way of ensuring the rent increases in line with inflation. It is common with RPI and CPI increase clauses for the reviews to be more frequent than open market reviews (i.e. annually) but often subject to minimum and maximum increases (often referred to as the "collar" (minimum increase) and "cap" (maximum increase)). The benefit of this is that a tenant can budget for worst case increases, which is not possible, for example, with an open market review;

In terms of which of the above is the best option for a tenant is difficult to say – for example, an open market rent review could, if the market is suppressed, result in a nil increase (whereas an RPI / CPI review subject to a collar will not). However, generally speaking an RPI / CPI is considered the safer option for tenants as this effectively tracks inflation (rather than market conditions or buoyancy in a given area) with a tenant able to budget more accurately for any likely increases.

7. Additional Security

Whilst dependent both on the status and standing of the tenant and a landlord's requirements generally, tenants may be asked to provide additional security for compliance with the terms of the lease – usually by way of either a rental deposit or a personal / third party guarantee. In the context of a rent deposit, this is usually requested in a sum equivalent to between three and six months' rent inclusive of VAT. This will then be held by the landlord for the duration of the lease (or until you assign the lease for example), with the landlord entitled to draw down any sums due but not paid or to compensate for any costs incurred as a result of any breaches of the lease (for example, where a landlord exercises its right to enter and undertake works required). The rent deposit is usually governed by a separate Deed to the lease which will then require the tenant to "top up" the deposit within a set period (usually 10 working days) following notice of any landlord withdrawal. A personal or third party guarantee is usually included in the lease where given from the outset and will make the guarantor personally liable for any tenant breaches – with the landlord then able to pursue the guarantor separately to the tenant for rectification of any breaches. Whilst it is technically possible for both a guarantee and a rent deposit to be given, in the usual course this should be resisted as excessive.

8. Outgoings and Service Charges

In general terms, a tenant will - in addition to the annual rent – be responsible (direct with the relevant authorities / suppliers) for all rates, taxes, assessments and utilities relating to a premises (in practical terms this will be business rates, electricity, gas, water and sewerage etc). In addition, where the premises are part only of a building or are a building which form part of a larger estate, a tenant will often be asked to contribute towards the general costs of repairs and maintenance to "common parts" (i.e. areas or services used or provided for the benefit of the tenants as a whole). Whilst it is possible to take comfort on the average running costs for an estate from a review of historic service charge accounts (with a landlord usually able to provide accounts for the past three years), if the premises you are taking comes with an obligation to contribute by way of a service charge it is important to be comfortable with the fact these costs may fluctuate and that any historic accounts are given by way of guidance or information only. The only way to secure greater comfort on your exposure to service charge payments is to seek to agree that these are capped to a maximum amount in any given year. Whilst this is fairly routinely accepted on short term lettings (i.e. 3 years or less), this is something landlords will usually try to resist on medium to longer term lettings as, ultimately, if the tenants collectively do not meet the full extent of the costs incurred, it will be the landlord who has to make up the difference.

9. Insurance

In addition to the above outgoings, a tenant will usually be required to reimburse the landlord for the insurance premiums payable for the premises being demised (or a fair proportion where in respect of a larger building or estate). Whilst standard practice, it is important that this is something which is factored into any budgets.

10. User

Whilst it is important to check and ensure the "permitted" use for the purposes of the lease is correct and adequately covers the proposed operation. Importantly, any consent given by the landlord for a specific use is not confirmation that that use is the permitted use for the purposes of planning legislation and this is something which will need to be checked with the Local Authority.

11. Alienation (Assignments, Underlettings etc)

Notwithstanding that the term of the lease will be fixed for a set number of years, it is usual that under the terms of the lease you will be able to assign and/or underlet the premises. Assignment is the process of transferring the lease to a another third party so that you are removed as tenant. Subletting is the process where you grant a further lease of the premises to another party but you remain tenant under the original (or head) lease. If you are expecting or will need to sublet part(s) of the premises it is important that this is covered at the heads of terms stage and this is something you should seek express confirmation on if necessary. As part of the above processes the landlord will need to approve the party to whom the lease will be assigned or to whom a sublease will be granted and, in the context of an assignment, you will be required to enter into an "authorised guarantee agreement". An authorised guarantee agreement is a statutory right under which the landlord can require you to stand as guarantor for any third party to whom you wish to assign the lease to for so long as they remain liable themselves.

12. Stamp Duty Land Tax (SDLT)

Similarly to residential premises, where the value of a lease (being any premium paid together with the sum equal to the annual rent multiplied by the length of term) exceeds certain thresholds the tenant will be liable to HMRC to pay SDLT on that lease and, in any event, will almost certainly need to complete and submit an SDLT Return in connection with the lease. As part of our instruction in connection with the negotiation and completion of the lease we confirm we shall assess and advise on whether any SDLT payment is due and complete the requisite SDLT Return for submission.

13. Land Registry

Depending on the length of term of the lease the lease will either need to be "noted" or "registered" at the Land Registry to protect the interest created and any easements over additional land (for example, access rights, parking, use of bins stores etc). This is a separate stand-alone application, with fees calculated on a sliding scale dependent on the annual rent payable under the lease. As part of our instruction in connection with the negotiation and completion of the lease we confirm we shall assess and advise on whether any SDLT payment is due and complete the requisite SDLT Return for submission.

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We recently used PDT for the negotiation of a new office lease and found the whole process simple, straightforward and problem-free. Craig displayed a welcome willingness to work with us, not only on the specific details of the transaction, but also in the relaxed way we wished the negotiation to be handled. We will certainly use PDT and Craig again.

Paul Argyle, Managing Director, Alternative Airlines Limited

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PDT have provided our family with a very professional service, in particular Craig Burton, who has helped us navigate the minefield of commercial leases and transfers. We would not hesitate to recommend them highly!

Ian Chun Lee

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- Rent and service charge recovery
- Disputes over breaches of covenant or requests for consent
- Adverse possession claims, boundary disputes, contested rights of way



We look forward to hearing from you.

If you want to discuss anything in this guide in more detail please contact Craig Burton or Elise Sherwell to see how we can help you.



Craig Burton

Partner

Real Estate

01403 831 259

cburton@pdt.co.uk

Elise Sherwell OLY

Associate

Real Estate

01403 831 210

esherwell@pdt.co.uk



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Contact us to discuss how we can help your business.

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