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Exit Strategies for Business Tenants

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Abstract

Many businesses in the UK occupy premises on fixed term leases, which usually run for several years. During this time property requirements can change. This research critically examines the three main mechanisms by which tenants can bring their leases to an end; breaks, assignment and subletting. We examine the legal rules governing these devices and undertake an analysis of lease data and surveys. Break clauses are providing a useful exit mechanism for many tenants, but they cannot give the more general flexibility of assignment and subletting. However, change is necessary to ensure that these latter provisions provide real flexibility for tenants.

Exit strategies for business tenants

Introduction

The ability of a business to adapt to changing circumstances is essential to its success. Many businesses operate from leased premises and the nature of their lease contracts can directly affect their capacity to change. As commercial leases typically run for several years, terms that govern the termination or transfer of a lease are central to the ability of the business to respond to changing property requirements. The importance of the terms of commercial leases has been recognized by successive UK governments who, in the 15 years since the property crash of 1990, have maintained pressure on the property industry to alter the nature of these leases (as part of their ongoing agenda for flexibility in business). The use of voluntary codes of practice to promote change has ensured that the whole lease package has been under continuous scrutiny.

Independent research commissioned by the Government to monitor the latest edition of the Code of Practice for Commercial Leases (Crosby *et al* 2005) showed that the early termination and transfer of leases currently cause some anxiety to tenants. Their concerns relate to assignment (the transfer of the whole of the remainder of the lease) and subletting (the creation of a subordinate interest that leaves the tenant's own lease intact). Largely as a result of this report, the current Government has accepted that "... the major problems are now inflexible assignment and subletting provisions in leases. These can make it difficult for tenants to dispose of properties they no longer need for their business. We intend to undertake a review of the law of assignment and subletting, with the aim of easing the position for tenants while not jeopardizing property investment, including looking at legislative options." (Ministerial Statement from the Office of the Deputy Prime Minister – 15th March 2005). Thus assignment and subletting provisions have now moved to the top of the policy agenda.

This paper draws together and extends the findings of Crosby *et al* (2005) by critically examining possible exit strategies for tenants wishing to leave premises before the lease expiry date.

Business flexibility and changing commercial lease structures

Commercial leases have got shorter in the last 15 years. Two reports (DETR (2000) and Crosby *et al* (2005)) chart the fall in lease length since 1990 when virtually all of the high value property owned by financial institutions and property companies was let on 20-25 year leases, although secondary, lower value, property was let on shorter terms. The difference between the two types of property remains, as the average lease length (weighted by rental value) fell to an average of 13.1 years in 2003, whereas the unweighted figure shows 7.8 years. Retail properties have consistently longer leases than industrial or offices and the difference between weighted and unweighted results suggests that smaller, lower value properties have shorter leases than the larger, higher value properties. Despite these variations across different sectors and sub-sectors of the market, the overall downward trends are clearly observable.

However, UK leases are still on average longer than in most other parts of the world (Lizieri *et al* 1997) and this, coupled with the continuing presence of upward only rent

reviews¹, affects the risk characteristics of the property investment. Ball *et al* (1998) comment that the “shorter the lease, the greater are the costs of renegotiation or tenant search, and the greater is the risk of vacancy”. Hoesli and MacGregor (2000) confirm that the UK is different to most other countries by identifying the equity/bond mix. “UK property contains features of shares and conventional bonds” while “property in other countries has similar features to shares”. Overall, “long leases and upwards only reviews contribute to a quality of income stream which will reduce the risk premium” (Baum and Crosby, 1995). These qualities have attracted investors. In a 1995 poll of international investors, length of lease was second to outlook for rental growth in a list of main reasons why they wished to invest in the London property market (Richard Ellis/Gallup, 1995). The Investment Property Forum (2000) survey of UK property investors placed income flow structures/leases and tenant covenant strength top of its ranking of risk issues.

The tenants’ perspective is more varied and difficult to identify. However, a number of studies have attempted to discover the views of tenants and have shown the importance of flexibility in lease structures to organizational adaptability. Lizieri *et al* (1997) and Gibson and Lizieri (1999) looked at the relationship between business practices and property and concluded that new working practices and a changing competitive environment increased the need for greater variety and flexibility in tenure choices. There was found to be a distinction between core and peripheral property requirements with different tenure solutions needed for say, the head office, as compared to the ad hoc space needed for a specific short term project.

Some corporate occupiers have argued that true flexibility of occupation can only be created through freehold ownership (Avis and Gibson, 1995). Since then the rise of the serviced office sector has modified this. Gibson (2001) emphasized the importance of flexibility of tenure to enable corporate real estate managers to manage the physical, functional and financial aspects of the business. She suggests that although the physical and functional aspects of space provision have been well researched, the financial costs of leaving existing premises are less well researched.

The specific appeal of breaks (rights to bring a lease to a premature end) to tenants was evident in the work of O’Roarty (2001). The corporate office occupiers interviewed in this study considered that a 15 year lease with 5 year breaks was more flexible than a 10 year lease without breaks. The occupiers felt that breaks and disposition provisions were the key to providing future flexibility, for which they were willing to pay. Crosby *et al* (2003) surveyed corporate occupiers and found an unsatisfied tenant demand for shorter lease lengths, more break clauses, and more flexibility on assignments; other lease provisions were of less concern to most occupiers. It was suggested that this might be because lease length, assignment and break clauses are all crucial to a tenant’s exit strategies and a tenant who can relatively quickly bring its lease to an end is

¹ The standard form of this type of review is that the rent can remain the same or increase at rent review, but can never fall, even if market rental levels have dropped.

inevitably less bothered about the detail of other lease liabilities.

Despite the apparent appeal of break clauses, the Strutt and Parker/Investment Property Databank Lease Events Survey (2005) shows that in 2004 only 30% of breaks in the databank were actually operated. The highest proportion of breaks (36%) was operated in the office sector, followed by the industrial sector (25%), with retail exercising only 18% of its breaks. Nevertheless, the proportion of breaks being operated has been rising steadily since 2000. The survey has only been running since 1998 so, as the 2005 report states, the time series is still too short to be able to tell if this is a cyclical phenomenon or reflects a permanent change in tenant behaviour. Changes in lease structures over the last 15 years may also mean that some breaks occurring in this period are within older style leases where breaks were more difficult to exercise; future breaks will be within newer style leases and this may also change the incidence of operation.

That tenant and landlord bodies recognise the importance of exit strategies to tenants can be seen in recent responses to the Government consultation paper on upward only rent reviews (ODPM 2004). The British Retail Consortium (BRC) stressed the importance of assignment and subletting as a key element of flexibility for retailers, but noted that leases continued to show inflexibility in this respect. *“Restrictions on subletting and assignment are designed to protect the status quo for the landlord and represent an onerous burden on retailers, particularly in the event of a market downturn. Alienation restrictions can prevent retailers moving to premises more suited to their needs limiting retailers’ ability to respond to changing consumer demands.”* (BRC, 2004). The response of the British Property Federation, the major landlords’ body, emphasizes the increase in number of tenants’ breaks. It also claims that the market is becoming more flexible on assignments and subletting at market rent rather than passing rent (BPF 2004).

The Legal Framework

A tenant wishing to leave leased premises before the lease expires would undoubtedly prefer to walk away with no ongoing liabilities to the landlord, and with no responsibility for finding a replacement tenant. This can only be achieved if there is a tenant’s break option in the lease. If there is no right to break then, unless the landlord is prepared to take back the lease, the tenant must market the premises and find either an assignee or a subtenant. In such an instance an assignment would usually be preferable since this means that, in theory, the tenant is not saddled with ongoing responsibilities to its landlord nor does it become the landlord to its subtenant. However, an assignment is not always possible, notably where market conditions are such that no-one is prepared to take over the tenant’s current lease. Here subletting may be the only viable way of at least offsetting the tenant’s losses.²

² It is recognised that subletting can be a positive tool for flexibility in estate management as well as an

In order to ascertain the effectiveness of rights to break, to assign and to sublet it is necessary to describe the legal framework in some detail.

Tenants' breaks

The inclusion in a lease of an option for the tenant to break is widely regarded as making longer leases more flexible. However, tenants' breaks are normally only operable at fixed points in time and, furthermore, the legal rules governing break options are complex.

The law does not constrain the way in which tenants' options to break are drafted; indeed, the courts have always strictly enforced the wording used by the parties. However, this means that, in practice, the right to break can readily be lost for technical reasons. Thus, time limits for the exercise of the break must be rigidly complied with; a late notice is always ineffective³. Any pre-conditions to the right to break, such as compliance with the lease obligations, must be satisfied to the letter; hence, a very minor breach of covenant can lose the tenant the right to break⁴. Finally, until relatively recently, errors in the drafting of break notices would frequently render the notice invalid meaning that, unless there was still time to serve a fresh notice, the right to break was again lost⁵. The legal rules on the validity of break notices have now become less strict⁶ (although the new approach can often leave the parties uncertain as to the effectiveness of any notice that contains mistakes).

These legal rules mean that it cannot be assumed from the mere presence of a tenant's break that the tenant really has the flexibility that the right to break appears to confer. The fixed timing and unpredictable operability of tenants' breaks means that alternative methods of disposal remain very important to lease flexibility. Where a tenant cannot break, it will need to rid itself of the lease by way of assignment or subletting. Both of these alternative options are exercisable at any time during the lease. Whether or not the tenant has the legal right to assign or sublet is a matter for negotiation. It is common for a lease to permit a tenant to dispose of its lease by way of both assignment and subletting, although the ability to dispose of part of the premises may be more constrained.

Assignment

The tenant who wishes to assign has two major concerns: first, the extent to which liability on the lease will remain after the assignment and, second, the degree of control

exit strategy. Likewise, assignment may be used strategically to realise capital value for a tenant. However, our concern in this paper is the use of these mechanisms as the means of leaving unwanted premises.

³ *United Scientific Holdings v Burnley Corporation* [1978] AC 904.

⁴ See for example *Trane v Provident Mutual Life* [1995] 1 EGLR 33.

⁵ *Hankey v Clavering* [1942] 2 KB 326.

⁶ *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749.

that the landlord will have over the choice of assignee. In both respects the Landlord and Tenant (Covenants) Act 1995 has made vital changes to the law and the way in which these changes are operating in practice has a key impact on the freedom to dispose of a lease by assignment.

Prior to the 1995 Act an original tenant always remained liable to the current landlord on the terms of the lease until the end of the lease, even where it had assigned. In theory the 1995 Act significantly improves the position of an assigning tenant by providing for automatic tenant release. However, tenant release is severely eroded by the landlord's ability to require the outgoing tenant to provide an authorised guarantee agreement (AGA). Under an AGA the assignor guarantees that its assignee will perform all the obligations of the lease. Even though the AGA cannot survive a further lawful assignment, continuing assignor liability for the duration of the assignee's tenure is a serious ongoing liability. The 1995 Act does not *require* the imposition of an AGA, it merely *allows* the landlord of commercial premises to demand an AGA in certain circumstances, notably, where a provision to that effect is included in the lease.

Prior to 1996, where there was a right to assign with the landlord's prior consent, it was invariably the case that this could not unreasonably be withheld: see section 19(1) of the Landlord and Tenant Act 1927. However, the 1995 Act now allows a commercial lease to specify the circumstances in which consent to assign will be given or to set out any conditions to be attached to the consent; these pre-specified conditions do not have to be reasonable, only where the landlord relies on other reasons for refusal does it now have to prove reasonableness. Again, the changes brought about by the 1995 Act do not *require* landlords to impose strict conditions; they can choose to continue with the old reasonableness test. However, even by 1999 (DETR 2000), it was clear that landlords were routinely including absolute conditions (i.e. conditions free from any requirement of reasonableness), notably a requirement for an *automatic* AGA.

Subletting

Even if assignment is permitted, it may not always be possible. The most obvious situation in which assignment may be a practical impossibility is where market conditions have changed so that no one is prepared to take over the premises at the rent or on the terms of the existing lease. Here subletting on terms that the market will bear may be the only way to dispose of the property.

The law's treatment of lease provisions on subletting differs in some respects from that relating to assignment. In particular, the 1995 Act amendments allowing the lease to specify absolute conditions relating to consent do not apply to subletting. Hence, in theory, so long as a lease allows the tenant to sublet with the landlord's consent, that consent cannot unreasonably be withheld. However, this masks the true situation.

Over the years the courts have, somewhat controversially, accepted the argument that,

because section 19(1) of the 1927 Act does not outlaw absolute prohibitions on subletting, it also does not prevent absolute pre-conditions to the right to sublet. Only where any pre-conditions are satisfied does the right to sublet actually arise and the statutory requirement for reasonableness kick in⁷. (This same argument has also been accepted in respect of pre-conditions to the right to assign; however, this is no longer significant because of the 1995 Act changes.) This has meant that, by drafting conditions as pre-conditions to the right to sublet rather than as conditions relating to the giving of consent, landlords have been able tightly to control the right to sublet. In particular, it has become common for leases to be drafted so that the right to sublet the whole of the premises is confined to subleases containing the same terms as the head lease and at the higher of either the rent passing under the head lease or open market rental value.

The efficacy (and legitimacy) of pre-conditions has recently been endorsed by a ruling of the Court of Appeal⁸. Here the court has refused to accept a well-used (but previously untested) device – the use of a side letter personal to the tenant and prospective sub tenant - for side stepping conditions in a head lease that dictate the terms of any subletting of the whole. Since the *Allied Dunbar* decision a High Court judge has held⁹ that the terms of the particular lease did permit the tenant to achieve a sub letting by paying an up front reverse premium to the sub tenant; however, this is not a solution that will necessarily be of general application.

It is clear that, despite a degree of uncertainty as to their precise legal effect, the imposition of strict controls on subletting can seriously restrict the tenant's ability to sublet in a market where it is no longer possible to match the terms (and, where so required, the rent) achieved in the head lease

Research Aims and Objectives

The review of the different perspectives of landlords and tenants indicates that the potential for a mismatch between the aspirations of landlords and tenants on lease length is high and suggests that an agreed lease length will often be a compromise that does not ideally suit either side. Landlords want the security of a known income flow for as long as possible and the right to increase the income flow if appropriate.

From the tenants' perspective, short term business horizons, the increasing pace of change within business and the distinction between core and periphery activities may mean that a tenant's demand for space will fluctuate. This requires tenants to be able to move premises cheaply, speedily and at a time that fits their business requirements. However only some of these can be predicted at the outset with any accuracy, for example, where the tenant's business depends on fixed term contracts to provide goods

⁷ *Adler v Upper Grosvenor Street Investments* [1957] 1 All ER 229, *Bocardo SA v S & M Hotels Ltd* [1979] 3 All ER 737, *Allied Dunbar Assurance plc v Homebase Ltd* [2002] EWCA Civ 666.

⁸ *Allied Dunbar v Homebase Ltd* [2002] 2 EGLR 23.

⁹ *NCR Ltd v Riverland Portfolio No 1 Ltd* [2004] EWHC 921

and services. In many instances it is impossible to anticipate at the time of signing the lease if, and when the tenant will need to leave; this inevitably means that identifying an appropriate lease length is difficult, even for the tenant.

The length of the lease cannot in itself, therefore, provide the necessary flexibility for tenants, even where the agreed lease length is initially satisfactory to both parties. This flexibility can only be achieved through additional exit mechanisms. However, the early termination and transfer of a lease strikes at some core requirements for landlords, namely a secure income stream for a known period of time payable by a tenant offering a good covenant and so is, in principle, highly unattractive. It is not, therefore, surprising if landlords strongly resist options to break and unrestricted rights to assign or sublet.

Having identified the various provisions by which tenants can bring their lease liabilities to an end and the legal framework for these, the objectives for the empirical research are to:

- Ascertain the incidence of these various exit mechanisms
- Identify the salient features of these mechanisms in recently agreed leases
- Describe the approach of the parties to these aspects of leases in negotiations

This will enable the effectiveness of these provisions for tenants to be evaluated. Conclusions can then be drawn on the extent to which exit mechanisms in modern commercial leases strike an appropriate balance between the interests of landlords and tenants, and on whether further change is necessary.

Research methods

The empirical work for this study included analysis of Investment Property Databank (IPD) lease data and interview and questionnaire surveys of participants in the leasing process. Methodological issues are discussed in detail in Crosby *et al* (2005), and so are described only briefly here.

IPD provides benchmarks for the property sector, and holds data relating to the property stock of financial institutions and the major property companies. 75% of leases by value in 2003/4 were occupied by the major corporate tenants, although by number, 60% of leases were let to small and medium sized businesses. The number of letting transactions recorded in the database is shown in Table 1.

Table 1: Number of transactions each year 1997 to 2003

Principal Commercial Sectors	1997	1998	1999	2000	2001	2002	2003
Retail	2,353	2,673	2,843	2,952	3,017	2,868	3,506
Office	1,322	1,493	1,425	1,827	1,569	1,588	1,529
Industrial	636	739	732	1,494	1,891	1,330	2,222
All Segments (excl other)	4311	4905	5000	6273	6477	5786	7,257

In order to find out how leases are negotiated and more detailed information about the operation of break and disposition clauses, a number of participants in the commercial

property market were surveyed. The survey was in two parts. First, a pilot study set of research interviews was held with a sample of property agents and solicitors. The interviews were used to supplement the broad picture of the major elements of leases gained from the IPD and were designed to obtain information on matters that are too detailed to be recorded by data collection systems, notably on the exact form of major lease terms. Professional advisers and negotiators were interviewed because of their experience of a wide range of transactions in different sectors involving a variety of landlords and tenants.

The sampling frame for the interviews was based on stratification by region and then by choosing different town types within these. As some of the larger transactions in a locality are carried out using London agents and solicitors, a sample of London practitioners with experience in the sample locations and across the three main property sectors were also chosen. A total of 21 solicitors and 25 property agents were interviewed using a semi-structured approach. The interview question schedule was tailored to the different stages of the process that the agents and solicitors undertake.

The findings of the interview survey were used to design questionnaire surveys of the four main participants in the leasing process; tenants, landlords, solicitors and letting agents. The aim of the second survey was to collect information on the detail of agreed lease terms and on the negotiations across a much wider spectrum of the market than could be obtained from the interviews.

The survey of tenants related to individual leases. Information on properties where a recent transaction had taken place was provided by the Valuation Office Agency (VOA), a government agency that has transaction data covering the whole property market. The surveys of landlords, letting agents and solicitors were not transaction specific and represented an investigation into their overall activity in the commercial lettings market during the two years to mid way through 2004.

The sampling frame for the tenant, solicitor and agent surveys was based on the same stratified model set out above. For the survey of tenants, a location within each town type and region was randomly selected and all transactions in that town over the period January 2003 to March 2004 were provided by the VOA. For the agent and solicitor surveys, towns of each type were randomly selected within each region and either all professionals or a sample of professionals were selected until the target number was arrived at. The target number for each of the surveys of professionals was 500 and the target number sent to each town or towns within a particular town type or region was based on the working population in each town type from the Labour Force Survey of 2004. This represented a proxy for commercial floorspace. The allocation to Inner London was increased to 20% to reflect the fact that London firms of professionals are often used as joint letting agents with a local agent across the country.

The sample for the landlords' survey was differently constructed. In total 808 questionnaires were sent to 540 individuals in 456 organisations. These were arrived at by splitting landlords into three sub-groups. 256 questionnaires were sent to small and medium sized landlords identified from Companies House data; 62 were sent to local authorities. The third group was the large institutional and property company landlords represented within IPD. The questionnaires for this group were distributed by IPD.

The IPD landlord database is organised by ownership by individual fund. Although there are 490 separate funds, some of them are held within the same organization or are managed by the same individual. While the ability to target all of the major landlords through IPD was a major advantage, confidentiality requirements meant that the research team could not monitor the returns. Some respondents managing multiple funds sent one response for all their funds, others returned separate responses for each. As a result, an accurate response rate cannot be determined for this part of the landlords' survey.

The total sent and response rates for each questionnaire are set out in Table 2

Table 2: Questionnaire surveys – destination and response

Survey	Questionnaires sent out	Useable responses	% useable responses
Tenants	1238	313	25
Landlords	808 total 456 organizations	111	14 24
Solicitors	494	111	23
Agents	501	156	31

The empirical data relevant to exit mechanisms

Breaks

Incidence of breaks

Tenants' break clauses are an increasingly common feature of commercial leases. In 1992 around 10% of all leases within IPD had breaks, with offices having the most at almost 20%. They steadily increased in all three main sectors until 1996 when offices reached 40% (DETR, 2000). Retail property, despite having the longest leases, consistently has the lowest incidence of breaks. As can be seen from Table 3 and Figure 1, the incidence has fallen back since 1996 but, over the last two years of available IPD data (2002 and 2003), there has been a significant increase in breaks in all three sectors.

Table 3 : Incidence of break clauses– 1997 to 2003

Breaks	1997	1998	1999	2000	2001	2002	2003
Retail	11.0%	10.5%	11.4%	9.7%	9.1%	15.0%	17.3%
Office	24.7%	17.4%	23.4%	17.1%	12.9%	27.9%	34.9%
Industrial	23.6%	19.2%	20.1%	25.4%	20.5%	19.0%	25.4%
All Property	17.1%	13.9%	16.1%	15.6%	13.4%	19.5%	23.5%

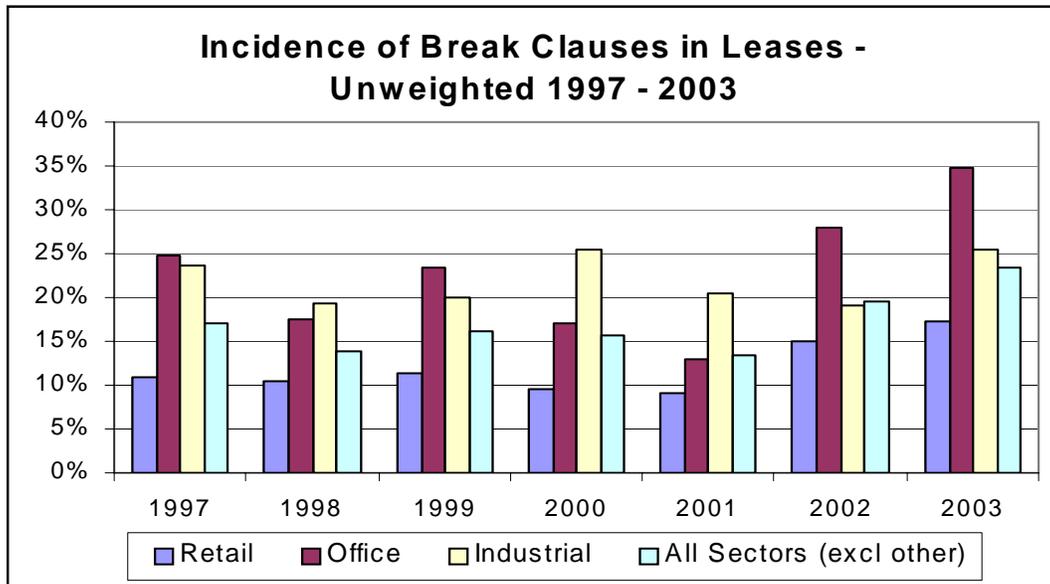


Figure 1: Incidence of break clauses 1997 - 2003

Landlords and agents were asked, in the questionnaires, about the numbers of breaks in the three property sectors in 2004. There was general agreement in the average figures for offices (landlords 60% and agents 65%) and for industrial (landlords 50% and agents 58%). However landlords reported an average of 28% of their new retail leases having breaks, compared with the 50% reported for the retail leases dealt with by the agents. Solicitors were not asked to distinguish between property sectors and reported an average of 45%. The survey of tenants showed a relatively even split between those that had a tenant's break clause in their lease (39%) and those that did not (45%). However, around 12% of respondents did not know. In common with the other sources, office tenants had more breaks (45%) than industrial (37%) or retail (36%) tenants.

The interview surveys revealed a common view that the numbers of tenant breaks were increasing although the time period for this perceived increase was not clear. This was pursued in the questionnaires where landlords and agents were asked whether the incidence of break clauses had changed over the last 2 years in the sectors with which they had experience. Approximately half of landlords and 60% of agents commenting on the trend in the industrial sector thought that the number of breaks had increased; in the office sector, around half of the landlords and agents commenting thought this was true. In the retail sector just over a third of landlords but half of agents commenting said that the numbers had increased. Very few respondents reported a decrease in any of the sectors.

At a time when lease lengths have been falling, a possible explanation for the increase in the incidence of breaks may be that they are being agreed in longer leases to compensate and bring effective lease lengths down. However analysis of 2003 IPD data suggests that this is not the case. Of the 7,257 leases signed in 2003, 23% have breaks: Figure 2 illustrates that the incidence of breaks does not simply increase as lease lengths increases. For very short leases of 1 year or less, the incidence of breaks is low

at less than 10% and it increases to over 40% for leases of 10 years. But after 10 years the incidence decreases again and for 20 and 25-year leases it is nearer 10%.

The distribution of lease lengths found in the tenant survey is similar to that found within the narrower market covered by the IPD data. The incidence of break clauses by lease length is shown in Figure 3. Whilst 12% of respondents did not know if they had a break clause, the results confirm the finding in IPD that the incidence of breaks is not simply higher the longer the lease. The overall incidence of breaks within the surveys is generally higher than in IPD which may suggest that there are more breaks in the secondary and tertiary markets.

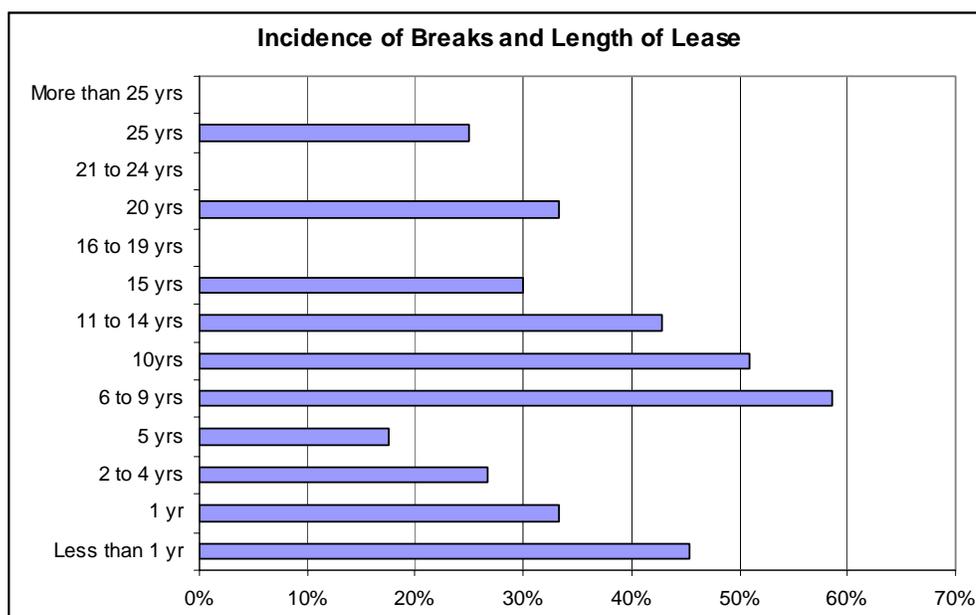


Figure 2: Incidence of breaks and lease length in tenant questionnaire survey

Note : No observations of leases of 16-19 years and only one observation of each of leases of 21 to 24 years and over 25 years in sample

Timing of breaks

Breaks are getting earlier. This can be seen in the falling average time to the first break between 1997 and 2003 in all property sectors within IPD illustrated in Table 4.

Table 4: Length of time to 1st break – 1997 to 2003

	1997	1998	1999	2000	2001	2002	2003
Retail	5.2	3.6	3.5	3.9	3.6	3.3	4.2
Office	5.5	4.9	4.1	5.1	4.6	4.0	3.7
Industrial	6.3	5.0	5.0	3.6	3.4	4.3	4.0
All Sectors (excl other)	5.6	4.4	4.1	4.1	3.7	3.8	4.0

The questionnaire survey of tenants confirmed how common early breaks are. 40% of the breaks were said to be operable within the first two years of the lease. Thereafter, the most frequent break point was three years (25%), followed by 5 years (16%).

Breaks and rent reviews

Breaks are commonly timed to coincide with rent reviews. The 2003 IPD data shows at least 65% of leases with both a break and a review had the first break timed at a review.

More than half of the agents interviewed said that breaks are usually timed to coincide with a rent review. However, a third felt that the timing of breaks is actually dictated by the tenant's operational requirements; this was particularly commented upon in respect of the distribution business. Solicitors said that tenants' breaks are timed either to coincide with a rent review (although they were not explicitly suggesting a link) or are geared to the tenant's operational requirements. Confirmation of the pattern of timing came in the questionnaire survey; 60% of solicitors and 82% of agents indicated that they thought these breaks were usually timed at the review.

Many of the agents interviewed believed that, where rent reviews and breaks are timed to coincide, landlords seek to ensure that the notice provisions for the break are drafted so that the tenant must decide whether or not to operate the break before any new rent is proposed. Similarly, in the questionnaire survey, only 15% of solicitors and 19% of agents thought that the lease would usually allow the tenant to operate the break after a new rent had been proposed whilst around 60% of solicitors and 53% of agents thought that the lease would seldom or never allow this to happen.

Operability of breaks

For a break clause to be a viable exit mechanism, the tenant must be able to operate it easily. Therefore issues of operability, such as notice periods and conditions, were addressed in the surveys. The agents interviewed said that the most common period of notice required by landlords is 6 months but periods of 12 months and 3 months are also used. They also remarked that the less comfortable the landlord is with the break, the longer the period of notice required. However, the solicitors interviewed said that the notice period was very variable, ranging from 3-12 months with shorter periods of notice being more prevalent in the small business market. Responses to the tenant questionnaire survey confirmed that the most usual period of notice is 6 months (43%), with 25% having to give only 3 months' notice; and just 8% have to give more than 6 months' notice.

The solicitors interviewed considered that strict conditional breaks are now a thing of the past with most breaks now being conditional only on the payment of rent. Some agent interviewees encountered occasional use of penalties on the triggering of a break, although the majority of solicitors had either never, or rarely, come across them.

Negotiation of breaks

The tenants' survey showed that 37% of tenants who undertook negotiations for their lease discussed a break clause, and that only 11% of those who negotiated thought that

break clauses were non-negotiable by the landlord.

Landlords were asked how often tenants' breaks came up in negotiations. They are frequently a subject for discussion, with 42% of respondents saying they always or usually feature in negotiations, with a further 42% saying this happens half of the time. However, discussions do not always lead to a change to the proposed terms since 26% of respondents say that that this seldom or never happens. Nevertheless change is likely; 36% said this would always or usually result in a change to the terms, with a further 36% saying that this happens half of the time

Assignment and subletting

The IPD database does not hold information on lease provisions relating to assignment or subletting. The rights to assign or sublet and any conditions attached to these were addressed in the interviews of solicitors and the questionnaire surveys of landlords and solicitors, but not in the agents' questionnaires as the interviews had shown that agents are rarely involved in negotiating the detail of these lease terms. In the tenants' survey respondents were simply asked if they have the right to assign or to sublet.

Assignment

About a quarter of the solicitors interviewed commented that very short leases, i.e. of 3 years or less, are usually made unassignable. It was seen as standard for the landlord to require an automatic AGA as a pre-requisite of any consent to assign, and few ever sought to have this modified. The majority thought that other conditions attached to the giving of consent are no longer as onerous as they were immediately following the 1995 Act changes to the law, with several interviewees saying that that the conditions now put forward by landlords are often negotiable. However a number of interviewees did believe that landlords frequently include what they perceived as inappropriate conditions. They also commented that some of the more common financial conditions, notably that requiring an assignee to be of equal financial standing, can make a lease virtually unassignable.

In the questionnaire survey, landlords and solicitors were asked about the provision for assignment. 15% of landlords (and 3% of solicitors) did not answer this question; the responses of the rest, set out in Table 5, show that, on average, the tenant was allowed to assign in approaching 90% of the 2004 leases they had dealt with. However, in 80-90% of these cases the tenant was required to enter into an automatic AGA before consent to an assignment would be forthcoming.

Table 5: Ability to assign

Assignment – all sectors	Average Responses (%)	
	Landlords	Solicitors
New leases where assignment permitted	87	88
Of the above, those with automatic AGAs	80	89

Almost all landlords and solicitors completing questionnaires agreed that there has been

no change over the last two years, either in the proportion of leases permitting assignment or in those requiring automatic AGAs, although 19% of solicitors did think this latter number had actually increased.

The tenants' questionnaire survey produced a lower figure than the other sources, as 44% said they could assign and 35% said they could not. However, 20% of respondents did not know, a high figure compared with responses to other questions on lease terms.

Subletting

The vast majority of the solicitors interviewed said it is standard for landlords to set pre-conditions on the right to sublet the whole, that require the sublease to be on the same terms and at the higher of the passing rent or market rent. The remainder, who felt that subletting was usually constrained only by the landlord's consent which could not unreasonably be withheld, all dealt with properties at the smaller end of the market.

Although more than half of the solicitors interviewed were aware of the difficulties posed by strict pre-conditions, the remainder did not see any problems with them. Most of those who appreciated the problems said that they could usually negotiate a modification from passing rent to market rent.

In the questionnaire survey, landlords and solicitors were asked about subletting provisions in their 2004 leases. 15% of landlords (and 8% of solicitors) did not answer this question; the responses of the rest are set out in Table 6 and show that, on average, around 70% of leases permit the tenant to sublet. The landlords said that this had to be at passing rent in 36% of these leases. However the solicitors saw this feature in 60% of the cases they dealt with.

Table 6: Ability to sublet

	Average Responses (%)	
	Landlords	Solicitors
Sub letting– all sectors		
New leases where subletting permitted	72	68
Of the above, those where subletting at passing rent	36	60

Neither the landlords nor the solicitors thought that there had been much change in the numbers of leases where subletting is permitted over the last two years. However around 17% of each group thought that, when subletting is permitted, the requirement for passing rent had decreased over this period.

As with assignment, the tenants produced a lower figure than other sources, as only 28% said they could and 56% said they could not. However, 12% of respondents did not know, again a relatively high figure compared with responses to other questions on lease terms.

Negotiation of assignment/subletting

These issues are rarely negotiated by the tenants; the reasons for this are not clear. It could be that these clauses are assumed by tenants to be non-negotiable, equally it may

be that their significance is not properly appreciated, especially by less aware tenants. The latter possibility may be borne out by the relatively high number of tenants who did not know whether they could assign or sublet. Only 20% of the tenants who had negotiations actually negotiated about these clauses and 20% of those actually thought that the assignment/subletting clauses were non-negotiable for the landlord

The landlords confirm that these provisions are not typically subjects for discussion as 47% say they are seldom or never negotiated while only 25% say that this always or usually happens. Even in the rare cases where there is negotiation, it is unlikely to result in a change to the proposed clauses in the lease with only 8% of landlords saying negotiation would always or usually produce a change compared with 65% who said it would seldom or never happen.

Discussion

The reasons why tenants may want to leave premises before the end of the lease have not been specifically explored in this, or any other, research. However, they are likely to fall into one of two categories. The first is operational; the business may have either failed or expanded, or the premises become unsuitable for the business. The second relates to the lease terms; for example, the rent may have become unaffordable due to a rent review.

Operational reasons for prematurely ending a lease can be due to predicted events or completely unforeseen occurrences. In many retail operations, unexpected changes in the quality of location may be catastrophic. In industrial and office property, the building could be more important and good quality tenants may want to relocate to better quality buildings; or changes to design requirements might render existing buildings obsolete. In other examples, a company providing a service under a fixed term contract may find that it is not renewed.

Regardless of the motivations, without exit options, tenants may be tied into locations or buildings which are no longer suitable or efficient for the operation of the business. It can therefore be argued that such inflexible leases could harm the efficiency of the UK economy by restricting the mobility of companies and the natural filtering processes within markets. It is this business efficiency issue that has interested successive UK governments over the last 15 years.

A lease containing a right to break and rights to assign and sublet provides a tenant with a wide range of exit mechanisms. The inclusion of such provisions is a matter for negotiation between the parties. However, some landlords may view them as contrary to their interests and may seek to keep the tenant's rights as restrictive as possible and, where their bargaining position is strong, can ensure that the tenant has little flexibility.

Breaks at fixed times have become an increasingly important part of lease structures (although noticeably less so in the retail sector) and often feature in lease negotiations. There are indications, from this and previous work that, while specific operational planning may be one reason for their popularity, for example, to coincide with a service contract renegotiation, breaks also appeal to tenants by appearing to provide general flexibility to cope with unforeseen events. However, in truth a break can only achieve this latter objective if its timing is either well judged or fortuitously occurs when

needed.

Breaks are getting earlier in leases; this is particularly so at the smaller end of the market. It is not known who is driving this move towards earlier breaks. It may be that some tenants, perhaps those starting up a new business or trying a new location, are seeking to provide themselves with an early exit route should things not work out. Alternatively, it could be landlords who are pushing for an early break in the belief that such breaks are less likely to be operated than those which occur later in the lease.

The legal rules relating to breaks, especially those relating to pre-conditions, notice periods, and strict time limits, can determine whether a tenant's break provides the flexibility expected. The imposition of strict pre-conditions is now relatively rare and it seems that the dangers of these are fully appreciated by today's practitioners. Periods of notice of up to 6 months seem to strike a fair balance between the needs of landlords and tenants. Landlords require enough notice to start marketing the property and so minimise the likelihood of a void period, while short notice periods enable tenants to respond to changing circumstances and make it less likely that they will miss the time for service.

The coincidence of breaks and rent reviews is commonplace and may, in part, reflect a belief by the tenant that this will provide an escape route from an unacceptable rent. But, in practice this is often prevented by a notice period which forces the tenant to decide whether to break before the new rent has even been discussed. For the less aware tenant this may well mean that the protection that the right to break was believed to give simply does not materialise. This may be one explanation for the IPD lease events study and the interviews showing that a significant proportion of tenants' breaks are not being exercised, despite the fact that they are now generally more readily operable than in the past. Of course, a more benign reason is that many tenants may not need to exercise their breaks, especially where they were inserted as a broad protective measure

The inherent limitations of fixed breaks mean that they cannot, by themselves, provide a tenant with a satisfactory exit strategy. Other mechanisms with less specific timing have to be in place. The alternatives available to the tenant are the rights to assign or to sublet, both of which are exercisable at any time during the lease. However, there are indications that tenants do not necessarily appreciate the significance of these alternative means of disposal. Rights to assign and sublet do not feature strongly in lease negotiations and many small business tenants in particular do not even know whether they have such rights. However, tenants usually do have the right to assign; only in respect of very short leases (less than 3 years) was it found that tenants may not do so. Whilst the right to sublet is less widespread, in the majority of cases subletting of the whole is permitted. However, the value of these rights depends on their detailed drafting.

In fact, while landlords do impose strict conditions on the giving of consent to an assignment, generally, most of these are now less stringent than those being imposed immediately after the 1995 Act. However, despite recommendations to the contrary in the Code of Practice for Commercial Leases (DETR 2002), there is evidence of two potentially onerous conditions being routinely required. First, there is an almost universal requirement for an AGA; this means that, despite the 1995 Act's provision for

tenant release, assigning tenants do not, in practice, walk away with no ongoing liabilities. Second, there is a common requirement that the incoming tenant must be of a financial standing equal to that of the outgoing tenant. This can make a lease difficult to assign, particularly for good quality tenants. It can also make assignment problematic for some properties as they age, effectively preventing the natural progression of these properties to tenants of lesser covenant strength.

Even where a tenant has a right to assign, a right to sublet can be a vital alternative. There are situations where market conditions mean that a right to assign is worthless. Here, subletting is a useful tool for property management and loss mitigation by the tenant. Where there is a right to sublet, it is still common for there to be a pre-condition that any subletting must be on the same terms as the head lease and at a rent that is no less than the passing rent. Although some of the more astute tenants are able to negotiate on this point, many either do not or cannot because it is regarded as non-negotiable by the landlord. These conditions can effectively prevent a subletting, and it is therefore legitimate to consider why landlords insist on them when, by definition, the tenant remains liable under the terms of the head lease.

One reason is because of the fear that, should the head lease fall away, the subtenant will become the direct tenant of the landlord on the terms of the sublease. However, in the two situations in which this can occur without the landlord's concurrence, it is suggested that the landlord's position can be protected without the need to resort to pre-conditions. Where the subletting is of the whole this will mean that the tenant will not have any statutory right to renew its lease. However, the subtenant will have a right to renew its sublease directly against the head landlord (a scenario that the Court of Appeal found persuasive in the *Allied Dunbar* case itself). This risk can readily be avoided (and often is) by a requirement that any subletting is contracted out of the 1954 Act. The second situation in which the subtenant may become the direct tenant is where the head lease is forfeited and the subtenant applies for, and is given, relief. However, although the conditions on which relief is given are at the discretion of the court, it is well accepted that the sub tenant must virtually invariably be subjected to terms that are no less onerous than those in the head lease¹⁰.

Therefore, as a matter of law, a landlord need not be put at any serious risk by a subletting on terms different from the head lease. This suggests that landlords' real concern is the level of rent under any subletting. Worries that tenants may offload a property at a rent below open market levels can be adequately addressed by a pre-condition that the rent under the sublease must be at or above open market rent. This suggests that the real reason for restricting sublettings to those at a rent that equals or exceeds passing rent is to maintain the value of the investment, or to protect the landlord's position at rent review. Where a subletting can only be achieved at a rent below the rent passing under the head lease, it provides clear evidence of a drop in rental value of both of the property itself and, possibly, that of the landlord's

¹⁰ See *Creery v Summersell* [1949] Ch 751; *Hill v Griffin* [1987] 1 EGLR 81.

neighbouring property. It may well be this that landlords are seeking to avoid.

The practice of imposing pre-conditions on the right to sublet seems unjustifiable, especially the insistence on a passing rent rather than a market rent test. This particular condition has been raised to the top of the Government policy agenda and 53 members of the BPF have declared their intention to put a stop to this practice in new leases and not to enforce it within existing leases (BPF, 2005). However, this declaration has only been made by some landlords (albeit many of the major ones) and it is not legally binding. Furthermore, it does not extend to other common pre-conditions (such as a requirement that all the terms of the sublease are the same as those in the head lease); these, notably where they require the imposition of full repairing obligations on any subtenant, can be just as effective in preventing a subletting.

Conclusions

This paper describes the various provisions by which tenants can bring their lease liabilities to an end, and aimed to:

- Ascertain the incidence of these various exit mechanisms
- Describe the salient features of these mechanisms in recently agreed leases
- Identify the approach of the parties to these aspects of leases in negotiations
- Evaluate the effectiveness of these provisions for tenants.

The lease provisions governing a tenant's right to break, assign or sublet have been examined. Each of these is fraught with legal pitfalls for the unwary occupier and landlords have historically deployed a number of devices which restrict the ability of tenants to terminate or dispose of leases before the full term. These restrictions have been assumed to add value to the landlord's investment and have therefore been defended and perpetuated within lease negotiations. However, market pressures, coupled with government interest in the operation of the commercial landlord and tenant relationship, have resulted in voluntary change and pressure for this to continue remains strong.

Since 1990, tenants' breaks have been seen as the central plank of an exit strategy, particularly in the office market. Breaks have become more operable than they used to be, more frequent and occur earlier in leases. Nevertheless, this research questions whether breaks alone can provide a flexible exit strategy for tenants. First, their timing is generally fixed at infrequent intervals which may have no relationship with the need to terminate the occupation. Second, where a break is timed at the rent review, the mechanics of the provision usually prevent the tenant knowing the new rent before deciding whether to exercise the break. Theoretically, this can be rectified by a change to the drafting of the clause, but the evidence is that landlords would not find this acceptable.

The problems with the fixed timing of tenants' breaks cannot realistically be avoided; rolling breaks would be too risky for many landlords. Therefore other exit mechanisms are needed. These alternatives are assignment and subletting. There is an argument to suggest that landlords (and those who provide the finance for property investment) ought to find these more attractive than breaks since they allow the lease to continue

and with it the existing income stream. Indeed, this would seem to be borne out in this research, as virtually all tenants had the right to assign compared with much lower numbers having breaks, and many tenants also have a right to sublet. However, there is clear evidence that, in certain respects, landlords are being unnecessarily restrictive as to the precise circumstances in which a right to assign or sublet can actually be exercised. Furthermore, there are signs that tenants and their advisers may not appreciate the importance of assignment and subletting although, for the major retail tenants, who rely less on breaks, restrictive assignment and subletting terms are said to be an important issue. Nevertheless even these tenants do not resist the imposition of restrictions as vigorously as they might.

Over the last 15 years, more flexible leases have been delivered without the need for legislative intervention. However, while break clauses are providing a useful exit mechanism for many tenants, they cannot provide the more general flexibility that tenants need. This conclusion of the research has led assignment and subletting to become a key part of the policy agenda. The UK Government has announced their intention to review this area and they have not ruled out a legislative solution. However, this will not be straightforward. The use of pre-conditions can probably only be stopped by outlawing absolute covenants against assignment and subletting. However, landlords can have legitimate reasons for preventing some types of assignment and subletting, for example those affecting part only of the premises. It will require careful consideration to provide any solution, legislative or voluntary, that will be fair to landlords, provide flexibility to tenants, and which is deliverable across the market as a whole.

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