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UPWARD ONLY RENT REVIEWS

THE LICENSEES ASSOCIATION

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BACKGROUND

In 2004 Jonathan Guthrie wrote in the Financial Times with regard to upward only rent reviews (UORR) that "There is something richly feudal about the rental ratchet. It benefits the landlord at the expense of the tenant, making humiliatingly clear who has the whip hand. When rents are rising all around a property, the landlord gets more money too. If they are falling, the tenant finds himself shelling out above the market rate." Jonathan was not alone in concerning himself with UORR clauses and the distortion they bring to the marketplace. For over two decades successive governments have voiced their concerns about UORR, commissioned reports, and then instructed landlords to adopt a voluntary code of practice, believing that their universal use is anti-competitive and unfair.

It will come as little surprise that landlords have been less than enthusiastic about moving away from UORR. Turkeys are not known for voting for Christmas. Successive governments have sought to avoid legislation preferring to rely on the goodwill of landlords, a request usually falling on deaf ears. Codes of Practice are not widely known about, particularly with smaller tenants and the Government's preferred option of alternatives is not offered, and the Codes are themselves voluntary.

The United Kingdom is virtually unique in allowing UORR clauses in leasehold contracts. Other nations that had them, namely Ireland and Australia, have banned them whilst they are not a part of contacts across Europe and America.

During periods of economic growth tenants rarely complain, but as we face possible recessionary times and relative growth hard to come across, UORR clauses will have an adverse impact on many tenants and in some cases may well lead to business failure. It's our concern that post-pandemic and Brexit many tenants will find themselves with rent demands that are far out of line with genuine open market values and with no means of re-balancing.

THE GLOBAL PICTURE

A number of countries have addressed the issues of UORR clauses in leasehold contracts. Whilst the use of UORR was historically mainly limited to nations that have been influenced by British law most of these have now banned their use leaving the United Kingdom almost unique in allowing their use.

IRELAND

In 2007 the Irish market began to slow. The Celtic Tiger had seen rapid growth for several years that led to a boom in the property rental market. It declined as rapidly as it grew and this led to a growth in unemployment and the closure of many businesses. Consequently, the property market faltered, credit dried up and this was exacerbated by the exposure of corruption within some Irish banks.

By 2008 unemployment had increased by 70%[1] and business closures increased by a whopping 86%[2]. One of the reasons cited by business was their inability to pay rents which were set during the previous boom. Consumer confidence shrunk and the retail sector was particularly hard hit. When one would normally expect to see prices fall as demand wained the reality was that prices stayed high, the retailer blaming high rent costs. Ireland in 2008 was had quickly become internationally uncompetitive. The inflated property values at the very heart of the problem.

Between 2007 & 2011 retail rents decreased by 50%[3]. UORR were blamed for keeping rental levels in legacy contracts too high and businesses were forced to close as a consequence. The Irish government came under significant pressure to abolish UORR from 2007 and did so On 28th February 2010.

The legislation introduced by the Irish Government abolished UORR clauses in all new leases. This created a two-tier system and failed to address the concerns of existing tenants and their representative bodies. The problem with this two-tier system is that tenants on legacy leases remained high, tenants looked to exit by offering reverse

[1] The Economic & Social Research Institute 2008

[2] Farrell Grant Sparks - Kehoe & Daly 2008

[3] CBRE - 2011

premiums as assignments proved very difficult to promote. Some landlords removed concessions and rent incentives. It was felt that the Irish government should have acted to avoid the two-tier system with a number of attractive solutions being forwarded including:

- Allowing an UORR only at first review and then upward and downward thereafter ensuring landlord concerns in obtaining investment funding were considered.

- The introduction of a property transaction database to ensure transparency and the accuracy of rental comparable and so reduce the effect of confidentiality clauses and side letters.

- Allowing tenants early exit options and to encourage more medium-term leases of ten year periods.

AUSTRALIA

As in Ireland, Australia's government was urged to look at UORR. Concern in the early 21st Century had grown about large corporate landlords, mainly investors and developers in the Australian market, seeking to leverage their considerable power against smaller tenants. The clear imbalance of power at negotiation led to aggressive behaviour from landlords who took advantage of the tenant's lack of renewal rights to force inappropriate clauses onto their tenants.

The government listened and abolished UORR in 2010. The Act forbade the use of UORR and recommended the use of alternatives such as turnover rents or indexation. Unlike Ireland, the Act was accepted without too much controversy.

THE REST OF THE WORLD

After both Australia and Ireland abolished UORR if left the UK as relatively unique in allowing UORR clauses. The US retail market is predominantly based around turnover leases. Across Europe, the majority of lease terms are for less than 10 years, with 34 out of 36 in a European Survey having a majority being below 10 years (the two exceptions were the UK and Ireland). In these areas, leases are mainly index-linked.

The use of short term leases and the nearly universal rejection of UORR pours cold water on the claims of landlords that investors will not consider markets where there are no UORR.

THE UNITED KINGDOM

The issue of UORR has been ongoing in the UK for over a quarter of a century. Following the recession of the early 1990s the UK saw the greatest fall in nominal property values since records began. As in Ireland and Australia, recessionary pressures resulted in stress to tenant's bottom lines and their ability to pay rents that stepped away from the original open market levels.

The 1995 Code

In 1994 the government called on the property industry to negotiate a Code of Practice relating to business leases following a consultation on UORR. The code was launched in December 1995 and the government undertook to review it after three years. The stated objective of the code was "to draw attention to the implications of upwards-only rent review clauses", this objective was not merely that tenants should be told what such clauses mean, but also that they should understand the implications of them.

In April 2001 research into the impact of the Code was published. It found that the Code was not in regular use and that it had had "practically no impact". UORR were found to still be the dominant form of the rent review mechanism.

The then Minister, Nick Raynsford, asked the industry to consider a number of measures including:

- how the market could promote alternatives to upward only rent review clauses, ensuring that they are presented attractively while bearing the appropriate price tag

A new working group was pulled together and asked to formulate a new voluntary code.

The 2002 Code

On the 22nd April 2002, a new voluntary code was published. Sally Keeble, Parliamentary Under-Secretary of State for Transport, Local Government and the Regions trumpeted its arrival:

> *"The Code of Practice breaks significant new ground. For the first time, a voluntary Code recommends commercial property owners to provide, wherever possible, a choice of leasing terms. It urges those funding property, wherever possible, not to impose letting constraints"*

Following the publication, a contract was awarded again to Reading University to gauge the impact of the code following the work they had done on the 1995 code, and it was made clear to all parties that if the research showed no signs of change then legislation would be on the agenda.

Prior to the publication of the review the British Property Foundation published research showing 92% of leases still contained UORR clauses. The study found:

- *The evidence on rent review indicates no change. The upwards-only review is virtually universal and the incidence of alternative review types is still rare. Review patterns remain the same with five-yearly reviews standard in the institutional market while 3-yearly reviews are still more common in secondary and tertiary property on shorter leases.*

- *There is no evidence that choice is being offered or sought in respect of rent review type. Where a lease is to contain a rent review, it appears to be accepted by both parties that it will be a standard upwards-only review to market rent.*

Again the new code was seen to have had very little impact on lease negotiations and in light of the findings, the government decided to launch yet another consultation and again threatening legislation. The Minster, Yvette Cooper stated:

> *"The report by Reading University has found that although there has been no reversal of previous trends towards shorter leases and that more leases contain operable "break" clauses, rent review provisions are almost universally upwards-only*

> *"It is particularly disappointing that there are few signs yet of landlords offering alternative leasing packages at different prices, although the report finds that a degree of negotiation does take place. We are also concerned about the evidence that small business occupiers have too little information to be able to negotiate the best deals"*

The 2004 Consultation

In 2004 The Office of the Deputy Prime Minister published a consultation paper noting:

> *"The Government is concerned that the widespread use of UORRs in longer leases has restricted the degree of flexibility in the market. Their predominance has inhibited the development of alternative forms of rent review, for example indexation or fixed interest rents (ie rents which rise periodically in accordance with a prescribed interest rate). Objections to UORRs are particularly acute either when the tenant has to accept a UORR clause because the landlord is offering no alternatives or where the tenant has accepted a UORR clause in ignorance of its implications or of the relative merits of available alternatives. The Government would expect landlords to offer alternative terms to UORRs, on an appropriate risk-adjusted basis, even where there was strong competition for occupation of premises on a particular site. The use of UORRs would be objectionable where the landlord has offered alternatives, but the pricing overstated the relative risk of non-UORR options. It is the use of UORRs in the circumstances set out above that the Government wishes to address."*

The consultation paper led to a report published in 2005.

The 2005 Report

The report found that landlords had become more flexible by offering shorter leases and allowing more tenants the right to break them, however, the majority of leases with rent review clauses still contained upwards-only clauses. Yet again it seems the property industry seemed wedded to UORR and unwilling to contemplate divorce.

The Minister Yvette Cooper noted:

> *"We continue to have concerns about the prevalence of upward only rent review clauses in longer leases. The Reading report shows that their impact has been diminishing, as fewer leases contain any form of rent review provisions, and that tenants are currently more concerned about inflexible assignment and subletting provisions than they are about upward only rent reviews. We do however believe that further progress in this area is necessary to improve the flexibility of the market. We will therefore continue to monitor the situation and retain the option to legislate in future if necessary. But we do not propose to legislate against upward only rent review clauses at present.*
>
> *"We are asking the property industry to undertake a joint review of the code of practice, to carry out a renewed campaign to disseminate the code and provide an effective mechanism for dealing with complaints. We want to make sure that everyone negotiating a lease adopts the code.*
>
> *"We will be undertaking a further monitoring exercise over the next three years, and we will be looking for further movement on flexibility. We believe that achieving greater flexibility in the market is extremely important and that further market reform is essential"*

A further review was launched and this led to a revised Code of Practice introduced in March 2007.

The 2007 Code

In March 2007 a revised code of practice was released under the title 2007 Code of Practice for Leasing Business Premises. Again the Minister, Yvette Cooper warned:

> *"I recognise the considerable changes in commercial leasing practices over recent years, especially the trends towards shorter leases. But I am concerned about continuing elements of inflexibility, particularly the predominant use of upward only provisions in rent review clauses and inflexible provisions for tenants exiting property they no longer need.*

> *"We will want to keep a close eye on market practice in these areas. If the market does not deliver, we have identified legislative options. Communities and Local Government will shortly be consulting the bodies that drew up the Code about suitable monitoring arrangements."*

The Code for Leasing Business Premises in England and Wales 2007 stated that landlords should offer alternatives to upward only rent reviews if requested and give reasons if they are unable to do so. Again the Code was voluntary, again it failed in its objective.

The impact of the 2007 code was again marginal at best. Awareness levels remained at the levels even lower than that achieved by the 2002 code for small business tenants with less than 40% of regional landlords having any knowledge of the code[4]. It was clear the Code had failed to reach small business and that the desired awareness resulting from the 1995 and 2002 codes hadn't materialised. Further to this, the evidence showed that UORR were still prevalent throughout the industry.

The Portas Review & Other Developments

A further wide-reaching review into a vision of the future for the High Street was carried out by Mary Portas and completed in 2011. In it Portas noted:

> *Government should -"Encourage a contract of care between landlords and their commercial tenants by promoting the leasing code and supporting the use of lease structures other than upward-only rent reviews, especially for small businesses.*
>
> *"The upward only rent review had its place but in the current economic climate can no longer be the broad brush solution it once was. In cases where a struggling small entrepreneur is interested in staying in a property for 15 years, the upward only rent review after five years can be a crippling factor in determining whether or not the business can survive in the location. I therefore recommend that, particularly in the case of small entrepreneurs without the negotiating clout of the big retailers, alternative lease structures are used. And Central Government, landlords and local authorities should lead by example here when letting out their properties*

[4] Business tenancies: rent reviews - Wendy Wilson and Robert Long 16/12/2011 (House of Commons Library)

> *to commercial tenants. We should increase awareness and availability of different types of lease such as turnover-based rent reviews that give landlords a stake in the success of the tenant's business. Tenants should have a good understanding of their options so they can negotiate arrangements that work for them."*

Upward only rent reviews were also raised as an issue in the House of Commons' Business, Innovation and Skills Committee's report on Pub Companies, 2011. The Government response, published in November, set out the following:

- Recognising the significant concerns identified by the Select Committee, the BBPA [British Beer and Pub Association] has agreed to make substantive changes to the Industry Framework Code. Once the Code becomes legally binding these changes, together with the rest of the Code, will become binding commitments enforceable through the courts (or through PICAS).

- Upward Only Rent Reviews: Upward Only Rent Reviews must not be enforced. No Upward Only Rent Reviews will be included in new leases.

CONCLUSIONS

It is clear that from 1995 successive UK Governments have been aware of the concerns surrounding UORR. They have repeatedly commissioned reports, published Codes of Practice, and sought to promote a self-regulated move away from UORR clauses. This was particularly acute a need where the tenant is a small business. Today matters are even worse as the new RICS 2020 Code for Leasing Business Premises has quietly dropped the reference of the 2007 Code that alternatives to UORR should be offered.

Despite continued threats to regulate the marketplace no legislation has been forthcoming. Successive governments appear to have not learnt the lessons of their predecessors in believing the market will regulate itself. This hasn't happened with UORR clauses still endemic within the marketplace. The one success appears to be tied rent leases in the pub sector.

As we face a period where open market rents are likely to fall we face the prospect of many existing leases being over-rented and struggling tenants. We already have a vision of what the future may bring with companies like Debenhams and House of Fraser turning towards CVA arrangements to try and alleviate the problems they faced from over rented properties subject to UORR clauses. The Pandemic has only accelerated the number of companies turning to CVAs to try and alleviate their exposure.

Of course, there is the flip side argument offered by landlords, their representatives, and banks. UORR ensure investments are secured and consequently allow for further investments to be made with confidence. We don't buy this. Firstly it needs to be recognised that the rest of the world doesn't insist on UORR and even where they had previously existed, Australia and Ireland, they have been abolished. Secondly, it seems incredulous to us that small businesses should be subjected to the possibility of serious over-renting and business failure to support the investment possibilities of their landlords. It is the landlord's risk, not the tenants.

The Licensees Association strongly believes that we need to address the issue once and for all. It is clear that despite a quarter of a century of review and code after code the problem is still alive and kicking. The fallout of the global pandemic is likely to have a strong adverse effect on the property market and urgent measures will be required to ensure the survival of many small businesses.

Allied to short-term solutions this is the ideal time for us to look at the long-term problems within the marketplace, resist further kicking of the can down the road and, seize the day. Doing so will ensure the confidence of small businesses to invest in moving forward with confidence that they will not face serious over-renting problems.

OUR FOUR POINT PLAN

- **The abolition of UORR clauses for one year from a set date to allow for all businesses affected by the pandemic to have the assurance that they will not be over rented as they recover from the pandemic.**

- **All businesses have the option of an open market rent review within one year of the set date and a moratorium against landlords taking action whilst negotiation takes place to ensure that landlords engage. Agreed rent to be backdated to the tenant's or landlord's request for the review[5]. The new set rent to be applicable for a minimum of 50% of the normal review cycle up to a maximum of the regular review period**

- **A review into UORR and Indexation to be commissioned by the government with legislation to follow should the commission recommend it. To report within one year of commission.**

- **The "Code of Practice for commercial property relationships during the COVID-19 pandemic" to be made mandatory**

OTHER RECOMMENDATIONS

- Where cap and collar indexation reviews exist the collar should be equal to the cap to ensure fairness and avoid UORR. For example, if a Cap is set at 5% a collar would be -5%. This avoids the indirect upwards only rent of indexation collared at a positive value.

- The abolition of the Retail Price Index which is itself inflationary

[5] Where a tied pub adopts a market rent solution, for the backdated rent to include wet rent compensation to ensure the landlord doesn't receive the benefit of both backdated rent and already charged wet rent, to a base level set following trade association consultation.