

CHANGES TO LANDLORD & TENANT LEGISLATION. A REVOLUTION IN THE MAKING FOR COMMERCIAL PROPERTY.

Almost without a sound a revolution in commercial property is about to take place. The most far reaching changes to the legislation surrounding commercial property leasing for decades have just been added to the statute book. The Civil Law (Miscellaneous Provisions) Act 2008 will amend Section 17 of the Landlord & Tenant (Amendment) Act 1980 whereby all commercial property users, including retail tenants will be able to contract out of their rights to a new tenancy either when their current tenancy expires or for new tenants before their lease agreement commences.

Since 1994 'contracting out' of the 1980 Act has been available to Office users only. Retail and industrial tenants can now also do so if they wish provided they have independent legal advice.

The implications will be considerable and property professionals will be expected to be able to advise if a tenant should contract out of renewal rights or not. Equally important should owners offer this option to their tenants? Owners and developers will have to decide if they want to lease their property under the 'old' familiar long lease system or the 'new' system where leases will be shorter and far more flexible and creative. The choice will have significant implications. How will the landlord / tenant relationships change where tenants are on say 5 to 10 year leases with no rights to renew at the end of that time. These changes will not only affect owners and occupiers but will go to the very heart of development financing, management (including service charges) and even property design.

Some time ago The Law Reform Commission examined property leasing practice and questioned if the current use of 25 year long leases were good for business. They noted that trying to explain our long leases to foreign investors was an 'embarrassment'. Why should tenants lock themselves into a position for decades? The current practice also gives rise to regular rent reviews to a formula designed with little relevance to commercial reality. And to cap it all these reviews, in the absence of agreement, were to be decided by arbitration. Leases are written by owners and not surprisingly the mechanics of the review often favoured the owner. Of course the long leases carried with them the wonders of the full repairing obligation. Owners had it easy. Sign up a long lease and watch the rent rolling for the next 25 years. The Commission pointed out that in fairness owners could not offer short leases because according to the legislation if a tenant was in possession for longer than 5 years he could effectively remain in possession indefinitely with the full protection of the courts. Delay, cost and uncertainty of the courts could play havoc with the sale value of the property. Owners have no choice but to design long term leases so as to avoid the harsh realities of the legislation. This embarrassing commercial leasing system was a creation purely of outdated legislation. The legislation at fault is to change under the 2008 Act.

According to the new legislation tenants will be able to contract out of the protection of the act for all types of property. Indeed some owners will offer no other terms. The commercial reality of the market place will prevail. Owners and occupiers will design leases to suite their requirements not to get over difficult legislation.

What will the changes mean? For building owners where tenants have agreed to 'contract out' it will mean that they will be able to negotiate any length of lease that they like. If a tenant is not performing then that tenant can be refused a new lease. If the market is showing that the rents should be doubled then that is what will happen. If the tenant is not complying with any other covenants he will be moving along. But it works both ways. If the property is no longer attractive then the tenant will relocate. He may even be attracted to relocate by a competing developer. Owners will have a real interest in the success of their property.

The biggest difference will be for retail tenants. If the shopping centre is doing well then both the tenant and the owner will share in that benefit. Indeed rents can now for the first time be linked to turnover without running the risk of having to live with a less than efficient tenant. Owners can share in windfall premiums. Of course it's not all one way. Tenants on short term leases can decide to move if the location is not performing as they expected. If the owner is not doing his part then the tenant can go elsewhere. Indeed competition for good tenants will become very active as new developers may well offer considerable incentives to take star tenants in his new development. Designers better take note. Poor finishes and facilities, a very common problem for many commercial tenants, will have a direct bearing on the owner's income as new rents will be calculated directly by the market and not by the current alchemy where in current leases everything is assumed to be fantastic whatever the reality. In short no more rent reviews as we know them. Service charges also will come under pressure on a value for money basis. If the centre is sloppy and there is poor value for money tenants on short leases can and will move elsewhere.

If commercial leases become shorter then user clauses, assignment and subletting rights will be less important. Repairing clauses will be more difficult to impose on the tenant and fitting out of shell and core buildings will become very difficult issues indeed. However the parties to the agreement will need to consider all of these options because they will become much more important in short term lettings than in the past.

The providers of development finance should also take note. Values underlying commercial development are often based on a multiplier of the annual net income from the development based on the assumption that the net income will be secured under a long term lease with a upwards only rent review every 5 years or so. These 'Institutional Leases' are well liked by the financial institutions and often mean that prime real estate is treated as a very low risk proposition. If there is no long term lease and market reality determines rental income then the risk element of the development changes considerably. Design, management and a professional approach by the owner and their advisors will be critical. Of course redevelopment becomes a very real possibility. If tenants are on say 10 year leases in a shopping centre then redevelopment or refurbishment in year 10 becomes possible and a lot easier than at present. If the site can take higher density and vacant possession is available then the market (and the planners) will decide.

Of course it will not all be plain sailing. The legislation reform could have gone a lot further. The changes under the 2008 Act will give rise to a two tier property market. The first will consist of all those properties on current leases with maybe up to 25 years to run and with renewal rights at the end of that time. The second will be all those new lettings from now on where the tenant has chosen to 'contract out' of the renewal rights. A third could emerge to make life really interesting where tenants are encouraged to renounce their renewal rights prior to the end of their lease, perhaps for some financial advantage. Medium to long term site development/planning could really benefit here.

Management of commercial property will change. Tenants and owners will have to discover their business partnership that underlines their relationship. Maintenance will change as owners compete not only to attract tenants but also to retain them. Letting agents will become busy as they re let buildings much more frequently than at present and indeed their role in identifying just who is on the move at any particular time will become very important.

Will these changes be beneficial? If properly used the answer is yes. Short term leases are the norm in almost all well developed economies from Hong Kong to Dallas. Owners will become much closer to their property from design through to day to day operation. Tenants will have more choice and undoubtedly a better product will emerge. In summary both parties may well discover that after all they share in the fortunes of the property and they are fundamentally business partners. Of course in order for contracting out to be valid tenants will need, according to the Act, to get independent legal advice. Just what framework that advice will take will be most interesting to see.

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