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TUMBLING RENTS AND COVID CLAUSES: WHAT TO EXPECT FROM YOUR RETAIL LEASE RENEWAL IN COVID TIMES

Lease renewals under the Landlord and Tenant Act 1954 are a very common feature of the commercial property market. In "COVID times" there are widely differing market conditions across sectors (contrast logistics and hospitality, for example) and the pandemic has had an impact on lease renewals, both in commercial agreements and also court decisions.

The average length of commercial lease terms has been shrinking for some time and tenants commonly ask for renewal leases with shorter terms as well as tenant break options. It is rare for the court to insist that a tenant takes a longer term than it wants and in certain sectors the lack of demand means that it is a tenant's market at the moment.

Since March 2020, so-called "COVID" clauses or rent suspension clauses have featured heavily in negotiations and the specifics of their triggers and operation have become more nuanced over time. Essentially, these clauses deal with the basis on which risk is shared between tenants and landlords, with tenants expected to take their own insurance cover out to cover loss resulting from business interruption while also benefiting from falling rents in certain sectors.

We will look at two recent lease renewal cases, both involving tenants in the embattled retail sector, both of which achieved reductions from the passing rent of over 50%. They are County Court decisions, meaning that they are not binding on future disputes, but they do offer some insight into how the Court is likely to approach COVID lease renewals in the current climate.

WH SMITH RETAIL HOLDINGS LIMITED V COMMERZ REAL INVESTMENTGESELLSHAFT MBH

WH Smith Retail Holdings Limited (WHS) sought a new lease of its premises at the Westfield Centre in Shepherd's Bush, London. WHS was in an interesting position during the various lockdowns of 2020/2021 as it was an "essential" retailer and therefore not required to close as part of the relevant government regulations. WHS gave evidence that the store was actually obliged to stay open during the lockdowns because it provides postal and banking services under contract with the Post Office.

COVID CLAUSE

The major issues in dispute between the parties were the terms of a rent suspension or COVID clause and the rent. The parties had agreed that the new lease should include a clause under which the tenant's obligation to pay rent would be suspended (either in full or in part) in certain circumstances, but there was a dispute over the precise terms of the clause and in particular its "trigger".

The landlord argued that the rent suspension clause should only be triggered if WHS itself was required to close and WHS said that the trigger should be the closure of non-essential retail. WHS' position was that there was no advantage to them to remain open during the various lockdowns; in fact, they were actually at a disadvantage compared to non-essential retailers because they had to cover staff costs to remain open and were not permitted to access the furlough scheme. Their evidence was that the lack of footfall in the Westfield Centre (where only a handful of other shops remained open) resulted in a 90% drop in sales for this particular store.

The judge in this case was persuaded by the evidence presented by WHS and ordered that the new lease should include a rent suspension clause under which WHS would have the benefit of a 50% reduction in the annual rent in the event of a government order to close non-essential retailers. WHS would continue to pay 100% of the service charge, even if the clause were triggered.

What swayed the judge in this case was the evidence which WHS put forward regarding the dependence of this particular store on footfall and the dramatic drop in its sales. The judge actually visited the Westfield Centre as part of the trial in mid-November, and was much impressed by the empty echoing space. It is important to remember though that this evidence was specific to the particular premises and the judge acknowledged that he might have made a different decision if the premises were in a High Street location.

Other interesting points which came out of this decision:

- The judge said that even if the landlord had opposed the tenant's request for a "COVID" clause, he would have ordered that one be included in the new lease on the basis of "essential fairness'" (i.e. that the tenant would have satisfied the test for the inclusion of a new term in the renewal lease as set out in *O'May v City of London Real Property Ltd [1983] 2 AC 726)*.
- There was no justification for an uplift in the rent as a consequence of its inclusion as the judge accepted the evidence of WHS' expert that this was something all tenants now want and the market has now "priced it in".

RENT/INTERIM RENT

On rent, the judge had extensive evidence from the parties' experts on the drop in rent. Both sides agreed that there was a 20% drop in the market as a result of COVID, and the tenant's expert also gave evidence that further discounts should be applied. The judgment includes a detailed discussion of the comparable evidence, and valuers will find it useful to see how a judge might approach technical valuation evidence.

The parties agreed that the zoning method should be used to value the premises. The passing rent was £953,000pa based on £327.50 Zone A, set by an arbitrator at the 2013 rent review. After examining the expert evidence (and the experts), the judge decided that the headline comparable ITZA was £255 per square foot. He then applied a discount of 20% for COVID, 10% for quantum, and 24% for location. This resulted in a new rent of £404,666 per annum based on £139.54 Zone A, a drop of more than half.

There was also discussion about interim rent, which was payable from 1 October 2018. The usual position is that the interim rent is the same as the new rent under the renewal lease, but this rule does not apply if there has been a significant shift in the market or change in the terms of the lease. While the interim rent valuation date was only just over two years earlier, the parties agreed that the market was substantially different. The judge found that the

relevant headline comparable was £368 Zone A, and applied a discount for 21% for pitch and 10% for quantum, resulting in an interim rent of £261.65 Zone A, or £758.785 per annum.

S FRANSES LIMITED V THE CAVENDISH HOTEL (LONDON) LIMITED

Another retail lease renewal, this time in the West End, involved two parties which will be familiar to many in the property world. S Franses Limited is the tenant of premises at Jermyn Street from which it runs a specialist textile dealership and consultancy. The tenant applied for a new tenancy of its premises which the Cavendish Hotel, as landlord, opposed on the ground that it intended to redevelop the site. S Franses challenged the landlord's grounds and the Supreme Court decided that the Cavendish Hotel did not have the requisite intention to redevelop, and therefore that the tenant was entitled to a new lease. You can review the details of the Supreme Court's decision here.

RENT

Following the Supreme Court's decision the case was referred back to the County Court to determine the terms of the new lease, including the rent and interim rent to be paid by the tenant. The passing rent was £220,000 per annum, as determined at a 2011 rent review (although this figure did not necessarily represent market value in 2011 because of the specifics of the rent review hypothesis). Both parties' gave expert valuation evidence on the impact of the pandemic on the retail sector, including the Jermyn Street rental market.

This judgment is also useful reading for valuers and those interested in expert witness work. As is common in these types of disputes, counsel for each party attacked the evidence of the other's expert witness and attempted to undermine their findings, and both counsel were successful to some extent. The judge was particularly critical of the landlord's expert witness who was accused of overplaying his hand for the benefit of the landlord. Expert witnesses may act for the individual parties but their duty is to assist the court in reaching the correct decision, and the court will be critical of experts who forget this duty in their eagerness to promote their own client's interests.

Overall, the judge appeared to prefer the evidence of the tenant's expert and largely agreed with the various discounts proposed. This included a discount to account for a 12 month rent free period which the judge found would have been negotiated by a new tenant of the premises. After applying the various discounts, the judge ordered that the new rent under the renewal lease should be £102,000 per annum i.e. a drop of over 50%.

INTERIM RENT

The experts also gave evidence regarding the interim rent valuation. As the parties had been engaged in lengthy litigation regarding the landlord's opposition to the tenant's application for a new lease, the valuation date for the interim rent was 3 January 2016. This was an opposed renewal and therefore the interim rent also had to be valued on the basis of a tenancy from year to year (to reflect the uncertainty experienced by the tenant) rather than a fixed term of five years. Between January 2016 and the date of the hearing in May 2021 the market had gone through a series of changes including of course the recent significant downturn, making it difficult for the court to assess the correct interim rent. The judge ultimately decided that this should be £160,000 per annum, meaning that the tenant would ordinarily be entitled to a rebate of the "overpaid" rent equivalent to £60,000 per annum since January 2016.

KEY TAKEAWAYS

These are County Court cases meaning that they do not create a precedent, and in reality there is no "new law" in the judgments. Nevertheless, prudent landlords and tenants will take note of the following points:

1. EVIDENCE IS KEY

Whether you are seeking a rent increase or decrease, or a change in the terms of the lease, you must be prepared to demonstrate to the court that this is justified. WHS persuaded the court that the "advantage" of remaining open during the lockdowns was illusory and were

able to point to evidence of falls in footfall, the drop in turnover and the very great number of shops which had closed in the Westfield Centre in order to justify the inclusion of a COVID clause in their preferred terms.

2. AN EXPERT'S DUTY IS TO ASSIST THE COURT

Experts are commonly criticised for perceived partiality towards their own clients, and this is particularly the case where an expert typically acts only for landlords or tenants. Experts need to be prepared for these criticisms and ensure that their evidence is consisted with their valuations.

3. BE PREPARED FOR A FIGHT ON INTERIM RENT

We are seeing more and more discussions of interim rent in our practice, and we expect to see the court making orders in the terms highlighted above. The recent crisis, and long delays at the court, means that neither party can be confident that the usual rule will apply and you should be prepared for a dispute on interim rent as well as the rent under the renewal lease. Again, evidence is key and experts must ensure that their valuation is on the correct basis and takes into account the relevant comparables.

4. AGREE WHAT YOU CAN

There is little to be gained (and much to be lost in terms of costs) by continuing to argue over the detail of lease terms unless these have a measurable and demonstrable impact on the rent and/or the value of the reversion. We haven't discussed the detail of the WHS dispute over lease terms in this note, but these included the landlord arguing unsuccessfully that the terms should be updated to reflect its preferred precedent wording. The landlord could not explain exactly what difference the changes to the lease would make, only that they would reduce disputes, and the judge was not persuaded that the changes were necessary. It was a similar story in the case of The Cavendish Hotel. Failing to agree lease terms also makes it more difficult and expensive to assess the rent as the experts will need to carry out alternative valuations.

5. SENSIBLE OFFERS ARE CRUCIAL FOR COSTS PROTECTION

Neither of these judgments deal with costs, but we would expect that the tenants as the "winning" parties will seek to recover as much of their costs as possible from the "losing" landlords. We do not know what offers were made before trial, but a well-judged offer to settle at a lower level can protect a "losing" party from a costs order. It is not entirely clear whether parties can avail themselves of the protection of a Part 36 offer in lease renewal proceedings, but our approach is generally to structure lease renewal offers as if they could have the consequences set out in CPR Part 36. This means that even if the court does not treat an offer as Part 36 compliant then it should still be taken into account under the court's general discretion on costs.

This briefing note was prepared in June 2021.

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