

## **Current Trends in use of Turnover Rents in Leases – A guidance note from the City of London Law Society Land Law Committee**

This note is intended for guidance to practitioners as to the types of turnover rent provisions that are being resorted to in pandemic trading conditions where tenants need rent concessions to tide over reduced levels of trading until more normal conditions prevail. It is thought that the variety of situations that have resulted makes it impractical for a turnover rent precedent of “all purpose” application to be produced; it is observed that none appears to have been prepared by publishers such as Model Commercial Leases and Practical Law beyond making “ad hoc” modifications to existing precedents and adding provisions as to accounting and termination arrangements. The note, based on the experiences of Committee members and other solicitors consulted, highlights the current trends in turnover rent drafting that seek to address these unprecedented times.

### **1. *Attitudes to turnover rent***

- (a) During periods of normal trading conditions, banks, financial institutions, pension funds, unit trusts and landlords have been generally unenthusiastic to embrace turnover rents, perhaps with exceptions in the case of hotels, casinos and restaurants, unlike the attitude in the US, Europe and widely also in other countries where no such reserve is experienced. In the UK, the approach has been heavily preferential towards investment in property on the basis of lower risk and return for greater certainty of income. That attitude persists in pandemic emergency conditions to the extent of landlords and lenders, wherever feasible, endeavouring to require a high percentage of basic rent with a top-slice turnover element.
- (b) The effect of the relentless advance of online sales on High Street trade over the last decade or so and the number of businesses going into administration was well-understood, but the catalytic effect of pandemic trading/non-trading conditions has caused acknowledgement that resort to turnover rents, rent-holidays, or reductions where turnover rent is inappropriate, has become inevitable for the time being, and for some time beyond, for landlords to avoid empty premises, inability to re-let them and liability for business rates. The contrast with attitudes in pandemic trading conditions is that, formerly, turnover rents perhaps afforded to landlords the possibility of obtaining higher rents than the open market rent of premises from sound financially based tenants in periods between rent reviews.
- (c) In pandemic trading conditions, a variety of landlords’ approaches towards turnover rents range from acceptance of full turnover income on a short term basis where the tenant cannot afford to pay a fixed minimum basic rent and immediate survival is at stake, to a sizeable basic rent and a “top slice” of turnover income from goods and services provided at and from the premises for a comparatively longer period, to aid the tenant in its present financial straits, but to retain a reasonable rental return in the circumstances, subject in any case to arrangements for early termination and reversion to a full fixed rent basis.

- (d) It is widely recognised that, when more normal trading conditions resume, the recovery period for rents will be lengthy, and that resort to turnover rents to some extent or another will remain a notable feature of market practice, on a greater scale than experienced before the onset of the pandemic.

## **2. Definition of “turnover”**

- (a) The definition of “turnover”, setting out what is included and what is deducted, has changed little since turnover rents have been used in the UK, the main adjustment subsequently made being for online orders to and/or delivered from the relevant premises and more recently for “click and collect” sales. The published precedents all contain standard provisions which, in general terms, remain appropriate in present conditions.
- (b) In respect of “click and collect” transactions, there is some resistance from tenants where goods ordered online are satisfied from warehouse stock but collected from the relevant premises; tenants of the premises often resist inclusion of these items in their turnover calculations and require them to be disregarded.
- (c) There can be many specific items for deduction in circumstances particular to the relevant premises or trades; e.g. the costs of home delivery of meals from restaurants. Subscription payments are sometimes deducted in the case of all branches of a retailer unless they are captured for the particular sale paid for with a subscription card. The sale of gift vouchers, card or smaller vouchers are not included until converted into sales by redemption
- (d) Tenants should be vigilant in negotiations to make the case for deduction of items where relevant in such circumstances. Refunds are sometimes directed to specific branch premises of the tenant to assist the tenant on turnover calculation.

## **3. Rates of basic fixed rents, turnover rent and provisions for reversion to fixed rents**

- (a) An average band of rates of fixed basic rent appears to have resulted of between 75-85% of open market rental value with a top slice turnover income. An average band of percentages of turnover rent appears to vary between 4-10%.
- (b) The rate of turnover percentage may be fixed or “staircased” at certain levels. There may be “capped and collared liability “ or variable rates. These are matters for negotiation in each case.
- (c) Established practice on turnover rents leases on a top-slice turnover basis requires the rent review of the open market rental value of the premises periodically, disregarding for that purpose the turnover rent provisions. In the response to pandemic trading conditions, it may be thought unlikely that *ad hoc* turnover rent arrangements will necessarily continue long enough to outlast a reversion generally to an overall fixed rental basis; short term turnover rent tenancies predominate in pandemic conditions.
- (d) Precedents of standard turnover rent contain landlord options to terminate top slice turnover and to revert to a full open market rental basis in specified events. The triggering events might be the elapse of a fixed period having allowed time to assess the average returns of turnover income, periods of non-trading, or assignment or underletting by the tenant. In void periods of trading, there might be provision for payment of the full market rent or reduced rent for their duration.

In pandemic trading conditions, resort to turnover rent arrangements is limited to counteracting the financial straits suffered by tenants and landlords and requiring regular reassessment after short periods of trading; the length of the tenancy or concessionary waiver arrangements, and landlord options to return to a fixed rental basis, reflect that consideration.

- (e) There was no prevalence of contracting out of Part 2, Landlord and Tenant Act 1954 on the grant of new tenancies on a turnover rent basis. It was noted that there has never been a court decision on whether it has the power to award a turnover rent on a lease renewal in lieu of an open market rent. It is thought that the court certainly would not exercise a power to do so unless both parties agreed to one. The parties are free, however, to agree to renewal of the lease on that basis under s.28 of the Act.

#### **4. *Forms of turnover rents arrangements***

- (a) In the case of subsisting tenancies, there is the choice of varying the lease by a formal substitution of turnover rent provisions by deed or agreement of variation, or for a letter of concession of the landlord to accept, instead of the reserved rent of the tenancy, a turnover rent and setting out the terms permitted while the concession is to operate. The process will mostly be adopted for periods of concession of short duration, possibly with extensions at the option of the landlord; its informality and reliance on conditional waiver of relevant lease provisions are not suited to longer term arrangements or large scale business undertakings.
- (b) New leases and tenancy agreements will follow the conventional forms, but will contain provisions for termination and reversion to a fixed rental basis to meet the pandemic situation as relevant. Those tenancies are most likely to be for relatively short terms of years.

#### **5. *Other relevant factors***

- (a) *SDLT requirements* Attention is drawn to SDLT requirements in respect of contingent, uncertain or unascertained consideration in Finance Act 2003, s. 51 and Schedules 17A, paras. 7A and 8. The calculation of SDLT liability will be on a reasonable estimate of the annual rate of rent during the first 5 years of the term or the earlier date when the rent becomes ascertainable. Additional tax will then be due in respect of an under-estimate or a refund may be claimed for overpaid tax.
- (b) *Confidentiality.* Arrangements made in respect of turnover rents may well be commercially and financially sensitive and confidentiality is of the utmost importance to one or both parties. Where turnover rent provisions are introduced to subsisting leases, the variations made should include confidentiality provisions, where none had previously been incorporated, which allow exceptions for disclosure to financial and professional advisers; and mortgagees on their undertaking to be bound by those restrictions as apply to the parties to the tenancy. This is of particular importance to large scale business undertakings.

Where large scale tenant business undertakings are involved, a deed of variation is necessary and may require some redaction and exemption from disclosure on grounds of confidentiality if registrable at HM Land Registry.

- (c) *Assignment and underletting.* Where alienation of the tenant's interest is permitted, turnover rent arrangements may become unsuitable as involving another business and different trading conditions attaching to it. The landlord may require the incorporation of optional provisions for resumption of fixed rental provisions or other suitable measures. In general, special consideration should be given to whether

to exclude tenant rights to assign or underlet in turnover rent tenancies. Where alienation provisions are retained, specific measures should be considered for void trading periods while the premises are on the market and for a period of fixed rent while the new business becomes established in the premises. Where underletting remains permissible, the conventional stipulation that it must reserve an open market rental may be retained if it is a feasible measure in the circumstances.

- (d) *Certification of turnover income.* Clear and simple provisions for determinative certification of turnover income and reconciliation are incorporated in the lease, or terms of variation as the case may be. The arrangements should provide for a straightforward definitive determination in order to avoid repeated examinations and the heavy professional costs that would be incurred. Turnover rent arrangements are frequently disputatious with repetitive challenges not otherwise precluded. The certification process should be carried out by a professionally qualified party. In practice, landlords most often require their accountants to carry out the exercise and would argue that accountancy professional standards require impartiality; tenants do not always share the same degree of confidence in the process as landlords.
- (e) *Keep open covenants and void trading periods.* In conventional turnover rent precedents, keep open covenants are included, but exceptions should be included for unavoidable or routine closure. Closure for stocktaking, repairs, annual holiday periods, third party damage to the premises and other like causes, should be catered for by appropriate measures in the circumstances. Keep open clauses may be an acceptable obligation for the original tenant, but not be appropriate in case of and assignee or underlessee.

Measures should be included for non-trading days for routine causes. A maximum number should be set which qualify for full turnover rent exemption with a threshold level for other treatment, for example – grossing-up of returns from trading days in respect of non-trading periods (perhaps not exceeding level of rent greater than the open market rent of the premises), or setting a specific sum to be paid in respect of non-trading days (which may prove difficult). Care should be taken not to stray into penalty levels of payment for non-trading days.

- (f) *Group sharing arrangements.* Care should be taken that trading by members of the tenant's group of companies sharing at the premises should be captured in turnover income at and from the premises.

## 6. ***Company voluntary arrangements ("CVAs")***

- (a) CVAs under Part 1 of the Insolvency Act 1986, involving struggling businesses typically on a vast scale with numerous retail branches, frequently include provisions for turnover rents to be paid in respect of premises that are not sold off and retained for trading. The recent CVAs of C&J Clark International, New Look and Pizza Express were considered, each providing arrangements for turnover rents payable in respect of premises to be retained while others are to be sold.
- (b) The definitions of Turnover were of standard content with minor specific deductions according to the nature of the trade e.g. in the case of Pizza Express, home delivery of meals ordered by telephone or online by independent delivery agencies. There was distinct similarity of approach to the relevant terms applied in each.
- (c) No evidence was seen of a resort in CVAs to EBITDAR accounting arrangements which operate at net trading levels and rent liability and are available only at the end of the relevant financial year's trading. Turnovers rents appear to be dominant arrangements in respect of trading outlets that are retained as sharing a percentage of gross income returns with greater flexibility in the circumstances.

**7. *Is a precedent required for pandemic trading conditions?***

The sub-group concluded that the arrangements were too variable and of short term emergency nature for an attempt to settling a precedent for publication on the Committee website. The published precedents of turnover rent lease provisions provide good guidance of standard model provisions and provide a base from which to start subject to recognition of the trends of practice which have been noted. A version of this note might give practitioners in their negotiations some useful guidance of trends in current practice in pandemic trading conditions and how to adapt available model provisions.

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