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‘*Turning Over A New Lease?*’ Are turnover-based leases the answer for tenants facing COVID-19-related business disruption?

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Introduction

As the COVID-19 pandemic continues to disrupt businesses’ ability to cover their costs, landlords and tenants alike are looking for new ways in which to restructure existing lease obligations to adapt to the current market conditions. Tenants across all sectors, but particularly in retail and hospitality, which have been amongst the last to reopen, are requiring a greater level of flexibility in their contractual and financial obligations. One way of achieving this is through turnover-based rents. This operates as a performance-based rental payment, which can either replace or sit alongside a fixed rent.

Turnover-based rent is calculated as a percentage of the tenant’s turnover generated from the premises and benefits tenants by reducing rents when trading levels are low, whilst potentially giving landlords greater income than they might otherwise receive when trading levels are high. Nonetheless, certainty of income is a key factor for landlords and their lenders when modelling their investments, as well as for property valuation and the pricing of debt. This has historically made turnover-based rent a less attractive prospect than fixed rents. However, the current economic climate has led some landlords to conclude that sharing the pain with their tenants is a better option if it helps tenants to continue to trade.

Movement within the market

Despite the potentially complex nature of turnover-based rent, in May more than 40% of retail landlords surveyed by Colliers said that they would now be more likely to factor turnover, footfall or online sales into lease agreements. Shaftesbury, which has a significant portfolio in the West End of London, has announced that all future rents will likely include an element of turnover-based calculations and that from October, it will move its entire estate to monthly payments in a bid to help tenants recover.

Shaftesbury follows Capco, Cadogan and The Crown Estate who have all introduced turnover-based rents for tenants on a case-by-case basis. Their portfolios span London’s Covent Garden, Regent Street, St James’s and Chelsea. By contrast, shopping centre owner Westfield has thus far resisted turnover-based rental agreements.

Using a CVA process to restructure leases

A company voluntary arrangement or “CVA” is an insolvency process under the Insolvency Act 1986, whereby a company agrees a compromise or arrangement with certain or all of its unsecured creditors. An insolvency practitioner supervises a CVA, but no court involvement is required, unless there is a challenge. A CVA requires the approval of 75% by value of unsecured creditors who choose to vote, but also requires the support of at least 50% of all unsecured creditors who are unconnected to the company. As a CVA does not compromise secured creditors (except with their express consent), it is rarely used for financial restructurings. However, over recent years it has become an increasingly popular process to restructure leasehold obligations, and the trend looks set to continue.

In mid-August, Jigsaw launched a CVA proposal in which 41 of its stores would switch to turnover-based rent while the remaining 16 stores remained on full rent. Of the proposed 41, 24 would pay the higher of 11% of annual net sales turnover or 20% of contractual rent. The remaining 17 stores would pay the higher of 8% of annual net sales or 10% of contractual rent.

New Look has launched a CVA this week as part of a major restructuring. It is asking landlords at 402 stores to reset to a turnover rent model with a turnover percentage of up to 12% at each site. The remaining 68 stores move to nil rent. The proposal also includes enhanced landlord break rights for all stores, providing the landlord with the opportunity to exit the lease if it is able to replace New Look with an alternative tenant on improved terms. The move follows the retailer not paying its quarterly rent bill in March after asking landlords for a three-month rent holiday.

It remains to be seen whether Jigsaw and New Look will have their proposed terms accepted, but the proposals show that tenants remain open to using the CVA process to restructure their lease obligations as they deal with the impact of COVID-19.

Practicalities of turnover-based calculations

When making turnover-based rent calculations, landlords will need to access a wide range of commercially sensitive information, meaning that tenants may want to impose stringent confidentiality obligations. This will add to the cost and time taken in negotiating a new lease. Landlords should also be aware that commercially sensitive provisions within leases will be made publically available if a lease is registrable at the Land Registry. Care should be taken, therefore, to prepare a redacted form of the lease before submitting it for registration, relying on the Land Registry's exempt document process.

Turnover-based calculations can be particularly complex when a premises is not a standalone enterprise, but part of a wider network of premises involving numerous different landlords in different locations. Online sales, click-and-collect, and delivery and return services can add to the complexity of attributing a tenant's revenue to a specific, physical site. Landlords may seek to include online revenues in the calculations. This could require complex, case-by-case negotiations making lease negotiations for this type of rent more expensive and time-consuming than traditional fixed rent leases, as well as the ongoing turnover reporting obligations. It is vital that landlords have a good understanding of their tenant's business, in more depth than has previously been necessary.

Contractual protections for landlords and lenders

Should the parties decide to include turnover-based provisions in a lease, there are a number of contractual considerations that are relevant for landlords, lenders and tenants. Below are some examples of these considerations and protections:

1. **Base rent** – this ensures that rental payments never fall below a specified level and would be triggered in the event that a tenant's turnover is too low, providing landlords with a base level of income to assist with downside protection. In turn, it offers assurance to lenders that a specified amount of rental income can be used to service debt.

2. **Flexible turnover provisions** – a landlord should consider introducing flexibility into turnover provisions for leases lasting a number of years to allow for changes in the way a tenant's turnover is generated over the life of the lease. For example, online sales may become an increasingly important part of a tenant's turnover and landlords may want to be able to adapt provisions to capture these changes.

3. **Break rights** – a landlord may want to consider the ability to end a lease if turnover rent payments are too low or a tenant is not properly reporting its turnover and replace the tenant with one that could perform better.

4. **Prohibitions on assignment** – questions may be raised as to whether turnover arrangements should be applicable to an incoming assignee. Turnover-based clauses in the existing lease will often be complex and bespoke for the original tenant, and therefore not necessarily applicable to an incoming tenant. Whilst landlords may be happy to accept a bespoke turnover-based rent from their original tenant, accepting that for an incoming tenant or having an obligation to act reasonably when consenting to turnover arrangements with a new tenant may not be desirable. Instead, it may be advisable to consider requiring any assignee to switch to open market rent upon the assignment as a default option.

5. **Success payments** – if a tenant's turnover for a given period reaches a specified threshold, its landlord could benefit from a one-off payment. In turn, lenders may ask that these payments are applied in immediate, mandatory prepayment of any outstanding loans.

6. **"Keep open" requirement** – this is a contractual obligation imposed by the landlord on the tenant to keep the demised premises open for specified hours. A landlord can also impose specified fixed rents for any days on which the premises should have been open but were not. However, these provisions can be difficult to police and enforce.

7. **Guarantees** – a guarantor may be requested to top up any turnover rent payable to the landlord to a specified level. As with a base rent, this provides a level of guaranteed income for landlords and their lenders.

8. **Reserve accounts** – lenders may consider a deposit of funds in an interest or debt service reserve account which are releasable to lenders in the event that a landlord/borrower does not have sufficient rental income to service debt. Similarly, lenders will want to underwrite their loans carefully and set covenants based on revenues and EBITDA of the tenant operation at appropriate levels.

Conclusion

If drafted and negotiated properly, turnover-based rents can be mutually beneficial for landlords, tenants and lenders. For otherwise viable tenants, struggling to recover despite the easing of lockdown measures, turnover-based rents allow greater flexibility in meeting financial obligations. This could be vital for their survival. For landlords, this type of rent is a way to help their tenants to recover with the future prospect of sharing in their tenants' successes. However, landlords may continue to resist them and we are likely to see many tenants continuing to use the CVA process to restructure leases. What is clear, however, is that there is increasing movement within the market towards more flexible lease obligations.

This Alert was prepared with assistance from Louisa Northover, a trainee solicitor in our London office.