Surrendering to Market Conditions

Many commercial tenants are either struggling to meet premises rents or have recently downsized their operations and found that they are renting space that they no longer need. There is, therefore, a strong motivation in the current market for tenants to find ways to escape or reduce their financial liability for leasehold premises.

In our August 2009 briefing we considered the ways in which tenants might be permitted to sublet unwanted premises even where they wished to do so at less than the rent being paid to their landlord. There are, of course, a number of other ways that tenants can avoid future financial liability.

Assignment is a sound theoretical option and in a buoyant market popular premises may even attract a premium but at present tenants may struggle to find potential assignees willing to take the space. The ideal solution is, of course, to have the benefit of a break clause in the lease but although these rights to terminate the lease on set terms have become more popular over recent years they may not have been included when the lease was negotiated or the break date may not fall at the time it is needed.

Tenants who do not have the benefit of a break clause should carefully check what notice they have to give and what conditions they have to satisfy to operate the break successfully.

There is a further option where there is no break: ask the landlord to accept a surrender of the lease. Landlords are now finding it increasingly common to be approached by tenants wishing to surrender their leases and bring future financial liability to an end. Usually in the current market there is a very willing tenant and unwilling landlord and so the landlord’s usual answer will be no. Most would prefer to take their chances with a potentially defaulting tenant than have a vacant property handed back with the associated rates liability, void period and rent free period on re-letting but there may be some circumstances in which it might be beneficial for a landlord to accept a surrender.

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If, for example, the landlord is aware that the tenant is in difficulty and has another potential tenant of better covenant strength available, perhaps an adjoining shop owner or tenant of a different floor looking to expand, then it might be advisable for the Landlord to accept the tenant’s proposal. If the tenant can offer a lump sum payment to the Landlord as a reverse premium then that will, of course, make the offer more attractive, although the Landlord will still need to be satisfied that a new tenant can be found to protect the future revenue stream. It will often be sensible for a landlord to agree to a surrender in principle on the basis that the tenant will allow them to market the property and the surrender will then be completed once a new tenant is found. The landlord can thereby avoid taking back possession of the property and associated liability for business rates.

In particular, if the tenant is facing impending insolvency then the landlord will need to act quickly in deciding whether or not to accept a surrender. It will need to consider its duty to mitigate its loss together with the liability of former tenants and guarantors and preserve its loss in the insolvency.

If a surrender is agreed then there are a number of matters that the landlord and its advisers should consider in formally documenting the arrangement.

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What is a surrender?

The surrender of a leasehold estate to a landlord is a consensual arrangement whereby the lease is acquired by the landlord and is therefore extinguished. The landlord and the tenant are both released from future liability under the terms of the lease and the tenant no longer has any right to occupy the premises. A surrender will usually release all other parties to the lease such as guarantors and previous tenants from all future liabilities.

Methods of surrender

There are two methods by which a surrender can be effected: expressly or by operation of law. This briefing will only deal with the terms of an express surrender, which must be by deed. Many of the same considerations will, however, be pertinent to landlords considering taking a surrender by operation of law.

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The effect of the surrender

The tenant has no future liability for rent, insurance premium or service charge and is released from liability for performance of all future covenants. The landlord is similarly released.

Counter-intuitively there is no common law or statutory right to apportionment of rent for a tenant on completion of the surrender. Therefore, the tenant must pay the full quarter’s rent on the last quarter day before the surrender and will have no right to a reimbursement from the landlord in respect of the post-surrender period unless such a right is included in the deed. The same applies to insurance premium which has been paid by the landlord and has been refunded by the tenant before completion of the surrender.

The surrender does not release the landlord or tenant from past liability for breach of covenant but covenants that arise for performance at the end of the term will sometimes not be enforceable after the surrender depending on the wording of the lease. Typically this will be the covenant on the tenant’s part to reinstate the premises and yield it up in repair. The landlord will often deal with dilapidations in the deed and usually by way of a payment before completion of the surrender.

The surrender must take place immediately on completion of the deed. If it does not and is expressed to take place in the future then it will be an agreement to surrender and, if the tenant has the benefit of security of tenure under the Landlord and Tenant Act 1954, could be void. An agreement to surrender a lease with security of tenure is void unless the statutory procedure set out in the aforementioned act is followed.

Tax implications

There may be Stamp Duty Land Tax and VAT implications of taking or giving a surrender, depending on the particular property and how the transaction is structured. Landlords and tenants should take legal advice on those implications before committing to the surrender. In particular, tenants should be aware that a reverse premium is generally not tax deductible either as an income or as a capital payment. The surrender may also need to be registered at the Land Registry and it is important for the landlord to ensure that this is done so that title reflects the true position and can be relied on by future tenants or purchasers of the freehold.

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Summary

There may be circumstances in which landlords will be willing to take back premises from tenants that no longer require them. Those circumstances will not arise often and the decision to accept a surrender is generally at the absolute discretion of the landlord. When a surrender has been agreed in principle the parties must be aware of the effects and tax implications. The landlord in particular would be well advised to conduct pre-surrender investigations and in most cases raise pre-surrender enquiries of the tenant. What is appropriate will, however, vary between transactions and depend upon the nature of the premises and the terms of the lease.

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