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Commercial Property Guide

The Institutionally Acceptable Lease



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Owners of commercial property which is let to an occupational tenant(s) need to be aware of the concept of an "institutionally acceptable lease", and what is meant by that term. The value of commercial property as an investment, depends on a range of factors, including:-

- the income that the property generates (and the potential for that income to increase);
- the reliability of the current income stream, that is to say the quality of the current tenant (for instance, a property investor will be willing to pay more for a property with a "blue-chip" tenant than for the same property with a tenant covenant of lesser substance);
- the location of the property and its use;
- the condition of the property ;
- legal issues affecting the title to the property (for example covenants restricting the use of the property).

In addition to these considerations, anyone investing in commercial property as an asset, will want to see that the lease(s) of the property which is being acquired, is in an appropriate form. The expression "institutionally acceptable lease" means a lease in the form that would be acceptable to an investment institution (such as a pension fund), acquiring the property subject to the terms of that lease.

What is considered to be an institutionally acceptable lease has changed over the years, particularly since the property recessions of the 1990s and late 2000s, with tenants on the whole being able to demand a better deal from their landlords. For instance, until the 1990s, an institutionally acceptable lease would generally have had a term of at least 15 years and often 25 years, but rarely now does one come across a new property lease being granted for a term of 25 years, because tenants are not prepared to accept the potential liability for that length of time.

It is more difficult now to state what should be, and should not be, contained in an institutionally acceptable lease. The City of London Law Society has produced a lengthy document and form of report, which is often used when an institution is acquiring a property, or perhaps more to the point for many property owners, by a lender who wants to know that when it is lending money on the security of commercial property, the lease is in an acceptable form. The report goes to many pages and covers many issues, but the following is a summary of some of the key issues which might be considered most relevant in determining whether the lease is in an institutionally acceptable form:-

- it must be granted for an acceptable length of term, which will vary according to the nature of the property, the use of the property, its location, etc., but as a rule of thumb one would be looking at a lease with a term not less than between 5 and 10 years;
- if the tenant has a break option, it should not be exercisable until an acceptable period of time has elapsed, and must be subject to an appropriate period of notice (the period of notice should normally be at least 6 months);

- it should contain upwards only rent review provisions on at least a 5 yearly basis, on acceptable terms;
- it should contain a full repairing and insurance obligation. This will differ depending on the nature of the property, for instance if a lease is granted of the whole of the property, the tenant would normally be asked to keep the property in good repair and condition. However, in the case of a multi-let building, the landlord will maintain the structure and common areas of the building, with the tenant being made responsible for the interior of the part occupied by the tenant, and the tenant paying a service charge to the landlord so that the landlord can recover its costs of maintaining the building;
- the landlord will normally expect to insure the building (and the rental income), and to recover the cost of insurance from the tenant(s);
- control the tenant's ability to alter the property or its use, but this should be a qualified restriction so that it does not have an adverse impact on the rent achievable on rent review;
- control the tenant's ability to assign or sublet the property, but as in the case of alterations, the control should not be to such an extent that the rent achievable on review is reduced;
- the rent should be paid quarterly in advance (no more and no less, although sometimes tenants, particularly retail tenants, do negotiate monthly rental payments);
- the lease should contain a comprehensive forfeiture clause, which will enable the landlord to forfeit the lease in the event of tenant insolvency, non-payment of rent or other breach of covenant.

Whenever an owner of a property grants a lease, the lease should keep as closely as possible to what would be regarded as an institutionally acceptable lease, for 3 key reasons:-

- proper control of the property by the landlord owner;
- the ability to dispose of the property if required, in the knowledge that the occupational lease(s) is in a sound form, retaining the marketability of the investment;
- should the owner wish to offer the property as security for the raising of finance, the lender will expect to see any lease(s) in (or as close as possible to) an institutionally acceptable form, so that the lender could dispose of the property if needs be in the event of borrower default, at the best possible price.

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