Pubs, bars and restaurants

When trading down is affected by your good covenant

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Abstract

When a 'blue chip' tenant disposes of their leasehold interest, the landlord will invariably have the upper hand if another operator of similar covenant strength is not available to replace them; consequently, the outgoing tenant can find themselves being held to ransom and their leasehold trading asset becoming a financial liability. The impact on the freeholder's investment value of the blue-chip tenant vacating can be in the region of 1–4 times annual rent and not surprisingly landlords will wish to avoid their tenant leaving. This paper looks at the problems that can arise from the writer's practical experience of disposing of leases held by tenants of good covenant strength to tenants of weaker financial standing. Focus is given to the restaurant sector, a rapidly growing and dynamic market where leasehold property, due to reasons of supply and lower cost of entry (than freehold), is the preferred choice of tenure and where the failure rate of new restaurants is extremely high. The latter combined with the impact on the landlord's investment value are good reasons for the landlord to be difficult with the tenant's proposal to assign.

Keywords:

blue-chip tenant, covenant strength, privity of contract, alienation or dealings, restaurant, assignment, under-letting

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THE RESTAURANT MARKET

According to the Restaurant Association, more than one in two new restaurant businesses fail, resulting in sale or closure, although the

premises are invariably re-occupied by different restaurant business operators. Despite the high failure rate, the top ten UK multiple restaurateurs will be seeking to open some 250 restaurants this year, and during the last two years some 24,000 parties registered with Fleurets as looking for restaurant premises. The outcome is a constant churn of restaurants by new and existing operators, and in a number of cases the author has sold the same restaurant twice in less than two years.

Unlike retailers who are comfortable with leases of five or ten years in duration, restaurateurs will normally require leases of 15–20 years term to ‘write off’ their higher, relative to retailers, fit-out costs (typically £1,000–1,500 per sq m). The longer lease will mean an extended liability for the tenant, which can create problems if the tenant decides to exit the premises.

There are some 26,000 restaurants in the UK and with eating out growing by circa 5–7 per cent per annum over the past ten years, many operators and restaurant concepts have emerged to fuel consumer demand. Restaurant brands are relatively new to the UK and while few brands have survived the test of time, the likes of Pizza Express, Spaghetti House, Garfunkel’s and Aberdeen Steak House have been on our high streets for more than 40 years.

Many new brands have appeared in recent years and the likes of ASK, Carluccio’s, Giraffe, Fishworks, Café Rouge, Nando’s, Prezzo, Frankie & Bennies and Wagamama have expanded throughout the UK with London and the South experiencing most development. These types of restaurants offer ‘fast casual dining’, the label given to many of the new dining concepts because, firstly, customers can eat ‘casually’ dressed at a time to suit them, and secondly, will generally consume their meal and leave the restaurant in less than an hour. Twenty years ago, restaurants tended to be venues for special occasions, and visits would typically take up the whole evening. Today consumers think nothing of going to a restaurant two or three times a week.

Acquisitive restaurant groups have focused teams primed to secure new sites to open as quickly as possible. However, with strong demand for prime sites, it is a ‘landlord’s market’ and tenants often find themselves in the weaker negotiating position, having to concede to their requests for ‘tenant breaks’ and ‘tenant friendly’ alienation clauses. Weak negotiating to succeed in rapid expansion may come to haunt them in the future should they need to dispose of sites, by which time of course the people responsible for purchasing the premises will be long gone!

CHANGING MARKET

As new restaurants open, the old established restaurants invariably find themselves in secondary positions with their menus and decor appearing tired compared with the new competition. Demand from fast casual operators will tend to be for larger premises of circa 300 sq m, providing circa 120 covers (seats), whereas many traditional town centre restaurants tend to be smaller providing circa 60 covers, and are therefore disadvantaged in terms of trading potential during peak periods.

Deep Pan Pizza (trading until early 2006) was a group of approximately 40 restaurants (now forms part of The Restaurant Group plc) and was one of the first multiple operators to take occupation in the towns and cities outside of London. At that time landlords were sceptical about restaurateurs as tenants, not really understanding their market and therefore uncertain about the opportunity for rental growth. Deep Pan Pizza was naturally a new company when it got started and only over the past 30 or so years has the owning company, The Restaurant Group plc, grown to a substantial operating company with some 300 outlets including other brands such as Frankie & Benny's, Garfunkel's, Bluebeckers and until recently Caffè Uno and Est Est Est. As the company has grown so has its 'tenant appeal' to landlords.

As one of the first-generation multiple restaurateurs, Deep Pan Pizza began to find themselves in secondary locations with the prime restaurant 'pitch' having developed later in another part of town as new operators opened, and as town centres have been redeveloped with pedestrianised areas and new shopping and leisure centres. As the restaurant's trade suffered from the new competition, outlets became marginal or even unprofitable, and the operators were faced with either reinvesting in the design and menu, or disposal.

Deep Pan Pizza being part of one of the largest restaurant companies in the UK was a 'blue chip' tenant, and consequently most landlords were reluctant to lose them as a tenant, not only because of the security they brought in being able to pay the rent and fulfil the tenant's obligations under the lease, but also because of the significant impact a weaker tenant can have on the value of the landlord's freehold investment value. Not surprisingly, landlords are in no rush to release their plc tenant when the proposed replacement is a new start-up company, particularly with such a high failure rate in the restaurant sector. The likes of Deep Pan Pizza therefore can expect a battle with landlords when it comes to disposing of their leasehold interests.

BASIS OF RENT REVIEWS

When the first restaurateurs leased shell units, both landlords and tenants were uncertain how rents should be determined at review, having so little rental evidence to compare with. Consequently, landlords insisted on rents being assessed on the higher of either restaurant or retail rental values, the latter providing the landlord with a wealth of rental evidence. Also, it was common for early restaurant tenants to accept rent reviews providing for the higher of Market Rent or annual Retail Price Index increases. Consequently, leases were entered into with tenants committed to fixed rental increases for 20 or 30 years; this was particularly onerous to the tenant if the initial rent was inflated. In some cases early restaurant rents were 'over-g geared' to retail rents, for example, 150 per cent of prime retail rents. Needless to say, some landlords are benefitting from long-term leases now with blue-chip tenants and fixed rental increases well above the market rent.

HOW TO DISPOSE OF A LEASE

Once the decision is made to dispose of an outlet, managing directors, legal advisors, estate managers and alike will be carefully searching through their copy of the lease to read the alienation provisions to ascertain their options to dispose of their interest. Multiple or established operators are unlikely to have entered into leases that are non-assignable. It is more common for tenants of commercial leases to be able to assign the whole (of the premises) subject to the consent of the landlord, which is not to be unreasonably withheld. The test of reasonableness is a matter of degree and when the financial standing of the assignor and assignee are disparate, landlords may have grounds to withhold consent. While the landlord has a duty to respond to a tenant's application for a licence to assign in a reasonable time, in practice the landlord may frustrate the application by continuing to request further information about the assignee. A no-nonsense approach is required by the assignor's solicitor in such cases to 'flush out' the landlord.

The selling tenant's agent will have scoured the market for the 'best' buyer before proposing an assignee to the landlord, and the landlord cannot just refuse consent to a proposed assignment without suitable grounds. While a proposed assignee may be of weaker financial strength or covenant, they may be able to offer other security in the form of: a personal guarantor supported by equity in a house owned by the guarantor, rent deposit, financial references or bank guarantee. The landlord will have to think carefully about withholding consent, as a claim against the landlord for unreasonably withholding consent can be costly if the Court awards in favour of the tenant. From experience, the matter rarely reaches Court and the threat of legal proceedings is often used by landlords, or tenants in negotiations to 'force' the issue (either way).

FACTORS AFFECTING THE LANDLORD'S DECISION

A landlord's decision to approve an application for assignment can be influenced by many different factors. In particular whether the lease is an 'old' or 'new' lease, meaning a lease entered into before or after 1 January 1996, respectively. This was the effective date for the Landlord & Tenant Covenant's Act 1995 coming into force, which changed the effects of privity of contract on tenants.

Pre 1996, the tenant and their successors to a commercial lease remain liable (are on the hook) for the tenant's obligations, that is keeping the property in repair, paying for insurance, rent, rates, etc, for the entire duration of the lease, even if the lease had been assigned to another tenant (assignee), or indeed if the tenant's assignee assigned the lease to another assignee, and so on. Therefore, the landlord under the 'old system' was in a relatively secure position if at any point during the lease, a 'blue chip' or plc company signed as tenant.

Liability for the full term

If a subsequent tenant failed to fulfil their obligations (often at the point of the tenant becoming insolvent), the landlord is able to look to the

succession of tenants on the lease for the breaches to be remedied and rent paid. The landlord is required to alert the previous tenants of material breaches and the possibility of their being 'called in' to remedy the situation. In respect of rent arrears, a strict timetable exists for the landlord to comply with. A tenant going into administration or liquidation normally means that the landlord will look to the blue-chip tenant first, due to their ability to 'make good'. This is particularly relevant to the restaurant sector where lease terms can be 20 or more years in length, and consequently while the lease may have been disposed of many times and many years ago by the blue-chip tenant, it is the tenant with the best financial standing who is likely to be footing the bill and often will have to retake possession/control of the premises to minimise ongoing liabilities, as the landlord will be keen to keep the lease running. The 'blue chip' tenant can potentially find their having to take over premises in a much different state than when they were in occupation.

There are some situations where the previous tenant/tenants are released from liability and this is normally when the premises or the lease have been materially altered, that is, where the landlord has enabled the tenant to change the use from a restaurant to say a car showroom, however, the degree of alteration/variation to release the original tenant from their obligations is a matter of degree and potentially litigious.

The outcome of privity of contract is that landlords of 'old' leases are protected by an assignment to a weaker tenant, because the original/successive tenants remain 'on the hook' for the term of the lease. The landlords' investment value may, however, be affected because the stronger tenant does not occupy the premises. This has a greater effect towards the end of the lease, as it is the occupying tenant who is entitled to a new lease under the Landlord and Tenant Act and only when the lease is renewed does liability end for the assignors.

Post 1996, the liability of tenants under privity of contract is restricted to the first assignment only. Therefore, once the lease has been assigned twice, the original tenant's liability ends. The outcome of this has been a tightening up of alienation clauses in 'new' leases and landlords taking a much closer look at proposed assignees when requests are made by tenants to assign their leases. Consequently, landlords will prefer the tenant to dispose of their asset by way of a sub-letting rather than assignment, and thus maintaining the direct contractual relationship with the blue-chip tenant. The tenant's obligations in the lease will subsequently be transferred to the proposed sub-tenant (purchaser) in the new sub-lease.

SUB-LET OR SURRENDER?

A common request by landlords when allowing tenants to sub-let is for the sub-lease to be outside the security provisions of the Landlord & Tenant Act 1954, which means that the new sub-tenant will be unable to automatically renew the lease at expiry. This will have a fundamental impact on the saleability of the new sub-lease as it approaches the end of the term, as restaurateurs will invariably require a lease with a minimum of ten years unexpired. Restaurateurs may, however, take a lease of

shorter term, provided the lease is 'inside the Act' and therefore affording automatic rights of renewal. With 'fag end' leases, it may benefit the tenant (and landlord if a higher rent is offered) to negotiate a surrender of the existing lease. If the landlord is not prepared to entertain a new lease for fear of losing the 'good covenant' for the remainder of the lease, the tenant could seek to persuade the landlord to grant a reversionary lease to the purchasing tenant, which would commence at the expiry of the current lease; this will afford the new tenant the necessary security of a longer lease.

Surrendering the lease will be most desirable from the seller's perspective because this brings about a complete cessation of the tenant's liabilities under the lease and consequently the outgoing tenant may consider offering a reverse premium as an inducement to make the transaction more appealing to the landlord. The amount of the reverse premium will of course depend on the respective negotiating positions of landlord and tenant. From experience, the cost of a surrender can be anything from six months rent to five years rent (the author has even heard of ten years rent offered by a tenant) and will depend on many factors, but in particular the length of unexpired lease, whether the passing rent is above the market rent and the covenant strength of the new tenant being proposed. The landlord may be keen to secure an early surrender of the lease for redevelopment purposes or to let the property for higher alternative use. This could result in the landlord paying the tenant to vacate.

It is important to note that while covenant strength is a key factor to landlords, developers of leisure developments will also be influenced by tenant mix and operator innovation. Depending on the tenant's proposition or offer, the landlord may be prepared to take risks with new and emerging concepts, which may help differentiate their leisure scheme from competing schemes.

TERMS OF THE SUB-LEASE

The alienation clause in a lease will normally dictate that the terms of any under-lease should effectively mirror the head lease, in respect of rent payable, rent review periods, use, repairing liabilities, demise, etc. In cases where the rent payable is above the market rent, and with most rent reviews being upwards only, this poses a problem if the head lease determines that the rent under any sub-lease should not be below the passing rent. Such situations have been overcome by way of 'side agreements' with the sub-tenant agreeing to pay the passing rent subject to receiving a sum of money back each quarter, representing the 'over-rent'. However, recent case law has severely limited the use of side letters/agreements and consequently tenants will be forced to negotiate with their landlords to vary their lease to allow the rent payable under the new sub-lease to be below the passing rent payable to the landlord. Landlords will be unwilling to create evidence of lower rents in situations where they hold other properties in the area. The result is often the tenant having to offer an inducement to the landlord to vary the lease.

THE COST OF MODERNISING THE EXISTING LEASE

The recent changes to the Use Classes Order in April 2005 sought to separate pubs, restaurants and takeaway premises into different planning uses, having all previously fallen in the same planning use; namely, Class A3. Pubs, bars and wine bars now fall within Use Class A4, restaurants in Use Class A3 and takeaway premises within Use Class A5. Planning permission for change of use is required when changing a restaurant to a pub or takeaway, however, planning permission is not required when changing a pub or takeaway to a restaurant. The sub-division of the old A3 Use Class is to give planning authorities greater control over their high streets; however, the eating-out market has developed significantly over the past ten years with some restaurants, pubs and bars not neatly falling into any of the new Use Class categories.

Confusion has resulted from the changes for businesses that cross Use Class boundaries, that is those that offer strong food and strong drink propositions and may even offer food to takeaway. Consequently, user clauses in historically written leases, crafted pre the Use Class changes, often do not reflect the modern demands of operators. A recent sale of a Café Rouge restaurant to a burger operator was held up for many months so that the purchaser could get comfort from the landlord that the A3 use permitted under the lease could be varied so as to enable the assignee to sell food to takeaway 'as ancillary to the main restaurant use'. Arguably, this was permitted under the lease in any event, since the takeaway use (being ancillary) was permitted under the old A3 use. Nevertheless, the assignee was not prepared to take the risk and sought a simple clarification from the landlord. The landlord managed to extract a reverse premium for this variation. The terms of the lease entered into by the blue-chip tenant had been overtaken by market events and consequently provided the landlord with an opportunity to extract a financial penalty from the tenant due to their need for the deal to proceed and because they were in a financial position to pay.

Tenants of 'new' leases will prefer to assign rather than sub-let, due to the potential of terminating their liability, upon the subsequent lease assignment. New companies seeking to take an assignment of a 'new' lease, from a blue-chip tenant, will be asked by landlords to provide guarantors and rent deposits, the latter often amounting to 6–12 months rent, references (bank, legal, accountant and trade), and also to provide a business plan. Proof of funding will be required not only for the premium for the lease (assuming there is one), but also for the rent deposit, proposed refurbishment works and rent being paid quarterly in advance.

ASSEMBLING A LANDLORD'S PACK

Despite the high failure rate in the sector, most major banks are prepared to lend up to half the restaurateur's total investment, subject to their believing in the borrower and their business proposition. Providing a 'landlord's pack' of information to support the assignee's application for the lease should be best practice for disposing of a leasehold interest, and is likely to be required to win bank/financial support in any event. If the assignee fails (regardless of new or old lease), the assignor will have to

‘pick up the pieces’. Assignors will need to satisfy themselves of the assignee’s credentials and chances of success, and after all if the assignor does not believe in the assignee then why should the landlord?

For blue-chip companies disposing of leasehold assets, it is far more complicated than simply finding a keen buyer. It involves a detailed understanding of the security offered by the assignee, the restrictions relating to ‘dealings’ contained in the lease, the credibility of the assignee’s proposals and the dynamics of leasehold transactions of operating businesses. While the above outlines the mechanics of some of the practical obstacles involved in winning the landlord’s approval, the assignee’s solicitor will have to be familiar with legislation surrounding licensing, health and safety, Disability Discrimination Act, employment and planning. Solicitors unfamiliar with licensed property sales can further add to the delays in getting the deal done.

THE NEED FOR PATIENCE

With so many hurdles to overcome, one of the key problems is ‘purchaser apathy’, in that newcomers to the sector do begin to wonder if they are ever going to realise their dreams of owning a restaurant. Rest assured restaurants are sold to those who are patient, and, where the covenant strength of assignee and assignor is similar, transactions can be much swifter. The balance between a long lease for depreciation purposes and extended liability for the tenant is a difficult one and consequently some restaurateurs prefer leases of 15 years in length rather than 20 or 25 years.