



Turnover Rents for Retail – the Way Forward in Recession?

Sharing the pain and (hopefully) the gain

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Some legal property commentators have been wondering how a commercial open market rent can be set for business premises when the relevant valuation date falls during the lockdown period or will arrive in coming months. They bemoan the likely lack of comparables and wring their hands. Personally, I have great faith in the skill-set of expert valuers' to meet this particular challenge. However, for my part, the true question is whether such commentators are actually looking at matters through the right end of the telescope?

Isn't the real question, and the potential practical answer, whether or not landlords and tenants should now consider the efficacy of different forms of rent-setting machinery altogether? Specifically, and particularly with regard to the hard hit retail and leisure sectors, whether the inclusion in commercial leases of a bespoke "turnover rent" clause may become a significant part of their "new normal"?

"The Times" (11 May 2020), carries an article which makes just this point: "*Rent deals will be linked to turnover, say landlords*". It cites research by Colliers International and quotes their survey of the owners of more than 120 million sq ft of retail property. Colliers' findings are reported to reveal that:

1. almost 80% of retail property landlords expect the pandemic to bring permanent changes to the terms on which shops are occupied; and
2. more than 40% of landlords are more likely to consider factors such as footfall and turnover when deciding an asking rent.

The comparison is made between Britain, with a tradition of longer leases with upward



only rent review clauses, and the United States, France and Italy, countries with shorter leases with a proportion of rent linked to turnover. Such provisions are known as “percentage rents” in the USA.

The use of turnover rents is said to be a model which encourages greater risk sharing and a stronger partnership between landlord and retailer. As “The Times” comments, such a shift will rely on data sharing and trust between landlords and tenants. Matters which may be more difficult where relationships between landlords and tenants have become strained through recent use of CVAs; issues around payment of the 25 March quarter’s rent, or monthly rents; and the temporary legislative changes which have resulted around landlords’ rights to enforce.

Necessarily there are pros and cons. Fundamentally, however, the ability to agree a turnover based rent is a readily operable route which is already available to landlords and tenants and their advisers.

Rents linked to the tenant’s turnover have in fact been common for many years, particularly in mining leases (Settled Land Act 1925, section 45). More recently, they have been applied to other commercial lettings, notably to lettings of shops, hotels and restaurants and they have become increasingly popular.

It is also well-established, that in times of recession, turnover rents are more favourable to tenants because the tenant’s liability to pay rent is related to its ability to pay. In essence, there may be a perception of fairness, of shared pain and shared gain, in the deployment of a profits-based methodology in order to set a rent.

Apart from the potential for the incorporation of turnover rent clauses in new leases, it continues to be surprising that it remains undecided whether the court has any jurisdiction to set a turnover rent on a lease renewal under the Landlord and Tenant Act 1954 Part II. It is simply stated in “Woodfall on Landlord and Tenant” (looseleaf), para. 22.149.6, that:



“In appropriate circumstances, the court may fix the rent by reference to a percentage of the tenant’s turnover or commission. To date this has only ever been done in the case of livestock markets, but it may be that the court would have such power in relation to retail units where there are no comparables ... or where the current tenancy provides for rent to be assessed on that basis. It is not entirely clear how the problem of disregarding the tenant’s goodwill can be overcome in these circumstances.”

In Reynolds and Clark “Renewal of Business Tenancies” (5th ed.), the authors set out a valuable analysis of sections 34 and 35 of the LTA 1954, and discuss the arguments for and against the court having jurisdiction to set a turnover rent, including such case law as exists. This issue was also considered by Della Gilbert of Maples Teesdale LLP in her 2019 Blundell Lecture “Getting Back to Business”. The topic forms part of Ms Gilbert’s subsequent article in the L&T Review 2019, 23(6), 224-228.

In “Lewison’s Drafting Business Leases” (8th ed), I discuss a number of factors which I believe landlords and tenants should take into account when negotiating a turnover rent clause. Amongst other matters, I suggest it is worthwhile for parties who may be tempted to set a rent by this route to consider the following:

- 1. Take care around the definition of profit and the interrelationship with taxes**

In *Debenhams Retail Plc v Sun Alliance & London Insurance Co Ltd* [2005] 3 E.G.L.R. 34, the tenant held department store premises under a lease granted in 1971 for a term of 99 years from 1965. The lease reserved a basic rent together with an additional rent calculated by reference to the store’s turnover, defined as “the gross amount of the total sales”. The Court of Appeal held the words “gross amount of total sales” meant everything that was taken at the till, including VAT, without deduction.

Today, a tenant would expect to see VAT expressly excluded from the definition



of “turnover”.

Tenants should consider SDLT.

2. Think about the potential for changing profit rates

If the price of a commodity rises at a faster rate than the cost of living, pressure is likely to develop on dealers in that commodity to reduce their margin of profit or rate of commission: *Naylor v Uttoxeter UDC* (1974) 231 E.G. 619, per Brightman J. Accordingly, the tenant may find that the proportion of rent to profit increases.

The same result may occur even if the tenant does not consciously reduce their profit margin. For example, if the government were to increase the rate of VAT gross turnover may increase (and with it the rent) while the tenant’s net profit remains static. See, by way of a specific example, *Tucker v Granada Motorway Services Ltd* [1977] 3 All E.R. 865.

3. Consider how to define Turnover

The tenant’s advisers should study carefully the definition of turnover upon which the rent is to be calculated. It should as far as possible be related to the actual profit made by the tenant.

From the landlord’s point of view too close a relationship between rent and profit means that their income will depend to a large extent on the efficiency with which the tenant carries on business rather than on the value of the demised property.

4. Ask whether a Basic Rent should be reserved

In the past, this has usually been done. Previously, often at between 70 per cent and 90 per cent of the open market rental.



An alternative is to use a guaranteed minimum which is reviewed at periodic intervals.

5. Decide if there should there be a Minimum and Maximum Turnover Figure

A tenant's adviser should ensure that there is a minimum turnover figure, which is not to be taken into account in assessing the rent, and possibly a maximum figure above which turnover is ignored.

6. Sales! Sales! Sales!

Where the tenant is likely to have sales or special offers, their advisers should attempt to ensure that it is the amount they receive rather than the full retail price which is to be included in the calculation of turnover.

7. Consider credit

Where the tenant's business includes a substantial number of transactions in which they give credit to their customers the draftsman will have to consider whether the amount of the transaction should be brought into account at the time of the transaction or at the time of payment, whether interest payments are to be included in the calculation of turnover and whether the tenant is to have an allowance for bad debts.

8. Vouchers, Gift Cards, the Internet and Click & Collect

The landlord's adviser should consider the impact of sales of store vouchers and gift cards. They should consider the way in which the retailer accounts for profits resulting from shoppers' and tenant's use of the internet.

Orders made via the internet on in-store computers should be attributed to that store's turnover rather than (perhaps) being notionally allocated to a different shop in the tenant group as a matter of the tenant's accounting practice.

Orders placed remotely on the internet but collected from the store should also



be attributed to the store where the collection is made.

9. Look to the future with Rent Review

If the lease is to include rent review provisions, it has been common to see clauses where the parties have provided for the base rent to be reviewed to the open market rental level disregarding the turnover provisions.

Equally, in the hospitality and leisure sectors, and for unique properties, a profits method of valuation is commonplace (and requires careful thought).

10. Look to the future with Alienation

The parties should also consider whether the provisions as to payment of a turnover rent are to continue if the lease is assigned or a sub-letting takes place, or are to be made personal to the original tenant.

If the provisions are to terminate, the full market rent should become payable.

The draftsman should ensure that any licence fee or sub-rent is taken into account in the calculation of the tenant's turnover.

11. Look at Keep Open Covenants

A particularly topical issue given the present impact of the Health Protection (Coronavirus Restrictions) (England) Regulations 2020 and the Health Protection (Coronavirus Restrictions) (Wales) Regulations 2020 enforcing the lockdown which has forced thousands of businesses to close.

Subject to the need for parties to consider the incorporation of pandemic specific drafting, a landlord's adviser will generally wish to couple a turnover rent clause with a tenant's covenant to keep open to attempt to ensure that the demised property is kept open and trading. Clearly, if the demised property ceases to be used for trading, the landlord's income will drop or possibly cease.



Although an injunction to compel the tenant to trade is thought to be unobtainable: *Co-Operative Insurance Society v Argyll Stores (Holdings)* [1998] 1 A.C. 1), a positive obligation will give the landlord a remedy in damages (*Costain Property Development Ltd v Finlay & Co Ltd* [1989] 1 E.G.L.R. 237; *Transworld Land Co v J Sainsbury* [1990] 2 E.G.L.R. 255). Subject, of course, to any defence which a tenant may be able to deploy.

In addition to the impact of government regulation, the tenant's adviser should ensure that the clause excludes circumstances where the store is, for example, closed for repairs, refitting or as a result of damage caused by insured risks.

The landlord may wish to include a term for the rent to revert to the open market rental level if the closure is in excess of a certain period.

12. Focus on the need for a robust Accounting Machinery

If a Base Rent is payable, then the lease will provide that the Base Rent is to be paid in conventional instalments in advance. Because the turnover for each year can only be established following the end of the relevant year, most landlords will also normally wish to provide for a provisional sum to be paid in advance on account of the turnover rent on the same dates as the basic rent is payable.

Terms should also be included setting out the appropriate machinery. For example,

- (a) the provision by the tenant to the landlord of a turnover certificate signed by a qualified accountant at the end of the turnover period within an agreed time period;
- (b) potentially (see below), for the production of audited accounts, and
- (c) for the tenant to make available to the landlord its accounts and all relevant supporting documentation for inspection.

The draftsman must provide for the landlord to have sufficient power of



inspection of the tenant's books to satisfy himself that any information supplied by the tenant is correct. There should probably be a provision for independent determination (by an accountant rather than a surveyor) in case of dispute.

Reliance on the tenant's audited accounts for the purpose of calculating turnover may be unwise for the landlord, not because those accounts may be inaccurate but because they may not be settled until well after the end of the rental period in question.

13. Ensure Confidentiality

The tenant's adviser will wish to ensure that confidentiality provisions are included to ensure that the landlord does not disclose the tenant's private business information, and that it uses that information solely to calculate the turnover rent.

14. Provide for Dispute Resolution

Linked to the need for confidentiality, a private arbitration mechanism will be the best way forward in the event of dispute.

In conclusion, whether or not a turnover rent machinery is the best way forward to level today's playing field, it is important for us to ask the bigger question about whether or not the correct default for present times is indeed the "traditional" machinery of a comparable based letting to open market rent.

Difficult times require consideration of all possible solutions and lateral thinking

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