

Retrospective banning of upward-only rent reviews

Policy Paper
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This brief paper sets out the issues that need to be considered in light of any proposal to retrospectively abolish upward-only rent reviews in commercial leases. It attempts to consider the issues from the perspective of both the landlord and the tenant.

In general, the common view is that changing laws which have a retrospective effect is unfair, and indeed the Irish Constitution (Article 15.1) restrains the power to enact such retrospective laws. In a commercial environment, the introduction of retrospective laws is likely to create enormous legal uncertainty and introduce substantial risk into doing business in Ireland.

That said, regulation of existing contractual obligations has taken place before, most notably under the provisions of the Landlord and Tenant (Amendment) Act 1980, which came into effect in respect of both new and existing contracts.

Upward-Only Rent Reviews

A standard lease in operation for commercial property in Ireland provides for rents to be revised to market value every five years. An upward-only rent review means that the rent payable after a revision cannot be less than either the rent payable at the start of the lease or before the revision.

A ban on upward-only rent review clauses was introduced in Section 132 of the Land and Conveyancing Law Reform Act 2009 which came into operation in 2010. Under this legislation, upward-only review clauses are banned in all new leases signed since February 28th 2010 but existing lease contracts that contain the upward-only mechanism have remained intact. The Fine Gael and Labour election manifestos expressly state that, in government, they will look at retrospectively banning upward-only rent reviews in existing business leases.

This means that because of the sudden and collapse in the economy and rental values, tenants in existing contracts must continue to pay rents at levels greater than the open market rental value, while those signing new contracts are able to reduce their rents to meet a declined market value, unless they are able to negotiate and agree directly with their landlord on this issue.

The recession requires an evaluation of the cost base of commercial and retail businesses

The collapse in consumer confidence over the last couple of years has completely undermined the economic basis for many otherwise viable businesses in Ireland. During the recession, commercial, retail and other businesses have reduced many of their overheads and costs, with some overheads remaining fixed, such as where an upward-only rent clause exists and a landlord is not agreeable to a downward review outside of the terms of the lease. Consumer confidence is going to remain weak as the economy slowly recovers and while customers will have less money to spend. There is a strong argument that the cost base of businesses must be able to fall to a level where they remain viable.

However, all economies are cyclical, and the amendment of multi-annual agreements such as rental agreements on the basis of today's economic environment has wide-ranging implications. Doing so could give an initial boost to struggling businesses, but would undermine all short, medium and long-term financial planning on the part of the landlord.

On the other hand, the process of re-adjustment, correction and a painful return to competitiveness should involve allowing businesses of all sectors to explore their cost bases in

order to maintain their viability, secure the employment of workers and maintain their capacity to deliver future economic and commercial activity.

While many appeals for rent reduction are genuine, it is difficult for landlords to assess the legitimacy of appeals for reduction because of the changed economic environment. Tenants too may be unaware of the financial commitments of their landlords which were entered into in good faith on foot of the lease contracts attached to their property.

Any decision to retrospectively change the rental agreement will have an immediate impact on tenants and landlords, and second-round impacts on the economy, the property sector, the exchequer, local government and Ireland's international reputation. Introducing a retrospective ban on upward-only rent reviews would have an immediate financial impact on pension funds.

Inflation and increases in commercial rents

In recent years, there has been a de-coupling of inflation in the economy and increases in commercial rents, with the latter growing faster than the former. Upward-only rent reviews were intended to maintain that link, but as rents have grown faster than inflation, the original purpose has been undermined. It could be argued that it is now time to properly assess the economic basis for reviewing commercial rents in Ireland without creating a two-speed market.

The legacy of a cyclical economy

Leases have been signed at all points in the economic cycle, but those signed at . in retrospect . the peak of the market could not possibly have been cognisant of the enormous collapse in the banking sector or economy, or the extent to which it would undermine consumer confidence. While it is important for businesses to assess their cost basis during a recession, and reduce them as far as possible to maintain their viability, rents are only one input cost amongst many, including labour costs, insurance costs, energy costs and rates, which are also playing a part in undermining commercial practices.

The new legislation, that banned upward-only rent reviews for new leases with effect from 28th February 2010, has created a two-tier rental market, with those new tenants in a much more competitive position than those commercial interests which are tied into existing leases, and which may have up to 15 years before they can obtain a reduction. This inequality is damaging the ability of the retail sector to reduce its cost base on a uniform basis, and may be anti-competitive.

Many landlords have simply re-let vacated units on lower rents and less onerous terms and conditions in order to generate rent roll. These new retailers, trading on a lower cost base, are able to positively position themselves against competing with other commercial operators who are obliged to pay significantly higher rents.

Informed Consent and revision of Government policy

The basis of a rental agreement is informed consent. Landlord and tenant had the opportunity to receive professional advice before signing the agreement, and if specific clauses in rental agreements were found to be unenforceable because of a government's decision to change the law, this would have a major impact on the legal basis of other agreements.

The process of retrospectively banning upward-only rent reviews may be unconstitutional. If it is not, then the legal challenges involved in retrospectively banning upward-only rent reviews is going to paralyse the commercial property market at a time where stability and confidence are needed. This is a significant first-round impact which will lead to further and wider impacts.

Economic and Exchequer impacts

There is no economic or commercial benefit to a vacant property, and landlords realise that a tenant, paying a lesser rent, is better than no tenant.

However, many landlords are multi-national institutions working on the instruction of pension funds, and have no mandate to reduce their income flows. The Irish pension funds could be

severely undermined if income flows from rental returns were reduced, and this would have disastrous second-round impacts on the economy, and the exchequer.

Although there is demand for retail accommodation in some locations, the rents and concessions that tenants are willing to pay are significantly less than was previously generated and most leases are short-term in nature, which prove extremely difficult to finance. As under-occupied multi-unit developments have an effect on the financial viability of an entire property portfolio, many developers and investors are under pressure to maximise occupancy. As a result, they are re-negotiating rents with existing tenants to assist them to remain in business, but as new tenancies will be on a different basis to existing ones, even such bilateral agreements may not be enough to reduce the gap between the two cohorts of tenant.

Impact on International Investors

A move to retrospectively ban upward-only rent reviews will severely undermine the considerable international appetite that currently prevails for prime investment opportunities in the Irish market at a time when domestic investors are few and far between and the market is largely reliant on international investors.

International property investors will be aware of the Minister for Finance's recent decision to prematurely terminate legacy reliefs. This has already raised investors concerns regarding the stability of the Irish property market and a further move to retrospectively change legislation in a market which requires long term planning and decisions will clearly reduce the level of investment funds so badly needed at this time. This would have a serious impact on all stakeholders such as private investors (large and small), the lending institutions, and of course NAMA. Arguably, any retrospective change to the lease code will require all NAMA valuations to be redone as the basis of valuation and assumptions that original valuations were carried out are now altered.

Income flows to financial institutions will be reduced which will impact negatively on loans and lead to more capital being required from the taxpayer. Currently the taxpayer owns about " 30 billion of Irish commercial investments roughly " 10 billion AIB, " 10 billion NAMA and " 10 billion

anglo investment book. To bring in this proposed legislation will knock values by say at least 20% thus costing the taxpayer say " 6 billion.

Foreign Direct Investment will also be impacted in so far as overseas confidence in the Irish economy will be diluted with fear as to what further retrospective measures might be taken by Government, particularly at a time when the 12.5 % tax rate is under the microscope.

If this measure is implemented, the UK will have a significant competitive advantage over Ireland in this respect and will therefore attract the lion's share of investment, from overseas and Irish investors alike.

Without the cushion of upwards reviews, rental values will decline further and will translate directly into further capital value erosion. A retrospective ban on upwards review clauses is likely lead to a deterioration in values and the decline in income return would also impact on an accelerated basis.

Furthermore it should be stated that any move to retrospectively alter contract law will have severe repercussions for Ireland as it will undermine our credibility worldwide. In addition a long period of uncertainty to take this to the Supreme Court may have worse consequences for the industry as a whole.

Can the Government afford a compensation scheme for investors?

It is probable that if the government are to change the terms of existing leases, they will leave themselves (and the taxpayer) open to a claim for compensation from existing investors. The country can ill-afford such a scheme at this time, and highlights an immediate exchequer cost to this policy decision.

The need for a Commercial Property Database

The commercial property sector in Ireland needs a database of all property transactions and leasing details in order to provide much needed transparency to the market and provide a sure

base on which future rental agreements can be made. A database of all leases and transactions would help close the gap in the two-tier market which currently exists, reassure investors and provide a common set of indicators for both tenant and landlord during the rent negotiation and review process.

The Society of Chartered Surveyors

The Society of Chartered Surveyors (SCS) represents 3,000 surveyors working in different areas of the building and development industry, including 750 trainees who are undergoing their assessment of professional competence in order to achieve the gold standard of chartered status. Members of the Society are typically professionals employed in the land, property and construction markets through private practice, in central, regional and local government, in public agencies, in academic institutions, in business organisations and in non-governmental organisations. The Society also has strong links with the RICS which represents over 140,000 members across 120 countries worldwide and is one of the most respected and high profile global standards and membership organisations for professionals involved in land, valuation, property, construction and environmental issues.

As the members of the SCS are fully professionally qualified personnel from a range of backgrounds, the Society has the necessary skills to advise on deliverable aims and market expectations.

Their broad areas of expertise include:

- Quantity Surveying
- Building Surveying
- Valuations surveying
- Planning & Development
- Geomatics & Land surveying