

SURPLUS PROPERTY PRESENTS A POTENTIAL BUSINESS RISK

The Court of Appeal's decision in the case of *Allied Dunbar Assurance plc v Homebase Ltd* causes serious difficulties for businesses with surplus property space they would like to sublet. The problem is made more acute by the provisions required for onerous lease liabilities under FRS 12 Provisions, Contingent Liabilities and Contingent Assets.

Homebase took a 25-year lease from Allied Dunbar in 1986, but by 1998 no longer needed the premises. The lease permitted subletting with consent, but only at or above the market rent and on the same repairing covenants. Homebase agreed a sublease with Lairdale satisfying this requirement. It also entered into a collateral deed, expressed as personal to the parties, that Homebase would refund part of the rent and indemnify Lairdale against the cost of specified repairs. However, Allied Dunbar refused Homebase's application for consent and sought an injunction to prevent the sublet. Homebase counterclaimed, alleging that consent had been unreasonably withheld.

The Court of Appeal ruled in favour of Allied Dunbar, finding that the proposed sublease and collateral deed were interdependent and to be read as one document. As there was an anticipated breach of the headlease, Allied Dunbar had not unreasonably withheld consent.

The effect

It has been common practice for tenants to sublet surplus space. Onerous lease clauses were

circumvented by entering into collateral agreements or side-letters giving a reduction in rent and/or indemnity against specified clauses by the superior landlord. This route has now been closed by the *Allied Dunbar* case.

Companies already subletting in this way will also be caught. "Most subleases are relatively short," says Howard Cooke, managing director of FraserCRE, a real estate management and consulting firm. "Where you have used this technique in the past, when you come to the renewal of the sublease, you won't be able to use it again if you are trying to get round a specific clause or if it's over-rented."

Over-renting, where the headlease rent being paid is higher than the market rent, is a particular problem. Where market rents have fallen, the sublease rent would need to be for a lower amount than the passing rent under the headlease. "Property market rents, particularly in terms of offices and industrial sites, have dropped," says Cooke. "You could easily find that space is over-rented. In the City, for example, the market rent might be £20 per square foot, but the passing rent could be £45 per square foot."

FRS 12 impact

FraserCRE notes that companies' legacy portfolios (meaning any space surplus to current requirements, whether vacant or sublet) can have a significant impact on the annual accounts. FRS 12 requires companies to make a provision on the balance sheet for any liabilities arising from surplus leasehold liabilities. If

companies are prevented from subletting, as they have been in the past, they will have to record increased liabilities, unless they find some alternative means of dealing with the problem.

Notably, research by FraserCRE found that just 46% of businesses with surplus property on their portfolio were making an FRS 12 provision. This implies that the remaining 54% are not currently complying with the UK accounting standard.

Quantifying the impact

FraserCRE has been working for organisations with large branch office networks, as is often typical in the financial services sector, for example. It found that about 30% of properties in such portfolios were affected by the *Allied Dunbar* ruling.

In financial terms, the impact can be huge. A review of the portfolios of 20 corporates found that they had gross liabilities in surplus properties exceeding £1bn.

Options for dealing with legacy property portfolios

Companies could "outsell" their legacy portfolios; in effect, paying someone else to take the onerous lease burden away. "Outselling enables the corporate to mitigate further liability," says Cooke. Depending upon the individual circumstances, this can be a one-off transaction which can be supported by an insurance product to protect the corporate from any future liabilities from the portfolio.

Another alternative would be to buy the freehold, gaining the ability to subsequently dispose of the property as desired. However,

for most companies this is not particularly practical, given the high amounts of capital involved. An alternative solution involves lining up a friendly purchaser who will buy the property from the freeholder. The deal would involve a pre-agreement, enabling the lessor to surrender the lease as soon as the purchase completes.

FraserCRE is currently handling such a deal for a City client with property it no longer needs. The client's gross liability for that one property (in terms of rent, rates, service charges and insurance until the end of the lease term) is about £170m – more than the value of the freehold. By agreeing a structure with a friendly purchaser, the risk can be removed for a fraction of the price by means of an upfront payment.

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A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- The implications of the *Allied Dunbar* ruling, combined with FRS 12, are outlined in FraserCRE's *Corporate Occupiers Report 2003*, available at www.frasercre.com

- Hardwicke Civil (part of Hardwicke Building chambers) has outlined the key details and impact of the *Allied Dunbar* case. Go to www.hardwickecivil.co.uk/property/articles/03020101.htm

- For an outline of FRS 12, go to www.frc.org.uk/asb/technical/pub0107.html