Striking a statutory balance: constant change in residential leases versus static change in commercial leases

Raphael J. Heffron
School of Law, University of Stirling, UK
raphael.heffron@stir.ac.uk

Paul Haynes
School of Management, Royal Holloway, University of London, UK
paul.haynes@rhul.ac.uk

Abstract

This paper provides a critical analysis of the reasons why the statutory code governing commercial leases has remained static when compared to those in the residential sector in the UK. Further it examines how far and in what ways the more recent additions and initiatives have altered or improved the law. The paper examines the degree to which there has been a political unwillingness to use legislation in the area, and examines the effort that has been made to simplify the process. The paper suggests that legislation has aimed at protecting the financial position of the tenant and in particular aiding the small business with limited access to legal resources, while also facilitating a market that has been changed by economic conditions, encouraging flexibility and adaptation. Recent initiatives that have involved a combination of legislation and a voluntary code to encourage self regulation are also examined, including that which encourages short term leases due to transaction cost increases for longer term leases.
1: Introduction

The last century in the United Kingdom has been witness to the development of landlord and tenant law. The French legal philosopher Michel Eyquem de Montaigne stated that the ideal, as regards legislating, is simplicity:

The most obvious laws are those that are fewest, simplest, and most general; and I even think that it would be better to be without them altogether than to have them in such numbers as we have at present (Montaigne 1958: 345)

As will be outlined in this paper there is a movement to restore simplicity to the legislation in this area as a response to the ever increasing complexity of the law of landlord and tenant (Haley 2000).

While the statutory code related to housing has become relatively complex and involves many layers of legislation, the statutory code governing commercial leases has remained static. This paper will examine why this is the case and assess how far, and in what ways, the more recent additions or initiatives have altered or improved law in the area of residential leases. The argument will be illustrated by examining the evolution of residential and commercial lease legislation. This will provide evidence of the static nature of legislation of commercial leases over time, which can be attributed to a political will not to legislate, but to assume that self regulation is a more effective measure. The two key pieces of legislation that regulate the sector were each introduced after World War I and World War II, respectively, regulating markets where the landlord had come to be in a dominant position. In addition, there have been minor amendments to bring the relationship between landlord and tenant into balance. An effort has been made to simplify the process so as to reduce the transaction costs in the process of drafting new leases and the renewal of existing leases. This will be seen to aid the small business owner, who does not have the same access to legal resources, while also facilitating a market that has been changed by economic conditions, while encourages flexibility and adaptation. More recent initiatives have involved a combination of legislation and a voluntary code to encourage self-regulation, while other additions to law in the area have been attributed to encouraging short-term leases because transaction costs have been increased for longer-term leases.

2: Commercial and Residential Lease Codes

The statutory code governing commercial leases has remained relatively static when compared to those in the residential sector. This section will examine the evolution of each line of legislation separately in order to identify key trends, reflecting Michael Haley suggestion that: “in order to understand the present it has become necessary to negotiate the past” (Haley 2006: 1).

Examining the legal framework of residential leases indicates an area of continual change. Residential tenancy law can be divided into two: short term, and long-term residential tenancy law. Statute has become a feature of residential tenancies since the
first Rent Act [known as the Increase of Rent and Mortgage Interest (War Restrictions) Act] was passed in 1915 in order to prevent landlords raising rents to exploit the increased wages of munitions workers. As the Law Commission has stated “the principle that the State should guarantee tenants’ security of tenure, irrespective of the terms of the contract, has become a central principle of housing law” (Law Commission 2002: 162). The Rent Act 1915 was a temporary Act, and was followed by a succession of Rent Acts which, in summary, reduced security and rent control (in 1923 and 1933), restored it (in 1939), withdrew it (in 1957), replaced it again (in 1965), and then extended it to most lettings of buildings falling outside of the ‘resident landlord’ exception (in 1974) (see Wilkie 2006).

When legislation first appeared in the area it was designed to limit or freeze rent increase so as to avoid social unrest during and after the war years (Law Commission 2002). Once established, it was difficult to abolish it completely. The different rationales behind the various Acts all failed to halt the decline of the private sector from 90 per cent of total stock in 1914 to 7 per cent in 1991 (Law Commission 2002). The last Rent Act was in 1989 and, along with the Housing Acts of 1988 and 1996, has led to an increase in the private sector to around 10 per cent of total stock in 2003 (ODPM 2003). The Housing Acts of 1988 and 1996 set out with the aim of regenerating the private rented sector. The Act of 1988 allowed the granting of assured tenancies, followed by the creation of assured shorthold tenancies by the Housing Act 1996. The latter dominates today and has an average length of around 15 months (Evans and Smith 2002). Yet, many tenancies still operate under the earlier Acts (so-called “Rent Act Tenancies”) that provide infinite security (even succession), together with rent control, and control of premiums, whereas the Housing Acts give much more limited security and rent is at market rates. The changes were intended to stimulate the private rented sector by encouraging potential landlords to enter the market. Returns would be better and possession would be easier to recover. Landlords’ confidence about letting property has increased since the 1980s through to the 1990s and early 2000s and empirical research supports this (see ODPM 2006: 26-31).

Five principal statutes have governed long residential leases – those of 1954, 1967, 1989, 1992 and 1993 – and the legislation has concentrated on protecting tenants against high service charges, security of tenure, the option of compulsory purchase of the freehold, and of increasing their interest in the property, either by acquiring a new or longer lease or a share of the property.

The previous UK government (1997-2010) had expressed its commitment to the structure it inherited, stating that it is a system that works well and that they do not envisage rent controls being re-introduced in the deregulated market (ODPM 2000), while the new coalition government is equally committed to market forces in the housing market. The drivers of change in the residential market seem initially to have revolved around the war years, where anxious politicians had to appease the vast majority of the population who were living in rented accommodation. The Housing Act 1988 has been marginally successful with many using the private renting sector as a first step to joining the high 70 percent of households who are owner occupiers in the United Kingdom (Wilkie et. al. 2006). It has been a government policy to deregulate the residential letting market, in order to stimulate efficiency and investment in the area. In a market where home ownership is extremely high in
comparison to European counterparts (except for Ireland), this can only improve the
good quality of the residences on offer (Landler 2008). The government policy has
increasingly consisted of market self-regulation (see Skousen 2007). Introducing
consumerism, in a formal sense to control unfair contract terms in tenancies, reflects
the reality that we live in a consumer era. If the use of plain language in tenancy
agreements reduces, rather than increases, disputes such a strategy can only be
welcomed. Further, the Law Commission (2003) is of the view that the system is
overly complex, and has stated that there should only be two statutory housing
statuses: type I agreements where there would be a high degree of security (periodic
agreements only); and type II where there would be a low degree of security, being
either fixed term, or periodic Law Commission 2003: 284). An initial assessment of
the Law Commission reforms would indicate that they do not represent a radical
break from the schemes that operate currently. No cast-iron security of tenure has
been conferred on tenants in near 30 years in either practice or law. The suggestions
from the Law Commission reflect this, and it is hard to dispute the Commission’s
ultimate objective of clarification and simplification of legal principle (Bridge 2002:
131).

In contrast to these layers of legislation, the framework for commercial leases is
relatively static. In the UK as in other countries, legal systems of land holding require
that the domestic/residential tenant is entitled to protection; however, the regulation of
business tenancies has been less formal. The first legislation in this area was
prompted by the Select Committee on Town Holdings 1889 who reported that
business tenants were being exploited and protection was needed in the form of
legislation. Aware that tenants placed a value on their location in the form of
goodwill, landlords demanded high rents when the time came for the lease renewal.
The Committee advocated that tenants should be entitled to compensation for
improvements made to the property and goodwill, though did not suggest security of
tenure for tenants. The emphasis was on safeguarding the tenant’s financial interests,
rather than ensuring the continuation of their business (Haley 2006). However reform
in the UK was initially led by the small shopkeepers and hence they, unlike other
business tenants, benefited from the limited Rent Restrictions Act 1915. The view of
Parliament at the time was that there was little gained by imposing controls upon all
landlords, when it was only the minority that constituted a threat (see Haley 2006).

After World War I there was a lack of new commercial buildings, and the revival of
trade and commerce meant there was increased competition for commercial premises.
Landlords began to exploit their market position, aided by entrepreneurs and multiple
shopkeepers who began to speculate on purchasing goodwill built up in properties,
buying leases unbeknownst to the sitting tenants. Action was deemed necessary to
address increases in rents and decreased investment in property by sitting tenants,
thought likely to stimulate inflation, unemployment, and closures. A temporary
measure to target all landlords was introduced by the Rent and Mortgage Restrictions
Act 1920 (only if they were of a prescribed rateable value). Following this was the
introduction of the Landlord and Tenant Act 1927, based upon legislation that was
proving to be successful in France and Ireland (Hurndall 1988), and also modelled on
the proposals of the Select Committee on Town Holdings 1889. Its essence was the
protection of the business tenant’s interests and the system revolved around giving
tenants the right to compensation for goodwill and improvements. Achieving equality
for both parties was the principle: if the landlord gained by the presence of a tenant,
then that tenant must be compensated or alternatively offered a lease renewal. The legislation did not fully address the problem, however, and security of tenure as a direct right was seen at the time as the measure that should have been legislated for (see Haley 2006). Of significance was that the Landlord and Tenant Act 1927 gave needed legal recognition to the relationship between landlord and tenant for business tenancies. In rare circumstances the courts could even decree that a new tenancy be offered and this influenced the direction taken by future legislation.

Problems arose again after World War II when, coupled with the destruction of commercial premises, an inadequate supply due to no investment over the war years, and the revival of commercial activity, there was an increase in competition for new premises. Previous legislation was held not to protect the sitting tenant, and revision of the area began with an Interim Report (1949), and a Final Report (1950). Provisional legislation was introduced in the form of the Leasehold Property (Temporary Provisions) Act 1951, which was only to have a three year lifespan. It was relatively restrictive and only applied to retail premises.

The Landlord and Tenant Act (1954), following the recommendations of government White Paper (1953), was a key piece of legislation. The renewal rights given by this Act prevented the exploitation of sitting tenants. The effect of the Landlord and Tenant Act 1954 lies dormant until the contractual tenancy is terminated. Until this point, the rights of either party are not affected, and the Act does not apply if the original lease is brought to an end by a term of the contract. Upon termination of the tenancy, a continuation tenancy is born, and exists until the renewal application is decided upon. The continuation tenancy is only brought to an end by methods allowed under the 1954 Act: forfeiture, notice to quit by a periodic tenant; consensual surrender; and landlord’s statutory termination notice. Under the Act, the tenant was given the right to a new lease on terms agreed by the court or with the landlord, and this right could only be defeated in limited circumstances. The availability of compensation was permitted but subject to the grounds upon which a landlord defeated the tenant’s right to a renewal. The 1954 Act was not all in favour of the tenant. Lease renewal was not automatic, and the process was arduous, long and tedious. Further, the landlord could defeat the renewal by claiming good management of his estate, bad conduct of the tenant, redevelopment, and intention to occupy the building himself. The original terms of the lease were not guaranteed to remain the same either and could be renegotiated between the parties or by the courts itself (see Furbur 2004).

The Law Commission was of the view that the 1954 Act worked quite successfully. In 1969 it produced a Final Report that formed the basis of the Law of Property Act 1969. The effects of this Act were minor, although the landlord’s position was strengthened to a small degree. The landlord, when there was a continuation tenancy, could apply for an interim rent review. The courts were given the power to include a new rent review clause, could sanction ‘contracting out’, and extend the scope for temporary lettings that fell outside statutory provisions. The tenant however was not totally ignored. In the setting of a new rent, the improvements made by a tenant were to be factored in. If the landlord claimed possession for redevelopment, the tenant was entitled to a lease for part of the original holding where work was not to take place. Further, it was no longer necessary for the tenant to apply for a new lease as a requirement to seeking compensation.
The Department of Environment in 1984 undertook a review of the legislation and its practical employment, and found that no legislative changes were required (Wilkie et. al. 2006). No fundamental reforms were recommended by the Law Commission Report of 1992 either which stated that the 1954 legislation had stood the test of time (Law Commission 1992). The Department of Environment, Transport and the Regions (DETR) published a Consultation Paper in 2001 and put forward some of the Law Commission’s proposals with the ambition of streamlining the process, and making for a fairer and effective renewal process (DETR 2001). However the intention was not to overhaul the 1954 Act as it was seen to be philosophically sound legislation Haley 2006). Indeed, the main principles of the 1954 Act remain in force today. Amendments, such as the Law of Property Act 1969 and the Regulatory Reform (Business Tenancies) (England and Wales) Order 2003, do not alter these but merely relate to improvements of detail (Hill and Redman 2007).

3: Recent Initiatives and Additions

The government amended legislation in the area of business tenancies in 2003. This was achieved by invoking the Regulatory Reform Act 2001 which provides a means to amend legislation where it is intended to remove or alleviate burdens on those affected by it. The Deputy Prime Minister in his published commentary on the reform proposals stated that the Order was:

to make the renewal or termination of business tenancies quicker, easier, fairer and cheaper. It would remove certain traps for the unwary. This is particularly important for small business tenants without access to in-house professional advice (Hunter 2004: 3).


[The Government] considers the current legislative framework to be philosophically sound: the legislation aims to be fair to both landlord and tenant, while underpinning the free operation of the property market. But there is some scope for modernising the detailed operation of the law. In particular, the government proposes to remove certain anomalies that have come to light, especially those resulting in unequal treatment for the parties; to ensure that the Act’s procedures are consistent with the new civil justice system; to reduce the amount of litigation; and generally to promote a less adversarial relationship between suppliers and occupiers of commercial property (DCLG 2006: 8).

The first draft went to Parliament in 2002, but after reaching the House of Lords, concern was expressed about the provisions for the intended landlord and tenant to agree to the removal of security of tenure (‘contracting out’). As a result these provisions were modified and the Regulatory Reform Order was passed in 2003. The resulting changes were neither radical nor controversial (Furbar 2004). In summary, the changes included: (1) On receipt of notice from the landlord, the tenant making a
declaration of his understanding of the removal of security; (2) The section 25 notice setting out the landlord’s proposed terms; (3) Applications for a new tenancy; (4) The landlord’s application to end a continuation tenancy; (5) Interim rent; (6) Compensation; and, (7) Notices requiring information (see Jones 2004).

A more recent development in the area of commercial leases has been the Code for Leasing Business Premises in England and Wales 2007 (hereinafter referred to as the ‘Code’). The first Code was published in 1995, before a second edition in 2002 and a revised third in 2007. The first Code in 1995 was deemed a relative failure. However since then the government has advocated its publication and called for adherence to the subsequent Codes (Keating 2002). The 2002 Code was also considered a failure due to the lack of awareness of its content (see Fenn 2007). The 2007 Code is the result of collaboration between commercial property professionals and industry bodies representing both owners (landlords) and occupiers (tenants). The Code is designed to promote fairness in commercial leases and increase awareness of property issues ensuring that those who occupy business premises have sufficient information to negotiate the best deal they can. The Code is voluntary so occupiers should be aware that not all landlords will choose to offer Code-compliant leases. However the government has stated that it will monitor the Code and if the impact of the Code is not as desired, the government will have little choice but to legislate on the various issues, such as upwards-only rennet reviews, that the Code attempts to address (Bamford 2003). The government will be influenced on this matter by the property industry demonstrating that it has altered market practice in accordance with the spirit and terms of the Code. The Code principally involves: the negotiation of the commercial lease and giving tenants choice as to the length of term including break clauses; the behaviour of the parties during the lifetime of the lease; specific changes to investor leases in the matters of: insurance; alienation-assignment; and alterations.

To date it appears that the Code has been a relative success and has become one of the drivers of change in the commercial property market (Hughes 2008), although there remain the tension that the lack of a precedent to follow when drafting leases that are Code-compliant is a barrier to compliance, and there is perhaps a need to incentivise landlords to become Code-compliant (Pain 2008).

4: Further Analysis

The legislative change in the landlord and tenant law has a political dimension, evidenced by the phasing out of the Rent Acts and the deregulation of both residential and agricultural tenancies by stealth (see Bridge 2002). A stage has been reached where the political differences regarding the future of landlord and tenant law are minimal (Sparks 2003). In recent decades, the Law Commission has had relatively little impact on the development of law in this area, although this is understandable at a time when the complexion of the government would impact on the success of its proposals. It is long understood that the Commission faces tremendous difficulty in proposing politically contentious reforms (see Bridge 2002).

A key consideration is whether the government went far enough when formulating the Regulatory Reform Order 2003. Potential improvement can be identified in a number of areas of the legislation, for example, regarding unlawful subletting; the higher rate of compensation for disturbance under s.37 (3); rent and renewals; and the section 30
ground of opposition relating to occupation for the purpose of the landlord’s business (Martin 2004: 52-54). This ground in particular required reform, since outcomes such as the limited nature of features of compensation are likely to favour the landlord. However while there is the view that there remain a few lacunae in the law governing commercial leases, other commentators believe that legislative changes to date, coupled with the Code and economic changes in the marketplace, have removed the need for the government to invoke far-reaching changes in the reform of the system of commercial leases (Bignell 2004: 1).

Proposed legislation related with how the Code deals with flexibility of lease length according to changing business needs, is also a key consideration. In the period 2001 to 2003 there was a reported doubling of the number of grants of 5-year leases, while the number of leases exceeding 25 years declined dramatically (see Bignell 2004) a trend that continues (Van Gent 2010: 741-742). One of the key intentions of the Code is to offer flexibility to enable tenants to adapt their leasing arrangements to suit changing business needs. Tenants are beginning to prefer shorter terms due to: (1) there is no rent review and at the end of the five years the tenant can seek the market rent (which may possibly be lower than the passing rent; (2) because the lease is only for 5 years it will avoid the necessity to be registered as, under the Land Registration Act 2002, all leases over 7 years need to be registered (Reynolds and Clark 2007). The benefit of remaining unregistered is that the lease will not be subject to public inspection and parties who want confidentiality will favour this; and (3) in December 2003 stamp duty land tax was introduced. Previously leases were taxable at a percentage of one years’ rent. Now a duty of one per cent will be applied on the total rent of the entire lease on any lease worth over £150,000. Hence many tenants may seek the short-term lease to avoid making a large initial payment, and may pursue a 5 year lease with the option to extend to a further short-term lease (Moran 2007). The latter two changes have altered the market in favour of short-term leases because they have increased the transaction costs of creating long-term leases. This is a significant development on both fronts, perhaps having more of an effect in practice than the 2003 Order. In addition to this, the Code has also facilitated the easier negotiation of the short-term lease.

Another key consideration in the shaping of legislation is that of transaction costs, i.e. the costs of making and policing contracts. Ronald Coase (1937) argued that transaction costs can explain the existence of organised economic activity. Such costs can be lowered when the parties involved in creating economic activity co-operate. Douglass North (1990; 1992) has demonstrated a relationship between institutions, transaction costs, and economic performance. Duncan McLennan indicates that transaction costs can have a big impact in housing economics (McLennan 1982), while recent studies have shown that transaction costs in housing can have a huge impact in residential mobility (Van Ommeren and Van Leuvensteijn 2005) and real estate markets (Jaffe 1996). The UK government has aimed to reduce transaction costs incurred by the setting of terms in business leases by introducing rules that have a greater degree of flexibility, ensuring both parties have full information, and promoting co-operation in decision-making, thus the 2003 Order, combined with the Code, is likely to simplify and streamline the system and encourage parties to negotiate before incurring legal expenses, lowering transaction costs (see Murch 2004; Webster and Lai 2003: 10).
Within this context it is unnecessary and indeed counterproductive to introduce new legislation, and should remain so until there is evidence that the system, the 2007 Code and the current legislation is becoming costly and inefficient. Ensuring that the rules are simple is crucial, to enable both landlord and tenant to be fully informed so that inefficiency and, consequently, inequality can be eradicated in the area of business tenancies. At the end of the 1990s reform was required of some areas of landlord and tenant law in order to simplify the process (Sparks 2001). The UK government at the time agreed (see DETR 2000) by introducing the Code and inserting appropriate detail into the legislation to this effect so that the Code would be able to increase flexibility in the marketplace, with the aim of aiding retailers to in job creation, increased productivity and economic growth (see Keating 2002), although, equally, it might be argued that it is perhaps little more than a political pacifier to avert more legislation, rather than aiming to achieve a truly balanced relationship between landlord and tenant, but it is, as yet too early to tell (see also Samson 2008: 60-61).

5: Conclusion

In the UK there remains the view that housing problems are the responsibility of government and that leveraging change and resources through government policy has been the ethos of collective stakeholders – and government – through periods of very different types of housing strategy decision making within the UK, from direct provision to income related or supply side. In contrast, with commercial property there is a very different, market oriented, perception of responsibility and a political reluctance to legislate from governments of different persuasions. This is reflected in the relative frequency with which the different statutory codes have been subject to change over a considerable time.

Wouter van Gent argued recently that housing policy should not be taken at face value but considered within the context of a government’s strategies in developing specific relationships between the state, market and households (Van Gent 2010: 750; Haynes and Rhodes 2004). The counterpoint to this is that policy for the commercial sector, in the UK at least, reflects considerable stakeholder consensus about the limits of state intervention – and market “interference” – beyond ensuring that there is a stable legislative and monitoring framework, appropriate for a wide range of business types. If indeed the difference in the perceived need to intervene between the two types of lease reflects the inherent politicisation of property – the need to be seen to have a clear policy to address “the housing problem” coupled with the need to be seen as active only in the removal of obstacles for small business – then the rationale for further legislation will not depend on policy makers wishing to deliver efficient policy, but rather in reacting to the changing strategic importance of emerging blocks of interested parties. Such interests have historically changed more rapidly in the area of housing than in the commercial sector, and are reflected in the relative frequency of modification to the respective legal frameworks (see Rhodes et. al. 2011: 40-77).

In this way, housing policy reflects, and is will continue to reflect, the assemblage of markets and submarkets for housing as both a capital and consumer good, with a broad range of constituencies reflecting the tenure, location, size and quality of their current house/s, their aspirations and related demographic changes. The perceived need to modify housing legislation will reflect the complexity of the relationship
between competing interests and the dynamic nature of the interdependencies between its component features, including the need to mitigate risk and create informed actors, even if a simplification of the legislation and rules, aimed at reducing transaction costs to both landlord and tenant, may achieve improved economic efficiency and have other positive outcomes (Van Ommeren and Van Leuvensteijn 2005).

On the other hand, this paper argues that in the commercial sector, clarifying and simplifying a compendium of rules, such as the Code, is likely to have greater benefits than a more nuanced approach to developing legislation, for example in being able to reduce transaction costs for small businesses. Support for small business has been one of the basic aims of successive UK governments and developing the Code within a self regulated market framework, has put in place a defence mechanism for businesses who do not have the same access to lawyers, be they in-house or otherwise (Webster and Lai 2003). Minimising and simplifying legislation in order for the commercial lease to be utilised and regulated is also a preferable option, reducing the threat of transaction costs incurred in resolving disputes caused by a lack of legal rule and consensus. At present, the combination of legislation and voluntary code encourages the drafting of efficient, commercial leases that are able to respond to economic and business conditions. The trade off between the benefits of simplicity and those of a more tailored approach mean that the issue of legislating leases will remain a fundamentally political decision, rather than a necessarily ideological one.
References


