solicitors@risk

ZURICH®

Welcome

Andrew Nickels

It's Spring – the time of new beginnings and growth. Which is why, this month, we are looking at break clauses – for landlords and tenants, it's the opportunity to cut ties and move on. Unfortunately, the drafting of break clauses and the exercise of them are a constant source of professional negligence claims; in the main, it's landlords taking advantage of errors to keep tenants in situ. Also, in this issue, a quick word of warning to all commercial property lawyers about new Capital Allowances legislation, two interesting landlord and tenant cases and a reminder of the change to manorial rights.

Commercial property – current issues

Capital Allowances – new legislation from April 2014

From 1 April 2014, new legislation introduces the "mandatory pooling" of integral fixtures and fittings for Capital Allowances purposes. The seller will have to produce a schedule and a valuation of all integral fixtures and fittings. If a figure cannot be agreed, both parties have two years to apply to HMRC for a first tier tribunal to settle the dispute and confirm a figure.

Answering "not applicable" or "not as far as the seller is aware" in replies to standard enquiries relating to Capital Allowances may come back to haunt you and your client in the future. Why? Because under the new legislation, if Capital Allowances are not claimed at the point of sale they are lost forever, and this could amount to considerable financial losses (by way of tax relief) for your clients.

You may not be tax experts and you may have a disclaimer to this effect in your terms of business, but with the new legislation, it will be important to ensure your client takes advice from an appropriate expert. You will also have to reconsider your replies to any enquiries raised in relation to Capital Allowances.

Break clauses – getting it right

Break clauses are not exclusive to tenants; landlords sometimes insist on a break clause. Whilst we refer to tenants exercising breaks throughout this note, most of what we say applies equally to landlords.

In a harsh economic climate, a break clause can be a godsend to a tenant who is struggling. Exercised properly, it will enable the tenant to bring its liabilities under its lease to an end. Disputes relating to the exercise of break clauses increase in difficult economic times, but as the market improves, so too do tenants' choices – they may want to expand their business and require larger premises; they may decide to go fully online and no longer need their retail premises; there may just be a better deal to be had elsewhere.

When instructed by a tenant to break a lease, the pressure is on to comply with the precise requirements of the break clause. By the time you have the lease to hand, you might not have long to advise the tenant client of what action it needs to take to comply with any pre-conditions and also to serve the notice. Get it wrong and your tenant client could be locked into a lease for years, either to the end of the Lease term or until another break option becomes available, if at all. Alternatively, it may have to pay a substantial premium to the landlord to accept a surrender of the lease; expensive for the client, and for you, if the inevitable professional negligence claim is made.

A tenant wishing to exercise a break may not always be good news for a landlord. The rental stream will end and a new tenant will need to be found. When acting for a landlord who receives a break notice, you should be looking at whether it complies strictly with the requirements of the lease, including whether any conditions precedent have been met.

Drafting

The Commercial Lease Code 2007 (use of which is voluntary, but serves as a useful tool for assessing best practice) recommends that the only pre-conditions to the exercise of a break clause should be that the tenant:

- Is up-to-date with the main rent
- Gives up occupation
- Does not leave behind any continuing subleases.

Some commercial property lawyers argue that there should be no pre-conditions whatsoever, particularly if, for example, the only subleases in place are those to which the landlord consented. The landlord can demand any outstanding sums, costs of repairs, etc from the tenant if the tenant has failed to comply with all its obligations but this should not prevent the tenant from exercising the break. The Code position (above) is probably an acceptable middle ground, at least for judging whether a solicitor has complied with his or her duty of care. If your tenant client accepts a greater burden by way of pre-conditions, you must advise it in writing of the risks.

Claim example

The tenant has served the 12 months notice required by the break clause but new solicitors have advised the tenant that, as the break is conditional on compliance with the terms of the lease, the insured, who acted for the tenant on the grant of the lease, was negligent in agreeing a break clause on those terms without advising the tenant of its effect. No trace of any advice/report to the tenant can be found. As the lease was granted in 1995, it is arguable that such conditional breaks were commonplace at the time and the insured was not negligent. However, although much will turn on the landlord's attitude at the end of the notice period, the tenant is being advised in the meantime of the practical steps to take to try and avoid any problems with the landlord. These include ensuring rent and service charges are paid on the due date, decoration is up-to-date or dilapidations are agreed, vacant possession can be given, etc.

CONTINUED

Payments

If the break clause requires payment of other sums, such as insurance, rent, or service charges, and there is a dispute as to what sums are due, the tenant may be advised to consider paying the sums demanded to avoid the landlord using non-payment to frustrate the operation of the break. The tenant may then seek to recover what it considers to have been overpayment, after the break notice has been served/accepted or the lease has come to an end, (whichever is the most appropriate).

Where a break notice takes effect between rent days, unless the lease specifically states otherwise, the tenant should still pay the rent for the full period rather than paying rent only up until the date of the break. Otherwise, the landlord may argue that the tenant has not paid the full rent as required by the lease, is in breach of condition and cannot, therefore, exercise the break clause. However, unless the lease provides for repayment in such circumstances, there is no general legal right for a tenant to be refunded any rent that relates to the period after the break date.

With both service charges and rent, the decision on whether to pay the full amount must be the client's. What you must make clear to the client is that, if it does pay, there is no guarantee that it will be able to recover any element of the disputed service charge or any pro rata rent payment. You must also make clear, however, the risk that, in not paying, the client may not be able to exercise the break clause. It's not your job to make the decision, just to make sure that your client fully understands the options and implications. Before breaking the lease, the tenant should ask the landlord for a statement of the amounts the landlord claims are outstanding, so that no sums will go unnoticed. Beware of late interest payments, however.

The case of **Avocet Industrial Estates LLP v Merol Ltd and another company** [2011] EWHC Ch 3422 muddies the waters. A standard clause in a commercial lease obliging the tenant to pay interest on late payments "whether formally demanded or not" was used successfully by the landlord to invalidate a break notice served by the tenant. The break was conditional on payment of all sums due under the lease up to the break date, and, although the interest payments had not been demanded, they were due and the break notice was held to be invalid. This is a trap for tenants: Beware!

Last month we reported that the appeal in the case of **Mark and Spencer plc v BNP Paribas Securities Trust Company (Jersey) Limited** [2013] EWHC 1279 (Ch) is due to be heard in late March 2014, (provided it doesn't settle before then). For the first time, the High Court held that the landlord was under an implied obligation to pay back to the tenant the balance of the quarter's rent, service charge and insurance monies where the tenant's break date fell part way through that quarter. The landlord has lodged an appeal. Until the appeal is determined, it could well be regarded as negligent to rely on the first instance judgment and to pay no attention to the rent payment requirements. When acting for a tenant on the grant of a new lease, you should seek to ensure that, in order to exercise a break, the tenant need only pay sums due up to the break date or, at the very least, the landlord is obliged to refund any over-payment for the period following the break date. If you cannot secure a break clause on these terms for your tenant client, ensure your client is fully apprised of the implications.

Pre-conditions to the exercise of a break should not be accepted by a tenant in a new lease. However, if they exist in a current lease, payment patterns will need to be analysed and interest paid accordingly if a repeat of the **Avocet** scenario is to be avoided. If your client is taking an assignment of a lease containing a conditional break clause, make sure you fully advise them of the practical implications.

CONTINUED

Other pre-conditions

Conditions that a tenant has complied with all the repairing obligations in a lease are often expressed in absolute terms and are usually strictly enforced. If a lease requires the tenant to paint the interior in the last 12 months of the term, the landlord is likely to succeed in frustrating the break if the tenant redecorated, say, 1 4 months before the end of the term.

In older leases, an obligation requiring 'material' or 'reasonable' compliance with lease obligations may not be favourable to a tenant if the landlord wishes to be difficult. Deciding whether compliance is material or reasonable often causes conflict between landlords and tenants.

Some break clauses require the tenant to make an early termination payment to the landlord, usually before the break date. Payment on the day will not suffice. This has caught out many a tenant and solicitor. Read the lease carefully and ensure your client knows what sum is due, when and how to pay (a cheque is not usually acceptable). Make sure you know who is taking responsibility for the payment being made.

It's advisable to check all the terms of the lease, and any supplemental documents, to consider whether there is any scope for the landlord to argue that the tenant is in breach of any provisions. It may be that the best that you can do is to make tenant clients aware of the strict interpretation of any conditions precedent and of the fact that the tenant should make the best possible preparations to comply well in advance of the break date.

CONTINUED

Dates

It is important to ensure the correct dates are inserted in the break clause either at the drafting stage or when the dates are inserted in manuscript on completion of the lease. Are the dates intended to tie in with an anniversary of the term commencement date, a rent review date, or another date? It is essential you get this right.

Claim example

The dates in the break clause hadn't been inserted on completion and the tenant served a break claiming that the lack of a date meant it had a right to break at anytime. A tenant taking advantage? Absolutely. Worth going to court over? The rent was £10,500 per year and the tenant sought to break two years before the end of the term, so "No", it wasn't worth going to court. The negligence claim against the solicitors was settled; a disappointing scenario, given that the claim could have been avoided had the firm used a simple checklist to ensure the dates had been inserted in the lease prior to or at completion.

When inserting dates in a break clause, check the actual day that the date falls on. Try not to use a date that is a weekend or a bank or public holiday, as it impossible to serve a notice on those dates. If you are faced with a lease with a break date that is a weekend, for example, you must serve the notice early. Why have the worry and stress of serving a day late and waiting to see if the landlord accepts it?

Get the date wrong when purporting to exercise the break and it will be fatal for your client and you; a claim is all but inevitable. The cases on this point are numerous and you must ensure that all your fee-earners are up-to-date with recent decisions and that new fee-earners are properly supervised. Understanding the difference between the term commencing "on" a certain date and running "from" a certain date can be the difference between a last minute notice being valid or invalid.

Claim example

The Insured were instructed to operate the break clause which was exercisable six years from the date of commencement of the lease. The fee-earner misunderstood the break clause and calculated the six year period from the date of the lease which was seven months later than the term commencement date. The tenant instructed new solicitors who negotiated a surrender of the lease for £69,503.31. The tenant claimed the surrender amount and fees from the Insured.

Claim example

The Insured gave advice to a tenant on the break provisions of a lease. The fee-earner entered 21 August 2013 in the firm's diary as the date by which a break notice had to be served. The fee-earner later received instructions from the client to exercise the break, the email from the client stating incorrectly that the deadline was 29 August 2013. The fee-earner had a heavy workload and passed the file to another fee earner, failing to point out the mistake in the client's email. The fee-earner who took over the file relied on the client's instructions; he did not look at the file, the lease or the electronic diary until after 21 August 2013, when, to his horror, he realised that the break date had been missed. The tenant client was locked into the lease for six years until another break right became available and claimed £375,000 from the Insured in respect of rent payable for this period.

CONTINUED

Identity of parties

When serving a break notice there are several fundamental points to get right. The most important of these are making sure that you prepare the notice on behalf of the right party and that you serve it on the right party. This may be self- evident, but the number of times it all goes pear-shaped confirms that, in some cases, it can be a real challenge.

The starting point must always be the lease. Is the break clause expressed to be personal to the original tenant, a specific group (for example, a named tenant or any group company) or another entity? It may not be the individual/ entity you have received instructions from. Remember a break clause may be varied by a deed of variation or another document supplemental to the lease.

Unless there is anything in the documents expressly to the contrary (such as the examples referred to above making the break clause personal), the benefit of the break clause passes on assignment to the new tenant, whether or not the lease defines "the tenant" as including successors in title.

Claim example

The Insured dealt with the assignment of a lease from ABC Limited to Company XYZ Limited, a group company of ABC Limited. Four years later, ABC instructed the Insured to exercise the break clause. The fee-earner removed the file from storage but failed to review all the documentation and missed the fact that the lease had been assigned to XYZ. He served a break notice on behalf of ABC, but the landlord refused to accept this, as the break hadn't been exercised on behalf of the current tenant as required by the lease. By that time, it was too late to serve a notice on behalf of XYZ. Getting out of the lease didn't come cheap. XYZ had to pay the landlord £190,000 to accept a surrender, which XYZ in turn claimed from the Insured.

Claim example

The Insured acted for a tenant, DEF Limited, on the assignment of a lease to a company within the same group, UVW Limited. A few years later UVW instructed the Insured to exercise the break clause. The landlord rejected the break notice as invalid; the lease stated that the break clause was personal to "the original tenant, DEF Limited, only". The Insured had failed to advise DEF at the time of the assignment that the benefit of the break clause would be lost, and the claim made against the Insured had to be settled.

It isn't always the identity of the party with the benefit of the break clause that causes headaches. The identity of the party on whom to serve the notice can sometimes be problematic too.

Claim example

The Insured was instructed by a tenant to exercise a break clause. The fee-earner assumed that the landlord named in the lease was the current landlord and served the break notice on that company. In fact, that landlord had assigned its interest under the lease. The notice was invalid. In response to the resulting negligence claim from the tenant client seeking the costs of surrendering the lease, the Insured admitted that it should have checked the identity of the current landlord, both by asking the tenant client and by carrying out a land registry search. The cost of the omission: £102,409.

CONTINUED

Contents of Notice

Ensure any notice you prepare on behalf of a business tenant to operate a break clause complies with the express requirements of the clause.

In Friends Life Ltd v Siemens Hearing Instruments Ltd [2014] EWCA Civ 382, the break clause stated that any notice to exercise the break clause "must be expressed" to be given under the Landlord and Tenant Act 1954 s.24(2). The tenant served notice of its intention to terminate the lease within the appropriate period and in compliance with the clause in all other respects, but did not expressly refer to s.24(2) of the Act. The Court of Appeal held that the purported exercise of the option to break failed to satisfy both the formal and substantive provisions of the clause and was therefore ineffective!

Service

When you are deciding to whom to address the notice, and where to send it, check the break clause for any specific service requirements, and then the general service provisions in the lease (and any relevant supplemental documents). Any mandatory requirements for service must be complied with. Otherwise, the notice will be invalid. If the lease is silent on service, you may be able to serve under section 196 of the Law of Property Act 1925 which allows service by registered post. But check the lease first. Don't assume that the Act applies.

If the lease requires service at the registered office – always check the up-to-date address at Companies House.

Keep a record as to when and how you serve the notice – you will have the evidence in the event that service is challenged.

Notices are usually served on the landlord under leases and statute. However, in the 2010 High Court decision in **Hotgroup plc v Royal Bank of Scotland plc (as Trustee of the Schroder Exempt Property Unit Trust)**, a lease required a notice to be served on the property manager as well as the landlord. The notice was served in good time on the landlord but no notice was served on the property manager. The court held that the notice was invalid, despite the fact that the landlord had received the notice and therefore was not prejudiced.

Claim example

The Insured acted for one of its biggest clients on the exercise of a break clause. The lease required the notice to be served at the landlord's registered office. The fee-earner dealing with the matter served the notice on what they thought was the registered office, but after contacting the landlord who denied receiving the notice, they carried out a company search. Surprise! Surprise! The landlord had moved to a different registered address three years previously. The landlord demanded one years' rent plus other costs, in total amounting to £57,000, to accept a surrender of the lease. The client claimed this amount from the Insured, and if that wasn't bad enough, it also informed the Insured that it wouldn't be instructing the firm again!

CONTINUED

For your break notices to be effective:

- Read the lease and any supplemental documents
- Identify the rights of all the parties under the lease
- Advise your client of conditions precedent
- Communicate clearly with clients and colleagues
- Get the contents of the notice right
- Get the date right
- Serve the notice in accordance with the requirements of the lease

Recent landlord and tenant cases

Guarantor – release

In Topland Portfolio No. 1 Limited v Smiths News Trading Limited [2014] EWCA Civ 18, the Court of Appeal upheld the High Court decision that a guarantor was released from its obligations under a lease when it was not a party to a subsequent licence for alterations permitting structural works to be carried out that would not otherwise be permitted by the lease. The guarantor had not consented to the works either. Whilst some leases may have protective wording in the guarantee provisions (such as confirming that the guarantor will not be released in certain situations), it is preferable to make the guarantor a party to any supplemental document to avoid any doubt.

Administrator – obligation to pay rent

Video retailer Game went into Administration in March 2012. The administrator continued to trade from some shops and closed others. The Court of Appeal held that rent is due on a daily basis for the entire period during which the administrator trades from the shop as an **administration expense** (payable in priority to unsecured debts). It is not affected by the date on which the administration began – perhaps bringing to an end the practice of administration beginning on the day after a rent payment date to avoid paying rent for the current rent period, as previously the rent payable in this situation would have been an administration debt rather than an administration expense.

Manorial Rights – register or lose them

From 13 October 2013, manorial rights must be protected by registration against the affected title. Such rights (e.g. the Lord of the Manor's sporting rights, rights to mines or minerals, etc) remain binding against the current owner as an overriding interest even if not registered, but are lost on a purchase for valuable consideration without notice, i.e. if not registered. The Land Registry is wading its way through the many applications it has received, so be ready to offer your clients advice if a unilateral notice is registered against their property. If you have any clients likely to have the benefit of such rights, you will presumably have offered them advice on how to protect their position, but if not, you'd better do so now.

CONTINUED

Who to contact

solicitors@risk

Editor: Andrew Nickels
Telephone: 0207 648 3698
Email: riskman@uk.zurich.com

Sales

Telephone: 0845 606 3322
Sales fax: 0845 600 4036
Claims helpline: 0845 600 4035
Claims fax: 0845 600 4034

Zurich Financial Lines

London Underwriting Centre,
Third Floor, 3 Minster Court,
Mincing Lane, London
EC3R 7DD

www.zurichprofessional.co.uk

The material contained in @risk is issued by Zurich and does not establish, report or create the standard of care for solicitors, nor does it represent a complete analysis of the topics presented or constitute legal advice. It is intended to highlight issues which may be of interest to our customers. Readers should conduct their own appropriate research on how to act in any particular case.

Zurich Insurance plc. A public limited company incorporated in Ireland Registration No. 13460.
Registered Office: Zurich House, Ballsbridge Park, Dublin 4, Ireland. UK branch registered in England and Wales.
Registration No. BR7985. UK Branch Head Office: The Zurich Centre, 3000 Parkway, Whiteley, Fareham, Hampshire PO15 7JZ.
Zurich Insurance plc is authorised by the Central Bank of Ireland and subject to limited regulation by the Financial Conduct Authority.
Details about the extent of our regulation by the Financial Conduct Authority are available from us on request. These details can be checked on the FCA's Financial Services Register via their website www.fca.org.uk or by contacting them on 0800 111 6768.
Our FCA Firm Reference Number is 203093.

Copyright © Zurich 2014. All rights reserved. Reproduction, adaptation, or translation without prior written permission is prohibited except as allowed under copyright laws.

710512052 (04/14) RRD

ZURICH