MAINLY FOR STUDENTS

In today's economic climate, landlords are likely to seek to oppose a tenant's request to break

Tenants need to obtain expert advice on their obligations under the lease at an early stage

Reach breaking point

Complete covenant compliance and break clauses are an explosive combination. *Simon Edwards*, *Patrick Stell* and *Keith Firn* explore the bombshells that a tenant may face if it is slow to check its lease

As the commercial property market weakens and the demand for office, retail and industrial accommodation decreases, tenants are seeking to escape their leasehold obligations. Often, the best way of achieving this, usually at no cost (unlike a lease surrender), is for the tenant to exercise a break clause in its lease.

A tall order

Such clauses require the tenant to pay all the rent, service charges and insurance sums up to date before the break date and to give vacant possession on that date. They also oblige the tenant to have complied with all the other lease covenants.

Initially, this requirement may not appear to be of great concern to the tenant. However, when the tenant realises that it is obliged to hand back the building in full repair, decorated in accordance with the lease provisions and having had any alterations (including partitioning and building services) reinstated, it may find that compliance with these obligations will prove difficult. In some circumstances, the tenant may find it almost impossible to achieve the requisite break covenant performance standard.

All too often, tenants discover that they are unable to ensure that the building is in full repair, decorated and with all the alterations reinstated prior to the break date. This is particularly so if they have not planned sufficiently in advance to carry out the works.

A tenant's difficulty in achieving complete covenant compliance is beneficial to landlords in a falling market. Understandably, a landlord will not want to have void periods. Thus, if it can prove that its tenant did not hand back the premises in accordance with the lease obligations, it may be able to thwart the break.

Recent case law

Case law on complete covenant compliance clauses (CCCCs) has evolved significantly in the past 20 years, although only a handful of cases have been heard on the issue. This may be due to a combination of the parties not needing to litigate and the fact that many disputes of this type are settled by negotiation and so will not come into the public domain via the courts.

A case from 1992 illustrates the problem that a tenant faced when it sought to exercise its break and how a technical non-compliance with the precise wording of the lease thwarted its right to break.

In *Bairstow Eves (Securities) Ltd* v *Ripley* [1992] 32 EG 52, the tenant had painted the premises just before the start of the final year of the term. However, the lease stated that the premises had to be painted within the last year of the term. The court held that the terms

of the break had not been met, despite the fact that there was no practical difference between the timing of the date at which the works were carried out and when they were obliged to be carried out under the break clause.

The first notable case on CCCCs was *Reed Personnel Services plc* v *American Express Ltd* [1997] 1 EGLR 229. There, the tenant was obliged to "pay the rent reserved and reasonably perform and observe the covenants". The court held that the tenant had breached the repairing covenants and refused the break on the ground of disrepair.

The judge looked at the meaning of the word "reasonably". He considered that the tenant had not acted reasonably in complying with the repair covenants in the lease. Although acknowledging that the tenant did not have to comply fully with those covenants, he held that it had not attempted even a reasonable performance of them.

The next important case was *Commercial Union Life Assurance Co Ltd* v *Label Ink Ltd* [2001] L&TR 29. The lease stated that the tenant could break the lease so long as there "shall not be a material breach of the covenants on its part herein contained".

The judge defined a "material breach" as one that was material having taken account of all the circumstances and considered whether the breach of the lease covenants was such that it would be fair and reasonable not to permit the tenant to break its lease. The judge held: "The extent of any breach, the practicality of quantifying any damage arising out of it, the efforts made by the tenant to avoid it, the genuine interest that a landlord had in strict compliance are, in my judgment, all material factors in determining materiality."

That approach has since been reviewed and a slightly different emphasis has been put on the appraisal of material compliance (see below). However, in this particular case, the judge determined that the tenant could not break the lease; ironically, not because of the state of repair of the premises but because the rents had not been paid up to date on time, thus highlighting the important point that tenants have to comply with all covenants in the lease.

Interesting case

Perhaps the best-known case followed in 2005, when the *Financial Times* wanted to break its lease of office and industrial/storage premises close to the City of London.

Fitzroy House Epworth Street (No 1) Ltd v *The Financial Times Ltd* [2005] EWHC 2391 (TCC); [2006] 02 EG 112 came to the High Court following the *FT*'s decision to exercise its option to break its lease and the landlord's view that the premises were not returned in "material compliance" with the lease covenants.

The trial judge considered the relevant cases, including *Commercial Union*, and held that the tenant could break the lease because the breaches of the lease that had not been remedied before the break date were not ones that could be perceived as being "material".

The landlord appealed and, in 2006, the case came before the Court of Appeal: [2006] EWCA Civ 329; [2006] 19 EG 174. It agreed that the outstanding breaches were not material for the purposes of breaking the lease. However, the three Court of Appeal judges held that the methodology adopted by the trial judge in *Commercial Union* was not correct.

In fact, one went as far as to state that the word "material" may have a number of meanings, "but what is fair and reasonable is not one of them". "Material" was held to relate to "the ability of the landlord to relet or sell the premises without delay or additional expenditure".

What is interesting in this case is that the Court of Appeal held that, in its view, the trial judge had assessed the lease requirements incorrectly, but had achieved the same result as the one it had reached.

A further interesting point is that the Court of Appeal concluded that, contrary to the trial judge's original view, the landlord's lack of response to the tenant's queries could not be criticised. This leads to a situation whereby landlords can reasonably decline to respond to tenant requests for guidance and clarity on how they should return the premises on break dates. This is understandable from the landlords' point of view because a successful break action may have negative financial consequences that they will want to avoid.

Do the CPR apply?

Some question whether this non-co-operative approach could be contrary to the overriding objective of the Civil Procedure Rules (CPR). This requires parties to a dispute to co-operate. Others, though, point out that, arguably, the CPR do not apply at the pre-break stages because there is no legal cause of action until the attempted break date has passed.

Further interpretation of this issue has not been tested in the courts. When this happens, it will interesting to establish whether the courts consider that the CPR apply in the usual way to pre-break conduct.

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Why this matters

In today's market, a landlord may seek to oppose its tenant's request to break its lease. This means that tenants must continue to pay the rent, service charge and other liabilities until the end of the lease, even if the premises are vacant. If the tenant vacates, it will be faced with now less generous void business rating liability until it can assign or sublease or negotiate an expensive surrender deal.

The wording in break clauses can often go unnoticed until the tenant considers whether or not to break its lease. When entering into the lease, the tenant may not have been aware of the precise wording of the break clause or of the revisions made to it by the landlord's solicitor.

When seeking new premises, tenants will usually be concerned with the main details such as rent and lease length, and will overlook the precise details of exercising a break clause at a future date. Break clauses containing CCCCs are problematic and can lead to litigation involving many millions of pounds. A landlord, knowing that a tenant's lease contains onerous requirements, may insist that the tenant carries out all the repair, redecoration and reinstatement obligations prior to the break date, in the knowledge that this will be impossible and that the tenant is likely to make an attractive offer to settle the matter to enable the break to go ahead.

Disputes concerning CCCCs are likely to become more commonplace in the current economic climate. Landlords and tenants should therefore be wary of the obligations that CCCCs impose on tenants. Phrases requiring substantial or material compliance of the tenant's lease requirements warrant scrutiny well in advance of an attempt to break a lease. Such phrasing will often lead to disputes between parties, where the cost consequences for an incorrect interpretation or performance of obligations can incur significant costs. CCCC obligations may take up to a year to carry out, so expert advice is required at an early date.

Further Reading

Case in point – Dilapidations
Hunter J, RICS Books

Dilapidations and Service Charge Disputes – A Practical Guide
Edwards S, Stell P and Firn K, EG Books

West & Smith's Law of Dilapidations
Smith PF (11th ed) EG Books