BREAK CLAUSES – AN UPDATE

Katharine Holland QC

Landmark Chambers

The need for strict compliance with conditions for exercise of a break clause

1. In *Legal & General Assurance Company Ltd* v *Expeditors International (UK) Ltd* [2007] 2 P&CR 10, Lord Justice Lloyd stated:-

> "in general, conditions attached to a break clause, as with any other option provision, must be strictly complied with, so that even a day's delay in giving vacant possession or a shortfall in the payment of rent of a few pounds would be fatal"

2. The recent cases on break clauses have done nothing to undermine this principle. As Lord Justice Lewison observed in April of last year in *Siemens Hearing Instruments Ltd v Friends Life Ltd* [2014] EWCA Civ 382:-

> "If you want to avoid expensive litigation, and the possible loss of a valuable right to break, you must pay close attention to all the requirements of the clause … and follow them precisely"

Conditions relating to compliance with covenants

3. The principles relating to strict compliance continue to be demonstrated most strongly in relation to the interpretation of break clauses which are conditional upon compliance with the covenants. The traditional principle continues to be followed,

namely that where a break clause is absolute in its terms, even minor or trivial breaches will deprive the tenant of the ability to break the term.

4. A recent example is provided by *Sirhowy Investments Ltd v Henderson* [2014] EWHC 3562, where the tenant's attempt to break a lease failed on the grounds that they had not kept their fencing in proper repair because they had patched holes in it with sheeting rather than making repairs which were consistent with the fencing that was there.

5. A recent Scottish case also demonstrates the importance of ensuring that there is the appropriate standard of compliance with covenants upon the dates referred to in the break clause. In *Arlington Business Parks GP Ltd v Scottish & Newcastle* [2014] CSOH 77, the break clauses stipulated that the tenant should not be in breach of any of its obligations "as at the date of service of such notice and/or the termination date". The tenant admitted that it had not fully performed its repairing obligations on the date of the service of the notices. However, after the service of the notice and before the break date, it had spent as much as £1.3M on the premises, in order to ensure that they were in appropriate repair on the break date. This was not good enough. The Outer House of the Court of Session ruled that there had to be compliance with the covenants as at the date of the service of the notice. It accepted the argument of the landlord that such a condition in the break clause was there to ensure that the landlord could market the premises in proper repair during the 12 month notice period. Having failed to ensure that this was the case, the lease continued.

Conditions requiring vacant possession

6. It is common for break clauses to be drafted so as to be conditional upon vacant possession being given on the termination date and in such cases failure to provide vacant possession will invalidate a purported break. Surprisingly, there have not been many recent cases on this type of condition in relation to break clauses. This is particularly surprising given the uncertainty that continues to surround the meaning of

the term "vacant possession". However, in the most significant case in recent years on this topic, *NYK Logistics (UK) Limited v Ibrend Estates BV* [2011] EWCA Civ 683, the overall approach of the Court at first instance and the Court of Appeal did not to display a generous approach to tenants in such circumstances. The landlord's argument, to the effect that the continued presence of the tenant's workmen and security staff and also some items of the tenant's property meant that vacant possession had not been given, was the successful argument. Lord Justice Rimer considered that the "the only safe course" was to move everything out and to deliver the keys to the landlord.

Conditions relating to payment

7. Most commonly, break provisions make the exercise of a break conditional on payment of all rent due on or before the termination date. Often, a break clause may be exercisable on or immediately after a rent payment day, even if the rent is payable quarterly in advance. Where rent is payable in advance, it is not apportionable under the Apportionment Act 1870: *Canas Property Co. V KL Television Services* [1970] 2 QB 433. An express term will need to be found in the lease for a tenant to have to pay only the apportioned part. However, such terms are usually few and far between. This principle has been resoundingly affirmed by the Courts in a number of recent cases.

8. A very detailed consideration of the point was undertaken by Mr Justice Peter Smith in *PCE Investors v Cancer Research* [2012] EWHC 884 (Ch). In that case, the tenant served a break notice but did not pay the full amount of the quarter's rent falling due on the quarter day prior to the break date but only an apportioned part. Mr Justice Peter Smith first considered the wording in the lease to the effect that the rent was *"payable by equal quarterly payments in advance on the usual quarter day in every year the first such payment to be made on the Rent Commencement Date and to be in respect of the period from and including the Rent Commencement Date until the next following quarter day"* and the fact that the Break Clause required the *tenant "[to] have paid rents reserved and demanded by this Underlease up to the Termination*

Date and by the Termination Date". On the strength of this wording, Mr Justice Peter Smith was willing to find on a summary judgment hearing that there was no reasonable prospect of the tenant successfully arguing that payment of the full quarter's rent was not a condition precedent to the effective operation of the break clause. He said:-

> "That was payable in advance and on that day it could not be certain that the lease would terminate on the Termination Date. There is a commercial and sensible certainty in requiring all obligations to operate until the very date of termination but not be retrospectively changed if an early termination occurs. For the Tenant to succeed it seems to me that the obligation to pay rent on the September Quarter Day as contended for by it requires the Underlease to be rewritten to include a variation of covenant 4.1 of the tenant's covenants to read *"to pay the yearly rent as reserved herein ..... unless this Underlease is subsequently terminated after the days when rent was payable in advance."* I can see no justification for any such rewriting of the Underlease. There is no ambiguity and no difficulty in my view"

Permission to appeal in the PCE case was granted by Lord Justice Lewison but the matter did not reach the Court of Appeal.

9. The point was the subject of further review in the case of *Canonical UK Ltd v TST Millibank* LLC [2012] EWHC 3710. The break clause permitted the tenant to terminate its lease on six months' notice if it paid the rent "up to and including" the break date and an additional reverse premium equivalent to one months' rent. The tenant paid the rent that fell due on the quarter day prior to the break date. However, it neglected to pay the reverse premium. The tenant had agreed to pay rent *"yearly and proportionately for any part of a year"* and so it as argued that the rent was only payable up to the break date and not beyond. On the basis of this argument, the tenant claimed that it had overpaid the landlord and that the balance of the overpayment should be treated as part of the reverse premium – such that the conditions for the effective exercise of the break had been met and the landlord was actually in credit in the sum of about £12,000. Mr Justice Vos held that the words *"proportionately for any part of a year"* could not be taken as reducing the rent otherwise payable after a break notice had been served just because the lease might end in the middle of the

quarter. Mr Justice Vos pointed out that although such an outcome might seem harsh on the tenant, in reality, it should not be regarded as harsh because the meaning of such clauses was reasonably well-known.

10. The question sometimes arises of whether there is anything in the communications between the parties which affects the liabilities of the tenant in relation to pre-conditions in a break clause. It is relevant in this regard to note the judgment of Mr Justice Morgan in *Avocet Industrial Estates LLP v Merol Ltd and another* [2011] EWHC 3422. In that case, the claimant was the landlord and the first defendant was the tenant under a lease for a term of 10 years from February 2005. In March 2010, the tenant purported to break the lease. The landlord asserted that the tenant had failed to comply with the conditions for an effective break, including that, by the break date all payments due under the lease had to be paid. In relation to this argument, the landlord contended that the tenant had persistently paid rent and other sums late, such that it still owed outstanding sums of default interest on the break date. Mr Justice Morgan had to deal with an estoppel argument which was raised on behalf of the tenant to the effect that the landlord had a duty to speak out and to tell the tenant that it owed default interest, such that the landlord's failure to inform the tenant of this amounted to a representation that the tenant did not owe default interest.

14. In considering this argument, Mr Justice Morgan clearly took the view that there could be circumstances where such an estoppel argument might succeed. At paragraph 99 of the judgment, he said:-

> "Did the landlord know at any point before the end of 17th March 2010 that the tenant's belief was wrong because the tenant owed Default Interest to the landlord? If I were able to hold that the landlord did know that matter, then I would hold in the same way as was held in The Lutetian that the landlord cannot take advantage of the tenant's mistake which at the time the landlord knew that the tenant was making, Whether one calls it an estoppel by representation through silence or an estoppel by acquiescence may not matter. In such a case, I would hold that the landlord is estopped from taking advantage of the tenant's mistake".

11. Nevertheless, on the facts, Mr Justice Morgan held that the landlord was not estopped from asserting the tenant's non–payment of default interest by reason of any failure to correct the tenant's mistaken belief that it did not owe any sums under the lease. He held that it was not possible to find, on the evidence, that the landlord had known that the tenant was mistaken in its belief or had had such a degree of suspicion of that matter as to amount to "blind eye" knowledge, which was one of the requirements of the principles stated by Mr Justice Bingham in *Tradax Export SA* v *Dorada Compania Naviera SA, The Lutetian* [1982] 2 Lloyd's Rep 140. Hence, the tenant's failure to pay default interest meant that it had not validly broken the lease. An appeal in *Avocet* was partially heard but settled before judgment.

12. In the *PCE* case, an attempt by the tenant to rely upon the observations made by Morgan J in *Avocet* was rejected by Mr Justice Peter Smith. Prior to the break date in that case, an email had been sent to the landlord's agent referring to the rent payment and asking for confirmation that "*this is the correct basis for calculating the liability for the short period"*. The landlord did not respond to this prior to the break date. Against the background of the comments of Mr Justice Morgan in *Avocet*, the tenant sought permission to amend to assert that (a) it believed it only had to pay apportioned rent up to the termination date (b) the landlord knew of that belief (c) the landlord thought the break would only be effective if a full quarter's rent was paid (d) the landlord "*acting honestly and responsibly*" would have replied promptly to the tenant's email enquiry telling the tenant that it needed to pay a full quarter's rent (e) had the landlord replied promptly the tenant would have tendered the full amount. Accordingly it was contended that the landlord was estopped from relying on the failure of the tenant to pay the full quarter's rent. Mr Justice Peter Smith refused permission to amend and observed:-

> "That puts the Landlord in my view in an impossible situation. If the law is as the Tenant contends then the Tenant can challenge the claim for the full rent. However on the way in which the Tenant puts it before me if he loses that point he can assert that the Landlord ought to have told him he was going to lose the point. Thus the Landlord is put in an impossible position. It is not in my view for the Landlord to have to deal with it in that way"

The ability to recover sums pain in advance of a break and the Court of Appeal decision in *Marks & Spencer plc v BNP Paribas Securities Trust Co (Jersey) Ltd*

13. For some years, there has been debate on the question of whether a tenant would be entitled to pursue a claim for restitution of sums paid before a break date in respect of a quarter which continued after the break date. This issue was considered in the recent Court of Appeal case of *Marks & Spencer plc v BNP Paribas Security Services Trust Co (Jersey) Ltd* [2014] EWCA Civ 603. In that case, the tenant had the right to terminate its lease conditional upon there being no arrears of rent and on the payment of a premium to compensate the landlord for its loss of income. The tenant duly complied with the conditions of the break clause. It paid a full quarters' rent on the December quarter day and the break premium on the 18 January 2012 in readiness for a break date of 24 January 2012. Could the tenant could subsequently seek repayment of the rent pertaining to the rest of the quarter? In the Court of Appeal, the question was considered by reference to the issue of whether a term could be implied which would enable the tenant to get back that part of the advance payment of rent relating to the period after the break date. The Court of Appeal refused to imply a term that the tenant could be refunded for this period. It held that the lease, read as a whole against the relevant background, would not reasonably be understood to include such a term and the test for an implied term was not met. The rent paid in advance was not simply a payment to the landlord for the use and occupation of premises but was also used as a yardstick for compensating a party for some loss that it incurred. Lady Justice Arden also took into account the fact that the admissible background to the interpretation of the lease included the state of the case law at the date when it was entered into. Such case law did not establish any precedent for implying a term requiring repayment of the rent for the period after the break date *(Ellis v Rowbottom* [1900] 1 QB 740; *Capital & City Holdings Ltd* v *Dean Warburg* [1989] 1 EGLR 90 and *Re A Company* [2007] BPIR 1 (decided after the original lease but before the deed of variation). Lady Justice Arden said:

"That case law forms part of the admissible background against which the lease is to be interpreted. It makes it all the more likely that a reasonable person, having knowledge of this background, would conclude that if the parties had really intended there to be an implied term for repayment they would have made express provision for it"

KATHARINE HOLLAND QC

Landmark Chambers