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Property and housing law UPDATE

Break clauses in commercial leases: a review



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Commercial leases; Break clauses; vacant possession; material breach

In a stagnant commercial letting market, both landlords and tenants are reviewing the break clauses in their leases. Tenants might be looking to leave their existing premises in order to find smaller sites or lower rent. Landlords, on the other hand, are keen to ensure that their existing tenants remain in occupation, perhaps with the knowledge that the rent that they are paying is higher than what they can demand on the open market.

Recent case law has re-emphasised the need to interpret break clauses strictly. The House of Lords decision of *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749 emphasised a more modern,

objective approach to the validity of notices as opposed to scrutinising whether the party giving notice had complied with the full technicalities required by the lease. It did not relax the need to comply with conditions precedent before break clauses were activated. After all, such clauses are an agreement to end leases early; the courts are extremely reluctant to let parties do this when they are in default.

Vacant possession

In *NYK Logistics (UK) Ltd v Ibrend Estates BV* [2011] 36 EG 94, the break clause specified that the tenants had to deliver up vacant possession of the premises in order for the break clause to take effect. If the landlord had not waived this condition, the lease did not determine.

NYK gave a valid notice to end the term on 3 April 2009. It received a schedule of dilapidations on 11 March 2009 that unfortunately did not take into account a Schedule of Condition in the lease which limited the standard to which the repairs and decorations needed to be performed. A meeting took place on 1 April 2009 which determined that some work still needed to be carried out. NYK had to be out by midnight on 3 April 2009 but their workmen remained in the warehouse until 9 April.

The seminal case on vacant possession is the Court of Appeal decision in *Cumberland Consolidated Holdings Ltd v Ireland* [1946] KB 264. Two examples of situations where there is no vacant possession were given:

- A vendor who leaves property of his own cannot be said to give vacant possession because he is claiming a right to use the premises for his own purposes i.e. a place of deposit for his own goods;
- Occupation by a person having no claim of right prevents the giving of vacant possession.

The Court of Appeal in *NYK* rejected a 'complicated' interpretation of vacant possession. At para 44 of the decision, Rimer LJ made the



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following points:

- If NYK was to satisfy the vacant possession condition in the break option, it had to give such possession to Ibrend by midnight on 3 April 2009 and by not a minute later.
- The concept of ‘vacant possession’ is the same as in every domestic and commercial sale.
- At the moment that ‘vacant possession’ is required to be given, the property should be empty of people and the purchaser should be able to assume immediate and exclusive possession, occupation and control of it.
- The property must also be empty of chattels, although the obligation in this respect is only likely to be breached if any chattels left in the property substantially prevent or interfere with the enjoyment of the right of possession of a substantial part of the property.

What could NYK have done? Rimer LJ suggested that the only safe course was to move everyone out of the premises on 3 April, and then to

ask Ibrend if it could be permitted to return to the warehouse as its licensee in order to complete the outstanding works.

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No ‘material breach of covenant’

Sometimes a break clause contains a similar condition to the one found in *Mourant Property Trusts Ltd v Fusion Electronic (UK) Ltd* [2009] EWHC 3659 (Ch):

It shall be a condition precedent to the customer’s right to determine this lease as aforesaid that... (c) there shall be no material breach of covenant on the part of a customer subsisting at the relevant determination date.

The landlord argued that the tenant was still in the course of carrying out repairs on the termination date. The tenant accepted this but argued that the dilapidations were not

enough to be ‘material’.

The leading case on the ‘materiality’ is the Court of Appeal decision in *Fitzroy House Epworth Street (No 1) Limited v Financial Times Ltd* [2006] 1 WLR 3207, from which the following points can be found:

- The court has no power to relieve a party in breach. Provisions have to be strictly complied with. The court should not attempt to rewrite the parties’ contract.
- The word ‘material’ is not intended to modify a rule requiring absolute compliance to the extent that it imports a test of ‘reasonable fairness’.
- The test is an objective one; the motive of the tenant is irrelevant.
- The landlord would be very much concerned at the time of the break that the covenants should be fully observed so that the property could be relet or sold without delay or additional expenditure. Materiality of any breach is to be assessed by reference to the ability of the landlord to relet or sell the property without delay or additional expense.

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The issue in *Mourant Property* was whether the dilapidations and repairs that remained outstanding on the determination date were material. Expert evidence was called. The landlord’s expert assessed that an incoming tenant would expect there would be some months rent-free as compensation; the tenant’s expert assessed this rent-free period to be negligible. The tenant’s expert assessed this on the basis of the passing rent, not the market rent, which was higher; secondly, he had not taken into account items that an incoming tenant would probably intend to refit anyway.

The Court (at para 37) preferred to use the market rent basis when evaluating the rent-free period. Secondly, the ‘disregarded’ items were still likely to increase the rent-free period. A rent-free period of c.4 months (as the landlord’s expert

suggested it was) was held to be a material breach.

Conclusion

The Court interprets break clauses strictly. When seeking to activate such a clause, a landlord or a tenant should examine the terms of the lease critically and allow itself plenty of time to deal with dilapidations and any other outstanding issues. A ‘materiality’ clause does not in fact give much leeway to a party who is potentially in default.

Some break clauses refer both to the determination date and to the date on which notice is to be given. Parties activating a break clause need to have a clear understanding of their obligations under such a condition and to ensure that they remain in strict compliance.

If a tenant finds itself in the position of NYK with the clock ticking down

to midnight, it needs to find a way to remain in compliance with the break clause, bearing in mind that the balance of power will often rest with the landlord.

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David frequently advises both tenants and landlords in respect of the construction, termination and extension of commercial leases. His full biography can be found at <http://www.4kbw.co.uk/members/David-Sawtell-2005.asp>.

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