

Real Estate Update

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Renting in the recession – rent deposits and insolvency

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A rent deposit is a sum of money provided by the tenant as security for the payment of rent and performance of their obligations under the lease. A landlord can draw down on the deposit in specified circumstances: generally when a tenant fails to pay the rent or otherwise breaches the lease. [More...](#)



Breaking up is never easy

In these tough times, tenants are increasingly contemplating downscaling their businesses and looking for ways to reduce costs. Utilising a break clause may seem an easy option, but tenants should not be under the misconception that breaking their lease will be straightforward. Break clauses are usually conditional and are always construed strictly in accordance with their terms. A failure to meet any of the conditions could result in the break being ineffective. Good planning and good advice are crucial for a clean break. [More...](#)

Lease assignment – landlord's consent

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Any comments or queries?

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As part of our commitment to corporate social responsibility we are proud to support The Anthony Nolan Trust as our current Charity of the Year (www.anthonynolan.org.uk).

This is a summary of recent developments. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the authors.

Renting in the recession – rent deposits and insolvency

In the current climate, both landlords and tenants could be forgiven for wondering what would happen if the other became a victim of the recession. For both parties, a rent deposit deed can provide some comfort. Such a deed would mean the landlord has immediate access to cold hard cash if the tenant fails to pay the rent, while a struggling tenant may get valuable breathing space before the landlord turns to other remedies.



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A rent deposit is a sum of money provided by the tenant as security for the payment of rent and performance of their obligations under the lease. A landlord can draw down on the deposit in specified circumstances: generally when a tenant fails to pay the rent or otherwise breaches the lease. Rent deposits are commonly structured either as a charge (where the deposit is still legally owned by the tenant but is charged in favour of the landlord) or as a trust (where legal title to the deposit passes to the landlord, but the landlord may only draw on the deposit in certain circumstances).

If the worst happens and the tenant becomes insolvent, can a landlord draw on the rent deposit? The answer to this is not an automatic “yes.” Much will depend on the precise terms of the rent deposit deed. There are also several different insolvency regimes and the landlord’s rights will vary depending on which of these applies.

Tenant in receivership

The appointment of a receiver (either under the Law of Property Act or an administrative receiver), will not prevent the landlord from drawing on a rent deposit.

Tenant in liquidation

A landlord may continue to use the deposit throughout the liquidation process, even after a winding-up order has been made. If the liquidator disclaims the lease, the position depends on the terms of the rent deposit deed.

In practice, the deed will often provide that the landlord can keep what remains of the deposit after disclaimer and use it to cover any costs incurred. Where the deed is silent on this point, a landlord could still argue that the rent deposit is ancillary to the lease and therefore if the liquidator disclaims the lease, it must also disclaim the rent deposit. However, the case law on this point is not clear, so it is best to spell out what will happen on liquidation in the rent deposit deed.

Tenant in administration

Administration aims to rescue insolvent companies. To facilitate this, an interim moratorium takes effect as soon as the relevant papers have been filed at court. This is followed by a further moratorium once the administrator is appointed. This means that, once the moratorium is in place, all creditors – landlords included – need permission from the court or the administrator before they can enforce any “security”, including a rent deposit.

However, at the end of 2003, the Financial Collateral Arrangements (No 2) Regulations 2003 came into force. Broadly, these apply where one party (in this case the tenant) owes financial obligations to another (the landlord) and there is an agreement to secure these obligations by giving the landlord a security interest in “financial collateral” (in this case cash).

The significance of this is that, if the regulations apply, the usual moratorium is lifted – so the landlord can draw down on the rent deposit without first having to seek permission. However, the regulations remain largely untested and there is some debate as to in which circumstances exactly they will apply. It seems likely that a deposit which is charged to the landlord will be covered by the regulations. The position with a deposit held on trust is not so clear. One of the key considerations is whether the deposit is in the possession or under the control of the landlord, which will largely depend on the exact terms of the rent deposit deed.

If the worst happens and the tenant becomes insolvent, can a landlord draw on the rent deposit?

Insolvency is a two-way street

Despite the restrictions imposed by the various insolvency regimes, a rent deposit remains a valuable source of security for a landlord. However, in the current market incoming tenants are in a position to drive a hard bargain and may simply refuse to tie up a substantial amount of money in this way.

Those tenants who are willing to enter into a rent deposit deed should also think carefully about how the deposit will be held. If the deposit becomes mixed with the landlord’s own money and the landlord becomes insolvent, the tenant will be an unsecured creditor, with a real risk of not getting their money back. One way to avoid this is for the deposit to be held by a third party as stakeholder. This will ensure that it is protected from the landlord’s creditors, although it does place a greater administrative burden on the stakeholder.

Breaking up is never easy

In these tough times, tenants are increasingly contemplating downscaling their businesses and looking for ways to reduce costs. Utilising a break clause may seem an easy option, but tenants should not be under the misconception that breaking their lease will be straightforward. Break clauses are usually conditional and are always construed strictly in accordance with their terms. A failure to meet any of the conditions could result in the break being ineffective. Good planning and good advice are crucial for a clean break.

Service

The majority of break clauses in commercial leases will require serving written notice on the landlord perhaps six or nine months in advance of the break date. The notice provisions in the lease must be followed meticulously, as any error could result in the break being



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ineffective. Notice should be served within the specified timescale, in the correct form, by the correct method of service to the correct address. As Lord Hoffman advised in the case of *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* in 1997, “*If the clause had said that the notice has to be served on blue paper, it would be no good serving it on pink paper, however clear it may have been that the tenant wanted to terminate the lease*”.

Rents

Many break clauses will require the rent to be fully paid and up to date at the break date in order for the break to be successfully exercised. Some clauses may go even further and also require that for a break notice to be validly served, the rent at the date of service must be up to date. Some clauses will refer to ‘rents’, but what exactly does the term ‘rents’ include? Usually this will include rent, service charge and insurance rent, but could include all other sums payable under the lease, depending on the definition of ‘rents’. Tenants should contact their landlord a few weeks prior to the break date asking for confirmation of the sums due and confirmation that there are no arrears. If any sums are disputed, for example service charge, it is advisable to make the payment on a ‘without prejudice’ basis, and argue about the sums later after the break has been exercised.

Vacant possession

Vacant possession is another common condition. This means giving the premises back to the landlord in accordance with the yielding up provisions in the lease. On the break date, the landlord will expect the premises to be handed back free from subtenancies, with all the tenant’s fixtures, fittings and chattels removed (including any waste and rubbish) and any alterations reinstated.

Compliance with covenants

Often break clauses will require some form of compliance with tenant covenants, either at the break date or on service of the break notice. Tenants should take great care and prioritise the meeting of this condition carefully – good planning is essential. It is not an option to simply leave the premises in disrepair and pay damages after the break, as is the case with dilapidations. A prudent tenant should consult the landlord with a view to agreeing a schedule of works or indeed instruct a surveyor/solicitor to provide some advice as to what is required and agree a suitable strategy.

Top tip for a clean break

Decide well in advance whether you wish to exercise your break and get advice on what is required to do so effectively.

Lease assignment – landlord's consent

As the economic downturn takes effect, many tenants are looking to reduce their costs. Assigning or sub-letting a lease may seem an ideal solution, albeit that the landlord's consent will generally be required. It is important that a landlord responds to a tenant's request for consent to assign or sub-let appropriately to ensure the landlord complies with their statutory duties as well as reducing the risk of the tenant pressing ahead and assigning or sub-letting the lease without formal consent. Equally, a tenant needs to ensure that any request for consent is made and dealt with correctly in order to maximise the prospects of obtaining the landlord's consent. This article sets out some key practice points for both landlords and tenants to consider when dealing with a request for consent.

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Background

Many commercial leases include a covenant whereby the tenant cannot assign (or sub-let) without the prior written consent of the landlord, such consent not to be unreasonably withheld. This is known as a qualified covenant. If there is no mention of reasonableness in the lease then statute adds this qualification. Where the lease contains a qualified covenant, the Landlord and Tenant Act 1988 imposes certain duties on a landlord, namely:

- To give consent where it would be unreasonable to refuse
- To give written notice of their decision within a reasonable period of time specifying in addition:
 - (i) the reasons for refusal where consent is refused; and
 - (ii) where consent is granted subject to conditions, to notify the tenant of those conditions in writing.

Practical tips for landlords when dealing with a request for consent

- Clarify with the tenant whether they are simply enquiring as to the likelihood of consent being given or whether it is an actual application.
- Review the lease carefully to see whether it contains any conditions precedent for granting consent (for example, a requirement for any sub-letting to be on the same terms of the lease) or any pre-agreed reasons for refusing consent (for example, breach of repairing obligations).
- Deal with any request swiftly. As regards what is a reasonable period of time, this is usually measured in weeks not months. If an application in a straightforward case is not dealt with within a period of, say, 2-3 weeks then the tenant may well be able to argue that the landlord has failed to respond within a reasonable period. A failure to give a decision within a reasonable period of time will be treated as a refusal of consent without reasons. Remember that the burden is on the landlord to "do something" rather than the tenant having to

“do anything”. If necessary, tell the tenant that you need more time to make a decision and give the reasons for this.

- You are entitled to be given sufficient information to enable you to make a fully informed decision. Therefore consider whether a request for further information (with reasons) should be made, again within a reasonable period of time. The time within which to respond to the tenant’s request will not expire until after the tenant has given satisfactory replies.
- Never give consent “in principle” or “subject to licence” as this can be construed as a binding consent upon which the tenant can rely. Instead, if you require the parties to enter into a licence, for example, to obtain a direct covenant from the assignee, then say that consent is conditional upon the agreement of a suitable document and its execution by all parties.
- When refusing consent make sure that the tenant is given careful and detailed reasons. Remember that in subsequent litigation you will only be entitled to rely on reasons given in writing and within a reasonable period of time.

Practical tips for tenants

- Review the lease carefully to check for any conditions precedent and make sure that these are fulfilled before making an application. Consider whether you have complied with all of the covenants in the lease and, if not, consider whether it would be worth remedying any breaches before making a request. At the same time, consider whether the nature of the incoming assignee or subtenant’s business is such that it might breach any use covenant and what, if anything, can be done about this.
- Submit a clear written request for consent, preferably by post and fax (and by email too if possible) and obtain proof of delivery and confirmation of receipt.
- Make sure that you include as much information as possible in the initial request for consent. As a general rule, the following information should be included:
 - (i) Three years’ audited accounts for the proposed assignee or under-tenant
 - (ii) Professional and trade references regarding the payment of rent and compliance with other covenants
 - (iii) An offer to provide further information if required
 - (iv) Also, consider whether it would be appropriate to offer additional security, for example, a rent deposit or guarantor
- Ensure that any requests by the landlord for additional information are responded to promptly. Also, make it clear that this information is being provided in connection with the existing application. This should avoid the landlord arguing that a fresh application has been made which they will need more time to consider.
- Remember to keep the proposed assignee or subtenant informed as to what is happening with the application.

Case Notes

The real risks of virtual assignment

What is a virtual assignment?

Many large corporate occupiers of leasehold property transfer their rights and interests in a property to a third party, but not their leasehold interest. Often, the motivation for the corporate occupier is that they have not been able to obtain the landlord's consent to an assignment or they wish to outsource the management of their portfolio to a third party. Many large corporate acquisitions contain such arrangements as an interim measure whilst the landlord's consent is being obtained, or in such cases where there is a risk that the landlord's consent would not be forthcoming, possibly because the purchaser was a new company with no track record. Such schemes allow occupiers to vacate earlier, to pass on the risks and liabilities of the lease and also to pass on the management of the property.

The common name for such an arrangement is a "virtual assignment" and the general definition is that all the economic benefits and burdens of a lease (including any management responsibilities) are transferred to a third party, but not the leasehold interest. The occupier of the property does not need to change.

A recent case

The recent High Court case of *Clarence House v National Westminster Bank PLC* [2009] EWHC 77 (CH) brought such assignments into the spotlight. In this case, NatWest had entered into a virtual assignment with a company called New Liberty. Neither NatWest nor New Liberty occupied the property and it had been sublet by NatWest in 2001 by way of a lease expiring in 2010. New Liberty was granted a power of attorney to deal with the property on behalf of NatWest, effectively meaning NatWest stepped aside completely. When Clarence House, the landlord, found out about the arrangement, they brought proceeding against NatWest on the grounds that the alienation provisions of the lease had been breached.

The case turned on whether the virtual assignment resulted in NatWest sharing or parting with possession of the property, or holding the property on trust for New Liberty. In a firm decision, the High Court decided that NatWest had breached the covenant not to share or part with possession of the property. Although there has been no news of a possible appeal, this may not be the last we hear of this.

What this means for landlords

Landlords will usually be concerned with virtual assignments when the third party virtual assignee receives all the rental income from the property. If the tenant falls into arrears and the virtual assignee does not pass on the rental income, the landlord has no contractual relationship to enable them to pursue the virtual assignee. By this stage, the tenant may be worthless (particularly if the virtual assignment was part of a corporate acquisition) and the landlord would have to forfeit the lease. This means that virtual assignment can take away an important income stream from the tenant and thus the landlord.



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How this affects tenants

Tenants will be concerned with the decision as it may result in their landlord looking at any virtual arrangements in closer detail. Current virtual assignments may be open to challenge by landlords and a landlord could threaten forfeiture. It is thus important that the virtual assignment can be terminated on short notice. Tenants may also need to consider approaching their landlord to either agree to a variation of the alienation provisions of their lease, or for retrospective consent to part with or share possession of the property.

Round-up

Remedies for breach of keep-open covenants

As a general rule, when a tenant breaches a keep-open covenant, the courts will normally refuse an order for specific performance but the landlord may be entitled to damages instead. In *Douglas Shelf Seven Ltd v Co-operative Wholesale Society Ltd* [2009] PLSCS 154 the landlord brought proceedings for the breach of their keep-open covenant when the tenant closed the store, resulting in compensation being paid to the landlord by the tenant. The landlord then brought a further action, seeking declarations that the tenant should pay the costs of security services for the empty store and also carry out works set out in an interim schedule of dilapidations.

The tenant argued that the landlord should have brought these claims with the earlier action for breach. Further, as the landlord had already received damages for the breach of the keep-open clause on the basis that the store would remain empty until the end of the lease term, the tenant's repairing obligations had been reduced to keeping the store wind-tight, watertight and secure, and then restoring the property at the end of the lease term.

The court found that although the tenant could not be required to contribute to security services under the terms of the lease, the previous award of damages for breach of the keep-open covenant did not prohibit the landlord from enforcing the tenant's other obligations under the lease until the end of the lease term.

Retail Partner Sarah Blunn notes: *"The decision in this case is good for landlords in that it reinforces the tenant's liability for dilapidations at the end of the lease term. However, for tenants in this position, it also highlights the possibility of negotiating a reduced liability for other covenants should the tenant be forced to cease trading"*.

Planning consent

The Department for Communities and Local Government will consult in Summer 2009 on measures to reinstate the five year consent period for planning permissions. The consent period was reduced to three years by the Planning and Compulsory Purchase Act 2004 in 2005.

Changes to the consent regime for Nationally Significant Infrastructure Projects

The Planning Act 2008, which comes into force during 2009/2010, will create a new unified consent regime in England and Wales for Nationally Significant Infrastructure Projects; namely the construction



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Round-up continued...

or extension of energy generating facilities (i) onshore, with a capacity of more than 50mW; or (ii) offshore, with a capacity of more than 100mW.

The new regime will alter the need for – and method of – obtaining consent under section 36 of the Electricity Act 1989. Planning applications will be determined by a new body, the Infrastructure Planning Commission, who will determine applications against National Policy Statements made by the Secretary of State.

Energy and Infrastructure Partner, Sarah Cassidy, says: *“This change will help to facilitate large energy infrastructure projects in England and Wales and the National Policy Statements should provide increased clarity as to the criteria against which applications will be judged”.*

Business rates

Business rates were adjusted in April in line with the Retail Prices Index for September 2009. Responding to criticisms that this would be catastrophic to the cash flow of many business in the 2009/2010 financial year, the Treasury introduced new legislation on 31 March 2009 which allows business ratepayers to spread payment of this year’s up-rating over three years.

Development – new powers for Local Planning Authorities

On 6 April 2009, Local Planning Authorities (LPA) were granted new powers to refuse to proceed with a planning application that: (i) is similar to another application being considered at that time by the LPA, or Secretary of State on appeal or call in; or (ii) has been determined by the LPA, or the time for determination has expired without a decision, and the applicant can appeal that decision to the Secretary of State.

A further change to the legislation is pending, which will allow applicants to appeal direct to the Secretary of State where the LPA has failed to reach a decision before the determination date, reducing the impact of the new powers on “twin-tracking” applications. This change will allow an additional period for the LPA to determine the application but also allow the appeal process to start in tandem. It is arguable that the LPA’s new powers should not be used before this change is also in force.

Development Partner, Philip Bournsnel, comments: *“Whilst on the face of it this impacts on the use of twin-tracking planning permissions for large-scale development projects, the LPA powers are discretionary. The use of twin-tracking may still be beneficial for developers and should not be immediately discounted”.*

Fire safety – how a recent case has highlighted the need for compliance

The Regulatory Reform (Fire Safety) Order 2005 came into force on 1 October 2006, bringing in a new fire safety regime for most premises in the UK. A recent case has highlighted the need to be aware of the obligations under that Order and shown that breaches will be prosecuted.



Round-up continued...

Shell was recently fined £300k plus £45k costs after two fires broke out in quick succession at its London offices. Fire investigators found “extensive breaches” of the Order, including blocked escape routes and defective doors. Shell’s fire risk assessment had also not been updated for three years.

Whilst many property owners and occupiers are aware of the Regulations, this case highlights the need for compliance.

Key points to note:

- As a default position, owners will be liable for compliance with the Order, but the Regulations also apply to employers or occupiers who have control of the building.
- The duties include: ensuring that the premises, fire safety equipment and emergency routes/exits are properly maintained; keeping records about the fire safety regime at the property; and carrying out a risk assessment and keeping it under review (a yearly review is recommended, but further reviews may be triggered by, for example, a change in the layout of the building or increase in the number of employees at the premises).
- The Regulations also apply to vacant buildings.

Guidance can be found at

<http://www.bre.co.uk/firerisk/page.jsp?id=644>
