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Papers

The Allied Dunbar v Homebase case and its impact on flexible leases

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Abstract

For many years one of the most contentious clauses in commercial leases has related to sublettings. In their negotiations, landlords and tenants have argued how their respective positions would be seriously prejudiced by failing to stand their ground. Landlords could end up with a direct relationship with their subtenants, a lease that is less favourable than the headlease which could be perpetuated on a renewal and a lower rent which could also be used as a comparable on a review under the headlease if still subsisting or on other adjacent premises.

Tenants acquiescing with landlords' demands in a depressed market could find themselves unable to sublet at all and the depressing effect on rent at review of a draconian clause would not help if the review was upwards only. Those tenants who did give in, particularly at times when the prevailing thought was that rents would never go down and therefore there would never be a rude awakening, dealt with the shock by side deeds with the subtenant to reflect the true terms of the deal, whereas the underlease followed the specific requirements of the headlease. Landlords either turned a blind eye to the arrangement or, more usually, were oblivious of it. Now following the *Homebase* decision, not only will landlords be more on their toes in asking specifically whether there will be a side arrangement, but all parties will be aware that this will not get round the terms of the headlease.

INTRODUCTION

When one thinks about it, for two parties to enter into a lease of a building, or part of a building, for up to 25 years and to expect to be able to cover not only the world at the time but also anticipate all of the fast-moving changes that inevitably will happen over the period is unrealistic. That is one good, but not usual, reason for shorter terms. Small wonder therefore that there is a plethora of case law on commercial landlord and tenant issues, and leading textbooks begin to match the good old *Encyclopaedia Britannica* in length. In selecting the case for the gold medal in this area of the

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law in the last 12 months, the author believes that few landlord and tenant lawyers would award it other than to *Allied Dunbar Assurance plc v Homebase Limited and Another*,¹ dealing with the interaction between a headlease, sublease and collateral deed.

THE FACTS

The circumstances were not unusual. Homebase, then known as Texas Homecare Limited, took a lease of Unit 1 Bilston Road, Wolverhampton on 6 January 1986, being part of what the judge described as 'a first generation retail warehouse scheme'. It was used as a DIY retail store until the middle of 1998 and then placed on the market with little demand, but by the end of 1999 the agents had managed to attract a potential purchaser, Lairdale Limited, which sold furniture under the trade name Furniture to Go.

Negotiations ensued, and on 17 February 2000 an agreement for underlease was entered into, but the rent that Lairdale was prepared to pay for the subtenancy was substantially less than the then passing rent under the headlease, which was £322,500 per annum with the next upwards-only review on 24 June 2000.

Apart from the rent issue there was another practical problem, namely that the premises were considered to be out of repair and Lairdale, not unnaturally in the market climate, was not prepared to take on repairing obligations as onerous as those in the headlease.

The rental and repairing issues were problematic because of the subletting covenant (clause 3(32)(c) in the headlease), the material elements of which read as follows:

Covenant

'Not to underlet the whole or any part of the demised premises without first obtaining the prior consent of the Landlord (such consent not to be unreasonably withheld or delayed) provided that

(a)

(b) any underlease ... shall not be granted at a rent of less than the full market rent reasonably obtainable without taking a fine or premium

(c) any such underlease ... shall contain covenants by the underlessee and its successors in title ... with the Tenant and its successors in title in the same form (*mutatis mutandis*) as the covenants on the part of the Tenant contained in this Lease

(d) neither the Tenant nor any person deriving title under it (including any undertenant whether immediate or not) will (but without prejudice to the foregoing) underlet or part with possession of the whole of the premises thereby demised for a term which shall extend beyond any date on which the rent hereby reserved is to be varied as herein provided unless such underletting or parting with possession shall include provisions to

the effect that the rent thereby reserved shall be subject to review on the dates on which the rent hereby reserved is to be varied to the intent that the rent reserved on and after any of the dates on which the rent hereby reserved is to be varied shall not be less than the full market rent obtainable without taking a fine or premium in respect of the premises comprised in such underlease calculated as at the dates on which the rent hereby reserved is to be varied ...'

A common practice solution was then found, namely an underlease to accord with the terms of the headlease and a separate deed to mitigate those obligations, such deed expressed to be personal to the parties.

Collateral deed

An application to the landlords, Allied Dunbar, for consent to the subletting was made on 20 January 2000 and a draft of the proposed collateral deed was sent to their solicitors in March 2000, with a revised draft sent on 4 April in that year. The second draft provided that Homebase would indemnify Lairdale for the difference between an initial rent of £100,000 per annum (rising to £200,000 per annum and thereafter to £322,500 per annum) and the rent expressed to be payable under the underlease, and Homebase further agreed to indemnify Lairdale against the cost of complying with repairing obligations in so far as they would require Lairdale to put the premises in any better condition than that evidenced by a schedule of condition.

With a certain inevitability, an order was sought by the landlords to prevent Homebase and Lairdale from completing the proposed underlease and the collateral deed, and on 9 June 2000 Homebase's solicitors, recognising the difficulties, sent what was described as 'an amended version of the Revised Deed' with the following material provisions:

'2. Homebase hereby undertakes to pay to Lairdale:

- 2.1.1 the difference between the rent payable under the terms of the Lease between the Rent Commencement Date and the date which is six months after the Rent Commencement Date and £100,000 per annum; and thereafter**
- 2.1.2 the difference between the rent reserved by the Lease and £200,000 per annum until and including 23 June 2005; and thereafter**
- 2.1.3 the difference between the rent reserved by the Lease and £322,500 per annum**
- 2.2 the cost (including all professional and other fees incurred by Lairdale and Homebase and the Superior Landlord) of complying with or paying any damages for any breach of:-**

- 2.2.1 any obligation to put and keep in repair the floor of the premises**
- 2.2.2 any obligation to repair or decorate the Premises (including any such obligation contained in any licence to underlet which Lairdale enters into) insofar as it would require Lairdale to put the Premises into any better state of repair or condition or decorative repair and decorative condition than that evidenced by the attached Schedule of Condition and whether or not any third party seeks to enforce this obligation against Lairdale; ...**
- 6. The rights and obligations of the parties under this Deed are intended to be personal to Homebase and Lairdale and are not intended to affect any other parties including the Superior Landlord and any assignees of the Lease or the Headlease.'**

Underlease rent

The proposed term of the underlease was to expire on 21 June 2010, three days before the expiry of the headlease term, and the rent payable under the underlease was reserved in Clause 2 of the draft annexed to the agreement of 17 February 2000:

- '(a) until 23 June 2000 and so in proportion for any less time than a year the yearly rent of three hundred and twenty two thousand five hundred pounds (£322,500) and thereafter during the remainder of the said term such yearly rent as shall be determined pursuant to the provisions of Clause 6 hereof such rents to be paid without any deduction whatsoever by equal quarterly payments in advance on the usual quarter days in every year (whether demanded or not) ...'**

Underlease repair

While the provisions for rent review in the draft underlease and the rent review dates were therefore the same in all material respects as those in the headlease and therefore complied with the alienation covenant, the effect was that under the provision in the underlease the yearly rent reserved from 24 June 2000 would be £322,500 or such greater sum as might be agreed or determined on a rent review as at that date to be the market rent, and such greater sum as might be determined on a further review as at 24 June 2005. But the effect of the collateral deed would be that so long as Lairdale was liable to make those payments of rent under the underlease, Homebase would make reciprocal payments to Lairdale to reduce the amount actually paid for the occupation of the premises to the equivalent of a yearly rent of £100,000 for the period to 14 December 2000, £200,000 for the period from 14 December 2000 to 24 June 2005 and £322,500 for the remainder of the term.

So far as the repairing obligations were concerned, the schedule

of condition of the premises as at 1 February 2000 was prepared and agreed between the surveyors for Homebase and Lairdale and sent to Allied Dunbar's solicitors on 22 May 2000, disclosing numerous defects in the premises and, while on the face of the underlease Lairdale would be liable to make them good, the collateral deed terms were such that they would require Homebase to pay Lairdale the cost of complying with or paying any damages for the breach of those obligations in relation to the floor, and in so far as the subtenant might be required to put the premises into any better state than they were on 1 February 2000.

Events

While Homebase sought consent through its solicitors on 9 June 2000, on the basis of the revised draft of the collateral deed, Allied Dunbar had already commenced the proceedings for a declaration that its refusal of consent was not unreasonable, and the request for consent was refused by a letter dated 2 August 2000; this letter stated that there would be a breach of provisos (b) (c) and (d) of section 3(32)(c) of the headlease based upon valuation advice on proviso (b) and legal advice on provisos (c) and (d). Although the solicitors stated that they were not obliged to consider an application for consent because the provisos being pre-conditions were not being satisfied, they went on to say that consent would have been refused in any event even if the proposed subletting had complied with the provisos, and detailed reasons were given. Matters came to a head so far as Homebase was concerned on 17 February 2001, when Lairdale gave notice determining the agreement — as they were entitled to do, because the landlord's consent had not been forthcoming by the cut-off date in the agreement.

By the time the proceedings came before the trial judge on 20 February 2001 the only issue therefore was whether Allied Dunbar had withheld consent unreasonably and would a counterclaim succeed under the Landlord and Tenant Act 1988; if so, potentially significant damages could be recoverable.

THE TRIAL IN THE HIGH COURT (CHANCERY DIVISION)

Trial

The trial judge first addressed the provisos to see if they had been met and clearly if Homebase fell foul of any of them Allied Dunbar was under no obligation to consider whether or not it was reasonable to withhold consent. The judge held that the requirement in paragraph (d) had not been met because the rent review provisions in the sublease had to include provisions for review 'to the intent' that the rent be no less than the full market rent at the date of variation, but as the rent from 2005 had already been fixed at £322,500 until the end of the term, it could not sensibly be concluded that that review would be to the full market rent in 2005. His words were that 'the provision for review in the underlease is therefore clearly intended so far as the parties to it are concerned to be fictional and nominal'. The counterclaim was therefore dismissed.

As it happened the judge rejected Allied Dunbar's contention that the requirement in paragraph (c) had not been met. The underlease contained a covenant to repair in the same form as the headlease and the judge did not accept that the collateral deed enabled the subtenant to avoid the repairing obligation, also the obligation on Homebase to make a contribution to the cost of the repairs did not in his opinion diminish the full repairing covenant in the underlease. 'There is nothing in the underlease which suggests that this obligation is fictional or notional.'

Market rent

He also rejected the contention that the requirement under paragraph (b) of the proviso was not met. He was satisfied that this was the market rent and no higher rent was obtainable in the circumstances. Although the point was academic the judge was of the view that the real reason for the refusal of consent was one which could not be regarded as reasonable, on the basis that it was contended that the rent was less than the market rent. A report had been prepared by retail property consultants Green & Partners in March 2000 for the landlords, and this had concluded that Homebase had 'thoroughly marketed' the unit and its effort to dispose of the headlease 'clearly suggests that little alternative demand exists'. In truth, Allied Dunbar's real concern was that consent to an underlease at that rent would make it impossible to argue for an increase in rent above the passing rent at the June 2000 rent review under the headlease and indeed the parallel lease of Unit 2. The judge described it as 'a collateral motive'.

THE APPEAL

Appeal Judge

On appeal Lord Justice Chadwick did not accept the contention of Homebase that there was some significance in the fact that the provisions in relation to repairs and rent in the separate deed were personal and only to have effect between Homebase and Lairdale. The fundamental point, he said, was that the words in the side deed had to be treated as if they were in the underlease, with the following effect:

'YIELDING AND PAYING therefore unto the Landlord (a) until 23 June 2000 and so in proportion for any less time than a year the yearly rent of [£322,500] and thereafter during the remainder of the said term such yearly rent as shall be determined pursuant to the provisions of Clause 6 hereof such rents to be paid without any deduction whatsoever ... PROVIDED that Homebase hereby undertakes to pay to Lairdale (it being intended that such obligation shall be personal to Homebase and Lairdale and not affect any other parties including the Superior Landlord and any assignees of this lease or the Headlease):-

- 1. the difference between the rent [hereby reserved] payable ... between [14 June 2000] and [14 December 2000] and £100,000 per annum; and thereafter**

2. *the difference between the rent [hereby] reserved ... and £200,000 per annum until and including 23 June 2005; and thereafter*
3. *the difference between the rent [hereby] reserved ... Lease and £322,500 per annum ...'*

By way of illustration, the tenant's covenant in the underlease in respect of repair during the term was:

Repair

'From time to time and at all times during the said term ... well and substantially to repair ... and keep in good and substantial repair and when necessary rebuild reconstruct renew or replace all the demised premises and every part thereof ... when and as often as occasion shall require ... PROVIDED that Homebase undertakes to pay to Lairdale (it being intended that such obligation shall be personal to Homebase and Lairdale and not affect any other parties including the Superior Landlord and any assignees of this lease or the Headlease) the cost ... of complying with or paying any damages for any breach of:-

1. *any obligation to put and keep in repair the floor of the premises*
2. *any obligation to repair or redecorate the Premises (including any such obligation contained in any licence to underlet which Lairdale enters into) insofar as it would require Lairdale to put the premises into any better state of repair or condition or decorative repair and decorative condition than that evidenced by the attached Schedule of Condition and whether or not any third party seeks to enforce this obligation against Lairdale; ...'*

Inconsistencies

Lord Justice Chadwick, in agreeing with the trial judge on paragraph (b), emphasised that Mr Bernard Livesey QC sitting as a deputy judge in the High Court reached his decision in paragraph (b) of the proviso not by ignoring the words in italics incorporated from the collateral deed, but because as a matter of fact the underlease was not a grant 'at rent less than the full market rent reasonably obtainable'. The appellant submitted that the trial judge's conclusion that the provisions for the payment of rent did not meet the requirement in paragraph (d) and its approach to the question whether those provisions met the requirements in paragraph (b) were inconsistent with his conclusion that the tenant's covenant to repair did meet the requirement in paragraph (c) of the proviso. Taking that line of approach the submission was that the conclusion in relation to the tenant's covenant to repair was correct (that the covenant to perform the repairs was not diminished by the provision of the collateral obligation on the underlessor to make a contribution to a part of the costs of those

Judge's reasoning

repairs), 'and accordingly the approach and conclusion in relation to rent and rent review must be wrong and should be rejected'.

The appeal judge was of the view that there was 'much force in the submissions' that the trial judge's conclusions in relation to paragraphs (c) and (d) of the proviso to clause 3(32)(c) of the headlease were mutually inconsistent, stating that it was difficult to see how the conclusions could both be correct but the appeal should be approached on the basis that either might be.

The appeal judge was quite clear that if the collateral deed words were, as they should be, deemed to be incorporated in the underlease, such an underlease which purports to reserve rent at a rate to be determined on a future review but which provides that whatever rate might be determined on a review in June 2005, the landlord would repay to the tenant the excess over £322,500 per annum, they could not be said to meet the requirement in paragraph (d) of the proviso to clause 3(32)(c) of the headlease that the reserved rent was to be varied on review 'to the intent that' on and after the review date the rent 'shall be not less than full market rent obtainable' as at the review date without cogent evidence that the market rent obtaining in June 2005 could not exceed £322,500.

Similarly, an underlease which required the tenant to put and keep each and every part of the premises in good and substantial repair, but which provided that the landlord would reimburse the tenant for the cost of putting and keeping the floor in repair or the costs of putting the premises into better repair than they were on 1 February 2000, could not be said to meet the requirement in paragraph (c) of the proviso that the tenant's repairing covenant is to be in the same form as that in the headlease. 'A covenant which requires the tenant to effect repairs partly at the expense of the tenant and partly at the expense of the landlord is not in the same form as a covenant which requires the tenant to effect repairs at its expense.'

Personal covenants

The Landlord and Tenant (Covenants) Act 1995, to which the new underlease would be subject, meant that the undertaking or covenant expressed to be personal was not enforceable by or against successors in title. The question was, therefore, did the fact that these were personal and only enforceable between the original parties mean that paragraphs (c) and (d) were met, even if they would not have been met had they been enforceable as between the landlord and tenant for the time being?

The appeal judge then said the intention of the original parties to the headlease had to be looked at by construing the headlease and having regard to the circumstances that they might reasonably be taken to have had in mind at the time. The judge concluded that what might have been reasonably foreseeable would include a subtenancy which would continue on expiry by virtue of the protection afforded by Part II of the Landlord and Tenant Act 1954. That being the case, the head landlord would wish to protect itself in relation to such continuation, including the possibility that,

Potential scenarios

having given consent to an underletting, it could have a direct relationship on a renewal with the former subtenants on the terms of the former subtenancy. Such direct tenancy would take into account the terms of that underlease, and the rent then payable under the former subtenancy could well be persuasive in evidence as to the reasonable open market rent.

The appeal judge was of the view that the head landlord had an interest in the terms of the underlease with regard to both rent and repairs for so long as the headlease subsists, firstly because the rent payable was a source from which its own tenant could fund the rent payable under the headlease, and it was also a comparable to be used on rent review under the headlease. The judge was similarly of the view that the head landlord was properly concerned to ensure compliance by its own tenant with the repairing covenants in the headlease, and that interest was served by ensuring that similar covenants were contained in any underlease and observed by the subtenant in occupation. The judge pointed out the requirement in paragraph (f) of the proviso to clause 3(32)(c) of the headlease that the tenant would not waive the covenants to be imposed on any subtenant, and that on any breach the tenant would forthwith enforce such covenants.

In anticipating the intention of the original parties to the headlease, the judge was also of the view that they must have been aware of the possibility that the contractual term granted by the permitted underlease would come to an end at a time when 'the landlord' in relation to the tenancy created by that lease was the tenant under the headlease. The head landlord would therefore be concerned not only with the terms of the underlease itself but also with the terms of any new tenancy between the intermediate landlord and the subtenant which could during the subsistence of the headlease be granted pursuant to the provisions of Part II of the 1954 Act, because there was nothing in the headlease requiring any permitted underlease to be for a contractual term equal or close in length to the remaining term of the lease. The terms of that new tenancy might well become the terms of any tenancy arising as between landlord and the former subtenant on the termination of the headlease; the terms of that new tenancy would be likely to reflect the terms of the 'current tenancy', and if at that time the parties were the original parties to the underlease, as could well be the case, there was an obvious risk that the terms of the current tenancy could be held to be the terms which those parties had agreed should have effect as between themselves.

The judge in conclusion, therefore, took the view that the original parties to the headlease would not have considered the fact that the undertakings in relation to the rent and repairing obligations, if made to be personal, would meet the requirements of paragraphs (c) and (d) of the proviso where they clearly did not if that personal limitation did not exist.

The concluding point was that in the circumstances it was not

necessary to consider whether it was reasonable for Allied Dunbar to give consent to the proposed underletting as no duty arose under section 1(3)(a) of the Landlord and Tenant Act 1988.

CONCLUSIONS

The future?

Transparency in the application for consent to a subletting is vital, and a tenant who makes an application for consent without full disclosure could be considered to be foolhardy. If any omission comes to light this representation might be either negligent or fraudulent, and there could be a claim for damages, forfeiture or an order to surrender the sublease. This is therefore clearly of concern both to the tenant and the prospective subtenant.

In the area of transparency it can be assumed that landlords will be much more alert now than they have been before when dealing with an application to obtain specific confirmation that everything relevant has been disclosed. Indeed, specific obligations to disclose may be more commonly seen in leases in the future, and the tenant can hardly object.

Implications and ideas

As will be seen from the detailed judgment, the precise wording of the subletting clause is all important. Ironically, a fundamental hurdle that has often been problematic in the past and necessitated side deeds, namely a covenant not to sublet at less than the market rent or if greater the passing rent, did not appear in this lease and the requirement to sublet at the market rent was satisfied.

As leave to petition against the refusal of an appeal to the House of Lords was refused, this is the established law and a conventional side agreement or side letter, whether expressed to be personal or not, is a 'dead duck'.

The best piece of advice to give to a tenant is that when it comes to 'deal breakers' in negotiating leases, the subletting covenant comes high on the list, all the more so the longer the term of the lease and where no break clause exists. The depressing effect on rent (let alone on the tenant!) of a tight subletting clause will be of little consolation to the tenant if it hampers the subletting because it is in those circumstances where the premises are likely to be over-rented anyway.

As always, the bargaining powers and commercial requirements of the parties may win out. Consider with a solicitor each and every word of the subletting covenant, and consider the problems these could cause in a more difficult market than prevails at the time the lease is taken. If necessary, walk away from the deal. At the time of writing this paper and as the recession bites, particularly in the City of London, much publicity has been given to the 'put' options in leases to bank tenants and law firms giving them the right to sell back 58,000 m² of space no longer required for a period of five to ten years. As a result of this, information from Canary Wharf estimates that if all of the 'put' options are triggered, vacancy levels at the Wharf could reach as high as 25 per cent.

It will be interesting to see, from October, when shorter leases

(those over seven years) will be registrable and it is proposed that registered leases will be open to the public, what 'secret' deals 'protecting' tenants will come to light. It is intended that the parties will be able to apply for the Registrar to designate a document as an exempt commercial information document so that sensitive information will not be open for everyone to see, and it is also proposed that there will be a year of grace for existing registered leases enabling anyone to apply for such a document to be given exempt status, but one could nevertheless see a spate of previously 'hidden' and imaginative schemes, perhaps protecting tenants from the rigours of tight subletting clauses, coming to light.

Sadly, on many existing leases the tenant will be caught, but it may be cheaper in the long run to approach the landlord either to persuade him to waive some of the pernicious provisions of the subletting clause or, at a price, to vary them. A landlord may well be happier to have a subtenant with or without a collateral deed, rather than run the risk of its own tenant going into liquidation and being left with vacant premises, difficult to relet. The existing tenant might well be supported and survive by the income from the subtenant.

Innovative suggestions have already reached the press, including the side agreement being with another group company (which could have tax implications and might also fall foul of the subletting covenant) and the payment of a reverse premium to the subtenant, although this could produce a double hit to the tenant if the subtenant goes bust by the loss of both the capital sum paid and the obligation to pay all of the rent again and comply with the other covenants. The headlease might also prevent the giving or the taking of a fine or premium on a subletting. Another suggestion made by Nicholas Shepherd, property litigation partner at Shoosmiths, in an article in the *Estates Gazette*² is that, assuming the lease allows the giving of a reverse premium to avoid the risk of the subtenant failing, once given it could be immediately repaid to the tenant to hold as a rent deposit — but there are also significant tax issues in this scheme, as he points out, and the figure will be difficult to calculate or agree if, as is usual, there are further rent reviews during the term of the proposed sublease. However, if the tenant is so keen to sublet it may not have the resources to pay the reverse premium in the first place, and if space is readily available on the market, the prospective subtenant may not wish to be bothered with a complex and possibly risky arrangement and will look elsewhere. These are early days and no doubt more ideas will surface.

Try as one might, one must not forget that landlords have concerns as well as to the terms of any sublease, particularly if it looks at the possibility of a direct relationship with the subtenant or its ability (if the sublease is not excluded from the security provisions of the Landlord and Tenant Act) of renewing the sublease and becoming by that means the immediate tenant of the

superior landlord and being able to negotiate the terms of the new lease by reference to the terms of the sublease. There is also the fear of having a comparable rent for review under the headlease or a lease of nearby and comparable premises, albeit that this is sometimes, but not always, successfully excluded and kept confidential.

There are many causes of insomnia!

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References

1. Allied Dunbar Assurance plc v Homebase Ltd and Another (2002) EWCA Civ. 666.
2. Shepherd, N. (2003) 'A do-it-yourself solution', *Estates Gazette*, 8 March, p. 159.