Where is the wriggle room for clients seeking to change the existing lease terms on renewal following the spate of recent cases?

1. The court's ability to step in and determine the terms under s.35 itself on a 1954 Act renewal, in the absence of agreement between the parties, is what influences most parties' approach to negotiating the terms whether there are proceedings in place or not.

2. It is fair to say that the events of the last three years have seen lease drafting evolve far quicker than at any point in the previous two decades. As a result the court is having to consider whether to order lease terms that were not on the radar prior to 2020.

3. My task for today is to consider some recent cases and identify where the 'wriggle room' might be found to help parties who may wish to improve the terms of their leases on a renewal.

The Legal framework

4. The legal framework is uncontroversial. The starting point is section 35(1) of the Act which provides that if the parties do not agree the terms between them, they may be determined by the court having regard to the terms of the current tenancy and all relevant circumstances.

5. The exercise of the court's discretion under s.35 - and in particular the extent to which it should follow and reproduce the terms of the old lease or may depart from those terms and introduce new terms - was considered by the House of Lords in *O'May v City of London Real Property Ltd* [1983] 2 AC 726. It was said that the answer should be flexible.

6. The court must *start* by " having regard to" the terms of the current tenancy.

7. The onus is upon the party seeking to introduce new, or substituted, or modified terms, to justify the change, with reasons appearing sufficient to the court on "strong and cogent evidence"[1]. The court also has regard "all relevant circumstances" and there must "*be a good reason based in the absence of agreement on essential fairness for the court to impose a new term not in the current lease by either party on the other against his will*"[2] (at p. 741).

[1] Cardshops Ltd. v. Davies [1971] 1 W.L.R. 591.
[2] *O'May* at p.741, per Lord Hailsham.

8. Subject to that, the discretion of the court was said to be "of the widest possible kind, having regard to the almost infinitely varying circumstances of individual leases, properties, businesses and parties involved in business tenancies all over the country". If such a good reason is shown, then the court, applying the words "all relevant circumstances," may consider giving effect to them: there is certainly no intention shown to "petrify" the terms of the lease.

9. The overriding question is whether the change is fair and reasonable in all the circumstances, having regard to the general purpose of the Act (the protection of the tenant's business interests so far as they are affected by the approaching termination of the current lease and its security of tenure).

10. It is the elasticity of the test – based on concepts of showing a "good reason", of "essential fairness" and on all relevant circumstances – that makes it inherently uncertain in its application. The words "have regard to" compel something between an obligation to reproduce existing terms and an unfettered right to substitute others. The "relevant circumstances" which form the backdrop for the discretionary test are clearly context specific and susceptible to evolution and change over time.

11. All of that makes it challenging for advisers to give definitive guidance as to when a particular change might be permitted and when not. The ability of clients and advisors to assess how the test will be operated in practice is compounded by the fact that arguments over new terms are often resolved by agreement rather than being the subject of a court determination and where matters do make it to court, judgments are often not reported as the disputes take place in the County Court.

Where is the wriggle room?

12. My task is to identify where the 'wiggle room' to change terms is to be found on a practical application of the *O'May* test. I aim to do so by reference to what has been referred to as a "recent spate" of cases – that is to say four relatively recent County Court cases in which the court considered proposals for new terms said to be justified by economic and legislative changes. They give some guidance as to how the test has been applied recently in the courts and in turn enable us to assess where the elasticity of the test (or the 'wriggle room') might best be employed.

13. I have grouped that potential wriggle room under 4 headings:

    1) Scope for changes to reflect economic uncertainties and market conditions.
    2) Scope for changes to take account of legislative updates.
    3) Scope for changes to minimise the scope for uncertainties under existing clauses.
    4) Other relevant circumstances.

1) <u>Scope for changes to reflect economic uncertainties and market conditions</u>

14. It is well-known that businesses have faced huge challenges and undergone rapid change over the past few years, post-pandemic and post-Brexit, with volatile market conditions and a slow-down in growth across various sectors. So, to what extent can market conditions be relied on to justify changes?

15. <u>Poundland Ltd v Toplain Ltd</u> (April 2021) is a recent example of a case involving a 'pick and mix' of proposed changes on the part of both landlord and tenant across a range of issues which were sought on the basis of changed market conditions. The decision provides helpful guidance as to how the Court is likely to approach applications for new terms on unopposed lease renewals.

16. One of the changes sought by the tenant was for a variation to the payment mechanism to "modernise" the lease by enabling the tenant to pay the rent monthly in arrears rather than quarterly in advance. The change was said to be justified on the basis that it reflected the challenging market conditions which the tenant need to react to post pandemic, would assist it with cash flow, which was said to be in both parties' interests, and was consistent the tenant's standard position across its portfolio.

17. In addition, the tenant sought the insertion of a clause which reduced the annual rent and service charge liability by 50% during any 'use prevention measure' as defined (covering periods when circumstances might make it difficult for the tenant to trade). The tenant sought the change under the guise of modernisation on the basis that the changes reacted to circumstances as experienced during the pandemic and that such relief would be fair and reasonable in the interests of both parties so as to enable it to continue to trade and meet its ongoing obligations to the landlord in similar circumstances. Reliance was also

placed by the tenant on the fact that the clause was in line with similar clauses agreed between many tenants and landlords over the past 12 months. The landlord unsurprisingly took a different view and argued that such a clause fundamentally changed the relationship between the parties and that it would not be fair and reasonable to impose that new risk on it.

18. The court rejected both changes and did so on the basis that they amounted to unreasonable attempt to reallocate contractual risk. It said that the tenants cash flow was entirely a matter for the tenant and that the tenant's portfolio position was not a relevant circumstance which justified recasting the lease in a way that varied the responsibility. The court also made the important point that changes to market conditions do not of themselves justify wholesale reallocations of risk:

> *"it is not the purpose of the legislation or the exercise of the discretion to approve opposed amendments to a lease which would result in a change to the respective risks obligations and benefits carried and enjoyed, nor to insulate the tenant against the commercial and trading risks they may face in a way that would either prejudice the landlord or interfere with their long term interests."*

19. However, there are circumstances in which changes based on economic and market conditions might be considered be fair and reasonable.

20. First, if the parties agree the change *in principle*, the court may have greater room for manoeuvre, even if they are not agreed on the detail. An example is WH Smith Retail Holdings Ltd v Commerz Real Investmentgesellschaft MBH (March 2021) where the parties agreed the principle of a rent suspension clause being inserted to mitigate the effect of forced closures as a result of the pandemic, but were at odds on the detailed terms of the trigger. The tenant occupied a unit within Westfield Shopping Centre and by the time the matter came to court in November 2020 the country was in the middle of its second lockdown. Although non-essential shops were closed, the tenant's premises remained open as it contained a post office providing essential postal and banking services, making it an essential retailer.

21. The court took the view that because the change was agreed *in principle*, there was no *O'May* burden on the tenant to persuade the court to accommodate its proposal. There was therefore no assessment as to whether it was fair and reasonable to include the clause in the new lease. However, the court did comment that the clause proposed by the landlord *would* have been fair in any event. The court then proceeded to accept the tenant's trigger (which operated if retailer around the tenant were unable to trade, even if the tenant itself was not precluded from trading). That decision was context specific: the unit was within a largely empty and echoing Westfield centre, and the tenant was surrounded by non-essential retailers which provided the necessary footfall, and there was no advantage of any substance to the tenant in being remaining open when the centre would be empty. The key difference between the two cases is that the parties had agreed the inclusion of the clause in principle in WH Smith. The Poundland decision dismissed the considered *O'May* in more detail but contrasts with the judge's obiter comments in WH Smith which made reference to factors which alter the retail landscape such as changes in shopping habits and increases in internet sales.

22. Second, even where the term is not agreed, the general state of the market, economic uncertainty and its impact on the parties' respective positions is capable of forming part of "the relevant circumstances" so as to provide scope for changes to be introduced on that basis if the change is appropriately balanced. As HHJ Dight put it in HPUT v Boots (May 2021):

> *"A consideration of all the relevant circumstances, in my judgment, require one, again, to have regard to the current uncertainty in the retail market and the need to protect the Tenant and the need to give sufficient security to the Landlord. Ultimately, as Lord Wilberforce said, the test is what accords with fairness and justice."*

23. Such changes could include:

    1) The insertion of a break clause – in HPUT v Boots the court allowed the tenant a break clause at three years which was not in the existing lease (in addition to a shorter term), on the basis that was appropriate in all the circumstances "to give the Tenant the degree of flexibility which it really needs".

2) Changes to alienation provisions to allow more flexibility to the tenant – see e.g. Clipper Logistics, where a fluctuations and uncertainties in the market were relied on by the tenant to support a change to the alienation provisions and the court accepted that the tenant should be entitled to a variation enabling it to share part of the premises (which were used for storage and distribution and ancillary offices) with customers and third parties to enable it to reduce the cost of any unoccupied space and generate positive returns for the business and guard against adverse market events which may arise from time to time.

3) Changes to the user provisions – in WH Smith, reference was made to "the trend for major outlets such as supermarkets to use greater amounts of space for non-food items". The fact that market conditions have changed how occupiers want to use their premises may necessitate expansion of the user clauses in existing leases to ensure that changes of use would not give rise to a breach. Market conditions might therefore also be relied on to support a proposed change to expand a user clause to support changing retail habits, other evolutions in the bricks and mortar sector and to provide greater flexibility to tenants.

24. Ultimately, the court is asking itself where is the risk to lie, in the interests of fairness, and is the extent of the departure from the existing lease justified - should the risk lie where the current lease provides or is the change and the reasons put forward by the proposing parties sufficient to shift the burden. The more fundamental the change and the more it has the look of a wholesale reallocation or redesign of previously negotiated risks, the more difficult it becomes.

25. Even if the change is capable of being characterised as appropriate and potentially justifiable 'rebalancing' rather than excessive and inappropriate 'renegotiation or reallocation of risk', evidence is key. Market conditions may provide a springboard to a change and thus introduce a degree of 'wriggle room', but it is clear from WH Smith[3] and HPUT v Boots[4] that the evidence adduced by the parties must justify the change by reference to market factors affecting *the specific premises demised* rather than by reference to more general considerations e.g. a general desire to retain flexibility.

[3] where the rent suspension trigger was evaluated on the basis of the specific location of the premises.
[4] where general cash flow considerations were disregarded as irrelevant.

26. The importance of specific evidence was also emphasised in both Clipper Logistics, where the court was persuaded to alter the terms to allow a sharing of part of the premises by specified persons on the basis of specific evidence advanced which demonstrated that the tenant had a reasonable need to share occupation of part and as that detriment would be suffered by the tenant if the alienation clause were not expanded. However, the court noted that no evidence had been advanced in support of a need to share occupation of *the whole*. Equally, lack of specific evidence was also a factor which led the court to reject the tenant's argument that a 5 year rather than 10-year term should be granted: the court accepted that the longer term would result in a higher SDLT liability but noted that there was no evidence from the tenant that payment of that additional SDLT would adversely affect the business in any meaningful way.

27. In HPUT v Boots the court said that it would have anticipated the tenant to have conducted an ongoing review of profitability and its strategy for development, looking at its continuing investment in its estate and infrastructure and the potential changes that it could make it light ot the challenges presented both by the economic circumstances .." As Dight HHJ put it: "*I have heard evidence that Boots has adapted to reflect the increase in online shopping. There is greater use of the click and collect facility for example. But I have seen no documents explaining how this review took place, what the current thought processes of the company are, nor what their current strategy is."*

(2) Scope for changes to take account of legislative updates

28. Another relevant circumstance which might justify new terms arises from changes in the legislative landscape which either impact pre-existing obligations or ought to be reflected in the new lease as a matter of essential fairness between the parties.

29. Updating a clause to take account of legislative updates (e.g. changes to the Use Classes Order) would usually amount to reasonable modernisation but what the position in relation to more fundamental legislative changes is less clear-cut.

30. An increasingly common example arises in relation to so-called 'Green Lease provisions', developed under the Energy Act 2011 and other legislation, in respect of renewals of leases which will not have included them. In Poundland the tenant sought a new clause which provided that that the landlord must carry out works to comply with new domestic minimum energy efficiency standard regulations 2018 (MEES regulations) which require

the property to meet certain energy efficiency targets and which therefore could result in significant works becoming necessary. The legislation did not expressly prescribe who should carry out or bear the cost of the works. The landlord argued that the change was unnecessary because existing provisions already catered for compliance with legislation.

31. Despite the legislation not expressly providing for the works to be carried out by the landlord, the court took the view that the insertion of the clause was consistent with existing obligations and therefore struck the right balance:

> *"As a general proposition it does seem to me to be appropriate if regulation requires that the property should meet those standards then the obligation to ensure that they are met should rest with the landlord".*

32. As well as being consistent with the landlord's perceived obligations, the court also considered that it was appropriate and reasonable to insert a clause imposing a contractual obligation in respect of the regulations in order to add clarity on the basis that if there was no such express obligation, the landlord could seek to enforce in respect of tenant breaches of repairing obligation even though there was a failure by the landlord to comply with the regulations itself.

33. The judge in Poundland also stated in passing that it might also be appropriate to relieve the tenant from compliance with insurance provisions where that would breach government legislation or otherwise be impossible. On the facts that was not suggested, but it seems that if there were specific evidence that a term would contravene subsequent legislation or be compliance rendered impossible in particular circumstances, that is an amendment that might be made.

34. However, if new terms are sought to be introduced on the basis of legislative changes, such terms will need to be sufficiently specific and focused. A salutary example is WH Smith. The landlord sought to include in the service expenditure changes which were said to reflect changes in the law since the lease had been granted in 2007 in the form of the Energy Efficiency Regulations 2011. The changes operated to restrict the landlord's ability to let or relet the premises after the specified dates, unless and until energy efficiency

improvements had been carried out and an Energy Performance Certificate (EPC) had been obtained.

35. The proposed changes which the landlord sought to include additional costs in the list of service charge expenditure, including (i) the cost of carrying out of works or doing anything so as to increase the energy efficiency and/or reduction in carbon emissions from the Premises; and (ii) the cost of preparing or obtaining any EPC or any ancillary documents "(provided that in so doing the Landlord shall act reasonably and in accordance with the principles of good estate management)."

36. The landlord argued that the inclusion of these items reflected changes in law since the original lease was granted and therefore amounted to reasonable modernisation. The original lease had contained a sweeper provision but the landlord contended that the insertion of more specific amendments provided greater clarity for the future.

37. The court sided with the tenant, and its stated reasons for dismissing the landlord's attempt are instructive. First, the changes "were opaque in their intent and likely scope and highly likely to lead to litigation". The judge was not convinced that the new heads of expenditure did provide greater clarity as the landlord was unable to explain to the tenant in any detail what the proposed changes were intended or envisaged to cover. Second, the court was not convinced that the substance of the items was such that they should be re-charged to tenants. Some of the heads of expenditure had "the look of capital improvement" which it was not fair to impose on the tenant. Third, the court noted that the inclusion of the references to the costs of obtaining an EPC conflicted with other provisions in the lease *excluding* the costs associated with reletting from the service charge expenditure. Finally, the court thought the wording was vague and that it was "not enough for a landlord proposing to impose a new term on a tenant to compensate for the vagueness of the wording and the uncertainty of what is intended by reliance on the uncertain mantra that everything will be conducted in accordance with the principles of good estate management."

38. The decision stems back to the *O'May* principles – the landlord had the burden to prove to the court that the changes were fair and reasonable in all the circumstances and the court found that the bar had not been met, due to a lack of specificity and focus on the wording of the terms and sufficient justification on the evidence.

39. Clipper Logistics was also a case where there was an attempt by the landlord to introduce changes on the back of new 'green lease' provisions. The court was asked to include in the renewal lease (i) a prohibition on alterations that would result in a sub-standard EPC rating; (ii) an indemnity for the cost of a new EPC if the tenant did make such alterations; and (iii) an obligation for the tenant to maintain the current EPC rating and to carry out remedial works to restore the EPC if it failed to do so.

40. The court decided that the landlord had pitched too high and that the proposed changes required the tenant to assume new risks which were on the wrong side of the 'rebalancing' vs 'reallocation' line. In relation to the first two clauses, the court held that they would unfairly impose on the tenant duties which statute imposes *on landlords* rather than tenants, that there was no reasonable requirement to include the prohibition on alterations given the existence of existing lease provisions which already contained sufficient controls on alterations and that the indemnity would place too significant a burden on the tenant.

41. However, the court was prepared to allow the term which required the tenant to return the property with the same EPC rating as at the start of the lease on the basis that it reflected an appropriate balance following the coming into force of the new MEES Regulations as otherwise the tenant's actions could make the property sub-standard.

(3) Scope for changes to minimise the scope for uncertainties under existing clauses

42. Although it is not appropriate to remove clauses on the basis that they are uncertain and potentially unfair – it might be possible under the guise of modernisation to amend wording and improve the language of existing clauses to minimise the scope for future uncertainties.

43. For example, in Poundland, the tenant sought to remove a clause that the landlord need not rebuild if there had been a failure by the tenant to pay insurance rent. The tenant argued that the sum might remain unpaid due to an administrative error and it would be unfair in those circumstances to allow the landlord that windfall. The court considered that the question of whether there had indeed been a "failure" was an issue which could be considered separately and did not justify the clause being removed. However, had the tenant asked for the clause simply to be reworded (for example by the insertion of words

such as "save where the failure is not due to any fault on the part of the tenant"), the position may well have been different.

44. Equally, the court refused to insert a service charge cap which had been argued for by the tenant on the grounds that it might unfairly face substantial payments in the last year of the term. The court noted the potential for unfairness but had regard to the fact that the service charge clause already had protective wording which acted as a limit on service charges and which made an artificial cap unnecessary. Again, if that protective language had not been present, the court may have been more amenable to the change.

(4) New terms to cater for other changes of circumstance:

45. Finally, as we have seen, the allocation of risk is key and as Dight HHJ put it in HTUP v Boots, consideration of all relevant circumstances requires the court to have regard to both the need to protect the tenant and to give sufficient security to the landlord. It follows that although the cases have shown it to be difficult for a landlord to pass new burdens across to tenants, there is nevertheless scope for protection for the landlord to protect its position if the tenant's covenant can be said to have been undermined so as to expose the landlord to a great extent than when the original lease was granted.

46. For example, the court has discretion under s.35 to insert a term obliging the tenant to secure that a satisfactory guarantor join the new lease: Cairnplace v CBL [1984] 1 WLR 696. In a suitable case, that can justify the incorporation of improved guarantor provisions in respect of the new lease or the provision of a rent deposit, but as before the landlord would need to adduce evidence in support of the proposal i.e. evidence of the tenant's changed financial position and justify the term on that basis.

Conclusion

47. I referred at the outset to the 'elasticity' and context-specific nature of the *O'May* test. Every case turns on its own facts. However, the recent cases have confirmed that whilst the O'May test remains relatively narrow and that changes must be appropriately balanced, the 'wriggle room' is to be found in the court's ability to consider "all relevant circumstances" which are expressly unlimited and constantly evolving and, as HHJ Dight put it in HTUP v Boots, in the fact that the court's task is to do justice to both parties.

48. So, what are the key take-aways?

49. First, both parties should consider the terms of the existing lease at the heads of terms stage, and consider whether market conditions or legislative changes justify specific changes on either side or whether the language of the existing terms require refinement to address issues which have been experienced. The parties should agree as many terms as possible and prioritise those which matter the most.

50. For tenants, the key take-aways are:

(a) Consider changes to reflect market conditions and provide more flexibility in respect of the premises (e.g. alienation, user clause, break).
(b) Consider incorporation of new landlord obligations to reflect and protect against legislative changes.
(c) Always check that the proposed changes amount to a reasonable re-balancing (which is permissible in principle) rather than being an attempt to insulate the tenant against commercial or trading risks they may face in a way that would prejudice the landlord (which is not).
(d) Always adduce specific evidence in relation to the demised premises (including of market and business evaluation, future plans and business strategy and any evidence of broader business operations where the term has been sought).

51. For landlords, the key take-aways are:

(a) Consider legislative changes carefully, with an eye on the yield up provisions, compliance with legislation clauses and alterations clauses. There may be justification to enable the landlord to share the risk or ensure that duties are imposed on the tenant during the term.
(b) Don't pitch too high. The court will not allow the landlord to impose capital expenditure or long-term risks on tenants.
(c) Be specific as to the practical objective of any proposed change.
(d) Ensure the proposal does not give rise to a conflict with existing provisions.
(e) Consider the terms of the existing lease to ensure that the landlord is not already adequately protected – is it necessary?

(f) Consider whether market conditions justify asking for additional security (improved guarantor, rent deposit).

MYRIAM STACEY KC

16 May 2023

Disclaimer: The contents of this talk do not constitute legal advice and should not be relied upon as a substitute for legal counsel.