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BREAK CLAUSES – BRIEFING NOTE

INTRODUCTION

Businesses need to continually adjust their Corporate Real Estate (CRE) to reflect changes within the business environment and hence to their business. It might be for a specific property at the end of a contract, or it could be a portfolio wide realignment reflecting broader operational changes. A break clause in a lease exists to allow the tenant to flex their property portfolio on a shorter timeframe than the lease expiry and with it an ability to reduce costs and liability.

Within the business world many contracts have the ability to be terminated early and are generally operated by simply serving a notice. In most of the property markets of the world the process is similar, but for the UK property market it is anything but simple. This Briefing Note looks at Break Clauses in England & Wales, how tenants should approach breaks and some of the questions that arise.

Including a Break Clause in a Lease does have an immediate impact on the tenant. The potential operational flexibility comes at a cost, in all probability the initial rent that a landlord will require will be higher, or they may reduce the incentive package offered, or both. At review the rent is likely to be higher than a lease without a break, because of the perceived value from the flexibility it offers the tenant. In addition, there is the impact on accounting for the tenant company to deal with: writing off costs incurred for the fit out and amortising any incentives given to the break date rather than the expiry date, both of which increase the cost to the tenant.

OVERVIEW

The paradox is that breaks are put in to leases to provide tenants with flexibility, but barriers are then put in place to frustrate their operation. Despite paying for the break clause benefits, a tenant will have to comply with specific requirements, indeed, there is not even an assumption in favour of the tenant, rather, and they have to show they have complied. The underlying precedents look to frustrate the operation of the break. Most break condition points are issues that a landlord has various rights of redress on if the tenant fails to remedy them. Hence landlords do not need to frustrate a break because they have no other option for redress.

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Typical issues are:

- Written notice: its form and timing (generally 6 to 12 months)
- Premium: amount and payment
- Vacant possession
- Payment of rent(s)
- Reinstatement of alterations
- Repair

The extent of compliance varies with more modern leases, generally, not as stringent in their compliance requirements as older leases. Some of the more difficult issues to address are:

- Payment of all sums – which now can include interest on late payment that the landlord has not even billed
- Break has to be served by the tenant, which is a named party, and hence assignments are difficult
- Serving on the registered office which might be overseas
- Reinstatement to a condition at a specific date

The onus on compliance is always with the tenant. Even the question of an acknowledgement of receipt of a break notice by the landlord can be an issue; there is rarely an obligation on the landlord to respond within a set time. Hence time, energy and money is wasted on getting confirmation that the notice has been received.

FREQUENTLY ASKED QUESTIONS

When do I need to start looking at the break clause?
A timetable needs to be drawn up for each break. Breaks are ideal for the adage: 'fail to plan; plan to fail'. If a tenant is considering exercising a break that process needs to commence at least 2 years, preferably 3 years, before the break date. This timeline is critical for a business looking to relocate an operation and taking space elsewhere. Getting it wrong leaves the business a property surplus to requirements until the next break or the expiry.

Even if the break is unlikely to be exercised it is worth undertaking a review 3 years out to consider what leverage the break might offer for the business. The landlord may be prepared to give additional incentives to avoid the break being exercised.

The Timeline needs to have clearly identified critical dates, beyond which there is a trigger of an action. For example, if the landlord has not responded to the break notice with 2 weeks of its service, use a process server to re-serve.

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Who should deal with the break?
Have the right team on the job. The Corporate Real Estate Manager who is dealing with a multitude of issues does not have the focus. It needs a Project Manager running it because getting it wrong is very expensive, and will probably tie the business in to costs for at least another 5 years. This person needs to be experienced in running such a process and be clear on the ramifications of the individual elements. They also need the power to make things happen directly and have an open line to the CEO or CFO.

The legal team has to have the right credentials. Who was right for day to day leasing work is not necessarily the right person for dealing with a break. The experience and knowledge for running litigation is a very different skill set; it needs a specialist. Claiming on PI Insurance is not a solution to a missed break.

If there is any complexity around the break then appointing Counsel at the start of the process is a wise investment. It is not as expensive as you might think, and ensures that the person who may be fighting your corner in court is with you from the start of the process.

The investment in the team needs to be weighed against the liability that accrues if the break fails.

Surely it is just a question of looking at one lease clause?
A lease needs to be considered holistically. Forensically analyse the break clause and all of the pertinent clauses in the lease and all the other legal and management documents. Identify the essential elements of the break and the compliance issues and be clear as to the compliance issues.

Who should be the decision maker?
Be clear that once a train of action is set in motion there will be a point of no return – the service of the break notice. If the break is served but the building is still required the notice cannot be readily retracted, and will provide the landlord with considerable leverage.

Ensure that the person holding the 'purse strings' does not get bogged down in the minutiae of costs and misses the bigger picture and the costs of failure. Looking to save £10,000 is fine, but not if the downside is £1m.

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Can I avoid the break process?
It is far better if you can take risk out of the break process altogether. Agreeing to a surrender on flexible terms and removing the dependence on the break is an ideal option in that regard. Have a dialogue with the landlord, offer to surrender and settle dilapidations in a way that allows them to use the money more effectively on the property, especially around upgrading services and finishes. You need to offer the landlord something more than they would normally get. This may, but not necessarily, increase the cost, but for the tenant it brings certainty. This approach needs time and you have to run the formal procedure by the side of any such negotiations, with strict timelines until a Surrender Deed is signed.

What if works are needed?
If reinstatement, redecoration, etc. are needed then allow time for the works to take place, be snagged and finished off. Delays in supply chains and completion can be difficult enough for internal works, if external works are required build in even longer buffer times. Failure by a supplier to deliver air conditioning parts is not an excuse if the requirement is to hand the premises back in repair.

How do I link the break with moving in to new premises?
To allow works to be completed in time on the existing premises the new premises need to procured and fitted out well in advance. The timetable for acquisition, completion of works, commissioning and the move in, all need to be generously assessed to avoid problems becoming critical. With many moving parts, having an Agreement for Surrender put in place that provides a flexible exit date, is paramount to remove risk.

Do not fall into the trap of false economy by focussing on the fact that there will be double holding costs and looking to minimise them. See the bigger picture and weigh the relative costs against the risks of the break failing.

The clause states I must pay all rents. What does that mean?
The courts have adopted a strict interpretation on the subject. This ranges from the need to pay interest that is not billed, to paying a full quarters rent, rather than apportion to the day of the break. The most extreme example being a break on the 24th June, meaning that a full quarter was due for one day into the quarter.

Service charge and insurance are generally reserved as rent, and need to be treated in the same way. Failure to pay a service charge bill, even if it is disputed, may be fatal to the break.

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I have to make a penalty payment – do I need to?

Payments due to the landlord relating to the break cannot be simply left to the accounts team. They are generally too remote from the break process and will not be party to the ramifications of the issues. Monies need to be easily accessible to make payments at the last minute, as landlords are known to have made late demands deliberately during the run up to the break date. Generally, there is no reasonableness obligation on the landlord nor do they have to submit a final invoice 14 days before the break. Therefore you need to be ready to react to what is sent through with very little notice.

On all payments required do not forget the VAT aspect.

The landlord has told me not to worry, but has not put anything in writing.

Leases are drawn up assuming an adversarial position of the parties. Hence anything to do with the break needs to documented in a binding manner. 'Without Prejudice' discussions will not count in court. Even if the point is eventually won in court, it will be couple of years after the break date and with a lot of management time and cost used up and a bill for at least some of the professional teams time. Assume a hostile landlord and be pleasantly surprised, rather than assume a co-operative one and be sadly disappointed.

Landlords are not obliged to co-operate, especially on agreeing issues such as dilapidations. Clearly document what has been asked for and what the response was. Evasion by a landlord of direct questions is not popular in court.

On completion of the works and at handover ensure that the condition of the property is well documented. There should be a clear process for handing over keys to ensure no subsequent claims of disrepair.

How do I avoid problems?

Get it right to begin with. Ensure that Heads of Terms, when taking a lease with a break clause in, is absolutely clear on the process for the break to operate and that it is totally unconditional. A simple reference to a break will often see a conditional break clause materialise in the draft lease, subsequently arguing to dilute the compliance points can be difficult. That means ensuring that the Heads of Terms are properly reviewed before being sent out.

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The landlord has said the break is not valid – what do I do?

Do not sit back, get in the driving seat and run the process. Showing a landlord that you are serious in dealing with any claim is important. Indeed that commitment should have been made clear in the lead up to the break with the approach adopted to the service of notice, etc. A robust approach may diffuse the claim before it even starts.

If there is a real issue then quickly assess how fatal it is likely to be. This is the point where having Counsel on board in advance pays dividends because getting to a clear understanding of the position is time critical. If Counsel has already seen the papers then an opinion can be quickly provided. Opinions are never black and white but the difficult area is when the chance of success is in the band 50% to 70%. Above that: follow through; below that, look at an alternative.

Irrespective of the course of action speak to the landlord and try and structure a deal. There is no absolute certainty with court action for either party other than costs. Circumstances change for both parties so try and avoid closing down lines of communication.

'Plan B' should ideally have been considered as part of the overall planning process. Look to agree to market the space on a 'without prejudice' basis during the process, then if a tenant turns up it is easier for both parties to reach a compromise.

ACTION

- Whilst there might not be any imminent breaks in the portfolio showing, how robust is the database?
- When was it last reviewed from base data, i.e. the leases?
- Who is seeing the list of break opportunities and deciding what to do?
- Is that decision-maker looking three years ahead?
- Is there absolute clarity on the breaks and how you are going to address any issues?

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OPINION

Tenants pay a premium for a break clause to be inserted in to a lease. In other areas one would expect to see a system that was simple to operate. For lease break clauses in England & Wales, that is not the case. The balance needs to be re-addressed and leases be brought into the 21st Century as commercial contracts. That change will only come from tenants' themselves being more robust in what they demand from landlords when they take space and being prepared to walk away from buildings if they do not get what they want. Businesses make such moves all the time on other issues, why is space so different?

CORE Consult (Corporate Occupier Real Estate Consulting Ltd) is a real estate consulting firm, which provides consultancy advice to Corporate Occupiers. Recent projects include portfolio analysis and restructuring; acquisitions; disposals; corporate disposals and acquisitions.

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