

O'MAY REVISITED – OR NOT

A review of the decision in *Edwards & Walkden (Norfolk) Limited and ors v The Mayor and Commonalty and Citizens of London* [2012] EWHC 2527 (Ch)

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Introduction

On 21.09.2012 Mr Justice Sales gave judgment in the trial of two preliminary issues in the case of *Edwards & Walkden (Norfolk) Limited and ors v The Mayor and Commonalty and Citizens of London* [2012] EWHC 2527 (Ch). The case involved 51 claims for new tenancies under the Landlord and Tenant Act 1954 brought by the wholesale meat traders who are tenants of Smithfield Market. The first issue involved the interpretation of legislation that relates to Smithfield Market in particular and therefore is of little or no interest to landlord and tenant practitioners in general. However the second issue required the Court to consider and apply the principles of *O'May v City of London Real Property Co Ltd* [1983] 2 AC 726 and is of wider interest.

This article therefore focuses on that issue, which was: “*whether the rent to be fixed in due course should be an all-inclusive figure for both rent and service charge (the tenants’ preference), or whether it should consist of a rent and a separate variable service charge (the landlord’s preference)*”. The landlord (“the City”) succeeded in persuading the court that a rent and separate variable service charge was appropriate. The City’s success in this regard is notable because the current leases (with the exception of some) were let on an all-inclusive rent and the Court held that a change to a separate variable service charge was justified. This is therefore an example of a party discharging the burden of establishing that a change from the existing terms was justified.

Initial reaction in various case notes and seminars which have followed indicate that this decision has been seen by some as moving away, or a deviation from, the *O'May* orthodoxy. This interpretation of the decision may stem from the fact that in *O'May* the landlord failed in exactly the same bid - the lease, which was an all inclusive rent and service charge, continued as such. It is considered however that it is wrong to interpret the Smithfield

Market decision in this way, and it confuses the wide and narrow *ratios* of the decision in *O'May*. When properly understood it is clear that the Smithfield Market case is simply an application of the *O'May* principles to the particular facts of the case, which in this instance led to a change in the terms of the lease.

Analysis

The question of how to structure payment under a lease, as opposed to how much will be paid, falls to be decided under section 35 of the Landlord and Tenant Act 1954. It provides:

“The terms of a tenancy granted by order of the court under this Part of this Act (other than terms as to the duration thereof and as to the rent payable thereunder)... shall be such as may be agreed between the landlord and tenant or as, in default of such agreement, may be determined by the court; and in determining those terms the court shall have regard to the terms of the current tenancy and to all relevant circumstances.”

It is trite law that the decision in *O'May* is the leading authority on the interpretation of section 35. In that case the landlord sought changes to the payment structure under the lease. Under the original agreement the landlord was responsible for repairs, maintenance and interior and exterior decoration, in respect of which it received a fixed rent and service charge. The landlord's proposal was that the variable cost of these services be separated out and borne by the tenant in full, but that in return the passing rent would be reduced.

Nowadays the rent plus variable service charge structure (often referred to as a “clear lease”) is more or less ubiquitous, and its strength lies in the fact that the tenant pays no more than, but also no less than, the costs of the services from which it benefits. The landlord is usually the party best placed to deliver the services, but it also makes obvious sense that the party which benefits from the services should pay for them. However there can be circumstances where an all inclusive model is appropriate – for example in short leases where there the building is in need of some long terms repairs. In such an instance the tenant may only be willing to accept a lease under which he is protected from the cost of repairs which do not benefit him. The difficulty with all inclusive rents is that the parties

have to take their best guess at the outset of the lease as to the costs in the future, and fix a figure to capture that in advance. Over the course of a long lease this may be unfair one way or another – in a year where costs are low the landlord may profit from the service charge element; in a year where costs are high he may be subsidising those costs.

Regardless of the pros and cons either way, the lease in *O'May* was on the all inclusive model, and section 35 requires the court “to have regard to the terms of the current tenancy”. The key question is what “having regard” means, and how the court is to absorb and reflect that requirement in reaching its decision.

On this point the comments of Lord Hailsham are authoritative, and should be taken as the wider *ratio* of the decision. It is the guidance which formed the broad basis of his Lordship’s decision in that case, but which at the same time provided the general guidance for future cases that is now so familiar to practitioners. He said, at 740F to 741D:

“A certain amount of discussion took place in argument as to the meaning of “having regard to” in section 35. Despite the fact that the phrase has only just been used by the draftsman of section 34 in an almost mandatory sense, I do not in any way suggest that the court is intended, or should in any way attempt to bind the parties to the terms of the current tenancy in any permanent form. But I do believe that the court must begin by considering the terms of the current tenancy, that the burden of persuading the court to impose a change in those terms against the will of either party must rest on the party proposing the change, and that the change proposed must, in the circumstances of the case, be fair and reasonable, and should take into account, amongst other things, the comparatively weak negotiating position of a sitting tenant requiring renewal, particularly in conditions of scarcity, and the general purpose of the Act which is to protect the business interests of the tenant so far as they are affected by the approaching termination of the current lease, in particular as regards his security of tenure. I derive this view from the structure, purpose, and words of the Act itself...”

A further point which was canvassed in argument, and with which I agree, is that the discretion of the court to accept or reject terms not in the current lease is not limited to the security of tenure of the tenant even in the extended sense referred to by Denning L.J. in [Gold v. Brighton Corporation \[1956\] 1 W.L.R. 1291](#). There must, in my view, 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. Any other conclusion would in my view be inconsistent with the terms of the

section. But, subject to this, the discretion of the court is 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.”

Thus it is clear that (a) section 35 does not prevent the court from changing the terms of the lease if it decides to do so; but (b) that if it does do that it must have a good reason based on essential fairness for doing so; and (c) the party seeking the change has the burden of persuading the court that the change is justified. In the words of Lord Wilberforce at 747G, “...there is certainly no intention to freeze, or in the metaphor used by learned counsel, to “petrify” the terms of the lease”.

Having addressed the correct approach to section 35, the House of Lords then rejected the landlord’s arguments, and this leads one to narrow *ratio* relevant to the facts of that case. It is convenient to refer to Lord Wilberforce’s judgment at 748F *et seq post* as a concise summary of why the landlord failed. The landlord’s case rested on the fact that the evidence demonstrated (a) that the freehold interest commanded a higher price if let on a clear lease and that the shift was therefore in the landlord’s interest; and (b) that new leases of property at that were by this stage (the 1980s) usually granted and accepted as clear leases. This was part of the modern trend away from all inclusive models which had tended to dominate in the past.

Although Lord Wilberforce accepted that these were relevant circumstances, he did not consider that that there was any obligation under the Act to make the lease conform to modern market practice. He also considered that the advantage sought by the landlord had to be weighed against the disadvantage to the tenant. In this regard he considered that the assumption by the tenant of an unpredictable and potentially very significant burden of risk in the future, which it had not originally bargained for, to outweigh the commercial advantage sought by the landlord.

Lord Wilberforce when on to describe other factors that influenced his thinking, by referring to the nature of the parties’ interest in the land. The landlord’s interest is an indefinite freehold interest, and the tenant’s interest is a limited one over a comparatively short period – such circumstances suggested that it was appropriate for the landlord to assume

long term risks and not the tenant. Taken in isolation this particular consideration may seem to be at odds with the Sales J's willingness to transfer the long term risk to the tenants at Smithfield Market, but in fact it is one point amongst several others that led the House of Lords to conclude in *O'May* that on balance there was insufficient justification for changing the terms of the lease.

Turning now to the Smithfield Market case it becomes clear that Sales J correctly applied the principles laid down by *O'May*, Sales J quoted, *inter alia*, the passage set above, which gave him the wide *ratio* guidance as to how he was to deal with the question before him. He then quite properly turned to deal with of the particular case before him. This is entirely in keeping with Lord Hailsham's guidance "*that the change proposed must, in the circumstances of the case, be fair and reasonable*". The question therefore is subjective, and will turn on the facts of the case, and the facts in the Smithfield Market case were somewhat unusual.

The particular features in the Smithfield Market case which were important were as follows. Firstly, it was common ground between the parties that the service charge mechanism, whether fixed or variable, ought in principle allow the landlord to recover its costs. This concession (albeit entirely reasonable and in accordance with RICS guidelines) immediately put the tenants on the back foot because, as explained above, a variable service charge is inherently more likely to achieve this goal. It adapts each year to the landlord's actual expenditure, ensuring that over time the landlord neither profits nor loses from the provision of services.

Secondly, the peculiar history of the leases at Smithfield Market showed that the tenants, who had by and large been at the Market for many years under predecessor leases, had previously bargained for and accepted a variable service charge arrangement. Leasing arrangements were introduced across the market in the early 1980s, and that first wave of leases had been clear leases. In the late 1980s the City intended to carry out a massive refurbishment programme, and for that reason it was agreed that the tenants could pay a fixed charge for period of time whilst that was carried out. It was however expected that

the tenants would revert to the variable charge in due course, and indeed the tenants later entered into agreements for clear leases.

This was closely linked to a third point, which is that the tenants later reneged on those agreements for lease and persuaded the landlord to grant all inclusive leases. A compromise was the creation of a large number of leases, now under consideration by the court, which were indeed all inclusive leases, but which also contained a clause which provided as follows:

“Upon service by the Landlords of notice to terminate this Lease under section 25 Landlord and Tenant Act 1954 or upon service by the Tenant of a request under section 26 Landlord and Tenant Act 1954 then the parties shall enter into negotiations to determine whether this Lease shall be renewed on an all inclusive rent or on a separate rent and service charge and in the event that agreement is not reached then the parties shall apply to Court in accordance with the Landlord and Tenant Act 1954 in respect thereof.”

The court accepted the City’s argument that the effect of this clause as to lessen the weight of its burden of proving that a change in terms was justified. In fact the court held that *“for the purposes of application of section 35 relatively little weight attaches to the simple rent provision in the 2001 leases, as compared with other factors relevant to the assessment of what terms should apply”*.

The City thus had a double advantage – it was little burdened by the fact that the terms existing leases were all inclusive, and the tenants had accepted that it was entitled to recover its costs via the service charge.

To this the court added, fourthly, that the tenants had been at the premises for a long time and had a long term interest in being there in the future, and fifthly that services provided by the City at the market were so bespoke as to in essence be of direct use to the meat traders only. These included the costs for items such refrigeration and meat transport system that specifically catered to the tenants’ needs. There were some more finely tuned factors to take into account but such detail is beyond the scope of this article.

Finally, insofar as the tenants had a justifiable concern that under a variable service charge they would be exposed to significant costs for historic disrepair, the landlord neutralised

that concern by accepting responsibility for all such costs and proposing a mechanism for identifying them before the inception of the new leases.

With all this factors in mind the Sales J found support for the inherent fairness of a variable service charge over a fixed charge in the Court of Appeal decision of *Hyams v Titan Properties Ltd* (1972) 24 P&CR 359. Sachs LJ said:

“It is quite clear that in the conditions which have been over recent years prevailing as regards increases required on expenditure on services the charges for those services should, when questions arise under the [Landlord and Tenant Act 1954](#), normally be separated from the rent itself. It is equally clear that it is necessary that when a new lease is granted, at any rate where the service charge is not merely minimal, there should be inserted in the lease a formula of the type referred to by Buckley L.J.; the simple reason for this is that in no other way can one obtain an appropriate measure of fairness as between landlord and tenant. To try and fix for these somewhat unpredictable increases—and I mean, of course, “unpredictable” as regards percentage—over a period of some five years a fixed mean sum is an exercise which is bound to result in unfairness to one side or the other.”

Although *Hyams v Titan* pre-dates *O’May*, the force of this observation is not diminished by *O’May*. *O’May* provides the conceptual framework on how to approach 35, and *Hyams v Titan* provides an insight into the relative fairness one may attribute to a variable service charge. *Hyams v Titan* was referred to in *O’May*, but ultimately the landlord was unable to persuade the court that in the circumstances of the case a change was justified. In Smithfield Market case the opposite was true – the narrow circumstances of this case, when seen through the lens of the wide *ratio* in *O’May* permitted the landlord to succeed. To paraphrase Lord Wilberforce, Sales J properly exercised the wide discretion of the court, having regarded to varying circumstances of individual leases, properties, businesses and parties involved at Smithfield Market, and held that for reasons of essential fairness a change in the terms of the leases was justified.

Conclusion

The Smithfield Market case is not a heterodox decision, and it does not re-open questions previously settled by *O’May*. It is actually a good demonstration of the inherent flexibility of

O'May, as long one makes sure to separate the general guidance set out in that case from its narrow decision on the facts. The general guidance requires the court to consider the circumstances of each case, and therefore by definition the subjective part of the decision in *O'May* should not be taken as binding. Sales J correctly accepted applied the principles he was bound to apply under *O'May*, and reached a decision suitable to the facts of the case before him.