Case Commentary

The Vogue for Side Letters and the Need to Follow New Fashions

Vivienne Westwood Ltd v Conduit Street Development Ltd [2017] EWHC 350 (Ch)

Agreements; Breach of contract; Business tenancies; Leases; Penalty clauses; Rent reviews; Termination

This case concerned the interpretation and effect of a side letter made contemporaneously with the grant of a commercial lease. The tenant argued that the terms upon which the landlord could terminate the side letter were unenforceable as a contractual penalty. Applying the test set out by the Supreme Court in El Makdessi v Cavendish Square Holding BV *[2015] UKSC 67, Timothy Fancourt QC (sitting as a deputy judge of the High Court) held that this argument was correct. The judgment also contains some useful guidance on the nature of implied terms.*

Facts

The claimant, Vivienne Westwood Ltd, was the tenant of retail premises in Conduit Street, London, under a lease made by deed on 18 November 2009. By the lease, the premises were demised to the tenant for a term of 15 years from 18 November 2009 at an initial yearly rent of £110,000 per annum subject to "upwards only" rent reviews to the open market yearly rent on 18 November 2014 and 2019. The yearly rent was payable quarterly in advance on the usual quarter days. Insurance and service charge payments by the tenant were also reserved as rents.

The lease contained covenants by the tenant to pay the rents, interest on unpaid rent at 4% above base rate, the landlord's costs of recovering arrears of rent on an indemnity basis and to indemnify the landlord against all liabilities, costs and claims arising from any breach of covenant. The tenant also covenanted to use the premises for the sale of men's and women's clothing and fashion accessories during the normal trading hours for the locality.

The side letter

The side letter was dated 18 November 2009 and was from the original landlord to the original tenant. It was personal to the original tenant but not to the landlord and conferred on the original tenant the conditional benefit of a lower rent than that reserved by the lease for the first five and potentially 10 years of the term. It provided for the landlord to terminate the agreement set out with immediate effect in the event of any breach and, in the event of termination, for the rents to be immediately payable pursuant to the lease. The precise terms were of central importance to the decision and are, therefore, set out in full:

> "We agree that (subject to the following conditions):-
>
> 1. Notwithstanding the rent reserved by clause 1.25 of the Lease, we will accept a reduced yearly rent form you as follows:
>
> From 30 April 2010 to 17 November 2010 £90,000 per annum exclusive

From 18 November 2010 to 17 November [2013] £95,000 per annum exclusive
From 18 November 2013 to 17 November 2014 £100,000 per annum exclusive.

2. In the event that the amount of yearly rent payable under the lease pursuant to the rent review on 18 November 2014 exceeds £125,000 we will accept a reduced yearly rent from you of £125,000 exclusive up to and including 17 November 2019.
3. The annual rental figures stated above are exclusive of rates, outgoings, service charge, VAT and all other payments arising from time to time under the lease.

The conditions of this agreement are:

(a) This agreement is personal to you Vivienne Westwood Limited (Co regn no 2682271) and does not extend to any other person.

(b) This agreement ends immediately if you:
- assign the lease or
- allow someone else to trade from or occupy the shop or
- cease trading form the shop premises yourselves or
- become insolvent (as defined by the Insolvency Act 1986), are the subject of a petition or resolution for winding up, have an administrator or receiver appointed or enter into an arrangement or composition under the Insolvency Act 1986

(c) Any dealing with the legal and/or beneficial interest in the shares of the tenant company is to be treated as an assignment of the lease for the purposes of this agreement.

(d) You must not disclose the provisions of this letter to any third party either while the agreement is in force or at any time after it has ended.

Subject to compliance with the terms of this agreement, we agree not to take any action in respect of any breaches of the lease that may arise due to the concessions set out in this agreement.

If you breach any of the terms and conditions contained in this agreement or any term of the lease and/or any document supplemental to it for example a licence to alter, we may terminate this agreement with immediate effect and the rents will immediately payable in the manner set out in the lease as if this agreement had never existed. If we terminate this agreement, we will serve written notice to that effect on you at your registered office.

It is agreed that this agreement is not a variation of the lease.

No term of this agreement is enforceable under the Contracts (Rights of Third Parties) Act 1999 by a person who is not a party to it."

Although the letter was not signed on behalf of the tenant, it was common ground that its terms were agreed at the same time as the lease.

The principal issue

Amongst the issues raised between the parties, the principal issue identified by the deputy judge was whether or not the right of the landlord to terminate the side letter upon any breach of contract by the original tenant, thereby rendering the rents payable (without reduction) in accordance with the reservation in the lease, was a penalty and, therefore, unenforceable. That question fell to be determined on the true interpretation of the letter as at 18 November 2009 when it was signed together with the lease. The terms of the side letter and the lease were to be read together.

There had only been one transaction between the parties and the side letter was dependent upon the terms of the lease.

The principles

The deputy judge noted the several judgments of the Supreme Court Justices in the comprehensive review of the law of penalties in *Cavendish Square Holding BV v El Makdessi* revealed differences in approach. The main principles were, however, clearly restated. Those principles were:

1. Whether or not a contractual provision is a penalty is a question of interpretation of the contract and the real question is whether it is penal or punitive in nature.
2. In English law, a penalty clause can only exist where a secondary obligation is imposed upon a breach of a primary obligation owed by one party to the other. It is to be distinguished from a conditional primary obligation, which depends on events that are not breaches of contract.
3. Whether a clause imposes a secondary liability upon a breach of contract is a question of substance and not of form.
4. A provision that in substance imposes a secondary liability for breach of a primary obligation is penal if it imposes on the party in default a detriment out of all proportion to any legitimate interest of the innocent party in the performance of the primary obligation, or (using traditional language) which is exorbitant, extravagant or unconscionable.
5. The onus lies on the party alleging that a clause is a penalty to show that the secondary liability is exorbitant, extravagant or unconscionable.
6. Since the penalty rule is an interference with freedom of contract, it is not lightly to be concluded that a term in a contract negotiated by properly advised parties of comparable bargaining power is a penalty.

The issues to be addressed were identified as follows. First, the threshold issue: is the stipulation in substance a secondary obligation engaged upon breach of a primary contractual obligation? Secondly, the extent and nature of the legitimate interest of the promisee in having the primary obligation performed. Thirdly, to determine whether or not whilst having regard to that legitimate interest, the secondary obligation was exorbitant or unconscionable in amount or in effect.

The threshold test

The deputy judge held that the substance of this particular transaction was that the original tenant's obligation was to pay rent at a lower rate, with a default to a higher rate in the event of any breach of contract. The landlord was agreeing to a lower rent, personal to the original tenant only, because the original tenant was an attractive tenant to have trading from its premises. On the true interpretation of the side letter, its terms made plain that the reduced rent was attributable to the benefit to the landlord of the visible presence of the original tenant in the premises. The lower rent ceased not only on assignment but also if the original tenant ceased trading from the premises or allowed someone else to trade from or occupy them.

The obligation could not be categorised as a discount for prompt payment. The concession was not linked solely to payment of the rent. The rent could also be increased in event of any breach of covenant. As a result, the threshold test was satisfied. The provisions of the side letter amounted to a change in the primary obligation with which the original tenant had to comply

whilst it traded from the premises. To the extent that the side letter purported to permit the landlord to impose a greater obligation upon the happening of any breach of any obligation of the lease, the secondary obligation was therefore *capable* of being a penalty.

Legitimate interest in performance

The deputy judge held that it was necessary to approach the question whether the landlord had a legitimate interest in having the original tenant comply with its obligations in the lease in the light of his conclusion on the threshold test. That the reduction in the rent was not simply a conditional right to which the original tenant was not otherwise entitled but a substantial term of the bargain it had struck with the landlord in taking the lease. As he rather neatly put it:

> "The [landlord] cannot therefore argue that it had a legitimate interest as such in seeing the rent revert to what it calls the market rental level. That would be a legitimate interest in non-performance of the [original tenant's] obligations, not a legitimate interest in their performance."

It was necessary for the landlord to establish that it had a greater interest in seeing the tenant perform all its obligations promptly than would be compensated by the interest, damages and costs otherwise recoverable for a breach of covenant. That was particularly so when the lease provided for interest to be payable at 4% above base rate and for the landlord's costs to be paid on an indemnity basis.

Noting that a landlord will always have a financial interest in having a performing tenant, rather than a defaulting tenant, and that a tenant's failure to perform its obligations under the lease is, in theory, capable of impacting on the value of the reversion, the deputy judge commented that such a result was only likely to follow in the event of a serious breach of covenant. It was, therefore, telling that, under the terms of the side letter, the same consequences would follow whether the tenant's breach of covenant was minor, a one-off, serious or repeated. Although stated not to be conclusive, the fact that the identical substantial financial consequences applied without regard to the nature of the obligation broken or any actual or likely consequences for the landlord was recognised as one of the hallmarks of a penalty.

Exorbitant or unconscionable?

The question of how onerous is the secondary obligation arising as a result of the breach of contract gave rise to two subsidiary issues on the facts of the case. The answers turned on the interpretation of the side letter and lease. The first question was what kind of breach gave the landlord the right to terminate the side letter benefits? The second was whether those benefits were terminated with retrospective and prospective effect or only with prospective effect?

At face value, the landlord had the right to terminate the benefits of the side letter if there was "any" kind of breach of the terms of the letter or lease. However, seemingly appreciating the unattractive impact of such a literal reading upon its case, the landlord submitted that it was necessary to imply the word "materially" before the word breach in order to prevent the side letter from having a wholly uncommercial effect and undermining the value of the letter to the original tenant. The deputy judge's treatment of this submission is instructive.

As the deputy judge noted, the starting point is that terms are only implied into professionally drafted contracts where it is necessary to imply a term in order to give the contract business efficacy and/or it is obviously what the parties meant to provide: *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 7; [2015] 3 W.L.R. 1843. The

deputy judge added that he was doubtful whether it can ever be right to imply a term that will cause uncertainty or difficulty in the operation of a contract which is otherwise unambiguous in its terms. That being so, it was unclear how the landlord's suggested criterion of "materiality" would be applied to determine whether the landlord had the right to terminate the side letter:

> "Where parties use such express terms in a contract, the court must do its best to interpret them, however problematic that may be: see, e.g. *Fitzroy House Epworth Street (No 1) Ltd v The Financial Times* [2006] EWCA Civ 329 ... But that is a different matter from implying a term that is not there on the basis that it is necessary to give business efficacy to the contract."

Steering a middle course against a background where the original tenant had argued that the reduced rent was to be regarded as part of the basic bargain made between itself and the landlord, the deputy judge reached the pragmatic conclusion that the parties could not have meant that a "trivial" breach of contract by the original tenant would enable the landlord to terminate the side letter. He reasoned that, given all the obligations arising from the lease and the supplementary documents, there was bound to be a trivial breach of some obligation from time to time, particularly in cases where, as in this case, there was an obligation to keep the premises in good and substantial repair and condition. In his judgment, if the side letter was to have sensible commercial effect it was therefore necessary to imply a term to exclude a trivial (de minimis) breach of covenant from triggering the landlord's right to terminate. Whilst acknowledging that there may be a dispute about whether a given breach is trivial, the deputy judge considered there was no real difficulty in applying such a test if the word trivial was implied.

As to the second interpretation issue, the deputy judge held that there was no realistic interpretation of the paragraph in the side letter to the effect that the higher rent was payable prospectively only in the event of termination of the side letter.

The ruling

The deputy judge concluded that the obligation to pay rent at a higher rate as from the rent commencement date of the lease, regardless of the nature and consequence of the breach and of the time at which it occurred within the term, was penal in nature. In circumstances where the higher rent was payable with retrospective and prospective effect and, in addition to the other remedies the landlord had in the event of breach, including the payment by the tenant for the full measure of compensation for any loss caused by the breach, he held that the consequence of a non-trivial breach of contract was:

> "out of all proportion to the legitimate interest of the [landlord] in having the original tenant comply with every one of its obligations rather than pay full compensation for any breaches".

Indeed, on the facts before him, the deputy judge opined that, even if the obligation to pay an increased rent had been prospective only, it was a "blunt instrument" that "may give rise to a very substantial and disproportionate financial detriment", and would also have been penal in nature.

Commentary

Fundamentally, as the deputy judge made clear, the finding that the termination provision was penal in nature was based upon the specific terms of this side letter and of this lease and against the background of the facts of this case. That said, the terms of the side letter were held to be

penal notwithstanding the deputy judge's recognition of the "equality of bargaining power between two well-advised parties".

It should be noted that the deputy judge identified that the issue would have been "less clear-cut" for him if the consequences of termination of the side letter had been prospective only. The cumulative nature of the adverse consequences of a termination under the side letter plainly also played a key role in this decision. As did the fact that the concessions could be terminated in the event of a breach, which was more than trivial, of *any* of the covenants within the lease (plus any supplemental documents).

The lesson for the practitioner is, perhaps, that as much time should be invested in drafting the terms of any side letter as the terms of the lease in future.

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Notices of Application—Is Posting Enough?

Salehabady v Eyre Estate Trustees [2017] UKUT 60 (LC); [2017] 2 P. & C.R. DG4

Application notices; Enfranchisement; Postal service; Time limits

This case examines the question of when a referral to the First-Tier Property Tribunal must be made and what constitutes such a referral in relation to lease extensions under the Leasehold Reform, Housing and Urban Development Act 1993.

The relevant provisions

Tthe Leasehold Reform, Housing and Urban Development Act 1993 ss.42–48 set out the procedure which must be followed when making a referral to the First-Tier Tribunal (FFT). In essence, if the tenant seeks an extension, the procedure is begun by him serving a notice under s.42 of the Act. The landlord responds by serving a counter-notice under s.45. There is then a period of two months when the parties can negotiate and aim to reach agreement on the terms of acquisition. After the expiry of this period, either party can apply to the FTT to determine the matters in dispute by means of a s.48 notice of application. However, any application to the FTT must be made within six months of the date when the counter-notice is given.

Facts

The facts were relatively straightforward. The leaseholder, Mr Salehabady, occupied a residential property and sought to claim a new lease (a lease extension) under the 1993 Act. He served a notice, as required by s.42 of the Act, and the landlord served a s.45 counter-notice in response. The tenant, therefore, had six months from the date the counter notice was received by him to file a s.48 notice of application to the FTT asking it to determine the issues in dispute. Although the leaseholder's solicitors sent a notice to the FTT in advance of the deadline of 21 April 2016, it was not received until after that date.

The FTT dealt with the question of its jurisdiction as a preliminary matter on the papers before it. It declared that it did not have jurisdiction to deal with the appellant's application for an extended