



REPORT OF THE ABI WORKING PARTY ON THE LANDLORD AND TENANTS (COVENANTS) ACT 1995

January 1996

1 INTRODUCTION

- 1.1 The Landlord and Tenant (Covenants) Act 1995 significantly changed the law relating to privity of contract. In effect, for new leases, privity of contract is abolished. However, landlords and tenants may now agree, at the grant of a new lease, the pre-conditions which would apply in controlling assignments.
- 1.2 The provisions of the Act came into force on 1 January 1996.
- 1.3 This paper was prepared by an ABI Working Party which was asked to consider the provisions which should be included into new leases in order to exercise sufficient control over assignments, to prevent a significant increase in the risk to cash flow.

The members of the Working Party are listed at the end of the Report.

A copy of the terms of reference is attached as Appendix A.

2 SUMMARY

- 2.1 Draft clauses providing a framework for the inclusion in new leases to control the assignment of leases are set out in Appendix B of this paper.
- 2.2 The draft clauses follow the framework of the Act and provide two elements to the pre-conditions: circumstances and conditions.
- 2.3 The circumstances which will allow a landlord to withhold consent include where the assignee is not of sufficient financial standing to comply with covenants set out in the lease, or where the assignee is an associated company of the tenant.

This latter provision is to help prevent the movement of assets and liabilities within a group of companies, such that the ultimate tenant in the group is a shell with no assets. This could leave the landlord with no worthwhile recourse against an authorised guarantor in the event of the default by a subsequent assignee. To give the tenant some operational flexibility, the lease should be drafted to permit sharing of possession within group companies.

- 2.4 The conditions govern the terms on which a landlord may permit an assignment to take place. The conditions proposed in the paper

include the provision of an authorised guarantee in each case and prior payment of all sums owed under the lease to the date of assignment.

- 2.5 Further conditions and circumstances are set out in the appendices to Appendix B. In addition, there is also attached a commentary which should be read when considering inclusion of the conditions and circumstances in a new lease.
- 2.6 In all leases the alienation provisions cannot be read in isolation and it is presumed that the remainder of the leases will be drafted in the appropriate modern form to allow landlords to exercise sufficient control over the tenant's occupation of the building.

3 BACKGROUND

- 3.1 The Working Party considered a wide range of tests and conditions for inclusion which, for various reasons, were ultimately not adopted. Generally it was felt that in being too specific with these terms and conditions, the Court might infer that those matters which were excluded were of lesser importance to the landlord. Furthermore, the Working Party concluded it was very difficult to devise a financial test or tests which could apply in the majority of cases.
- 3.2 As a consequence the Working Party fell back on the concept of reasonableness which confers an ability to consider a broad range of factors in coming to a judgement on the suitability of a proposed assignee. This was felt to give a landlord greater scope to exercise control than very precise and rigid tests.
- 3.3 The additional subjective test which the Working Party considers does have some merit is set out in Item 1 of Appendix 1. This allows a landlord to refuse consent to an assignment where the value of his reversion will be diminished as a result of the assignment. Any significant increased risk to the cash flow would normally be reflected by a reduction in the value of that cash flow. In determining this, a valuer should take into account all factors affecting the assignee's covenant.

However, it was felt by the Working Party that its application should not be universal and so it was placed as an option. In particular, it was felt that it would be fiercely resisted by High Street Multiples and add little benefit to the landlord for prime retail properties. Similarly it would have little benefit in large, multi-let properties. It would have benefit in more secondary properties where the strength of a tenant's covenant is of greater importance than other property factors.

- 3.4 The factors considered and rejected fell broadly into the following categories:

3.4.1 Financial Tests

These included profits tests, net assets tests, gearing tests, operating cash flow, and the level of bank facilities. However, there was no single test, or combination of tests which could be applied consistently to provide a reliable result. Many companies approaching financial difficulty could pass one or more of the tests whilst at the same time many financially sound companies could fail one or more of the tests.

For example, one major clearing bank failed the three years' profits tests.

3.4.2 Credit Rating Test

A reference to an equivalent covenant strength as measured by one of the major credit rating agencies, or a minimum credit rating requirement was considered. These are crude measures which are backward looking and can result in companies whose financial strength differ, all achieving the same credit rating. As a consequence, an unsatisfactory covenant could pass the test.

3.4.3 Good Estate Management

As the Act, for the first time, allows landlords and tenants to agree preconditions, consideration was given to including a number of these. For example, that assignment could not occur where there were material breaches of covenant, the tenant had not completed required works; there were uncompleted licences or rent reviews outstanding. It was felt that in these cases and where the issue was significant it would be reasonable to refuse consent, without the need to specify them as pre-conditions. Furthermore, these cases were not directly related to the cash flow. Other factors including tenant mix or types of user or trading style (which, again, were better controlled in the user provisions) would be covered under the reasonableness test.

3.4.4 Absolute Bar on Assignment

This is a draconian measure which could be applied in very particular circumstances but which would have a severe adverse impact on the rent achievable at first letting and at review. Therefore it was rejected.

3.4.5 Other Requirements

These included a requirement for a rent deposit in every case or that the third party guarantee be provided in every case. It was agreed that these were inappropriate for inclusion in leases but, if the assignee's covenant was not satisfactory, it would be reasonable to require such additional security as a condition of that particular assignment.

4 NEXT STEPS

4.1 All members should be encouraged to record their experience of the Act in practice. This should include the success in resisting assignment to unsuitable assignees, the grounds used for refusal, the attitude of the Courts and the tests applied by the Courts in arriving at decisions.

4.2 The Property Panel should formally review the impact of the Act annually and consider altering the policy set out in this paper in the light of changing circumstances.

MEMBERS OF THE WORKING PARTY

Steffan Francis
David Alker
Jamie Davey
Limited

Prudential Portfolio Managers Ltd
Legal & General Property Limited
Norwich Union Investment Management

Ian Evans
Hamish Hodge
David Knight
John Edgcumbe
meetings)
Emily Gestetner
Paul Emerton (Secretary)

Commercial Union Properties Limited
Dundas & Wilson
Lovell White Durrant
Hillier Parker May & Rowden (two
Price Waterhouse (one meeting)
Association of British Insurers

APPENDIX A

PRIVITY OF CONTRACT - LANDLORD AND TENANT (COVENANTS) ACT 1995

Working Party Terms of Reference

Aim

To produce a uniformity of approach to the conditions landlords will seek to include in new leases, granted after the Act becomes law, to control assignments.

With the adoption of a common standard, to exercise sufficient control of assignments to prevent significant increase in the risks to cash flow, whilst avoiding any adverse impact on rents at review as the degree of control adopted will be common through most modern leases.

To consider or suggest conditions to be proposed in new leases. Any conditions proposed for inclusion will need to be (1) legal (2) practical (3) commercial. It is likely that any reference to (3) will be mere commentary.

Terms of Reference

To consider and recommend the conditions which should be included in leases to control assignments following the introduction of the Act. To consider possible wordings to be used and the production of model clauses, and to identify the nature and degree of tests to be applied in controlling assignments and to be clear on the grounds upon which landlords could refuse consent to assign.

11 September 1995

APPENDIX B

Working Draft Clauses providing a framework for the inclusion of preconditions to be assignment of the whole of the demised premises. (Please read the accompanying commentary).

- 1 Not to assign the whole of the demised premises without the prior written consent of the Landlord (such consent not to be unreasonably withheld) provided that the Landlord shall be entitled (for the purposes of section 19(1A) of the Landlord and Tenant Act 1927):
 - 1.1 to withhold its consent in any of the circumstances set out in clause 3;
 - 1.2 to impose all or any of the matters set out in clause 4 as a condition of its consent.
- 2 The provisos to clause 1 shall operate without prejudice to the right of the Landlord to withhold such consent on any other ground or grounds where such withholding of consent would be reasonable or to impose any further condition or conditions upon the grant of consent where the imposition of such condition or conditions would be reasonable.
- 3 The *circumstances* referred to in clause 1.1 above are as follows:
 - 3.1 Where the assignee is an associated company of the Tenant.
 - 3.2 Where in the reasonable opinion of the Landlord the proposed assignee is not of sufficient financial standing to enable it to comply with the tenant's covenants in the Lease.
 - 3.3 [Additional optional circumstances are set out in Appendix 1]
- 4 The *conditions* referred to in clause 1.2 are as follows:
 - 4.1 The execution and delivery to the Landlord prior to the assignment in question of a deed of guarantee (being an authorised guarantee agreement within section 16 of the Landlord and Tenant (Covenants) Act 1995) in the form set out in Schedule [] in a form reasonably required by the Landlord.
 - 4.2 The payment to the Landlord of all rents and other sums which have fallen due under the Lease prior to the date of the assignment.
 - 4.3 [Other optional conditions are set out in Appendix II].

APPENDIX 1

Other possible circumstances entitling the Landlord to withhold consent

- 1 Where in the reasonable opinion of the Landlord the value of the Landlord's interest in the demised premises would be diminished or otherwise adversely affected by the proposed assignment on the assumption (whether or not a fact) that the Landlord wished to sell its interest the day following completion of the assignment of this Lease to the proposed assignee;
- 2 Where the proposed assignee enjoys diplomatic or state immunity [but this circumstance shall not apply where the proposed assignee is the Government of the United Kingdom of Great Britain and Northern Ireland or any department thereof].
- 3 Where the proposed assignee is not resident [in the United Kingdom of Great Britain and Northern Ireland] [in the EC] [in a jurisdiction where reciprocal enforcement of judgements exists].

APPENDIX II

Other possible conditions to be attached to the Landlord's Consent

- 1 The assignment shall not take place until any requisite consent of any superior landlord or mortgagee has been obtained and any lawfully imposed condition of such consent satisfied.
- 2 The execution and delivery to the Landlord prior to the assignment of a rent deposit deed for such sum as the Landlord may reasonably determine in the form set out in Schedule [] [or in such form as the Landlord may reasonably require] together with the payment by way of cleared funds of the sum specified in the rent deposit deed.

COMMENTARY

- (i) Clearly, some landlords may try to include in leases more restrictive pre-requisites than those contained in the attached draft and, at the same time, seek to negate their negative impact through the wording of the rent review clause. Apart from the initial difficulty which landlords will face in securing an appropriate provision during lease negotiation, landlords will also have to consider very carefully the potential "circular effect" of any amendment to the rent review clause which does not reflect the terms of the actual lease.
- (ii) The distinction between *circumstances* (clause 3 of the draft) and *conditions* (clause 4 of the draft) was regarded as the simplest structure to use as it mirrors closely the wording of the new section 19(1A) of the Landlord and Tenant Act 1927 which has been added by section 22 of the Act.
- (iii) A few areas within the drafting (eg paragraphs 2 and 3 of Appendix I) have deliberately been dealt with in 'shorthand' as each landlord will no doubt have its preferred expressions.

- (iv) Where the lease in question is a sub-lease, the terms of the superior lease (in particular those relating to assignments of sub-leases) will, of course, need to be considered when framing the provisions relating to assignment. For example, paragraph 1 of Appendix II of the draft may be relevant.
- (v) The draft does not provide for any reference to an independent third party determination. For the sake of simplicity, and to limit the possibility of a two tier approach, the services of the courts are relied on.
- (vi) Landlords may wish to draft the surety provision so that the surety also guarantees the obligations of the Tenant under an authorised guarantee agreement.
- (vii) Observations on specific provisions of the draft now follow:

Clause 3.1 the Lease will have to specify a definition of "associated company" and may provide for increased sharing among associated companies.

If this proves unacceptable, a fall back position might be one of the following:

(a) to provide for the lease to be assigned to the assignee jointly with the existing associated tenant or with the parent company. Care will need to be taken to ensure that this does not fall foul of the anti-avoidance provisions in the Act.

(b) the landlord makes no special provision for inter group assignments and merely relies on Clause 3.2 of the draft (the "sufficient financial standing" test).

(c) the landlord might impose an "equivalent status" test for intergroup assignments only. This could be further qualified as follows:

(i) where another associated or group company assignee fails the equivalent status test, the lease could still provide for the assignment to proceed as long as another associated or group company, of equivalent status to the assignor, guarantees the obligations of the assignee; but

(ii) the new associated or group company guarantor also guarantees the obligations of any further assignee that is an associated or group company. Such a provision may also, possibly, fall foul of the anti-avoidance section.

Clause 3.2 the use of the word "reasonable" will make this clause susceptible to review by the court.

Clause 4.1 each landlord will probably have its own preferred form of authorised guarantee agreement. This can largely follow the terms of the usual type of existing guarantee subject

to the parameters set out in the Act; in particular the guarantor's liability cannot last beyond a lawful assignment by the assignee.

**Appendix I,
Paragraph 1**

This is made an optional clause as it may prove unacceptable to many major retailers. Diminution in value could also relate to the landlord's reversion to the building or centre of which the demised premises form part.

**Appendix I,
Paragraph 3**

The concepts here will need more elaborate definition depending on the landlord's precise concerns. In the case of a corporation, the location of its registered office may be the most relevant factor. Care needs to be taken in drafting this test. Too narrow a requirement might adversely affect the rent obtainable.

**Appendix II,
Paragraph 1**

Depending on the terms of the superior lease or any mortgage this provision could render the lease unassignable or could be very restrictive. Landlords should therefore consider carefully the terms of any superior lease or mortgage.

Enquiries to:

John Hale (020) 7216 7674

January 1996