



Alert

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Property @ction



Break clauses and the Milton Gate problem

In this Alert, we consider the important case of *PW & Co v Milton Gate Investments Limited and another* [2004] EWHC 1994 (Ch). This concerns the effect of determination of a head lease on sub-leases deriving from that head lease. We have found that some clients seeking to take a sub-lease have not appreciated the effects of Milton Gate (and the underlying case of *Pennell v Payne* to which we will also refer).

The facts

In 1990, Milton Gate's predecessor in title granted PW a 25 year lease of a substantial office building in the City at Milton Gate, 1 Moor Lane, London.

PW was given a right to sub-let the building in parts, albeit on a strictly controlled basis. The lease contained provisions as to what was meant by a "Permitted Underlease", meaning broadly that any sub-lease had to have rent review provisions identical to the lease and reserve no less than the open market rent reasonably obtainable for the premises.

The lease also gave the tenant the right to break at the end of the twelfth year upon giving 12 months notice. The effect of the determination provision was the crux of the dispute and it is therefore worth noting in full.

The determination provision was as follows:

"The Lessee (ie PW) may determine this Lease on the 24 June 2002 by giving to the Lessors not less than 12 months prior written notice and on the expiration of such notice this present Lease shall determine **subject to any Permitted Underleases** but without prejudice to any claim by either party against the other in respect of any antecedent breach of any covenant... and in the event of the Lessee serving such notice the Lessee shall upon the 24 June 2002 pay to the Lessors a sum equivalent to 9 months yearly rent payable at that date

Provided that such sum will not be payable if on the expiration of such notice 75% of the lettable office area of the... premises is underlet in accordance with the terms of this Lease **and such Permitted Underlease or Underleases have an unexpired term of at least 5 years"**

Between 1994 and 1995, PW had granted a total of seven Permitted Underleases under which the entire building was effectively sub-let. Five of these were granted to BT for terms that would have lasted for at least five years following the break point in the head lease. The other two underleases were not due to expire until 2015.

PW decided to break its lease and served a notice to that effect in 2000.

What was the dispute?

While there were many issues between Milton Gate, PW and BT, one of the key considerations was as follows:

PW believed that, notwithstanding the termination of the lease, the sub-leases would survive. They argued that, by virtue of the determination provision, the landlord and tenant had agreed not only that PW could determine the lease on 24 June 2002 but also, because of the phrase "**subject to any Permitted Underleases**" that any sub-lease would continue (provided that it was a Permitted Underlease). This was of considerable importance, given the penalty payment that would need to be paid by PW (amounting to £5.17 million) if the sub-leases had, in fact, come to an end.

As for BT, despite initially wishing to stay, their objective was to vacate the premises. So, they wished to establish that the sub-leases had, in fact, determined.

The rule in *Pennell v Payne* [1995] QB 192

Before considering the court's ruling, it is worthwhile highlighting the general principles derived from the case of *Pennell v Payne*, as the Milton Gate case is inextricably linked with that decision.

In *Pennell v Payne* the question was this: where a tenant serves a notice to quit on his landlord, is the landlord entitled to possession against a sub-tenant, irrespective of whether that sub-tenancy was granted within the terms of the lease?

Note, firstly, that it is implicit that, without the notice, the sub-lease would otherwise have continued. Secondly, even if the effect of the notice is to determine the sub-lease at common law, it is possible that the sub-tenant would be entitled to remain in possession as against the landlord

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under statute (e.g. by virtue of Part II of The Landlord and Tenant Act 1954).

The Court of Appeal held in *Pennell* that where the lease is determined in accordance with its terms, then any sub-leases will also determine, even if the sub-lease was granted within the terms of the lease.

The court's decision in *Milton Gate*

The court approached the dispute by looking at the following issues:

- whether the parties had purported to contract out of the rule in *Pennell v Payne*.
- if they had, was that purported contracting out effective as a matter of law?

On the first issue, the court considered whether, in fact, the parties had actually intended to contract out of the consequences of the general rule laid down in *Pennell* and decided that that was, indeed, the intention.

Generally, the court accepted that the natural meaning of the words "subject to any Permitted Underleases" indicated that any Permitted Underlease would be unaffected by, and would continue notwithstanding, the determination of the lease. It was not obvious what other purpose the words in question might have been intended to have. Further, of course, the lease had been drafted **prior** to the rule in *Pennell*. So the court accepted that the parties could well have expressed their agreement fairly shortly, because they believed that it was consistent with the general law in any event. Also, the closing words of the determination provision made it abundantly clear that the parties did believe that any sub-lease would survive the expiry of the lease.

As to the second issue, having decided that the parties had purported to contract out of the consequences of the rule in *Pennell*, was this effective? The court concluded that it was not.

The court said that a tenancy is not merely a contract. A tenancy is and creates an estate in land. So, when a tenant grants a sub-lease, it is granting a subsidiary estate out of the estate vested in it. Inevitably, therefore, if the tenancy determines, any subsidiary estate carved out of it must also determine. Therefore a sub-lease cannot survive the destruction of a lease, simply because the landlord and tenant agree that it should (although the statutory rights of a sub-tenant to remain in occupation under the Landlord and Tenant Act 1954 are not affected.)

At first sight, this would appear to contradict the well established principle that a sub-lease **does** survive in the case of a consensual surrender of a lease. However, the court got around that by saying that the surrender exception was one of "great antiquity" and it did not think it legitimate to invent a new exception to the rule. (It went on to reject the argument that the determination provision in the lease could be treated as a determination by surrender, rather than by notice to break, with the result that the sub-leases would continue, notwithstanding determination of the lease.)

How did the case conclude?

Because of the rule in *Pennell v Payne*, the sub-leases had expired on 24 June 2002. Despite the attempt by the landlord and tenant to contract out of the general rule, it was not, as a matter of law, possible to do so. PW was liable for the payment of the penalty to Milton Gate.

Leases drafted nowadays will hopefully take the Milton Gate decision into account and draftsmen will make no attempt to provide that sub-leases will survive the exercise of a break clause contained in the lease. However, there are still some leases about, prepared before the *Pennell* decision, that do contain such a provision and potential sub-tenants need to be wary. The danger is that, without proper advice, a party may take a sub-lease without appreciating the possibility that its interest may be terminated far earlier than originally envisaged, due to premature termination of the head lease.

If you have any questions regarding this article or any issues raised by it, please contact:

Birmingham

Arren Thornton: Associate

Tel: +44 (0)870 839 3405

Email: arren.thornton@hammonds.com

Leeds

Patrick Walker: Director for Advocacy

Tel: +44 (0)870 839 7566

Email: patrick.walker@hammonds.com

Manchester

Helen Hoath: Senior Associate

Tel: +44 (0)870 839 5068

Email: helen.hoath@hammonds.com

London

Will Lawrence: Partner

Tel: +44 (0)870 839 1551

Email: william.lawrence@hammonds.com

WWW.HAMMONDS.COM

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