Making a molehill out of a mountain

Charlotte Ross explores a case concerning forfeiture of a head lease where the court refused to grant relief

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'There might be some breaches that would be so serious and irremediable as to justify the refusal of relief, but in most cases relief will be granted on the breach being remedied and the tenant paying the landlord's costs.'

When the court is asked to consider an application for relief from forfeiture, it often has the difficult task of balancing the rights of the landlord under the lease with the need to find a proportionate solution which will give the tenant an opportunity to retain its leasehold interest.

Relief from forfeiture is an equitable remedy and so is granted at the court's discretion. The court's decision as to whether to grant relief is made more difficult where the lease itself has value, and forfeiture will result in an uncovenanted 'windfall' for the landlord. In the recent case of *Freifeld v West Kensington Court Ltd* [2015], the Court of Appeal was asked to rule on an application for relief where the relationship between landlord and tenant had broken down completely as a result of the tenant's behaviour. However, a refusal by the court to grant relief from forfeiture would result in the tenant losing a significant asset and in the landlord benefitting from a multimillion-pound windfall. The judgment gives useful guidance on how the court will approach such circumstances, and highlights the breadth of the court's discretion.

Statutory right to relief

A landlord may only forfeit a lease for breach of covenant by the tenant if the lease contains a right of re-entry or forfeiture.

The right for a tenant to claim relief from forfeiture is statutory, and is found in s146(2) of the Law of Property Act 1925. In essence, this provides that where a landlord is proceeding (by either court action or peaceable re-entry) to enforce a right of forfeiture, then:

- the tenant may apply for relief from forfeiture;
- the court may grant or refuse relief as it sees fit; and
- where it grants relief, the court may do so on such terms as it thinks fit. These may include terms as to costs, expenses, damages, compensation, penalties, and injunctions to restrain any similar breach in future.

The discretionary nature of the court's power to grant relief means that the usual equitable rules apply. In particular, the court will consider the conduct of the parties.

The facts in *Freifeld*

The case related to property at West Kensington Court located in Kensington, London. The building is a 'mixed-use' development, comprising seven commercial retail units on the ground floor and in the region of 150 residential flats above.

The freehold of the building is owned by West Kensington Court Ltd. The majority of the long lessees of the residential flats are shareholders in the freeholder company.

The seven retail units were let together in 1982 under one 99-year head lease. The head lease was granted at a premium, and the head tenants were not required to pay the freeholder an annual rent. The rental value that the head tenants could achieve by sub-letting the retail units was in the region of £133,000 per annum.

As a result, the head lease was a valuable asset.

The head lease contained various covenants on the part of the head tenants, including a covenant:

> ... not to underlet the whole or any part of the demised premises without the consent of the Landlord (such consent not to be unreasonably withheld).

The relationship between the freeholder and head tenants had not always been an easy one. In particular, tensions had arisen as a result of a sub-letting of one of the retail units to a Chinese restaurant. The freeholder claimed that the restaurant was very poorly run and, among other things, had complained about the restaurant's waste management and food preparation practices, noisy air conditioning and use of areas outside its demise. The freeholder alleged that the Chinese restaurant caused nuisance and annoyance to the residential tenants, and that much time and money had been used up dealing with issues caused by the restaurant's behaviour.

Despite the freeholder's concerns about the way in which the restaurant was being run, in 2011 the head tenants granted a future sub-lease (the future lease) to the existing sub-tenants of the Chinese restaurant. The future lease was granted without the freeholder's consent and in breach of the terms of the head lease. Furthermore, it was established on cross-examination that the breach had been deliberate. At the time the future lease was granted, the head tenants had known that they were obliged to obtain the freeholder's consent to any sub-letting, and yet proceeded to grant the future lease without it.

In April 2012, the freeholder found out about the grant of the future lease. The head tenants reacted by applying for the freeholder's retrospective consent. This was not given (there being no obligation on the freeholder to give it) and, on 31 May 2012, the freeholder served notice to forfeit the head lease pursuant to s146 of the Act (the first notice). The first notice claimed that the head tenants were in breach of the alienation provisions in the head lease. The freeholder argued that this breach was serious, since it had deprived it of the opportunity to seek undertakings about the way the restaurant would be run in future.

In August 2012, the freeholder served the head tenants with a further section 146 notice (the second notice) citing other breaches of the head lease. The second notice was served without prejudice to the freeholder's pre-existing right to forfeit.

In September 2012, the breaches of the head lease had not been remedied and the freeholder forfeited the head lease. The head tenants responded by applying for relief from forfeiture on such terms and on such conditions as the court thought fit. The freeholder asked the court to consider the head tenants' application in light of the grounds specified in both the first notice and the second notice.

A landlord may only forfeit a lease for breach of covenant by the tenant if the lease contains a right of re-entry or forfeiture.

Decision at first instance

In this case, a decision to refuse relief from forfeiture would result in the freeholder receiving a significant windfall, since it would be handed back the value in the head lease. The judge at first instance was aware of this, and he made clear that he was obliged to consider whether any damage suffered by the freeholder was proportionate to the advantage it would obtain if no relief was granted.

The judge held, however, that the intrinsic value of a head lease could not be persuasive. If this was to override all other considerations, tenants could commit breaches of valuable leases with impunity. He also commented that a tenant would bear a heavy burden in demonstrating to the court that it has taken all reasonable steps to ensure compliance with its lease covenants, particularly where a breach was deliberate.

The judge's assessment of the head tenants' behaviour was damning. He commented that they had shown:

> ... a cynical disregard for their own obligations under their lease and also for the very real and longstanding problems which had been encountered for many years in respect of the Chinese restaurant.

Furthermore, the judge felt that it was difficult to see why the freeholder should be compelled to remain in a contractual relationship with the head tenants and that, in the circumstances, the head tenants faced 'a vertiginous, but not impossible, climb up to the peak of relief from forfeiture'.

At the date of the hearing, the head tenants had not taken the steps necessary to remedy the breaches of covenants. The judge's conclusion was that the head tenants 'had not even begun to make preparations to leave base-camp in order to embark upon their vertiginous journey up to the peak of relief from forfeiture' and refused to grant relief.

Post-judgment application for relief

On 5 December 2013, after judgment had been given but before the order for possession on forfeiture had been drawn, the head tenants made a further application for relief from forfeiture. They requested that relief should be granted on condition that they should be given six months to assign the head lease, failing which it would be surrendered.

The purpose of the application was, of course, to allow the head tenants to sell their leasehold interest and preserve some of its value for themselves. It would also prevent the freeholder from obtaining a windfall, which the head tenants estimated as being in the region of £1m to £2m.

The judge disagreed with the head tenants regarding the value of the head lease. He commented that the value had begun to diminish when its terms had first been breached and that, by the time the lease was forfeit, all that was left was a 'hope value': the hope

being that relief from forfeiture would be granted, if applied for. His view was that the head tenants had not taken any steps in the run-up to the hearing to make relief from forfeiture likely to be granted. As a result, the hope value had diminished as time had gone on.

tenants finally realised the potential consequences of their actions and managed to procure the surrender of the future lease. They also appointed a new managing agent to take charge of the retail units, with authority to enforce the terms of the sub-leases if

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The judge did express concerns about the freeholder obtaining a monetary benefit from forfeiture but took the view that the head tenants were 'simply reaping what they ha[d] sowed'. The head tenants' application was refused, and they subsequently appealed.

In the Court of Appeal

In the period between the decision at first instance and the appeal, the head

necessary. The head tenants applied for the Court of Appeal to take account of this new evidence. The Court of Appeal agreed to read the new evidence, and to give judgment about its admissibility at the same time as giving judgment on the appeal.

The head tenants' position

Counsel for the head tenants, Mr Mark Warwick QC, argued that the decision to refuse relief from forfeiture on any conditions had been disproportionate to the damage suffered by the freeholder as a result of the breaches.

Mr Warwick also argued that the judge had erred in his approach to the wilfulness of the breaches. The court should have been concerned only with ensuring that the damage occasioned to the freeholder by the breach was made good. The uphill climb which the head tenants faced in order to convince the court that relief should be granted should not have been made any more 'vertiginous' as a result of the fact that the breaches had been committed deliberately.

The head tenants relied on the decision in *Southern Depot Co Ltd v British Railways Board* [1990], which established that relief from forfeiture can be granted even where a breach is deliberate. It had also established that the court was not required to find 'an exceptional case' before it was permitted to grant relief.

Mr Warwick cited *Magnic Ltd v Ul-Hassan* [2015], which had dealt with similar issues. *Magnic* had made clear that the purpose of a forfeiture clause in a lease is to provide the landlord with some security for the performance of the tenant's covenants, and that the risk of forfeiture is not intended to operate as an additional penalty for breach of those covenants. The judgment in *Magnic* indicated that there might be some breaches that would be so serious and irremediable as to justify the refusal of relief, but stated that in most cases relief will be granted on the breach being remedied and the tenant paying the landlord's costs.

Finally, the head tenants argued that the judge at first instance had misdirected himself regarding the value of the head lease. They claimed that an order for the sale and assignment of the head lease would allow them to keep the benefit of the value of the head lease, while also drawing the problematic relationship between the freeholder and the head tenants to a close. Mr Warwick drew the court's attention to the case of *Khar v Delbounty Ltd* [1998], in which the Court of Appeal had made such an order, describing it as 'the fair and just solution in this situation'.

The freeholder's position

Conversely, the freeholder's position was that the court was entitled to take

Summary

- Relief from forfeiture can be granted, even though a breach is deliberate.
- A tenant's behaviour will be taken into account when deciding whether or not to grant relief from forfeiture.
- The court has a broad discretion when considering an application for relief, and will attempt to 'square the circle' between a landlord's right to possession and the tenant's interest in preserving the value of its lease.

account of the fact that the breaches had been wilful. Their counsel also quoted the decision in *Magnic* and drew attention to the passage in the judgment which stated that:

> ... [i]f... the defendants' conduct in this case had amounted to a conscious disregard of the terms for relief which the court had imposed then it would be much more difficult to argue that the refusal of further relief was wrong in principle even though it would produce a windfall for the landlord. The balance to be struck will obviously depend on the relevant circumstances.

The freeholder argued that the circumstances in this case justified the refusal of relief, despite the consequential windfall that would come their way. They pointed out that the burden had been on the head tenants to sort out their affairs, and they had not done so. They reminded the court that the complaints in the second notice had been regarding nuisance, and that these had been proved. Accordingly, the freeholder saw no basis on which an interference with the judge's discretion could be justified.

Court of Appeal decision

The Court of Appeal agreed with the head tenants that relief from forfeiture could be granted, even though a breach is deliberate. That said, the judge at first instance had been correct to make findings about the wilfulness of the head tenants' breaches and to take those findings into account in deciding whether or not to grant relief from forfeiture. The Court of Appeal agreed that this was a situation where the history of the head tenants' behaviour meant that there could be no guarantee that they would not lapse back into their old ways. Relief should not be granted on terms which would mean the parties would have to continue as landlord and tenant as before.

The Court of Appeal did not agree, however, that the 'windfall' should be disregarded. The correct approach was to consider the question of the windfall on its own merits, and then to weigh this against the head tenants' reprehensible behaviour. The windfall was one factor that should be considered alongside all the other circumstances.

In her judgment, Arden LJ concluded that the judge at first instance had failed to weigh the windfall against the other factors. In taking the view that the head tenants were 'reaping what they have sown', the judge had failed to account for the advantage that the freeholder gained from the forfeiture of the head lease. The judge had not attempted to 'square the circle' between the freeholder's right to forfeit and the head tenants' right not to give the freeholder an uncovenanted benefit. Furthermore, he had misdirected himself regarding the value of the head lease. His approach in valuing the leasehold interest at nil had been incorrect, since the head lease was not a flawed asset if the court gave relief from forfeiture for the purposes of a sale.

The Court of Appeal's decision was to permit the fresh evidence and allow the appeal. An order was made to grant the head tenants relief from forfeiture for the purposes of and conditional upon the sale of the head lease within six months from 1 September 2015. Such a sale would be subject to a number of practical conditions, meaning that the head tenants would need to obtain the freeholder's consent to the assignee (such consent not to be unreasonably withheld), that the retail units would be properly managed in the run-up to the sale, and that any sums owing from the head tenants to the freeholder must be paid from the proceeds of the sale.

Conclusion

The solution which the court came to was attractive, since it allowed the dysfunctional landlord/head tenant relationship to be terminated, while at the same time allowing the head tenants the possibility of retaining some of the value of their asset. The onus will now be on the head tenants to achieve the sale of their interest, and to maximise the value of that asset in so far as they can.

It seems likely that this decision would have been different if the head tenants had not managed to procure a surrender of the future lease, or if they had not managed to convince the court that the retail units would be properly managed in the run-up to the sale. While the judgment provides some useful guidance on the approach to be adopted in situations such as this, it is clear that each case will turn on its own facts.

In his supporting judgment, Briggs LJ commented that the conclusion of the court should not be misinterpreted as conferring *carte blanche* on tenants to disregard their covenants, wherever there is value that would be lost by an unrelieved forfeiture. In every case, a balance will have to be struck and there may be cases where substantial value has to be passed to the landlord, if no other way of securing the performance of the tenant's covenants can be found. ■

Freifeld & anor v West Kensington Court Ltd
[2015] EWCA Civ 806
Khar v Delbounty Ltd
(1998) 75 P&CR 232
Magnic Ltd v Ul-Hassan & anor
[2015] EWCA Civ 224
Southern Depot Co Ltd v British Railways Board
[1990] 2 EGLR 39