

BREAKING A LEASE AT A DISCOUNT

A little-known House of Lords court case has the potential to increase the ability of companies to break long commercial property leases, without having to pay all the remaining rental to the landlord. It also marks an important use of discount rates in the calculation of statutory damages.

The 1999 case of *Christopher Moran Holdings v Birstow*, known as the *Park Air Services* case, is regarded by Richard Stanley, head of corporate and banking support at property consultants Colliers CRE, as an important legal development that may be of great help to commercial property occupiers, "particularly in softening market conditions, where landlords have little confidence in their ability to relet vacant property quickly. It has, he says, "revolutionised the compensation payable to landlords" by providing "a workable and definitive solution to companies wishing to close down operations and limit their exposure".

In the *Park Air Services* case, the tenant took out a 25-year lease on a property on Gray's Inn Road, central London, in 1989. By the time of the first rent review five years later, the open market rental value was less than a quarter of what *Park Air Services* was paying.

Until this case, the prevailing legal wisdom was that a company that goes into liquidation and "disclaims" a lease is liable for all the remaining lease payments due under the contract. Broadly speaking, they had to pay a sum equal to the annual rental multiplied by the number of years remaining in the lease. However, in this case,

five law lords overruled three Court of Appeal judges and decided that:

- The landlord must mitigate his loss; hence, a claim for damages must allow for the ability of the landlord to relet the property
- Any loss over the balance of the period of the lease must be reduced by an appropriate discount rate to allow for the fact that the landlord is receiving payment now rather than over a period of time

For this procedure to be useful, the company occupying the property must go into liquidation. It is not necessary, however, for the company to be insolvent.

In the *Park Air Services* case, the occupier was solvent at all times and was put into voluntary liquidation by its shareholders. The liquidator then disclaimed the "onerous" lease, triggering a claim under section 178(6) of the Insolvency Act 1986.

Note, however, Colliers CRE's warning that the option of voluntary liquidation as a means of disclaiming an onerous lease is not available if there are parent

company or other guarantees that the landlord can exercise.

In his judgment, Lord Hobhouse said that the payments due by the occupier were "compensatory" in nature. The landlord did not have a right to performance of the contract; ie, the right to payment of future debts. In this respect, the act of disclaiming the contract under the statutory insolvency provisions was analogous to a breach of a commercial contract.

He added that failure to apply a discount rate that allows for immediate payment of damages rather than future payment of rental would lead to overcompensation.

In these respects, the Court of Appeal "fell into error" and its judgment was "misconceived", he ruled. The Court of Appeal said there should be no discount rate, unless the Insolvency Act required it. Lord Millett said, "The opposite is the truth." Rental payments are not debts; they are consideration for the right to remain in the property.

Lord Millett noted that the Insolvency Rules provide for certain types of debts to be discounted at a rate of 5%. He added, "The 5% rate is a purely nominal rate, which has remained constant for more than 100 years during periods of high and low interest rates alike."

He concluded that such a rate would not properly represent the landlord's loss. Instead, he ruled that the yield on gilt edged securities for an equivalent term was the appropriate rate, which the High Court had previously found to be 8.5%.

Comment: The government's leasehold stamp duty consultation paper (see Extraordinary Items, June 2003) is regrettably at odds with the House of Lords ruling on the use of a commercial discount rate. The government's stamp duty proposals have the effect of discounting future lease payments at 3.5%, then charging stamp duty at 1% of the net present value. The government ought to follow the House of Lords' guidance on discount rates, even though this would reduce its desired effect of penalising long leaseholds.

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Useful links

- Colliers CRE is at www.collierscre.co.uk
- The *Park Air Services* case is at www.hrothgar.co.uk/WebCases/index.htm

Effect of *Park Air Services* on landlords' claims

BEFORE		AFTER	
Unexpired term	18 years	Unexpired term	18 years
Rent	£100,000 pa	Rent	£100,000 pa
18 x £100,000	£1,800,000	Open market rental value	£80,000 pa
		Annual rental loss	£20,000 pa
		£20,000 x 18 discounted @ 8.5%	£181,000
		2 yrs' rental loss, £80,000 x 2 discounted @ 8.5%*	£142,000
		Agents' & legal fees, etc (say)	£30,000
Claim	£1,800,000	Claim	£353,000

source: Colliers CRE

* Assumes one-year vacancy, plus one-year rent-free period to subsequent tenant. The effect of structuring the calculation in this way is to pay the landlord the full £100,000 (discounted) for the two years in which the property will be unlet; ie, an additional £80,000 over and above the £20,000 estimated in the previous line.