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Contract & Exchange

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Peta Dollar
of Dechert LLP

Peta Dollar has more than 25 years experience of commercial property law.

After 17 years as a Real Estate Partner at Denton Wilde Sapte, she has recently made a lifestyle change, and is now the Real Estate Professional Support Lawyer at Dechert LLP.

Peta is a member of the Editorial Board of Landlord and Tenant Review and the author of a book Tenants' Pre-emption Rights: A landlord's guide to the Landlord and Tenant Act 1987, published by Jordans. She regularly writes and lectures on commercial property topics

Deposits

Except in exceptional circumstances, a contract for the sale of land will always contain a provision requiring the buyer to pay to the seller a deposit, i.e. a percentage of the purchase price, on exchange of contracts. Both the Standard Conditions of Sale and the Standard Commercial Property Conditions provide (Condition 2.2) for a **10% deposit**, to be held by the seller's conveyancer as stakeholder (although on a sale at auction, they provide (Condition 2.3.6) for the deposit to be held by the auctioneer as agent for the seller) and to be paid to the seller on completion together with accrued interest. The payment of a 10% deposit, the holding of that deposit as stakeholder, except in the case of auction sales, and the paying of the interest on the deposit to the seller is all standard practice, but there are some exceptions to this, namely:

- in the case of residential transactions, particularly where the buyer is borrowing the whole, or 95%, of the purchase price, the seller may sometimes accept a 5% deposit only;
- in the case of very large commercial transactions, where the purchase price is many millions of pounds, the parties will sometimes negotiate a reduced deposit, perhaps 5%;
- very substantial institutional buyers, such as pension funds, generally refuse to pay a deposit, and this will normally be agreed by the seller;
- it is not the practice of the Crown or the Crown Estate to pay a deposit;
- it is not unheard of on a substantial commercial transaction for the buyer to seek to share in the interest earned on the deposit, and for this to be agreed by the seller;
- where the contract is conditional on the satisfaction of one or more conditions, and there is to be a substantial delay between exchange and completion, it is not uncommon for there to be a reduced deposit and/or for the parties to share the interest paid on that deposit. Sometimes no deposit is payable on exchange but a deposit is payable on satisfactions of the condition(s) if there is then to be a substantial delay before completion takes place.

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Deposits

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PRACTICE POINT

Although there is no reason why a deposit should not be more than 10% of the purchase price, there would have to be an exceptional reason for this (such as the fact that the seller is carrying out works to the property on behalf of the buyer between exchange and completion) otherwise there will be a risk that the deposit will be treated as a penalty and accordingly the buyer will be able to recover it in full if he defaults on the contract.

Stakeholder or agent for the seller

Where the deposit is held as stakeholder, the stakeholder will hold the deposit on behalf of both parties and cannot pass it to either party without the consent of the other (at least pending completion or default by either party). Where the deposit is held as agent for the seller, however, the agent may pass the money to the seller at any time, and as a result, the buyer may have difficulty in recovering the deposit if the seller defaults on the sale.

Payment of the deposit in case of default

The main reason why a deposit is normally payable is because, if the buyer defaults on his purchase, the seller can forfeit the deposit and thus recover his costs, together with some compensation for inconvenience caused, without the need to resort to litigation. This is why a reduced deposit may be payable on a multi-million pound commercial transaction, since the amount of money involved may be out of all proportion to the loss which may be suffered by the seller if the buyer defaults. Indeed, if the buyer defaults and the seller is able immediately to find an alternative buyer, the deposit may be in the nature of a windfall for the seller, effectively increasing the value of his property to 110% of that value (less costs incurred in connection with the abortive sale).

Both the **Standard Commercial Property Conditions** (Conditions 9.5 and 9.6) and the **Standard Conditions of Sale** (Conditions 7.5 and 7.6) provide that if either party fails to comply with a notice to complete,

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Catherine Kent of Forsters



Catherine was involved in a wide variety of commercial and residential property transactions before becoming a property professional support lawyer.

In this role she is responsible for keeping a large property team up to date and trained in property matters including related online services.

She has contributed to various Legalease publications including the Property Law Journal.

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Fiona Larcombe

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Fiona Larcombe has been a Professional Support Lawyer in the Real Estate Division of SJ Berwin LLP since 1998.

Before that, she was an assistant solicitor at Simmons & Simmons, where she specialised in landlord and tenant matters.

Leases - The basic terms

helping the landlord to keep track of them. This does not mean that the obligations in the lease will bind the parties before the lease is actually completed, unless the parties expressly agree that they will.

PRACTICE POINTS

If the term is expressed to be "from" 24 June, it is presumed to start at midnight between 24 and 25 June, unless there is evidence that the parties intended something different. Avoid uncertainty by stating that the lease is for a term "beginning on [date] and ending on [date]".

Landlords - if the lease is protected under the Landlord and Tenant Act 1954, state that the term includes any statutory continuation of the lease, to make sure that any authorised guarantee agreement covers that period (*City of London Corporation v Fell* (1993) 4 All ER 968)

Rent

When and how is rent paid?

As well as stating that rent is payable, the demise should set out how and when the rent is to be paid. The most common arrangement is for rent to be paid quarterly, in advance. Most leases require rent to be paid on "the usual quarter days" (25 March, 24 June, 29 September and 25 December), although some landlords specify other quarterly payment dates. Most landlords also require rent to be paid by direct debit.

What does the rent include?

The demise will normally list a number of items that will be treated as rent:

- The principal rent - the yearly rent agreed for the Property. If the lease has rent review provisions, the definition of principal rent should include the rent as reviewed from time to time. The lease should also state expressly that the principal rent is exclusive of VAT (see VAT on rent).

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- Insurance rent - the amount the landlord is entitled to recover from the tenant in insuring the Property as required by the lease (see Insurance).
- Service charge - this will be calculated by reference to the relevant part of the lease (see Service charge).
- Interest on any payments the tenant makes late (see Interest)
- VAT on the rent (see VAT on rent)

PRACTICE POINTS

If payments are reserved as rent, the landlord can use (or threaten) the remedy of distress to recover them.

Landlord - consider reserving all payments due under the lease as rent.

Tenant - try to restrict items reserved as rent to those listed above. In particular, make sure that only quarterly advance payments of service charge are reserved as rent, leaving the balancing payments to be demanded in accordance with the service charge provisions.

VAT on rent

The landlord may charge VAT on rent if it has elected to waive the exemption from VAT in relation to the Property. [Will there be a general note that detailed consideration of tax is outside the scope of this section?] The landlord will want to charge VAT in addition to the principal rent agreed.

PRACTICE POINT

The principal rent must be expressed to be exclusive of VAT. If it is not, the landlord will have to account for VAT out of the rent it actually receives, so will be out of pocket.

The lease should also include a tenant's covenant to pay rent, VAT and interest.

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PRACTICE POINT

Provisions dealing with uninsured loss should cover

- the period of any rent cesser;
 - the landlord's obligation to decide whether or not to reinstate;
- and
- the right of either party to bring the lease to an end.

Publicity surrounding terrorism and flooding mean that tenants are increasingly insisting on some explicit sharing of risk in relation to uninsured loss. The Code recommends that the tenant should have the right to break following damage by an uninsured risk, unless the landlord agrees to reinstate at its own expense. In practice, the provisions being negotiated are more complicated than this and depend very much on the bargaining position of the parties. Typically, the parties will agree a period during which the landlord must decide whether or not to reinstate at its own expense. If it decides not to, either party may bring the lease to an end by notice. If the landlord decides to reinstate, the tenant will be required to carry on paying rent for at least part of the period. Whether or not the tenant carries on paying rent while the landlord makes up its mind is a matter of negotiation.

Rent review

Landlord's objective:

- to maintain a minimum income stream: and
- to adjust the rent at regular intervals, to achieve the best return available from letting the Property from time to time.

Tenant's objective:

- to avoid paying more rent than it would pay if it took a new

Leases - The basic terms

lease of similar premises; and

- to make sure that rent reviews are conducted on a basis that reflects as closely as possible the actual Property the tenant occupies and the terms of the actual lease by which the tenant is bound.

Whole books have been written on the immensely complex subject of rent review. This section concentrates on the main points the landlord and tenant should bear in mind when negotiating the most frequently encountered form of rent review clause.

The basic mechanism

The most common form of rent review provision is still what is referred to as an upwards-only review to open market rent. This means that on each designated review date, the rent will be reviewed by comparing the rent actually payable under the lease on that date (the passing rent) with the rent that would be obtained if the Property had been marketed and was being re-let on similar terms on that date (the hypothetical letting). If that rent is higher than the passing rent, the passing rent will be increased. If it is the same or lower, the passing rent will stay the same until the next review date. Reviews like this are called "upwards-only" because even if the market rent at the review date is lower than the passing rent, there is no reduction.

Upwards-only reviews are perceived to be unfair to tenants during periods where market rents are falling, especially if tenants are tied in to long lease terms. The Code recommends that tenants should be offered priced alternatives to upwards-only reviews and the government has put considerable pressure on landlords to implement this recommendation. It was widely expected that the government would legislate to ban upwards-only rent reviews following a consultation in 2004 but so far, it has not done so. In practice, the market has changed and tenants are taking shorter leases, with more opportunities to terminate, so the impact of upwards-only reviews is less significant.

The rent review provisions should set out

- the dates on which the rent is to be reviewed;

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- what premises are assumed to be being let and what state they are assumed to be in;
- the exact terms of the hypothetical letting, including the length of the hypothetical term;
- how the revised rent is to be settled; and
- when tenant is to start paying the revised rent.

It used to be common for rent reviews to be triggered by a landlord's notice, to which the tenant had to respond with a counter-notice. Provisions like this frequently gave rise to litigation and are best avoided. Most leases now simply state that the rent is to be reviewed on the specified review dates and provide a mechanism for the revised rent to be settled by a third party if the parties cannot agree it.

PRACTICE POINT

Set out the mechanism for the rent to be determined by a third party and state whether the third party is to act as expert or arbitrator. The parties should be allowed a fixed period after the review date to try to agree the revised rent, after which either of them should be entitled to refer the review for determination.

What is being reviewed?

The revised rent will ultimately be determined by valuation. The lawyer's role, when negotiating the lease, is to set out as clearly as possible what the valuer is to value.

The basis of the hypothetical letting is usually set out in three separate parts of the rent review provisions, which need to be read together:

- the definition of reviewed or revised rent;
- the assumptions; and
- the disregards.

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Definition of revised rent

Typically, the definition of revised rent would refer to the "best rent" available on a new letting of the Property on the open market. This is the landlord's preferred position, as it arguably allows the valuer to take into account any unusually high bids that might be made by a tenant that really wanted the Property and would be prepared to pay higher than average rent to get it. The tenant will prefer to refer simply to the rent payable in the open market.

The definition of revised rent should also deal with rent free periods and concessionary rents. The landlord wants to make sure that the tenant cannot argue for a discount to reflect the fact that on a new open market letting, the incoming tenant would be allowed a rent free period to fit out the Property. This is sometimes dealt with by an assumption that the Property is fitted out but this can lead to uncertainty over the exact nature of the assumed fitting out. It is better to provide that the revised rent will be the rent payable "after the expiry of any rent free period.....given in connection with the fitting out of the Property".

PRACTICE POINT

The reference to the rent free period (or any concessionary rent period) having been given in connection with fitting out is important, because it distinguishes this sort of inducement from more significant payments or rent concessions. Without the reference to fitting out, the landlord might be able to argue that the revised rent should be the higher rent a tenant would pay after receiving a more significant inducement.

Assumptions

Most of the terms of the hypothetical letting are set out in the list of assumptions that the valuer is to make.

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PRACTICE POINT

When called to interpret rent review provisions, the court will generally adopt a “presumption of reality” (St Martin’s Property Ltd v (1) CIB Properties Ltd (2) Citibank International PLC [1998] EGCS 161). This means that the rent review provisions will be construed to reflect the actual situation rather than an imagined one, unless there are very clear words (Beegas Nominees Ltd v Decco Ltd [2003] 3 EGLR 25). Any assumptions that depart from reality must be very carefully worded, so that there can be no doubt about what was intended.

A typical lease would include the following assumptions:

- Basis of letting

The Property is available to be let by a willing landlord to a willing tenant, with vacant possession. This ensures the hypothetical letting reflects a genuine new open market letting.

PRACTICE POINT

Tenant - make sure the assumption also states that neither willing landlord nor willing tenant is to pay a premium, as this might affect what would otherwise be the market rent.

- Terms of the hypothetical lease

The usual starting point is that the hypothetical lease will be on the same terms as the actual lease, with the exception of the amount of rent stated. It is, however, very important to make it clear that the hypothetical lease contains rent review provisions, otherwise it may be treated as a fixed rent lease, for which the tenant might be expected to pay more. To put this beyond doubt, most leases state expressly that rent review provisions are included.

Leases - The basic terms

Landlords may want to exclude any particularly onerous terms in the actual lease from the hypothetical lease, to prevent the tenant arguing for a discount. Tenants should resist this, on the basis that it is unfair for the rent to be fixed by reference to lease terms that are better than those the tenant actually enjoys (see Practice Point).

PRACTICE POINT

Deal specifically with any terms of the actual lease that are personal to the actual tenant, such as break clauses. If they are to be taken into account in the hypothetical lease, say so expressly (*St Martin's Property Ltd v (1) CIB Properties Ltd (2) Citibank International PLC* [1998] EGCS 161).

• Length of the hypothetical lease

The length of the hypothetical lease will affect the level of rent, although the actual effect can change over time. Earlier cases on this issue involved landlords arguing for longer hypothetical terms, because these would attract a higher rent (*St Martin's Property Ltd v (1) CIB Properties Ltd (2) Citibank International PLC* [1998] EGCS 161). By 2003, the opposite was true and in *Canary Wharf Investments (Three) Ltd v Telegraph Group Ltd* [2003] 3 EGLR 31 the landlord successfully argued that a shorter term was intended.

PRACTICE POINT

State clearly how long the hypothetical lease is intended to be and whether it is to begin on the relevant review date or the date on which the actual lease term began (for example " a term equal to the residue of the Term on the relevant Review Date or 10 years commencing on the relevant Review Date, whichever is the longer"). Do not simply refer to a term equal in length to the term originally granted.

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Leases - The basic terms

- Compliance with covenants

It is usual to assume that at least the tenant's covenants have been complied with. This is to make sure a tenant that is in breach of its repairing obligation cannot argue for a discount on the basis that it is occupying dilapidated premises. Tenants may resist an assumption that the landlord's covenants have been complied with, so that the landlord cannot argue against a discount to reflect any actual reduction in the value of the Property as a result of a breach on the part of the landlord.

- Property fully restored

The landlord will want to assume that if the Property (or any part of it) has been damaged or destroyed, it has been fully restored, so that if a review falls at a time when the Property has been damaged, this does not affect the rent for the next five years. This is fair in relation to damage by insured risks but may be very unfair in the case of uninsured loss.

- No work carried out that decreases rental value

It is normal to assume that no work has been carried out on the Property by the tenant, any undertenant or their respective predecessors in title that has decreased the rental value.

PRACTICE POINT

Tenant - try to exclude any work done to comply with statute.

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Disregards

The main purpose of the disregards is to make sure that the specific circumstances of the actual letting do not affect the valuation of the hypothetical letting. A typical lease would include the following disregards:

- Effect of occupation

The effect on rent of the fact that the tenant, any undertenant and their respective predecessors in title have been in occupation.

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