# Real Estate Quarterly

Spring 2017

Hogan Lovells

# Contents



# UK Head of Real Estate, Daniel Norris, comments on the challenges that lie ahead

In December 2016, Daniel Norris was appointed UK Head of Real Estate for Hogan Lovells. A partner for 9 years and at the firm for 19, Norris has worked on many high profile matters and experienced first-hand the cyclical nature of property investment. Two months into the job, he comments on what he sees will be the challenges for the market and how he plans to meet them.

This is a challenging climate in which to take the reins. Even at the height of the global financial crisis there was plenty of activity in the market, although that movement was downwards and our restructuring and insolvency teams had larger mandates than the institutional investors, developers and propcos would have liked.

Since the peak in Q4 2015 we have experienced a flat market. Sellers don't need to sell because values are holding up and there is not enough distress to encourage lenders to restructure/enforce. Adequate amounts of available debt and buyers with high price expectations have all contributed to a flat market. The referendum and its result have prolonged the stasis into a period of "stable uncertainty", with investors waiting to see what will happen. Tenants have slowed their decision-making processes, and retailers especially are digesting the recent business rate changes.

There are, however, significant positives, with a lot of interest in the UK from North America and Asia, particularly China, looking to take advantage of a weak pound. Clients are increasingly taking advantage of our international network to run cross-border real estate deals. Recent jurisdictions have included the Netherlands, Spain, Italy, the USA and Poland. The appetite for development risk has certainly returned and we are currently working on a wide range of cross-sector schemes with different time horizons and risk profiles. Our disputes team has seen an increase in vacant possession strategies and rights of light issues whilst our planning team has grappled with the government's constant tinkering with the planning system.

There is growth in our more specialist sectors, notably student housing (investment and development funding), private rented sector and build to rent. The HL Hotels team continues to flourish and the sector remains vibrant. Meanwhile, our private equity/hedge fund real estate team is seeing a significant increase in instructions as investors continue to find more unusual and opportunistic investments.

What does this mean for us? Our strategy is to anticipate and monitor how clients adapt to these market changes. Where clients make early forays and need multi-discipline legal strength, our broader real estate expertise in joint ventures, onshore and offshore structuring and tax considerations are crucial.

We operate a high performance culture both internally and externally and we view this as mandatory. We are well known for being commercial, collaborative and engaging, and we underpin that with: ambition for ourselves and our clients; commitment; accountability (which means giving and standing by strong commercial and legal recommendations); innovation (we are leading the way on thinking about cyber risks in real estate, for example); and support for our clients and team.

I believe in engagement with clients at all levels. I am constantly seeking ways to improve and innovate. If you ever have anything you want to share with me, good or bad, please call me. In 19 years at Hogan Lovells, I have discovered many coffee shops for brainstorming and getting to know people better – a tradition I fully intend to continue.

Daniel Norris
Partner, London
T +44 20 7296 5590
daniel.norris@hoganlovells.com

# Lost in translation – the interpretation of contracts

As cases on the interpretation of contracts abound, Paul Tonkin and Shanna Davison examine the courts' likely approach to them.

Disputes about the interpretation of contracts are rarely in short supply. In some cases, the words the parties have used may be genuinely ambiguous. In others, the literal meaning of the words may be quite clear but one party argues that this literal meaning does not accord with what was really intended. How do the courts resolve these differences?

## The starting point

In the leading case of *Investors Compensation Scheme Ltd. v West Bromwich Building Society*[1], Lord Hoffman set out five key principles to be applied when interpreting contracts (see text box on page 7). His Lordship's view was that, whilst words should generally be given their ordinary and natural meaning, there may be cases where that creates a commercially absurd result. If so, the courts can give them a different meaning to arrive at a result which makes commercial sense and reflects what the parties intended.

The court must ask what an objective observer would have understood the contract to mean, had he been furnished with the background context known to the parties – the so-called "matrix of fact". This does not include knowledge of the parties' subjective intentions or prior negotiations. Evidence of these matters is excluded. Whilst this is often a source of frustration and surprise to commercial parties, the courts have firmly resisted attempts to relax this rule.

## Justified departures

When is an outcome absurd enough to justify departing from the ordinary and natural meaning of the words used? In *Litman -v- Aspen Oil (Broking) Ltd*[2] a tenant's break clause was subject to the satisfaction of conditions by the landlord. The court had little difficulty in finding that the parties could not have intended such a commercially nonsensical result and that, although the lease said "landlord", the parties must have meant "tenant" and the break clause should be read accordingly.

At the other extreme is the House of Lords' decision in *Chartbrook -v- Persimmon Homes*[3]. The case concerned complex provisions for calculating the sale price of a residential development. On a literal interpretation, Chartbrook was entitled to the first £76.34 per sq ft of net sales value plus 23.4% of the surplus. Persimmon argued that the parties had actually intended that Chartbrook would receive the greater of £76.34 per sq ft or 23.4% of the net sales price, not both. If correct, this would reduce the price from £9,168,427 to £5,580,616.

The House of Lords accepted that there was nothing inherently unworkable about Chartbrook's literal interpretation. However, it considered it to be "commercially nonsensical" as it resulted in Chartbrook receiving an absurdly high proportion of the sale proceeds. Having reached that conclusion, the House of Lords considered it was free to re-write the words as extensively as was needed to give effect to Persimmon's interpretation, which it believed represented the parties' true intentions.

Lord Hoffman (again giving the leading judgment) said that *"there is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed. All that is required is that it should be clear that something has gone wrong with the language and that it should be clear what a reasonable person would have understood the parties to have meant."*

1 [1997] UKHL 28
2 [2005] EWCA Civ 1579
3 [2009] UKHL 38
4 [2015] UKSC 36
5 [2016] EWHC 3012 (Ch)

## Back to basics

Some considered that *Chartbrook* went too far. How could commercial parties have confidence in their agreements if the court was free to re-write them?

The opportunity arose for the Supreme Court to revisit the approach in *Arnold –v- Britton*[4]. The case concerned service charge arrangements in long leases of chalets which, read literally, provided for a 10% annual increase on a compound basis. This meant that a service charge which was originally £90 a year would be £550,000 per year by 2072. The court accepted that this was unlikely to have been the expectation of the parties, but it was not prepared to depart from the clear words used.

Whilst commercial common sense was an important factor *"a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed"*.

The unlucky tenants may not have foreseen the consequences of the service charge provisions but that was not the same as saying that they did not at the time intend to sign up to the provisions as drafted. The mere fact of commercial absurdity was not enough to indicate that a literal interpretation could not have been intended.

## Falling on different sides

The dividing line can be seen in two very recent cases. *Helix 3D Limited -v- Dunedin Industrial Property Nominee Ltd*[5] concerned an option agreement for the purchase by a tenant of the landlord's freehold.

The price was to be £1.5m if exercised by 20 July 2014 or the open market value thereafter. The option was conditional upon the tenant paying a 5% deposit at the time it served its option notice. The tenant sought to exercise the option in 2015 and paid a deposit of £75,000 (5% of £1.5m).

### Key Principles

– Interpretation involves ascertaining the meaning which the document would convey to a reasonable person with all the background knowledge which would reasonably have been available to the parties at the time of the contract.

– Interpretation should take account of the "matrix of fact" – the context and factual background known to the parties at the time of the contract.

– Evidence of the parties' prior negotiations is not admissible.

– Interpretation is a contextual exercise, not a literal one – the background context will be relevant to choosing between different meanings of words and may indicate that the parties meant something other than a literal interpretation.

– The courts should be slow to assume that parties have made a mistake but, where a literal interpretation of the words flouts business common sense, the court may conclude that something has gone wrong.

The landlord argued that, because the option was being exercised after 20 July 2014, the price would not necessarily be £1.5m and therefore the condition requiring payment of a deposit of 5% had not been satisfied. The court rejected this approach. Read literally, the option would have effectively been unworkable after July 2014 and that could not have been what the parties intended. The court was therefore prepared to interpret the agreement so that it was sufficient for the tenant to pay 5% of its proposed purchase price by way of deposit.

Coming just a week later, the case of *Elmfield Road Ltd -v- Trillium (Prime) Property GP Ltd*[6] fell the other side of the line. The parties agreed that a literal application of the rent review provisions resulted in a "double counting" as the 2010 rent was increased by reference to a 2005 index.

The tenant argued that this could not have been the parties' intention. The court disagreed. Applying *Arnold*, it held that the ordinary and natural meaning of the words was clear and there was no obvious mistake on their face. While the result of the drafting may seem uncommercial, it formed part of a complex series of transactions and it was not for the court to delve into the overall commerciality of the parties' agreement.

If these recent cases are anything to go by, it is clear that parties cannot rely on the courts to save them from a bad bargain. Where the words used are clear, parties can expect to be held to them in the absence of an obvious mistake.

Paul Tonkin
Senior Associate, London
T +44 20 7296 2456
paul.tonkin@hoganlovells.com

Shanna Davison
Senior Associate, London
T +44 20 7296 5524
shanna.davison@hoganlovells.com

### Avoiding Ambiguity

– Don't assume that heads of terms, "gentleman's agreements" or pre-contract discussions will help if a dispute arises – they won't!
– Formulae are a frequent source of dispute – consider including a worked example in the agreement.
– For particularly complex provisions think about including a statement of intent which sets out in non-legal language what the parties intend the provisions to mean.
– Never under-estimate the value of a second (or third) pair of eyes.

6 [2016] EWHC 3122

# Legal viewpoint on CVAs

## Mathew Ditchburn discusses why CVAs fail more often than not, and what it means for landlords.

In March 2016, BHS entered a company voluntary arrangement (CVA) with its creditors, designed to transform the company's fortunes and avoid full-blown insolvency. Just a few weeks later, the retailer collapsed into administration. This was not a one-off. According to the Insolvency Service, 388 of the 563 CVAs in 2014 failed. R3 (the Association of Business Recovery Professionals) has begun a new research project to investigate what is going on.

A CVA is an agreement between a company and its creditors that compromises debts and liabilities so it can continue trading. If approved by 75% of creditors by value, it binds all creditors irrespective of how they voted. CVAs are a popular tool for restructuring leasehold liabilities and, in recent months, the model has evolved to comprise trade debts as well.

When coffee shop Love Coffee proposed to close 11 out of 30 outlets and halve the rent for another six under its CVA, the British Property Federation objected to the perceived lack of prior engagement with landlords. Matters were not helped by the CVA's stated aim of attracting funding for the company's new store concept – it seemed that landlords were paying to supplement shareholders' profits rather than save an insolvent tenant. Fortunately, further dialogue and changes to the CVA led to its eventual approval.

Some CVAs fail to achieve their aims. BHS successfully agreed to close 40 of its 164 stores and reduce the rent for a further 47, but the company still needed £100 million to continue trading. One month later, when it failed to raise the funds, the business went under. There was no provision within the CVA that such an agreement would cause it to terminate. The administrators tendered rent at CVA discounted rates but claimed not to be bound by break rights given to landlords in return.

Landlords will be wary of other CVAs that could lead to such a result. This includes The Food Retailer Operations' proposal to close a number of former Somerfield and Budgens stores, which was voted down by creditors in February this year. Landlords were also concerned about the low return on rent arrears and lack of any investigation into antecedent transactions prior to the company's failure.

Even if a CVA runs its course, that is not the end of the story. Some businesses still go on to fail. Unlike a firm in administration, a company proposing a CVA remains in the hands of its current management, who might be overly optimistic about its future. There is no requirement to change the fundamentals of the business or address its structural problems. The trick for landlords is to separate those CVAs that genuinely show how things will be done differently from those that are just a tool to cut bills.

*This article was co-written with John Cook, revenue manager at Capital & Regional. John and Mathew are chair and vice-chair respectively of the BPF's insolvency committee. A previous version of this article appeared in Property Week on 17 February 2017.*

Mathew Ditchburn
Partner, London
T +44 20 7296 2294
mathew.ditchburn@hoganlovells.com

# Falling foul of Flying Freeholds

## Julia Heyn explains flying freeholds and asks why they raise alarm bells for property lawyers and those in the real estate industry.

A mental image of a building sprouting wings and taking to the sky is one way to picture a flying freehold, but mention the phrase to most property lawyers and their hearts will sink. Discovering a flying freehold raises alarm bells because, without appropriate reciprocal rights between adjoining owners, they can leave both owners exposed.

### What are flying freeholds and do they really need to cause such fear?

Put simply, a flying freehold is part of a freehold property that either reaches into or is built over a neighbouring property. The flying freehold owner owns the "flying" part, but not the land or buildings beneath it.

The difficulties stem from the fact that, without express agreement, each land owner has very limited rights in relation to the other's land. In particular they cannot force the other owner to maintain or repair their property, even if the flying element is structurally dependent on the other land, or where a flying element in disrepair risks damaging the adjoining property. In these circumstances, financing either property may be difficult as lenders will want a clean title certificate. Problems can also arise where one owner wants to redevelop or carry out works because rights of access can be limited. These problems apply equally to the owner of the flying element and the owner of the adjoining land.

In the absence of express rights and obligations, there are a number of options:

#### Title indemnity insurance

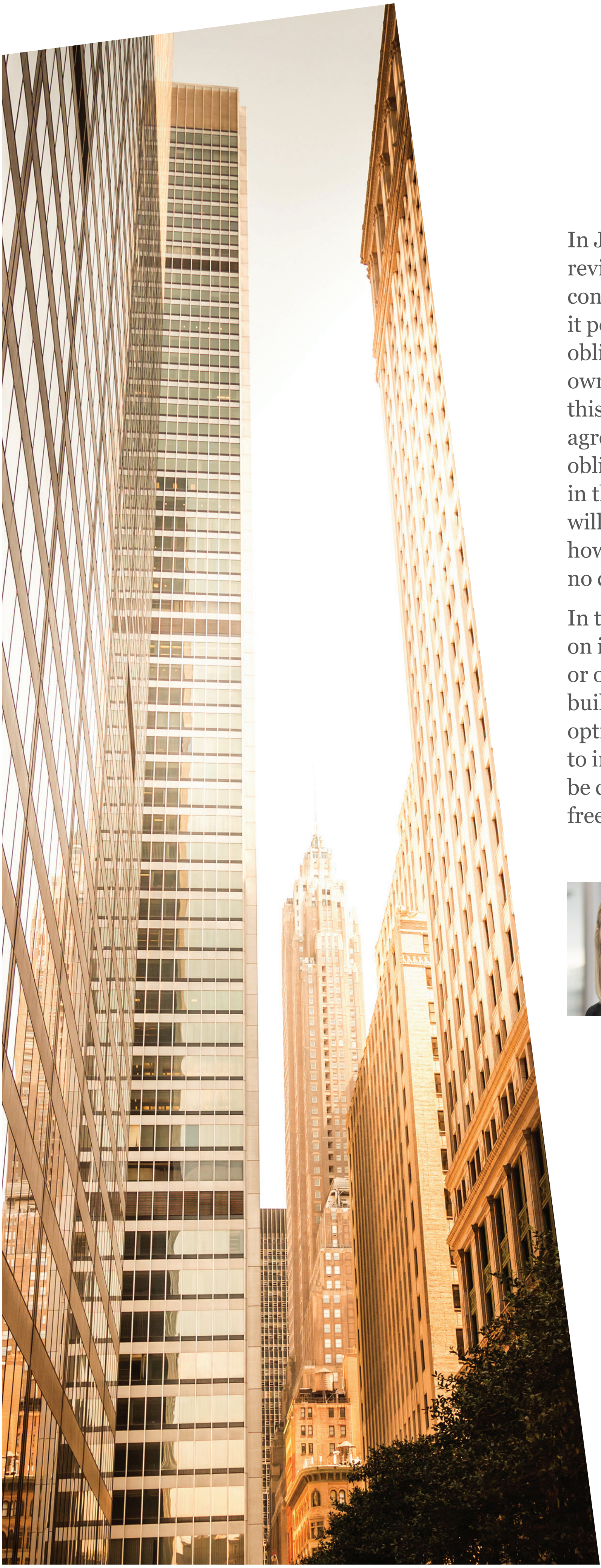
Typically insurance would cover loss of value following damage due to lack of repair of the adjoining property and costs incurred in prosecuting the adjoining owner. However, it does not resolve the fact that there are no access rights and insurance may be invalidated by any redevelopment or structural alterations.

#### A new mutual agreement

A mutual agreement can be put in place between the two owners, documenting the reciprocal rights and obligations. As with any positive covenant, the agreement would only bind future owners if they agree to be bound by it when they acquire the property. This can be built into the agreement and backed up by a restriction on the title register. However, the process of putting an agreement in place may be time consuming and costly, particularly where there is little or no incentive for the non-selling owner to co-operate quickly.

#### Alternative structure

It may be possible to convert the flying freehold to a leasehold structure so there is only one freehold out of which a long (999 years) lease is granted to the adjoining owner. The advantage of this is that the appropriate rights and positive covenants can be included in the lease and will not be affected by a transfer of the freehold or leasehold interests. However a lease may also be time consuming and costly to negotiate and tax structuring advice should be sought at an early stage.



In June 2011, the Law Commission recommended revising the law of easements and introducing the concept of a "legal obligation". This would make it possible for the benefit and burden of positive obligations to be enforced by and against subsequent owners. So far as flying freeholds are concerned, this would simplify and make more attractive a mutual agreement as it would avoid any concern that those obligations could be lost over time. It was announced in the Queen's Speech in May 2016 that the government will bring forward proposals to respond to the report; however, any progress appears painfully slow and no change is on the immediate horizon.

In the meantime, identifying flying freeholds early on in a transaction is key. This is not always easy or obvious and careful analysis of the plans of the building may be required. After that, there are various options to address the risks but they may take time to implement and a wary lender's views should be considered early. With careful thought a flying freehold need not result in the death of the deal.

**Julia Heyn**
Senior Associate, London
T +44 20 7296 5354
julia.heyn@hoganlovells.com

# Cyber wars and the importance of cyber security to real estate

Daniel Norris explains why cyber security is of increasing concern to the real estate industry.

With an estimated 12.5% of our economic activity now conducted online, the UK's percentage of GDP attributed to the digital economy is the highest in Europe. And this is a figure that only includes what is now measurable. A former governor of the Bank of England, Sir Charles Bean, concluded that, if the digital economy was fully captured by the Office for National Statistics, the UK's economic growth would be revised upwards by up to 0.6%. Whatever the measure, the digital economy will continue to expand and technology will continue to revolutionise all industries, including the real estate sector. And a fair chunk of this digital revolution will happen in London.

Consequently, UK businesses in the capital and beyond are particularly vulnerable to hacking, cyber crime and cyber terrorism. A 2015 government survey estimated that 90% of large corporations and 74% of small businesses suffered a cyber breach in 2015, with the average cost of a breach being estimated at between £1.46m and £3.14m for a large business.

With most reported cyber attacks relating to data breaches (think password or bank account theft), it is easy to assume that the commercial real estate industry is neither a likely nor lucrative target for hackers. A real estate investor is no different to any other business, however, with the confidential data stored on its systems replete with financial information, and tenants of smart buildings often having their systems linked to the landlord's Building Management System (BMS). Hacking a BMS may enable access to other data systems and networks, so a potential cyber attack presents a unique problem which users and owners of smart buildings need to grapple with.

## The reality of hacking a BMS

Potentially vulnerable BMSs are now found in many buildings. A 2015 paper published by QinetiQ listed systems that included: lighting (deactivation of lights may cause safety and productivity issues including public panic); access control (remote release of secure doors resulting in unauthorised access, erasure of access logs to cover criminal activity); HVAC (activation or deactivation of heating or cooling causing plant/equipment shutdown or malfunction); CCTV (increased situational awareness for intruders); lifts (denial of service, overriding lift access control); and tenant billing as possible targets for everyone from terrorists through to bored teenagers.

## Futuristic nightmare?

Such concerns are emphatically not just a futuristic nightmare. In China in 2014, Jesus Molina found that he could easily take control of the thermostats, lights, TVs and window blinds in all of the St. Regis Shenzhen Hotel's 250-plus rooms. Recently, a member of the Free Software Foundation discovered much the same thing at the hotel he was staying at in London.

Fortunately for the hotel owners, neither hacker's intent was malicious, but that is not always the case. The German government's report in 2014 that hackers had taken control of a steel mill's blast furnace, causing massive damage, and recent shutdowns in Ukraine's power grid have been widely attributed to hackers. Late last year, three NHS hospitals fell victim to a cyber attack affecting the hospitals' computer systems and forcing the cancellation of all appointments and operations for two days.

With those involved in installing and managing BMSs tending not to have security expertise, new systems are often connected into wireless networks without adequate security. Alternatively, standalone systems are installed but later connected to wider networks or access points (think how you can now control your home heating system from your smartphone), and an independent system is always vulnerable to a disgruntled employee.

As a result, a malicious attack on a smart building BMS in the UK may well be a matter of when, rather than if. It is all too easy to imagine a hacker gaining access to a property's BMS and holding a building owner to ransom or setting off the sprinklers in a shopping centre and destroying stock, or overriding lift braking systems in a skyscraper.

## Protection

The implications for landlords, tenants and their visitors and staff are varied and manifest. Quite apart from ensuring that systems are secure and security is current and maintained, we recommend implementing the following steps, which align with the government's published Cyber Security Strategy built on the principles of defend, deter and develop:

### Assess

Assessing the risk profile of individual assets along with the owner's legal obligations (statutory and contractual including to its tenants) and incident and response readiness. This risk assessment is not something that can be pulled off the shelf – it requires bespoke planning and implementation.

### Prepare

Preparing before an incident occurs, developing response plans and incident response simulations, and consider insurance strategies.

### Respond

Management of breach notifications, communications and public relations (the reputational risk should not be underestimated), law enforcement interactions, and vendor and forensic expert identification.

### Engage

Interaction with the legal, regulatory and governmental authorities.

### Defend

Consider the risk of exposure to potentially costly and damaging claims and plan a defence strategy.

## Other practical implications

### Insurance

Traditional buildings insurance in the UK does not fully address the challenges presented by these sorts of cyber attacks. Property damage cover typically excludes losses resulting from cyber attacks. Further, traditional business interruption cover isn't triggered where the incident doesn't result in physical damage. For instance, turning up the heating in a refrigerated warehouse, or opening all the doors in a shopping centre out of hours may not result in damage to the building, but the consequences for the occupiers could be material. The insurance industry is consulting extensively with the government specifically on this issue.

Typical cyber policies that do exist are focused on data breaches and system failures and may not assist with the major exposures facing landlords because of BMS, or older control systems that may still have internal or external connections. Some providers are aware of the issues. Jack Lyons of the JLT specialty cyberteam confirms that customised cyber policies can be placed to fit specific client needs, including the insurance of liability arising out of ‘loss of quiet enjoyment’ resulting from a cyber incident.

Even if a landlord can get insurance, who will pay for it? The relevant lease clauses need to be looked at carefully, as the traditional "insured risks" wording may be inadequate to enable recharging the cost to a tenant. If the cost can be recharged but that cost is high, it may make the financial package on offer to prospective tenants uncompetitive.

### Service charges

Similarly a review of the service charge provisions is needed. With tenants increasingly astute about what services are covered and what they are bound to pay for, it is possible that a specific new insurance cost could not be put through the service charge (and again the cost may be problematically high). The same is also true of the costs of installing, upgrading, maintaining and securing a BMS. Tenants may also have a concern if the landlord is not under any obligation to maintain, upgrade and protect the BMS.

The real estate industry needs to focus on the unique challenges that it faces from technological innovation and cyber attack before if becomes when.

*An earlier version of this article was published in the Spring 2017 edition of the London Investor Guide.*

**Daniel Norris**
Partner, London
**T** +44 20 7296 5590
daniel.norris@hoganlovells.com

# Case Round Up

## Lien Tran and Paul Tonkin review the recent case law

### *Rowntree Ventures Ltd v Oak Property Partners Ltd [2016] EWHC 1523 (Ch)*

### Court exercises discretion against administration order for hotel owner

Oak Property Partners was the freehold owner of two hotels, whose business model involved selling long leases of individual hotel rooms to investors. The applicants were the leaseholders of the hotel rooms. They were entitled to require Oak to repurchase the long leases within two years after serving notice on Oak.

The applicants were dissatisfied with their investments because the projected returns had not emerged. They alleged that Oak had misrepresented the quality of the investments by making reckless and misleading promises of a guaranteed return. The applicants served notice on Oak requiring them to repurchase the long leases. Once the notices were served, they applied to court for the appointment of an administrator over Oak.

Under the Insolvency Act 1986, two preconditions must be satisfied in order to appoint an administrator. The first is that the court must be satisfied that the company is, or is likely to become, unable to pay its debts. The second is that an administration order must be reasonably likely to achieve the purpose of administration.

The court found that, despite being cash flow solvent, Oak was balance sheet insolvent and likely to become fully insolvent in the future due to the lease repurchase obligations. To finance these, it would need to recover a doubtful debt and resell the leases for at least the same value very quickly after repurchasing them. Both of these assumptions were deemed unrealistic.

The court also held that administration would achieve a better result for the company's creditors than a winding up. However, the court has a residual discretion, which it exercised against ordering an administration. It decided that an administration order was premature and that the company ought to be given an opportunity to see its way through its current difficulties. In the court's view, the company would have better prospects for creditors and the company itself by staying out of any insolvency procedure. The court noted that its decision would have been different had there been any firm evidence that the company had misappropriated assets.

### *Morgoed Estates Limited and others v Lawton and others [2016] UKUT 395 (TCC)*

### Rentcharge leases upheld despite being a disproportionate remedy

Historically, rentcharges were a popular method for landowners to gain additional income from the sale of land to developers. Rentcharges are fixed, annual payments owed by the purchasing freeholder to the original landowner.

When a rentcharge remains unpaid for 40 days, there are various remedies available for recovery of the arrears. The owner of an unpaid rentcharge can, for example, grant a lease of the burdened land to a trustee to recover arrears. Such leases may be granted without giving notice to the freeholders and the freeholders have no right to terminate the leases even if they pay the arrears.

Morgoed Estates was a company which bought and managed rentcharges. The defendants were the freeholders of various residential properties which were subject to rentcharges in sums of between £6 and £15 per annum. When they fell into arrears Morgoed granted 99-year leases out of the defendants' properties to its directors and applied to register them with the Land Registry. The existence of the leases meant that the defendants were unable to sell their freehold properties and they argued that the leases should not be registered at the Land Registry.

The Upper Tribunal (Tax and Chancery) expressed discomfort at Morgoed's conduct and observed that the grant of a rentcharge lease was a disproportionate remedy for the nominal arrears in question. Nevertheless, the judge held that the leases were valid. Therefore the leases should be registered at the Land Registry.

## *Stodday Land Ltd v Pye [2016] EWHC 2454 (Ch)*

### Notices to quit must be served by registered proprietor

Stodday was the registered proprietor of farmland in Lancashire, which Pye rented.

In 2013, Stodday sold part of the land to an associated company called Ripway. Following the sale, Ripway wrote to Pye to confirm that there had been a change of landlord and to demand payment of rent. Ripway then served notice on Pye, seeking possession of the sold land on the basis that it was needed for non-agricultural use. Stodday served a separate notice on Pye seeking possession of the retained land on the grounds that Pye was in arrears of rent. At the time the notices were served, the transfer of the sold land had not been registered at the Land Registry and Stodday remained the registered proprietor.

Pye disputed the validity of the notices on the grounds that they had not been correctly served. In respect of Ripway's notice, it had not been served by the legal owner because Ripway had not yet been registered as proprietor. As for Stodday's notice, Pye argued that it had not been given in relation to all of the land comprised in the holding. Ripway contended that it could serve a valid notice because the person entitled to the rents is entitled to take advantage of the lease terms and an unregistered buyer should, therefore, be able to exercise the powers of the legal owner.

The High Court held that the notices were invalid. The notice could only be served by the legal (rather than equitable) owner of the land. Although a person is entitled to exercise the owner's powers if he is entitled to be registered as proprietor, the court did not consider under the general law that it enabled such person to serve an effective notice to quit. Ripway's subsequent registration could not retrospectively validate the notice.

## *Kateb v. Howard de Walden Estates Limited and Accordway Limited [2016] EWCA Civ 1176*

### Competent landlord's agreement binds intermediate landlords in lease extensions

Howard de Walden was the freehold owner of a block of flats on Harley Street in London. Kateb was the intermediate landlord of the flats. A tenant of one of the flats served notice on Howard de Walden (as the competent landlord) seeking a 90-year lease extension. Kateb was entitled to a portion of the premium payable under the lease extension and she served a notice of separate representation.

Howard de Walden and the tenant reached agreement on the amount of premium payable to the freeholder and intermediate landlord and the apportionment between them. Kateb disagreed with the apportionment. As she had chosen to be separately represented, she argued that the First-tier Tribunal should determine the issue.

The Court of Appeal held that the intermediate landlord's election to be separately represented did not qualify the competent landlord's absolute authority to conduct the negotiations and reach agreement on a new lease with the tenant. The competent landlord's agreement should bind all intermediate landlords and the tribunal does not have any residual discretion. The intermediate landlord does, however, have recourse to court if the competent landlord fails to reach agreement with the tenant and a right to damages if he breaches his statutory duty of care. The Court of Appeal concluded that the interference with the intermediate landlord's right of direct access to court was proportionate from a human rights perspective.

***Elmfield Road Ltd v Trillium (Prime) Property GP Ltd [2016] EWHC 3122 (Ch).***

## Court applies literal interpretation to rent review clause

Elmfield Road was the landlord of office premises in Bromley which it let to Trillium. The parties entered into a reversionary lease of the premises in 2005, as part of a complex series of transactions. The reversionary lease was due to commence in 2010 and contained an unusual calculation of the initial rent, which was defined as the highest of three alternative calculations. The rent review paragraph stated that the annual rent was to be determined by reference to the initial rent under the lease and the increase in the RPI index from 2005. Trillium argued that the calculation contained an obvious mistake as the rent review clause should have indexed the much lower rental figure from 2005 rather than the passing rent under the reversionay lease. This they said, resulted in double counting and did not achieve the general purpose of a rent review clause.

The commercial purpose of a rent review clause is to enable the landlord to obtain a market rent as if the premises were let on the same terms on the open market at the review dates. The aim is to reflect changes in the value of money and increases in the value of the property. The court held that this principle is applicable to reviewing rent by reference to RPI as well as to market rents.

Here, however, the unusual facts reflected a carefully structured bargain between the parties where each party made some gains and some losses. The court held that it was not clear that there was a mistake in the rent review wording, nor that the arrangement was commercially absurd.

The court found that there was no difficulty in giving the rent review clause a literal interpretation. There was no obvious mistake and the rent review paragraph made sense on its own.

### *Millgate Developments Limited and another v Smith and another, Re: Exchange House, Woodlands Park Avenue, Maidenhead [2016] UKUT 515 (LC)*

## Developer in breach of restrictive covenant successfully relies on public interest argument

Millgate was a developer who owned land which was subject to a restrictive covenant that prevented building on the land or using it for any purpose other than a car park. The covenant benefited the Alexander Devine Children's Cancer Trust, which was building a hospice on the neighbouring land for terminally ill children.

Millgate built 13 properties intended for social housing on the burdened land in full knowledge that it was in breach of covenant. The developer applied to court to modify or discharge the covenant under Section 84 of the Law of Property Act 1925.

The Upper Tribunal held that the restrictive covenant should be modified, in spite of the fact that it provided a practical and valuable benefit as the land had been private and secluded prior to Millgate's development. However, the covenant was contrary to the public interest because there was a pressing need for social housing and it would be an unconscionable waste of resources if the properties were unoccupied. Money would be adequate compensation to mitigate the loss of privacy, as trees could be planted along the boundary which would cost between £37,000 and £70,000.

The Upper Tribunal warned prospective developers that it was "*not inclined to reward parties who deliberately flout their legal obligations*". In these circumstances, however, it considered that the public interest outweighed the benefit of the covenant to the hospice such that it should use its discretion to order modification. Millgate was ordered to pay £150,000 to the hospice trustees as compensation for loss of the benefit of the covenant.

### *James Allan Thornton v The Commissioners for Her Majesty's Revenue & Customs [2016] UKFTT 767 (TC)*

## Surrender premium for dilapidations is taxed as capital receipt

Thornton owned a block of 18 flats and let them out to a tenant company under a standard repairing and insuring lease. Despite being responsible for the upkeep of the properties, the tenant failed to keep them in repair and they became unfit for habitation. Thornton entered into negotiations with the tenant to take back possession of the flats and secured a surrender of the lease. During the negotiations, Thornton had proposed a figure equivalent to six months' rent as a surrender premium. However, a sum of £250,000 was eventually agreed in "*full and final settlement of all issues associated with the lease*". The final figure was a "*simple compromise*" to dispose of the matter rather than being attributed to any particular issues. The receipt of the funds was included in Thornton's balance sheet as a credit but was not included in the profit and loss account. Thornton invested the funds back into the properties to repair the damage caused by the tenant's neglect.

Upon investigating Thornton's tax returns, HMRC decided that the settlement payment should have been taxed as an income receipt because it was in respect of loss of rental income. Thornton argued that it should be treated as a capital receipt because the funds had been invested solely in repairing the flats.

The First-tier Tribunal held that the payment should be regarded as a capital receipt. The judge found that no part of the settlement payment was attributable to rent. The properties had suffered a permanent diminution in value largely due to the tenant's failure to comply with its repairing covenants. The entire £250,000 had been used to make good that loss by repairing the properties and there were no residual funds to attribute to loss of rent.

### *Hautford Limited v Rotrust Nominees Limited [2016] (unreported)*

## Landlord unreasonably withheld consent for planning application for change of use

Hautford was a tenant who applied to its landlord, Rotrust, for consent to make a planning application for change of use of part of its premises.

Hautford sublet the property to Romanys Limited who wished to let out the upper floors of the building to residential tenants. The lease permitted residential use and Romanys had fitted out the floors accordingly. Two of the floors required planning consent for change of use. However, Hautford had covenanted under its lease not to apply for planning permission without the landlord's consent not to be unreasonably withheld.

When Hautford sought Rotrust's consent it refused because it wanted to keep control of the property for estate management purposes. It was also concerned that granting consent might enable Hautford to acquire the freehold of the property under the Leasehold Reform Act 1967. This would have a detrimental effect on both the reversion and the value of its wider estate.

The County Court held that Rotrust had unreasonably withheld consent. The purpose of the tenant's covenant was to protect the landlord from potential enforcement action in the event of a breach of a planning obligation. The covenant's objective was not to restrict the property's permitted residential use. As Hautford had paid a premium when it acquired the lease, the court considered that the sum would have been negotiated in light of the permitted residential use and it should not be restricted. The court also observed that the lease was granted after the 1967 Act was passed. At the time of grant, Rotrust would have known that there was a real prospect that a qualifying tenant could make a successful claim to enfranchise and should have taken this into account.

Lien Tran
Associate, London
T +44 20 7296 5502
lien.tran@hoganlovells.com

Paul Tonkin
Senior Associate, London
T +44 20 7296 2456
paul.tonkin@hoganlovells.com

# Q&A

This month, Simon Keen looks at exclusivity agreements whilst Adam Balfour flags up a new consultation which proposes that landlords help prevent illegal tobacco trading on premises.

**Q: We are selling a property and have found a buyer.At the buyer's insistence, we entered into an exclusivity agreement which gave the buyer an exclusivity period of 21 days in which to formally contract with us for the purchase of the property. However, another buyer has approached us and offered a higher price. Can we proceed with buyer number 2? Does the exclusivity agreement prevent that and what penalty would we have to pay if we ignore it and go ahead with buyer number 2 anyway?**

**A:** Exclusivity is quite normal in a commercial context. The buyer will have insisted on one so that when it starts spending money on legal and other costs, it doesn't find at the last minute that you have been negotiating with someone else and lose the deal. 21 days might not be long enough to exchange contracts, but it will generally be long enough to give the buyer a lead over anyone else and the best chance of closing the deal.

You cannot force the buyer to do a deal with you, and equally they cannot force you to do a deal with them so, if you now decide you want to go with buyer number 2, you might be able to let the 21 days pass and then start talking to that alternative buyer. You must be careful, however, that you are not in breach of the exclusivity agreement. I would expect it to prevent you from talking to anyone else about selling the property in the 21 day exclusivity period. If buyer number 2 has approached you then you must explain you have entered into an exclusivity agreement and you are not at liberty to discuss any other deal until the exclusivity period has passed.

You also need to read the exclusivity agreement carefully as some buyers include strict obligations in them that could affect how much you can say at this stage to buyer number 2. It may also require you to act in good faith to try to progress the deal with buyer number 1, or something similar, so you would not be able to just “down tools” while time passes.

Broadly though, now that you have signed up to the agreement, you should not breach it by engaging with another bidder and letting them have access to any information about the property. You certainly should not start discussing potential sale terms or send them a draft contract. If you ignore this you could be sued for breach of contract and be liable for the costs incurred by buyer number 1 who acted in reliance on the exclusivity agreement. These costs could be quite significant depending on the nature of the property and the extent of the legal and other costs buyer number 1 may already have occurred. There is also a reputational risk if you deliberately breach the agreement.

**Q: What's all this I hear about the government wanting to make landlords stop illegal tobacco trading on their premises?**

**A:** Landlords could potentially find themselves hit with new lease requirements, periodic checking obligations and even financial penalties following the publication of the *'Sanctions to tackle tobacco duty evasion and other excise duty evasion'* consultation document by the government.

The government is committed to tackle evasion of tobacco duty and the illicit tobacco trade. In 2015-16, the UK consumed around 5 billion illicit cigarettes and 3,200 tonnes of illicit hand-rolling tobacco. Evasion of tobacco duty robs public finances of revenue and undermines the government's wider public health objective of reducing smoking, which contributes to over 100,000 deaths each year.

**Q: Sure, but what does this have to do with landlords?**

Whilst the underground world of illicit tobacco trading may seem remote to landlords, they need to be aware of some key – and potentially onerous – proposals of the consultation. These proposals reflect a perception that some landlords are turning a blind eye to their tenant's behaviour to protect their rental income.

Whilst many leases prohibit a tenant from using the property for any illegal, immoral or improper purpose, HMRC are proposing to write to landlord associations to request that they voluntarily add a clause to their standard lease agreements prohibiting illicit tobacco or excise trading.

More serious is a potential sanction proposed in the consultation which would impose a statutory duty of care on the landlords of properties or land which are used in tobacco (or other excise duty) fraud. The proposals are:

- The duty of care would only arise once the landlord has been notified that the tenant has evaded an excise duty.
- Landlords who have taken reasonable steps to prevent future wrongdoings on their property would have a defence available (in an effort to minimise the burden on them). Such reasonable steps could include:
  - Including provisions in all new leases making it clear that any illicit tobacco trading or any other illicit excise activity will terminate an existing lease and providing HMRC with copies of tenancy agreements. It is not clear whether the usual forfeiture clause for breach of covenant would suffice.
  - Requiring the landlord to undertake periodic checks of the premises and request relevant information from tenants.
  - Contacting HMRC or Trading Standards immediately should landlords have any concerns.
- If the tenant continues to deal in illicit excise trading and the landlord cannot demonstrate that they have taken steps to address the issue, HMRC will consider action against the landlord. A new civil penalty would be introduced for non-compliance.

**Q: Sounds pretty onerous for landlords. What happens next and can I object?**

The consultation document seeks views on whether the proposed steps landlords could take to prevent illicit activity on their properties are reasonable and proportionate. HMRC is also querying what sanctions they should apply to landlords who fall short of their obligations, including whether they should suffer a financial penalty.

Responses to the consultation are due by 12 May 2017 and can be found at **https://www.gov.uk/government/consultations/sanctions-to-tackle-tobacco-duty-evasion-and-other-excise-duty-evasion**

*An earlier version of the question on illegal tobacco trading appeared on our blog:* ***www.ukrealestatelawblog.com****. Sign up to receive regular, topical commentary on real estate issues.*

Simon Keen
Counsel, London
T +44 20 7296 5697
simon.keen@hoganlovells.com

Adam Balfour
Associate, London
T +44 20 7296 5489
adam.balfour@hoganlovells.com

# Removing the limits – a new class of real estate investment vehicle

Sian Owles considers the proposals for a new investment vehicle – the private fund limited partnership.

UK limited partnerships have been go-to investment vehicles for United Kingdom real estate for many years. We see them frequently used in joint ventures and other investment structures, and also as a way to structure investment managers' fees. The attraction of limited partnerships lies principally in their tax transparency, contractual flexibility and the limited liability protection they are able to offer investors.

For all their appeal, UK limited partnerships can, however, be burdensome to operate and administer in practice. This is, perhaps, unsurprising; the law governing UK limited partnerships has been in place for over a century.

Industry has long lobbied for amendments to the relevant legislation. In January 2017, after a period of consultation, the government published draft legislation which is designed to modernise, simplify and amend the existing legislation in order to ensure that UK limited partnerships remain competitive, particularly in light of newer tax efficient vehicles offered by major offshore jurisdictions.

The legislative reform, which is expected to come into force on 6 April 2017, will create a new, more flexible and simplified class of vehicle - the 'private fund limited partnership' (PFLP).

All UK limited partnerships (both existing and new) that meet the PFLP conditions can apply to become PFLPs. The existing UK limited partnership regime will continue to apply to those partnerships that choose not to take on PFLP status and those that otherwise are not eligible for PFLP status.

Two key changes introduced by the PFLP regime are particularly noteworthy:

– The inclusion of a "white list" of activities that a limited partner can undertake without jeopardising its limited liability status.

– Increased flexibility in how PFLPs are funded by limited partners and in how limited partner capital is returned.

We will look at these changes, and other key elements of the proposals, in more detail below.

## How to qualify as a PFLP

To qualify, the UK limited partnership must have a written partnership agreement and be a "collective investment scheme" for the purposes of the Financial Services and Markets Act 2000. This will include UK limited partnerships that would qualify as collective investment schemes were it not for one of the statutory exceptions. Those who are familiar with joint ventures that are structured using UK limited partnerships might have come across these exemptions when considering whether a UK limited partnership was required to appoint an operator authorised by the Financial Conduct Authority.

## Registration as a PFLP

UK limited partnerships that qualify as PFLPs may opt into the PFLP regime:

– if registered on or after 6 April 2017, immediately upon registration (or they can opt in at a later date); or

– if registered before 6 April 2017, at any time after the legislation comes into effect.

Once a UK limited partnership becomes a PFLP, however, it will not be able to return to its ordinary limited partnership status.

## A non-exhaustive "white list" of limited partner actions

If a limited partner in a UK limited partnership participates in the management of the partnership's affairs, it risks losing its limited liability for the debts and obligations of the partnership. As a result, the introduction of a "white list" of safe harbours for limited partners in PFLPs provides welcome clarity. The white list proposals align PFLPs with a number of offshore jurisdictions regularly used in real estate investment structures (including Jersey, Guernsey and Luxembourg), which already provide safe harbours for limited partner involvement in decision making.

The white list includes: amendments to the PFLP agreement and the PFLP's business; approving valuations of the PFLP's assets; approving the PFLP's accounts; extending the life of the PFLP; and

deciding who will run the PFLP's day-to-day business (all of which are matters that are usual for investors to carry on). In addition, a limited partner of a PFLP will be allowed to be a director or shareholder of the general partner and to appoint representatives to a limited partner committee.

The white list is not exhaustive nor is it prescriptive; it will be a matter of commercial negotiation and agreement between the partners as to whether limited partners will be entitled to carry on any of the listed activities.

## Relaxation of capital requirements

On the administrative side, the requirement to make a capital contribution will be removed for new PFLPs set up after the legislation comes into force and there will be no need to declare capital contributions at Companies House. If any (optional) capital contributions are made to these new PFLPs, they will be capable of withdrawal. The current law will continue to apply, however, to capital contributions that were made to existing UK limited partnerships before they opted into the PFLP regime. This means that although such capital contributions can be withdrawn, the limited partners may be required to return them.

The dual approach will ensure that any creditors who might have taken comfort from the legal position prior to a UK limited partnership's designation as a PFLP will not be prejudiced by that partnership's subsequent reclassification as a PFLP.

## Simplified filing requirements

Other administrative improvements include the removal of the requirement to file a Gazette notice when a limited partner sells its interest, and the deletion of some of the information on the relevant Companies House form for registration of PFLPs.

## What next?

At the same time as the government published the PFLP legislative proposals, it also published a call for evidence on reforms to limited partnership law. The call for evidence has been driven principally by media reports which have suggested that some Scottish limited partnerships are being used for money laundering and to hide other criminal activity.

The government wants to examine the use of Scottish limited partnerships (which, unlike English limited partnerships, have legal personality and can therefore contract and hold property themselves) as well as look at the registration, transparency, reporting and accounting requirements that apply to all UK limited partnerships.

As the accountability of UK limited partnerships comes under renewed scrutiny by the government, it raises the possibility of reform of UK limited partnership (including PFLP) legislation more generally. With that, the celebrated reduction in the operational and administrative burden of running UK limited partnerships, which is being introduced under the PFLP regime, may well prove to be a temporary feature.

Sian Owles
Partner, London
T +44 20 7296 2426
sian.owles@hoganlovells.com

# Contacts

This newsletter is written in general terms and its application in specific circumstances will depend on the particular facts.

If you would like to receive this newsletter by email please pass on your email address to one of the editors listed below.

If you would like to follow up any of the issues, please speak to one of the contacts listed below, or to any real estate partner at our London office on +44 20 7296 2000, or to any real estate partner in our worldwide office network as listed at the back of this newsletter:

**Jackie Newstead**
Global Head of Real Estate
jackie.newstead@hoganlovells.com

**Jane Dockeray**
Editor and PSL Counsel
jane.dockeray@hoganlovells.com

For topical commentary on key issues in today's rapidly evolving real estate market, visit our Keeping it Real Estate blog: www.ukrealestatelawblog.com or follow us on twitter at @HLRealEstate

# Notes

Alicante
Amsterdam
Baltimore
Beijing
Brussels
Budapest
Caracas
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, D.C.
Zagreb

Our offices
Associated offices

www.hoganlovells.com