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Real World

Finance and Real Estate News

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HEADNOTE

The Outlook for 2007

by **Ciaran Carvalho**

As we approach the end of the year, the real estate investment market and capital markets remain strong. Whether we will continue to see yield compression against the spectre of rising interest rates remains to be seen in 2007. However, with the continuing weight of capital, many commentators do not see dramatic re-pricing.

We have seen a huge increase in the volume of issuance of U.K. and European commercial mortgage-backed securities (CMBS) in 2006. They are the fastest growing asset class within European asset-backed securities, now representing 11 per cent of total European mortgage financings. There are broad expectations of continued growth towards the 40 per cent share which they have in the U.S. Dechert is proud to have produced the first European book dealing exclusively with all aspects of European CMBS (see the article on page 10).

January will see the long-awaited launch of U.K. real estate investment trusts (REITs). We are pleased to see that many of the comments made in Dechert's submission in response to the Treasury's consultation paper in July 2004 have been taken up in the legislation, after persuasive argument by real estate bodies such as the IPF, BPF and RICS. We have included a basic summary of the key points on U.K., and German, REITs in this issue.

It is already clear that a large number of companies will choose to convert to REIT status. Nevertheless, U.K. REITs may not spell the death knell for offshore structures. These will still have their place as U.K. REIT structures will not suit everyone. This is partly because of the prescribed framework and also because there is far less mystique these days over setting up and administering offshore.

I hope you find this issue of Real World both informative and interesting. Finally, I wish you all a very successful 2007.

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FINANCE AND REAL ESTATE

U.K. REITs – A Summary of the Key Points

by **Ciaran Carvalho**

To qualify as a REIT, the company and its business must satisfy certain conditions.

Conditions relating to the company:

- **Residency.** The company must be tax resident solely in the U.K.
- **Closed-ended.** It must not be an open-ended investment company
- **Listing.** The company's shares must be listed on a recognised stock exchange
- **Not "close".** It must not be a "close company" (i.e. under the control of five or fewer participators)
- **Shares.** The company must have only one class of ordinary shares.
- **Loans.** The company must not be party to a loan which is not a "normal commercial loan".

Conditions relating to the property rental business:

- **Three or more properties.** The company must have at least three "single" properties (in the U.K. or overseas)
- **Each property must not be more than 40 per cent of total value.** This is determined using a fair value rather than a cost basis
- **Not owner-occupied.** None of the properties may be occupied by the company or a member of its group
- **90 per cent income distribution.** The company must distribute as dividend at least 90 per cent of the income profits of the business by the corporation tax filing date for that accounting period. (Failure will result in extra tax but not removal of REIT status)
- **75 per cent rental income.** At least 75 per cent of the company's total income profits must derive from the property rental business, net of capital gains and losses
- **75 per cent rental assets.** At least 75 per cent of the total value of the company's assets must be in the property rental business, using a fair value rather than a cost basis and disregarding liabilities secured against property or otherwise used to fund the business. Start-up REITs will have a year to satisfy the 75 per cent income and assets conditions but the 2 per cent entry charge (see below) will bite on the value of assets held at the end of that year.

Tax Exemption. Once a REIT, the company's profits from its tax exempt business are exempt from corporation tax. Instead, shareholders who receive distributions are taxed in the same way as rental income, and a deduction at source for U.K. shareholders or a withholding for offshore investors of 22 per cent is made by the company.

Entry charge. Entry charge of 2 per cent on the gross market value of the assets of the property rental business. The charge can be paid over four years by instalments of 0.5 per cent, 0.53 per cent, 0.56 per cent and 0.6 per cent of the market value, equating to 2.19 per cent in total. No losses or other deductions may be offset against the charge.

Substantial shareholders. If a REIT makes a distribution to a corporate shareholder holding 10 per cent or more of its shares/voting rights, a 22 per cent tax charge will be levied on the profits distributed to such shareholder. This mandates against any shareholder owning 10 per cent or more of the shares/voting rights in a REIT, unless the company has taken steps to prevent the possibility of such a distribution being made (e.g. in its Articles of Association).

Leverage ratio. Rental income profits (before interest or capital allowances) must exceed financing costs by a ratio of 1.25:1. This allows gearing of around 80 per cent of loan-to-value as a maximum.

Group Structures. A group of companies may be a REIT if the parent owns at least 75 per cent of the ordinary share capital of the subsidiary and is entitled to at least 51 per cent of its profits available for distribution and 51 per cent of the voting rights and assets on a winding up.

Development. If a property is developed for sale, or developed with the intention of retaining it as an investment but then sold within three years, gains or losses on sale are treated as part of the non tax-exempt business and taxed.

Ring-fencing. The property rental business is effectively treated as a separate company and losses cannot be offset against profits of another business of the company.

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FINANCE AND REAL ESTATE

GERMAN REITs-A Summary of the Key Points

by **Dr. Olaf Fasshauer**

The legislation on German REITs (G-REITs) is expected to come into force on 1 January 2007. To qualify as a G-REIT the company and its business must satisfy certain conditions.

Conditions relating to the company:

- **Corporate structure.** The company must be a German stock corporation with a minimum share capital of □15 million
- **Residency.** It must have its corporate seat and its management in Germany
- **Listing.** Its shares must be listed on a recognised stock exchange in the E.U. or the E.E.A.
- **Shares.** It must have only one class of ordinary shares. The free float must be at least 15 per cent at all times and 25 per cent at the date of the IPO. Only holders of less than 3 per cent of the outstanding shares count towards the free float
- **Substantial shareholders.** No shareholder should directly own more than 10 per cent of shares or voting power, otherwise tax benefits can be lost by both the G-REIT and the large direct shareholder. Indirect ownership of more than 10 per cent is permitted

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- **Loans.** The company must not be party to a loan which is not a "normal commercial loan". The maximum LTV is 60 per cent

Conditions relating to the company's business:

- **75 per cent real estate.** At least 75 per cent of the total value of the company's assets must be real estate (using a fair market value and less the amounts to be distributed to the shareholders)
- **No occupational properties.** The company must not own occupational properties (i.e. private housing or other non-commercial property), unless such properties were constructed not earlier than 1 January 2007
- **75 per cent rental or sales.** At least 75 per cent of the company's total income profits must derive from the property rental business and the sale of real estate
- **90 per cent income distribution.** The company must distribute as dividend at least 90 per cent of the income profits of the business, including sales proceeds. Fifty per cent of the sales proceeds may be booked to the reserve and used for acquisitions in the following two fiscal years, or must be distributed to the shareholders
- **No trading.** The company must not engage in property trading. Property trading is assumed if the sales proceeds within a timeframe of five years exceed half of the average fair market value of the company's real estate portfolio in such timeframe
- **Third-party business.** The company may offer third-party services (management services) only through a subsidiary. The value of the assets of such subsidiary must not exceed 20 per cent of the value of the company assets. The gross income of the subsidiary must not exceed 20 per cent of the gross income of the company

Tax exemption. The company is exempted from corporate income tax and trade tax. It is not exempted from property tax and real estate transfer tax. VAT regulations apply to G-REITs. Any entity selling real estate to a G-REIT may also benefit from an exit tax which reduces the normal tax rate applying to a realised gain by 50 per cent.

Shareholder's taxable income. All income is taxable at the level of the shareholders.

Penalty. The company will have to pay a penalty to the tax authorities if less than 75 per cent of the total value of the company's assets is real estate, or less than 75 per cent of the company's total income profits derive from the property business, or the company distributes less than 90 per cent to its shareholders. However, this will not result in a removal of the REIT status.

End of tax exemption. Tax exemption to end in case of delisting, less than 15 per cent free float (within the first three years) and more than 60 per cent LTV (within the first three years).

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LANDLORD AND TENANT

Are Parent Company Guarantees Worthless?

by **Gillian Baxter**

Landlords are often willing to grant leases to insubstantial companies provided their obligations are guaranteed by a parent company of satisfactory covenant strength. But the value of such a guarantee is now in question following the use of a company voluntary arrangement (CVA) by electrical retailer Powerhouse earlier this year.

Powerhouse proposed a CVA (see box below) under which it would be released from all future liability in relation to its loss-making stores and, controversially, its parent company, Pacific Retail Group Ltd., would also be released from the guarantees it had given. Despite the landlords' objections, the proposed CVA was approved by the necessary majority at the creditors' meeting, as all other creditors were to be paid in full.

The landlords, who include Prudential, Hammerson, Slough Estates and Land Securities, have applied to the court to have the CVA revoked on the grounds that it unfairly prejudices their interests and that the release of the guarantee is not permitted by the legislation governing CVAs. The case is expected to be heard in March.

If the landlords' challenge fails, the practice of using a CVA to release a parent company guarantee on the insolvency of the subsidiary could well become widespread, which would seriously devalue such guarantees. If the guarantee can be released precisely when the landlord needs to call on it – when the tenant becomes insolvent – then it could be regarded as worthless and that could have serious implications for the value of tenanted property.

What is a CVA?

A company voluntary arrangement, or CVA, is a compromise or arrangement with creditors under Part I of the Insolvency Act 1986. Proposals are put at a meeting of creditors and shareholders and, if agreed by a majority in value of the shareholders and 75 per cent in value of those creditors present and voting, they are then binding on all except secured or preferential creditors.

In the meantime, the lessons for landlords are clear:

- it is essential to attend any meeting called by a tenant at which a CVA is to be proposed
- vote against any proposal which involves the release of a guarantor
- do not delay in pursuing any alternative remedies available before the CVA is made – but this is not possible if the tenant is a "small" company which obtains a moratorium. "Small" for this purpose means satisfying at least two of these tests:
  - turnover £5.6 million or less
  - balance sheet total £2.8 million or less
  - no more than 50 employees
- do not assume that it will be possible to call on a parent company guarantee if the tenant fails.

Sources: Insolvency Act 1986

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LANDLORD AND TENANT

How Long is Reasonable?

by **Jane Grant**

On receipt of a request from a tenant for consent to a proposed assignment or sub-letting, one of the key questions in the landlord's mind should be "How long do I have to decide?"

Under the *Landlord and Tenant Act 1988* the landlord is obliged to give consent unless there are reasonable grounds for refusing. The landlord must give the tenant his decision in writing within a reasonable time and any conditions attached to the consent must be reasonable. The burden of proof is on the landlord and the tenant has the right under the Act to sue for damages for unreasonable refusal of consent.

Previously, the decisions in cases brought for non-compliance with the Act narrowed the decision-making window for the landlord and the courts considered a comparatively short period as "reasonable time". However, at the same time, the courts stated that each case must be decided on its own facts and depending upon the urgency of that matter.

In the 2002 case of *Go West v Spigarolo*, the Court of Appeal stated that a landlord cannot rely on reasons for refusing consent which he has not put forward in writing to the tenant within a reasonable time. The reasonableness of the refusal must be judged at the expiry of the reasonable time. Once the landlord has responded, then the reasonable time automatically expires and subsequent correspondence is irrelevant.

What the courts have said:

- 2002 Go West v Spigarolo—"reasonable time" would usually be weeks rather than months
- 2003 Blockbuster v Barnsdale – the landlord should have consented within a week, just over three weeks was unreasonable
- 2004 Design Progression Ltd. v Thurloe Properties Ltd. -- punitive damages awarded
- 2005 NCR v Riverland at first instance – consent should have been given in two weeks, but on appeal three weeks was not unreasonable

The court said that reasonable time would usually be weeks rather than months and begins when the landlord is in receipt of all relevant information.

In 2003, in *Blockbuster v Barnsdale*, the court said the landlord should have given consent within a week and that waiting for just over three weeks to respond was unreasonable. Damages were awarded to the tenant when the proposed underletting became abortive. In the subsequent case of *Design Progression Ltd. v Thurloe Properties Ltd.*, the court awarded compensatory and punitive damages to the tenant.

However, a recent change of heart brings positive news for landlords. In *NCR v Riverland* the court was more sympathetic to the landlord. On 28 July 2003 the landlord was in receipt of all information required to make an informed decision. The landlord responded on 20 August 2003.

At first instance the judge stuck to the previous line of decisions, which implied that the reasonable time period should be fairly short, and stated that the decision should have been made within two weeks.

But the Court of Appeal reversed the decision and favoured the landlord stating that the letter granting consent was sent within a reasonable time and that, bearing in mind the fact that "*Riverland, even with the assistance of experienced legal advisers, arrived at the wrong answer and thereby incurred a lawsuit involving a claim of some £3m*", the tenant's application was not simple.

There is still no fixed advice from the courts as to what constitutes a reasonable time, though as *NCR v Riverland* shows, the courts seem to be turning in favour of landlords. Landlords would still be well advised to respond as soon as possible once in receipt of all relevant information. If they wait too long, they risk being out of time and could be required to pay damages as a result. From the tenant's point of view, they should try to submit full details of any application to the landlord at the outset to ensure that reasonable time begins to run as soon as possible.

Sources: *Landlord and Tenant Act 1988, Go West v Spigarolo* [2003] EWCA Civ 17, *Blockbuster v Barnsdale* [2003] EWHC 2912, Design *Progression Ltd. v Thurloe Properties Ltd.* [2004] EWHC 324, *NCR v Riverland* [2005] EWCA Civ 312.

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LANDLORD AND TENANT

Rent Reviews and Former Tenants-The Landlord's Dilemma

by **Lynn Smith**

The recent High Court decision of ***Scottish & Newcastle PLC v Raguz*** *could have significant consequences for landlords and tenants.*

In this case, Hart J. stated that a landlord will not be entitled to recover sums from former tenants or guarantors if an outstanding rent review has not been determined within six months of the review date *unless* he has served a notice under section 17 of the Landlord and Tenant (Covenants) Act 1995 for any future increase within six months of each rent payment day which occurs while the rent review is being determined. The same point appears to apply to a service charge balancing payment, where the six-month period for service of the section 17 notice will begin on the date when the original on-account service charge payment was due.

The case has been criticised and may be overturned on appeal. Meanwhile, it appears that some major landlords are taking a cautious approach and serving section 17 notices as a precaution.

Former tenants or guarantors who receive a section 17 notice, can at least be reassured that, provided the only monies claimed in the notice are for the outstanding review or service charge top-up, then they do not need to pay any money now and may never have to if the current tenant does not default when the increase or top-up (if any) is determined.

Landlords who are involved in a rent review or service charge calculation where the final amount will not be determined for more than six months from the rent review date (or date for payment of the on-account service charge), may wish to consider serving notices on former tenant(s) and guarantor(s) as a protective measure. However, as no default has yet occurred, it seems doubtful that the cost of serving such notices could be recovered under the lease. Further, serving such notices may risk the former tenant or guarantor calling for an overriding lease, although it is not entirely clear whether an overriding lease could in fact be claimed on the basis of a landlord's notice demanding a nil amount.

Clearly it is a commercial matter for landlords to decide whether to serve protective notices or do nothing and hope that the case is overturned on appeal. This decision will depend on all the circumstances of the particular case. For example, the landlord may decide not to serve notices if the current tenant is of substantial financial strength and does not habitually pay rent late while the

former tenant or guarantor is not a particularly good covenant. Where, however, the current tenant habitually makes payments late and is a poor covenant, but a former tenant or guarantor is a good covenant, a landlord may decide to serve notices as a precaution.

This does not affect the normal situation where a fixed charge, such as rent or service charge, is not paid by the current tenant on time. In such cases a section 17 notice will be served in the normal way within six months of the date of default.

Sources: Landlord and Tenant (Covenants) Act 1995 s.17, *Scottish & Newcastle PLC v Raguz* [2006] EWHC 821.

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DEVELOPMENT

Bad News for Developers

by **Patrick Gloyens**

Developers will need to take complaints about interference with rights of light more seriously after a recent case in which the court ordered part of a development to be demolished because it blocked the light to a nearby maisonette.

Developers have always had to take account of rights of light when designing new buildings. It is well known that the court has the power to grant an injunction requiring a developer to demolish a building that interferes with the access of light to a neighbouring property. But until recently it was generally thought that if the interference was relatively small and did not prevent use of the neighbouring property, the court would most likely order the developer to pay damages rather than demolish the building.

But a recent decision, Regan v Paul Properties, appears to signal a change of attitude by the court. The case concerned a mixed-use development by Paul Properties in Brighton. A neighbour, Mr. Regan, complained that

the fourth floor penthouse would block a third of the light to the sitting room of his maisonette and reduce its value by about £5,500. When they failed to agree, Paul Properties continued building and Mr. Regan applied for an injunction to prevent the construction of a penthouse on the top of the proposed development.

The High Court refused an injunction and awarded damages, taking the view that damages would normally be awarded in such cases unless the claimant could show that they would not be an adequate remedy. Mr. Regan was not satisfied and took the case to the Court of Appeal, which applied principles laid down in 1895 in the leading case of Shelfer v City of London Electric Lighting Co Ltd. (see box). The court decided that Mr. Regan did not need to show why he should not be awarded only damages and granted an injunction.

The appeal court did not regard the loss of light to Mr. Regan's sitting room as a small infringement, or the £5,500 reduction in value of the maisonette as "a small money payment". Nor did it consider that the difference between that amount and the cost to the developer if an injunction were granted (estimated at £175,000) made it oppressive to grant an injunction. (The court made the point that the amount of any damages in lieu would be linked to the value of the penthouse and would be substantial). In particular, the court was not impressed with the developer's conduct, in that the developer had taken a calculated risk in deciding to proceed after Mr. Regan first complained and they must take the consequences of that. The developer's conduct, the court decided, should not prejudice Mr. Regan and weigh against his right to an injunction.

In drawing general principles from the case, it is clear that the court was also influenced by the fact the flat was Mr. Regan's home, that the affected room was his living room, and that the loss of light was material.

Principles laid down in Shelfer v City of London Electric Lighting Co Ltd. (1895)

- The presumption is that an injunction should be granted where legal rights are infringed by a wrongful act
- The defendant is not entitled to "buy out" the claimant's right to an injunction by offering to pay damages
- Damages should be awarded instead only in "very exceptional circumstances"
- Relevant factors include whether:
  - the infringement is small
  - a monetary value can be placed on it
  - it can be adequately compensated by a small money payment
  - it would be oppressive to the defendant to grant an injunction
  - the claimant has indicated that he wants only money
  - the claimant's conduct makes it unjust to award more than money
  - there are other circumstances justifying the refusal of an injunction

Sources: Regan v Paul Properties Ltd. [2006] EWCA Civ 1319; Shelfer v City of London Electric Lighting Co. Ltd. [1895] 1 Ch 287.

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FINANCE

Dechert Launches European CMBS Book

by **Andrew V. Petersen**

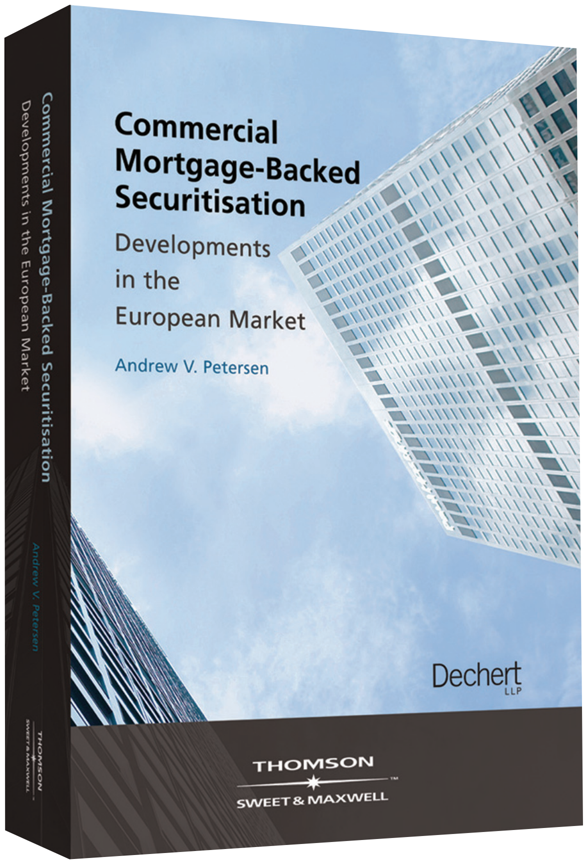
Dechert has launched the first European book dedicated to European CMBS. Entitled Commercial Mortgage-Backed Securitisation: Developments in the European Market, the book was launched in November during the CMSA-Europe Conference 2006 in Rome. It is published by Sweet & Maxwell.

The book's editor, Andrew V. Petersen, a lawyer at Dechert's London office who specialises in real estate financing, brought together a range of contributors who offer real insights into current commercial mortgage-backed securitisation practice.

Contributors include leading structured finance lawyers at Dechert as well as leading global investment bankers, including the head of CMBS EMEA at Merrill Lynch and the head of European ABS Trading and the director of European ABS Research at Barclays Capital. Other contributors include the assistant general counsel from top ratings agency Standard & Poor's, the head of Securitisation-European Debt Capital Markets at Eurohypo AG, and Chatham Financial, all of whom have considerable experience in the securitisation market in the U.K. and Europe. Lawyers from leading European securitisation law firms Garrigues of Spain, Gianni Origoni Grippo & Partners of Italy and Portugal's Vieira de Almeida & Associados also contributed.

The book examines the CMBS process from start to finish. It begins with the emergence of the asset, its economic environment and marketplace. It goes on to examine the ratings process and the structuring of major deals, including the use of technological innovations and credit enhancement products, such as synthetic swaps and property derivatives. It then moves on to the origination, structuring and issuance of CMBS deals.

Following that, there is detailed coverage of subordinated debt structures, intercreditor agreements, servicing, CRE CDOs and the European laws on market abuse and investor reporting. An analysis of the current European CMBS market follows, with an in-depth examination of the pan-European CMBS markets (including Germany, France, Spain, Italy and Portugal) written by the leading structured finance lawyers within those jurisdictions.



Finally, it discusses new innovations and potential developments, such as the role of CMBS in Islamic finance and title insurance.

This book will prove an essential guide to all participants in the CMBS industry. If you would like additional information, please contact:

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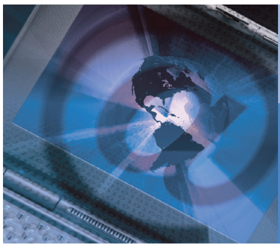
We are pleased to announce that **Kathleen O'Donnell** has joined us as a partner in our Finance and Real Estate group. Kathleen was previously a partner at Lawrence Graham and specialises in bilateral and syndicated estate finance and mortgage finance.



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