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Real World

Finance and Real Estate News

In this issue

HEADNOTE

What Next for Commercial Real Estate Investors?

by **Ciaran Carvalho**

The effects of the nervousness in the financial markets caused by the US sub-prime mortgage crisis have been well-documented in the media with gloomy headlines being a constant feature in recent months. The turmoil in the global capital markets and the resulting liquidity crisis has caused a widespread loss of confidence with contagion spreading rapidly to the commercial real estate sector, which has traditionally been seen as a safe haven. In Europe, retail investors made a speedy exit from property funds, the share prices of listed property companies fell significantly, lending on commercial property investment ground to a halt and the CMBS markets froze.

Whether this will be a short-term correction or a longer upheaval is open to debate, but recent reports have confirmed falling commercial property values and slowing deal volumes. There is much talk of deals falling through, going on hold or otherwise progressing extremely slowly with significant downward price adjustments. In the meantime, real estate investors anticipate that financings and re-financings will involve a higher margin and tighter lending conditions, especially LTVs and DSCRs, than has been the case in recent times.

As to the future, while the "correction" in commercial real estate pricing and the increased funding costs mean a downturn for highly leveraged investors, potential opportunities exist for those buyers with more equity to invest. Indeed, indications are that there are substantial amounts of capital, particularly in private equity funds, earmarked for investment in commercial real estate, but there is a waiting game being played, with investors unwilling to move until there is more certainty as to how far prices will fall. Ultimately, it seems that sellers need to adjust their expectations further downwards until the pricing compensates the buyers for the future higher cost of debt.

Parent company guarantees have been in the news recently with Powerhouse. Here we report on another recent case where the defendant was claiming the discharge of a parent company guarantee due to a variation of the underlying contract. We also take a look at the Companies Act 2006 and the codification of directors' duties.

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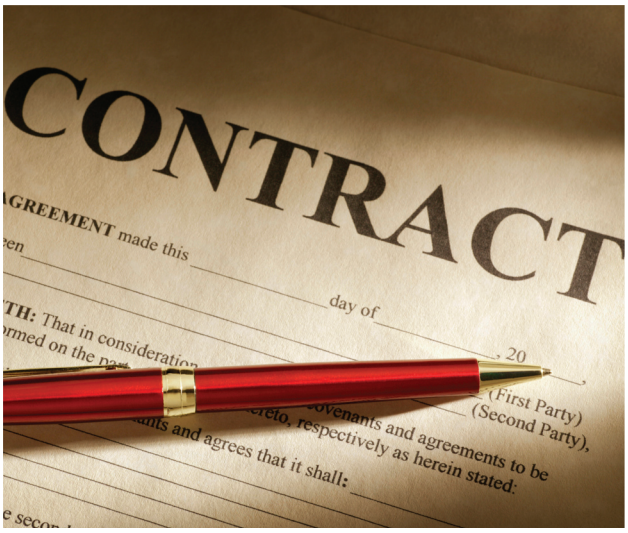

CONTRACTS

How is a Parent Company Guarantee Affected by a Variation of the Underlying Contract?

by **Catherine A. Stringer**

A variation of the terms of a contract normally has the effect of discharging any guarantee of the contract. The Court of Appeal, however, recently held in Wittman (UK) Limited and Willdav Engineering S.A, that, in certain circumstances, a parent company guarantee will not automatically be discharged by a variation of the underlying contract.

Facts

In this case, A contracted to purchase goods from Wittman ("W"). A made clear to W that it intended to obtain finance to pay for the goods. W was unwilling to deliver the goods until it knew that A could finance the purchases. A therefore arranged for its ultimate parent company, Willdav Engineering S.A. ("the Parent") to guarantee payment of the purchase price.

A ultimately secured financing for the goods on lease-purchase terms, and W entered into contracts with A and three finance companies under which title to certain goods passed to the finance companies in return for payment of part of the relevant purchase price. *The Parent was aware of the changes brought about by the new financing arrangements.*

The finance companies and A made payments under the contracts but there was an outstanding balance under the purchase contract. A failed to pay the balance and went into liquidation. W made a formal demand under the guarantee and then commenced proceedings to recover the amount outstanding.

The Parent denied liability under its guarantee on the basis that the contract under which W was now entitled to recover the amounts from A was not the contract to which the guarantee related as the original purchase contracts had been discharged and substituted by the new contracts.

The judge at first instance found for W on the basis that, although ordinarily a guarantee will not extend to obligations arising under a new contract entered into in substitution for the original contract, in this case the original contract provided for alterations of the contractual relationships of the kind that had occurred. Therefore, the guarantee did extend to A's obligations under the new arrangements.

The Parent appealed.

Decision

The appeal was dismissed. The court did not accept that the new arrangements were intended to discharge the original contract entirely and replace it with others to which the guarantee would not apply. Instead it found that A and W intended to discharge A's original obligation only to the extent that W had the right to be paid by the finance companies. Therefore, A's obligation to pay for the goods remained in respect of the residual amount. As a result, the Parent remained liable under the guarantee for payment of the residual amount.

Conclusion

The decision is likely to have limited consequences due to the particular nature of the negotiations between the parties. It illustrates, however, the important principle that the right of a surety to be discharged if the terms of the obligations under the principal contract are altered does not apply in circumstances where it would be inequitable. Where the guarantor consents to a variation of the underlying contract but then seeks to use that variation as a ground for the discharge of the guarantee, it would be inequitable for the court to allow the discharge. Guarantee covenants usually provide that variations of the contract will not affect the liability of the guarantor. Nevertheless, the safest course is to ensure that the guarantor is a party to any variation of the contract.

Source: Wittman (UK) Limited v Willdav Engineering S.A. [2007] EWCA Civ 824

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COMPANIES

The General Duties of Directors Under The Companies Act 2006 – A Reminder

by **Catherine A. Stringer**

The Companies Act 2006 ("the Act") sets out in statute for the first time the general duties of company directors. These provisions are stated to be based on the current common law rules and equitable principles applicable to directors.

Sections 171 to 174 of the Companies Act 2006 (setting out some of these duties) came into force on 1 October. Three of these sections set out duties which are already familiar: to act in accordance with the company's constitution and only exercise powers for the purposes they are conferred (section 171), to exercise independent judgment (section 173) and to exercise reasonable care, skill and diligence (section 174).

Section 172 of the Act, however, has now replaced the director's fiduciary duty to act in good faith in the interests of the company. It provides that a director must act in the way he/she considers in good faith would be most likely to promote the success of the company for the benefit of its members as a whole having regard (amongst other matters) to:

- the likely consequences of the decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.

It is clear from the Act and ministerial statements made in respect of it that, when making decisions (and not just those made in board meetings), the directors must also consider any other relevant factors as well as those specifically referred to in the Act.

There has been much commentary on how the board minutes should document the fact that all relevant factors have been considered. Views range from recommending that the minutes be very full and document the points made in discussions to the view that the board minutes should note that, in their discussions, the directors have also considered all those matters referred to in section 172 of the Act. The general consensus is that the latter course of action is most likely; although of course companies may also make sure that the directors' board papers set out all factors or that a copy of section 172 is attached to the board papers.

On a financing transaction, as is currently the case, a lender will need to see the board minutes to satisfy itself that the minutes authorise the relevant transaction. It is unlikely, however, that it or its advisors will require any major changes to the format of board minutes as a result of section 172.

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TITLE

Unregistered Landowners at Greater Risk of Losing Title By Adverse Possession

by **Gillian Baxter**

Nearly 150 years after the system of land registration was introduced, more than 40 per cent of the land in England and Wales is still unregistered. A recent decision of the European Court of Human Rights highlights an important practical difference between owning registered and unregistered land, which means that unregistered landowners are at greater risk of losing title to their land by adverse possession.

The European Court of Human Rights ruled at the end of August that the system of adverse possession, under which an unauthorised occupier can acquire legal title to land after 12 years occupation, does not violate Article 1 of the European Convention on Human Rights, the right to the peaceful enjoyment of possessions. The practical significance of the decision is that landowners who lose their land in this way will not be able to claim compensation from the government.

The case concerned a plot of agricultural land worth around £10 million, which the owner, J. A. Pye (Oxford) Land Ltd., hoped to develop. The land was occupied by Mr and Mrs Graham under a grazing agreement, but when the agreement expired in 1983, they continued to occupy without permission until 1999. In 1997, the Grahams claimed title by adverse possession based on their occupation for more than 12 years. Pye brought proceedings to recover possession, which it eventually lost in the House of Lords in 2002. Pye then tried a different approach and claimed compensation from the government on the basis that the system of adverse possession violated its human rights. The court decided in favour of Pye in 2005, but the government appealed to the Grand Chamber, which has now decided that there was no violation of human rights and, therefore, no right to compensation for the loss of the land.

Ironically, Pye's land had registered title, and the rules on adverse possession were changed for registered land by the Land Registration Act 2002. The new procedure makes it much harder for adverse possessors to acquire title to registered land. Under the new rules, once the squatter has been in occupation for a minimum of ten years he can make an application to the Land Registry. The registered owner is then notified of the application and has two years to take steps to regain possession. If the Grahams had applied to the Land Registry today, Pye would have been notified and could have taken possession proceedings.

However, the new rules do not apply to land with unregistered title. Unregistered landowners do not get a warning notice; for them, once the 12 year period of occupation is up, the title is lost and there is nothing the landowner can do to get it back.

It is possible to apply for voluntary registration of title, which might be worth considering, especially if the title is complex and registration might speed up a future sale. While the title remains unregistered, however, the lesson is clear. Unregistered landowners must take particular care to ensure that unauthorised occupiers are removed or their occupation is regulated well before they have been in occupation for 12 years. If they do not, they stand to lose their land with no right to compensation.

Sources: J A Pye (Oxford) Ltd v United Kingdom (application no.44302/02) [2007] All ER (D) 177 (Aug); Land Registration Act 2002.

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LANDLORD'S REMEDIES

Commercial Rent Arrears Recovery

by **Lynn Smith**

The ancient remedy of "distraint" or "distress", which enables landlords to recover arrears of rent without going to court by taking goods from the property and selling them, is to be abolished and replaced with a new procedure called commercial rent arrears recovery ("CRAR").

When Will The New Regime Begin?

The new law is contained in the Tribunals, Courts and Enforcement Act 2007, which received Royal Assent on 19 July 2007, but no date has yet been set for it to be brought into force.

The New Procedure

Under the new procedure, a minimum period of notice will have to be given before goods may be seized, and only a certified "enforcement agent" may exercise the right. The tenant will be able to apply to court to set aside the notice or prevent further steps, and there is concern that tenants will dispose of goods once they receive a notice. The detailed procedure and the notice period will be set out in regulations. The regulations will also specify a minimum amount of net unpaid rent that must be outstanding before the remedy may be used. This is expected to be a fairly small amount. The net unpaid rent will exclude interest, VAT and any amount that the tenant may claim by way of deduction or set-off. The landlord will have to calculate the net unpaid rent before serving notice and before taking the goods, which may result in delay and abortive costs.

Which Leases Qualify?

The new remedy will apply only to written leases of commercial premises. The remedy may not be exercised if any part of the premises is let or occupied as a dwelling, unless the residential use breaches the terms of the lease or a superior lease. The landlord will need to consider the permitted use and the actual use of the premises carefully.

What Rent Qualifies?

CRAR will apply only to "rent"; that is, the amount payable for the possession and use of the premises, including interest and VAT, but not other sums, such as service charge, insurance, and so on, even if they are reserved as rent. If the rent is inclusive, or if there is a turnover rent, only the proportion reasonably attributable to the possession and use of the premises is recoverable by the new procedure. If that proportion is not clear, it might be sensible to agree it and record it when the lease is granted. Interim rent payable when a lease is renewed under the Landlord and Tenant Act 1954 is also recoverable.

Subtenants

The landlord will also have a right to give notice directly to a subtenant, specifying the amount of arrears and requiring the subtenant to pay rent directly to the landlord. This procedure replaces the old "rent diversion notice". Detailed rules will be contained in regulations. If the subtenant pays, he can deduct the amount from the rent payable to the tenant. If he fails to pay, the landlord can exercise CRAR against the subtenant.

Anti-Avoidance

Lease wording that attempts to permit CRAR at residential premises or to extend the definition of qualifying rent will be void.

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CONTRACTS

Good News for Purchasers

by **Jon Bola**

As a result of a recent High Court decision, purchasers may not have to lose their deposit if they fail to complete a purchase on time.

Contracts for the sale and purchase of property almost always provide for the purchaser to pay a deposit, usually 10 per cent of the purchase price. If the purchaser fails to complete the purchase, then the seller keeps the deposit. Negotiation often occurs about the size of the deposit, or whether it is to be held by the seller's solicitors as stakeholders or as agents for the seller. But the basic principle that the deposit is forfeited if the purchaser defaults is not normally an issue.

There may be circumstances, however, in which it would be unfair for the seller to keep the deposit – the purchaser might have been prevented from completing the purchase by matters outside its control and the seller might quickly find another buyer and suffer no loss. To deal with that unfairness, section 49(2) of the Law of Property Act 1925 provides that the court can order the deposit to be returned to the purchaser if it thinks fit.

But purchasers have rarely used that section because buried in the small print of most contracts is a provision saying that the section does not apply. The provision is not seen as controversial, and purchasers do not usually object to it because they do not expect to default and do not want to give the seller the impression that there is a risk that they will not complete on time.

It was not until June this year, more than 80 years after the Act was passed, that the question first came before the court whether a provision excluding section 49(2) is valid. A Nigerian businessman, Chief Ajibola Anthony Aribisala, failed to complete the purchase of two properties for £2.16 million and stood to lose his £216,000 deposit. His lawyers successfully convinced the court that the provision is invalid and that he has the right to ask the court to order that the deposit be returned.

The judge's reasoning was that section 49(2) does not confer a benefit on a party to a contract, which that party may choose to waive. It confers jurisdiction on the court to exercise its discretion in favour of a purchaser. So a contract provision that intends to exclude that section is purporting to oust the jurisdiction of the court and is, therefore, void on grounds of public policy.

It does not follow, of course, that the court will necessarily order the return of the deposit. It will depend on what is just and fair in all the circumstances. If the buyer has breached the contract without any justification, then the court might well refuse to order the return of the deposit. But if the buyer has been forced to act as he did because of circumstances outside his control and the seller has suffered no real loss, the decision might be different. The courts have held, however, that they are unlikely to order repayment where the seller is contractually entitled to retain the deposit, unless the seller has acted inequitably or there are other special circumstances.

Source: Aribisala v St James Homes (Grosvenor Dock) Ltd [2007] EWHC 1694 (Ch); section 49(2) Law of Property Act 1925.

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