DechertOnPoint

Summer 2007 / Issue 9

Editor: gillian.baxter@dechert.com

Real World

Finance and Real Estate News

In this issue

HEADNOTE

Is the Summer Outlook Gloomy?

by **Ciaran Carvalho**

You don't have to look too far this Summer to find commentators with gloomy predictions for the property market. Interest rate rises have dented confidence, the secondary retail market in particular is beginning to struggle and an increase in loan defaults has been forecast, as interest repayment costs sometimes rise above yields. With commercial property lending at an all time high of £172.5bn and last year's loan originations 19.5% higher than in 2005, some fear that the market has peaked and comparisons have even been made with conditions before the crash of the early 1990s.

However, today's property investment world is a very different place from that of the early 90s. Lending for speculative development, although increased over the last few years, still represents only 3% of all outstanding loans, a much smaller percentage than in the early 90s. But the real change is the growth of structured finance and new investment vehicles, such as REITs. Research has shown that only 71% of loans are now kept by their originators, with the rest being passed to other investors through vehicles such as commercial mortgage-backed securities or syndications. This spreading of the risk means lenders are better equipped to deal with setbacks which 15 or 20 years ago might have been more serious.

The last few years have also seen a huge growth in the derivatives market and this issue contains the second part of Gary Walker's article on derivatives.

Another subject in which there has been a huge growth of interest is energy efficiency. Inside, Bill Fryzer considers whether landlords can require tenants to pay the cost of upgrading plant and equipment to improve efficiency.

Ciaran Carvalho
Head of Finance and Real Estate, London
+44 20 7184 7473
ciaran.carvalho@dechert.com

Dechert LLP

LANDLORD AND TENANT

Preserving the Value of Parent Company Guarantees

by **Gillian Baxter**

The benefit of lease guarantee covenants could be lost if the tenant becomes insolvent and makes a voluntary arrangement with its creditors. Careful drafting of the guarantee clause may provide a solution.

In our Winter issue, we reported on the controversial company voluntary arrangement put in place by electrical retailer Powerhouse under which:

- a number of loss making stores were to close but others continued to trade;
- creditors in respect of closed stores were to share a fund of £1.5 million, receiving 28p in the pound;
- their claims against the company would be released;
- guarantees given by parent company, PRG Group Ltd, would also be released;
- other creditors would be unaffected.

A group of major landlords of closed stores successfully challenged the CVA in the High Court on the basis that it was unfairly prejudicial to the landlords of closed stores.

The case attracted a huge amount of publicity in the property press because of the potential implications for the property industry if the landlords had lost and the fear that if parent company guarantees could be released when the tenant became insolvent, they would be virtually worthless. When the landlords won, there was a collective sigh of relief and many considered the matter closed. But the story is not over.

The main reason why the CVA was held to be unfairly prejudicial to the landlords of the closed stores was that it provided for landlords who were to lose the benefit of parent company guarantees to receive the same 28 pence in the pound as landlords without that benefit. It is possible that the decision would have been different if the pot of money to be distributed to the landlords of closed stores had been allocated on a basis which allowed them something extra to compensate for the loss of the guarantees. Therefore, there remains a risk that CVAs could yet be used to release parent company guarantees.

However, it may be possible to remove that risk by careful drafting of the guarantee clause. The legislation does not enable a CVA to operate directly to release the parent company from the guarantee. What it can do is to prevent creditors from enforcing third party obligations which give rise to a right of recourse against the company. Under the general law, a guarantor who is called upon to pay under a guarantee has a right to recover the sum claimed from the debtor. So the landlord is prevented from enforcing the guarantee in order to ensure that the release of the tenant's obligations is really effective.

The possible solution, therefore, is to include a clause which removes the guarantor's right to recover from the tenant sums which it is called upon to pay under the guarantee if a CVA is put in place.

A guarantor which is genuinely independent of the tenant is unlikely to be prepared to give a guarantee without a right of recourse against the tenant, so this solution will not be viable in such a situation. But in the majority of cases, as with Powerhouse, where the guarantee is given by the tenant's parent company, there ought to be no real objection to the removal of that right. After all, the effect is only to ensure that the lease obligations are met by the parent company if the tenant is unable to perform them, which is the point of taking the guarantee.

Gillian Baxter
Professional support lawyer, London
+44 20 7184 7450
gillian.baxter@dechert.com

LANDLORD AND TENANT

Energy Efficiency – Will the Tenant Pay?

by **Bill Fryzer**

The Government is committed to substantial reductions in emissions of carbon dioxide and we are told that buildings which are energy efficient will command a premium in the market. Can landlords look to their tenants to fund the necessary upgrading of plant and equipment?

The costs which a tenant can be required to pay will depend on the precise wording of the particular lease, but there are some general points to consider.

Leases invariably contain a tenant's obligation to carry out works necessary to comply with legal requirements affecting the premises. The cost of such works in respect of multi-let buildings is usually included in a service charge. However, so far at least, there is no specific legal requirement to upgrade plant and equipment in existing buildings to improve energy efficiency.

The building regulations have been revised to require new buildings to meet minimum energy performance standards and existing large buildings undergoing major renovation must be upgraded to meet the new standards so far as technically, functionally and economically feasible. But this does not apply to an existing building which is not being renovated.

Regulations will also be brought into force gradually from 2008 to require air-conditioning systems to be inspected regularly by an energy assessor, who must report on possible improvements to the system, including replacement. However, there is as yet, no requirement to make any improvements recommended by the report.

Where a tenant occupies the whole building, the lease will usually require the tenant to ensure that plant and equipment is properly maintained, but that will not imply an obligation to ensure energy efficiency. Liability under a repairing covenant will not bite unless there is some disrepair to be made good. Without specific wording, there is no requirement to improve or upgrade equipment which is in working order.

The same general principle governs costs which may be included in the service charge of a multi-let building. A head of charge which refers only to repair and maintenance will not cover the cost of replacement or improvement of plant which is in working order. Leases usually contain general wording allowing the landlord to add to or vary the services, but the courts have usually construed such wording restrictively and are unlikely to allow it to be used to cover the cost of upgrading to improve energy efficiency.

The only way for the landlord to ensure that the cost of upgrading can be passed on to the tenant, absent of any statutory requirement, is to include specific wording to that effect in the lease. Traditionally, however, tenants have refused to accept that they should bear the cost of improvement, especially where the capital costs incurred will not be recouped through reduced energy bills during the remainder of the term of the lease. The inclusion of such an obligation could also have an adverse effect on the rent at review. However, the RICS Code of Practice for service charges does allow the cost of enhancement of plant or equipment to be included "where such expenditure can be justified following the analysis of reasonable options and alternatives". This may give landlords some ammunition in negotiations.

Sources: The Energy Performance of Buildings (Certificates and Inspections) (England and Wales) Regulations 2007; Post Office v Aquarius Properties Ltd [1987]; Fluor Daniel Properties v Shortlands Investments Ltd [2001].

Bill Fryzer
Partner, Finance and Real Estate, London
+44 20 7184 7454
william.fryzer@dechert.com

DEVELOPMENT

The Commons Act – A 5 Year Time Bomb

by **David Gervais**

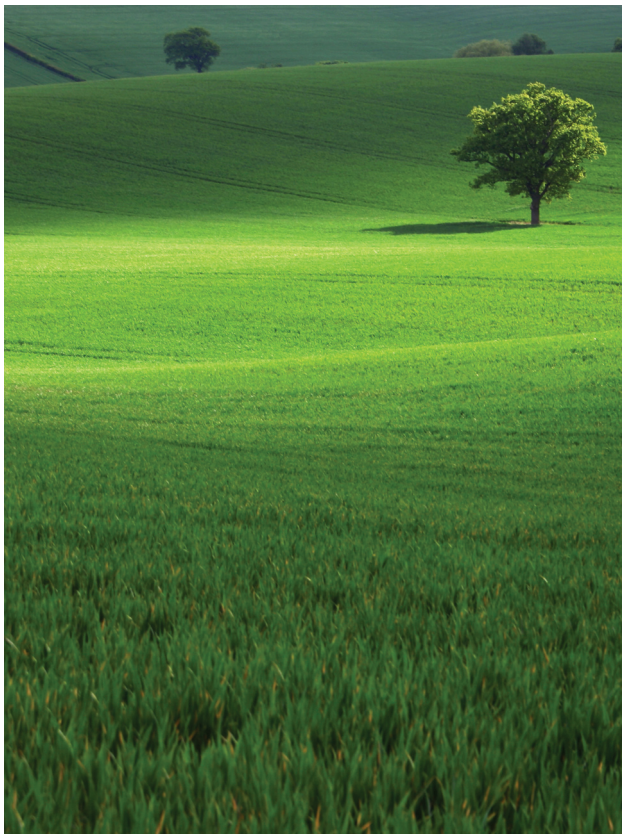
You've bought the land. You've got finance, planning and a pre-let in place. Construction is complete and you've got a buyer lined up – all the pieces have fallen into place. Then, at the last minute, a local resident, who used to walk his dog on the land years earlier, applies to have it registered as a village green. Now that section 15 of the Commons Act 2006 is in force, this nightmare scenario could come true.

The phrase "village green" conjures up an image of cricket on a lawn in a picturesque country village. But under the new Commons Act, any scruffy piece of wasteland could qualify as a town or village green. The test for registration under the Act is that the land has been used by a significant number of local people for recreation "as of right" for at least twenty years.

The first problem with this is that recreation, or "lawful sports and pastimes", as the Act puts it, includes not only organised games, but also informal unrecorded activities like local children playing or people jogging or walking their dogs. The "as of right" bit means that the activities must have been done openly, without force and without permission. So, anything that people got up to if they had climbed over the fence at night or broken in would not count.

Well, you may think, that's no problem. The land has been fenced off since you bought it, so there's certainly been no recreation since then. But that brings us to the second problem. Under the old rules, the recreational use had to continue until the application for registration as a town or village green was made. That meant that once the land was fenced off there was no more risk of an application for registration being made. But the 2006 Act has made a crucial change which creates a serious potential trap for developers.

Under the new rules, the application can be made up to two years after the recreational use stops, by which time a development could be well under way. But worse than that, if the recreational use ceased before 6 April this year, when section 15 came into force, then the application for registration can be made up to 5 years after the recreational use ended. There is an exception to the 5 year rule where planning permission was granted and construction work started before 23 June 2006. But otherwise the risk of an application being made could continue until 2012.



There is some uncertainty about the legal position of the development if the application for registration is successful. DEFRA have said that any building on land which is subsequently registered as a green is unlawful and may have to be demolished. Others say it is not unlawful to build on the land before it is registered as a green. The position is not spelled out in the Act and we may have to wait for a test case to be sure. In the meantime, it will be particularly important to find out as much as possible about the previous use of development sites and, of course, to ensure that they are properly fenced off to prevent any recreational use continuing.

Another provision in the Act might in future provide a solution. Section 16, which is not yet in force, will allow the owner of land registered as a town or village green to apply to have it deregistered provided it offers other suitable land to be registered in its place.

Source: Commons Act 2006

David Gervais
Senior associate, Finance and Real Estate,
London
+44 20 7184 7670
david.gervais@dechert.com

LANDLORD AND TENANT

Beware Rights of Way with a Life of Their Own! (or the strange case of the right of way that would not die)

by Elizabeth Dale

It is not often that a claimant takes a case to the Court of Appeal without being legally represented; far less often that he not only wins his case but upsets established legal thinking and makes the Land Registry re-write their guidance on the subject. That is what happened earlier this year when Mr. Wall claimed that he had a right of way over the passageway beside his house in Bolton and refused to believe the Land Registry when they told him it had ceased to exist.

The story started in 1910 when Mr. Olliwell sold a piece of land to Mr. Hurst on a 999 year lease. Mr. Hurst built two houses on it, kept one and sold the other to Mr. Morris together with a right of way over the passageway between them. Fast forward to 1986 when Mr. and Mrs. Green, who then owned the house, bought the freehold. Fast forward again to 1999 when Mr. Wall bought the house and reference to the old lease was removed from the register because it had merged into the freehold.

Established thinking was that when a lease merges with the freehold, any easements or covenants attached to the leasehold interest are extinguished. For that reason, it is common to provide that a lease is not to merge when a superior interest is acquired, to ensure that the benefit of rights will not be lost. However, the Court of Appeal did not agree. They decided that when a lessee has an easement, the easement relates to the property, but not to any particular interest in that property. The easement has a life of its own and can survive even after the lease ceases to exist, although only for the remainder of the term for which it was originally granted.

So, Mr. Wall had the right to use the passageway for the remainder of the term of 999 years, which was no doubt longer than his house would last. But what if his lease had been for a short term, say five or ten years or even less? A right of way for that short term would not be much use to a freeholder. Well, the Court went on to decide that the right could be converted into a permanent right because of a provision in the 1925 Law of Property Act. Under section 62 of that Act, a conveyance or transfer of land is deemed to include all easements and rights used with the land. Even if the right was granted to a short term tenant, the section converts it into a right attached to the freehold.

Mr. Wall did well, but the implications of the case could be quite worrying for the owners and occupiers of property over which an easement is exercised. Rights granted to a tenant of an adjoining property on the assumption that they would end when the lease ends may now continue indefinitely. It will now be particularly important to ensure that rights are granted on terms that allow them to be terminated if, for example, the property is redeveloped.

Section 62 does not apply if there is an indication of a contrary intention and nowadays it is fairly usual for transfers to contain wording to ensure that the section will not apply. Tenants buying their freeholds might want to delete that wording to ensure that the rights they exercise will continue for the benefit of the freehold.

Source: Wall v Collins [2007] EWCA Civ 444; section 62 Law of Property Act 1925.

Elizabeth Dale
Senior Associate, Finance and Real Estate, London
+44 20 7184 7599
elizabeth.dale@dechert.com

FINANCE

Romanes Eunt Domus (Syntheticus!) (or Property Derivatives are Back!) Part 2

by **Gary Walker**

Let us ignore the bad, Pythonesque Latin (and equally shocking translation) and concentrate on the facts. For the first time since a failed London launch in the mid 1990s, over-the-counter property (OTC) derivatives (i.e. privately negotiated contracts, distinguishable from securitised commercial property index certificates and residential property-linked bonds) are back – and in a big way.

An inaugural series of OTC contracts traded in London in 2005 (in relation to which the writer advised one of the participating investors – a FTSE 100 pension fund) has very quickly mushroomed into a liquid, bank-led, global market offering synthetic investment and divestment opportunities via a range of commercial and residential property indices.

The first part of this article, which appeared in the last issue, dealt with the basic building blocks of a property derivative and the rationale for entering into one. In this part, we will look at the available indices on which transactions may be based, some of the commercial and documentation issues that arise and the market.

Range of Indices

The most commonly referenced commercial indices in the UK are those of Investment Property Databank (IPD), which publishes a range of indices differentiated by periodicity (e.g. annual vs. monthly), sector (e.g. office vs. industrial), economic make-up (e.g. rental vs. capital growth) and country (e.g. UK vs. France). A residential index is available from the Halifax. Other indices exist in other centres of activity, such as the US. Most investment profiles can be accommodated and further indices will undoubtedly spring up over time.

Commercial and Documentation Issues

Clearly the economics (in particular the size of the spread) are critical. Investors may desire partial/total early termination rights and banks may insist on collateral, all of which is negotiable on a trade-by-trade basis. From a documentation perspective, ISDA-based precedents (themselves shortly to be put on a formal global footing) are a useful starting point and take much of the pain out of the negotiating process. Matters dealt with under the documentation unsurprisingly range from representations and termination rights to disruption events such as index disappearance and delayed or manifest error in publication. There is also the legal issue of whether a given investor has legal capacity to enter into a derivative - a thorny question for many types of body, including pension funds, investment trusts, charities and similar entities.

The Market - Today and Tomorrow

From a standing start in 2005, the UK market conservatively stands today, by various estimates, at £6-10 billion and is forecast to grow exponentially. Multiple banks are willing to make a market and the investment community has, after a hesitant start, finally woken up to the compelling nature of the argument. Indeed, it may not be too far-fetched to imagine the current index-based market both growing and transforming itself over time into one where pure property price risk in customised property baskets, individual properties and even floors of individual properties is traded as freely as is, say, single-name default risk under a credit derivative. What price, anyone, a synthetic Gherkin?

Gary Walker
Counsel, London
+44 20 7184 7874
gary.walker@dechert.com

About the writer

Gary Walker is a leading London derivatives lawyer and a senior Counsel within the Dechert FRE practice. He is author of Mastering Finance-linked Swaps (FT Prentice Hall 2003), is an international conference speaker and journal writer in his field of expertise and is an active member of ISDA's property derivatives working group. He regularly advises end-users on a wide range of derivative (including property derivative) transactions.

REAL WORLD FOR YOUR INBOX

If you wish to receive Real World by e-mail rather than hard copy, please send your e-mail address to realworld@dechert.com with 'E-MAIL ME' in the subject field and we'll amend our lists accordingly.

realworld@dechert.com

Dechert LLP, 160 Queen Victoria Street, London EC4V 4QQ
Tel: + 44 20 7184 7000 • Fax: + 44 20 7184 7001 • E-mail: realworld@dechert.com • Web: www.dechert.com

Dechert LLP

www.dechert.com

UK/Europe
Brussels
London
Luxembourg
Munich
Paris

US
Austin
Boston
Charlotte
Hartford
New York
Newport Beach
Philadelphia
Princeton
San Francisco
Silicon Valley
Washington, DC