DechertOnPoint

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Editor: gillian.baxter@dechert.com

Real World

Finance and Real Estate News

In this issue

HEADNOTE

Lazy Hazy Crazy Days of Summer

by **Andrew Hutchinson**

As we enter the third summer of the downturn, many continue to experience summertime blues as the real estate market continues to be defined by a serious shortage of available credit. Nevertheless, we are seeing increasing activity as those with equity to invest move in to pick up bargains. Overseas buyers are playing a disproportionate role at present, but if the current strengthening of sterling continues, we may see their influence reduce.

There is a growing view that, for prime property at least, the market has turned and the bottom of the cycle may have passed. Prime yields are stabilising and some institutions are now net purchasers of real estate rather than sellers. Certainly investment values for prime well-let properties in central London appear to be beginning to increase, and although rental values continue to fall, the pace of decline has slowed and sentiment is improving rapidly.

There is a great deal of money chasing a limited number of good opportunities, and this will continue to drive prices up, fuelling hopes that we may see the beginnings of recovery before too long.

Undoubtedly there are still many property owners in difficulties, a large number of them having secondary assets. We wait to see at what point the banks will introduce these properties to the market and with what effect.

Summertime and the livin' is easy? I think not.

This Summer edition of *Real World* focuses on landlord and tenant issues. We explain how the carbon reduction commitment to be introduced next year could have an indirect effect on tenants whose own energy usage will not bring them within the scheme. There is also a warning for landlords and their agents about the risk of granting consent inadvertently in correspondence, even where statements are qualified, to make clear that consent is not intended to be given. We explain the problems that can arise if the withdrawal of a break notice is not properly documented. Finally, we look at a recent case that has highlighted a deficiency in the drafting of commonly used rights to lay services across adjoining land.

Andrew Hutchinson
Partner
+44 20 7184 7428
andrew.hutchinson@dechert.com

Dechert LLP

Dechert LLP

LANDLORD AND TENANT

The Carbon Reduction Commitment – Implications for Tenants

by **Gillian Baxter**

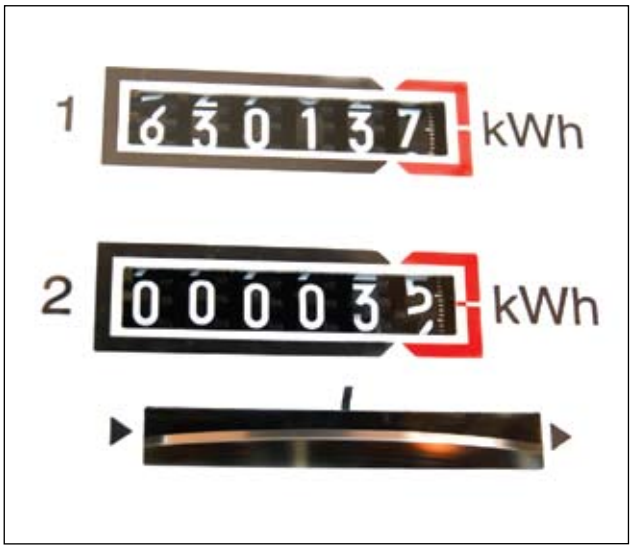
The carbon reduction commitment will apply to major users of energy from 2010, but many other tenants of commercial premises may be indirectly affected.

What is the CRC?

The carbon reduction commitment (CRC) is a mandatory emissions trading scheme designed to cut the carbon emissions of large commercial and public sector organisations. Organisations will be directly covered by the scheme if their total annual half hourly metered electricity use in 2008 was more than 6,000 MWh (that means an electricity bill of at least around £500,000 to £1,000,000). For this purpose, a group of companies is treated as one organisation, so the relevant factor is the energy consumption of the group, rather than each business or property within the group. Those organisations will be required to buy allowances to cover their estimated emissions—initially at £12 per tonne but later by auction. The money received from the sale of allowances will be repaid in the form of "revenue recycling payments". The amount each organisation receives will depend on its performance in reducing emissions as shown by its position in a league table compiled by the Environment Agency. So reducing emissions will result in a real financial return to the organisation.

How might small or medium sized organisations be affected?

Organisations whose energy use is well below the threshold could be affected by the scheme if their landlords are covered and pay for energy used at the premises. That is so even if the landlord only pays for energy used in the common parts (such as entrances, lifts, car parks and so on) and even if the tenant contributes to the cost of that energy, whether by sub-metering or by reference to floor area or in some other way. In those circumstances, energy used by the tenant will have to be covered by the landlord organisation's allowances. Therefore, the landlord may want the tenant to contribute towards the cost of allowances and the tenant will want a share of any revenue recycling payments received.



Regulations to implement the scheme have not yet been finalised, however it is clear that they will not regulate the position as between landlords and tenants in any detail. There will be no statutory right for landlords to require tenants to contribute towards the cost of allowances and no obligation on them to share revenue recycling payments with tenants. These matters will be open for negotiation between landlords and tenants.

What do tenants need to do?

A tenant that will not be directly covered by the scheme needs to ascertain whether it is likely to be affected indirectly.

- If the premises are self-contained with no common parts and the tenant pays for all its own energy, then the tenant should not be affected by the scheme.
- Otherwise, the first step is to find out whether the landlord is likely to be covered by the scheme (although, even if the current landlord is not covered at the outset, the issues will still need to be considered, because the landlord's energy use may increase, for example if it acquires more property, or the building could be sold to a company which is covered, the landlord could be taken over by an organisation which is covered, or the scheme could be extended in future).
- The tenant also needs to check who is the counterparty to the energy supply contracts. If the tenant pays the utility companies directly, then its energy use will not need to be included in the landlord's allowances. However, if the landlord pays for the energy, then the question of CRC may need to be addressed.

If the tenant is likely to be affected, the next step is to check the lease to see whether it allows CRC costs to be passed to the tenant. This will depend on the precise wording of each lease. CRC costs are most likely to be dealt with as service charge items as costs of complying with statutory requirements.

Challenging a service charge demand

There are various arguments the tenant could use to challenge a demand for CRC costs under the service charge:

- CRC will not of course be referred to expressly in leases granted before the scheme starts and it may be arguable that the service charge wording will not stretch to cover wholly novel costs that neither party could have contemplated at the time the lease was granted.
- The obligation to buy allowances will apply to the parent company in a group. Therefore, if the landlord is a subsidiary, it will not itself incur the relevant costs. The service charge wording might well not be wide enough to allow recovery of sums incurred by the landlord's parent.
- The landlord should be required to justify how it has calculated the amount claimed—both the total cost and the proportion attributed to the building. As CRC will be administered by reference to a group of companies rather than a particular property, it may be very difficult for the landlord to establish the precise costs associated with the scheme that are attributable to a particular building. Allowances may have been bought at different times and at different prices—some at auction at the start of the scheme year and perhaps others during the year on the secondary market, or by private arrangement if energy use is higher than estimated, perhaps because new properties are acquired. An added complication is that the scheme year (1 April to 31 March) may not coincide with the service charge year and allowances may be held over from a previous year. The landlord might decide to use the average cost of allowances bought over the scheme year, but the tenant might argue that additional allowances bought at a higher price did not relate to this property, but to others acquired during the year or where energy consumption was higher than expected.
- Apart from the cost of allowances, there will also be significant administrative costs associated with CRC, such as the cost of registration with the scheme administrator, the installation of software to manage compliance with the scheme, forecasting, monitoring and reporting emissions and surrendering allowances. The tenant will need to check that such costs are only charged so far as they relate to this building.
- The tenant should require any revenue recycling payments received to be deducted from the cost of allowances. This will not only reduce the amount payable but also introduce a cash flow advantage because the amount of the recycling payment will not be known until the following year. This will also make it even more difficult for the landlord to justify how sums are allocated to the building because recycling payments will relate to a reduction in total energy use across the whole of the landlord's group and that may be caused by a range of different factors, some of which may apply to this building and some not.

New provisions to deal with CRC

This short article focuses only on the recovery of CRC costs through existing service charge provisions. Much more could be written on the new provisions that landlords may seek to agree with tenants to deal with CRC, either by variation of existing leases, or by a memorandum of understanding which would operate outside of the lease. It remains to be seen how practice in this area will evolve.

Sources: *The Carbon Reduction Commitment User Guide* issued by the Department of Energy and Climate Change available at www.defra.gov.uk/environment/climatechange/uk/business/crc/pdf/crc-userguide-090312.pdf; *The Carbon Reduction Commitment a guide for landlords and tenants* issued by the BPF, the RICS and others available at www.bpf.org.uk/pdf/21383/CRC%20Guide%20A4.pdf.

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

LANDLORD AND TENANT

Consent to Assign – A Warning for Landlords and Their Agents

by **William Fryzer**

Following a recent High Court case, it may be easier than previously thought for consent for the assignment of a lease to be granted inadvertently in correspondence before a formal licence to assign is completed. The same principles also apply to consent to underlet, carry out alterations or change use.

Leases invariably prohibit assignment without the landlord's consent. Consent is usually given by way of a formal licence that may contain important provisions, such as a guarantee from directors or a parent company of the assignee or an authorised guarantee agreement by the outgoing tenant. The assignee might also be required to provide a rent deposit or other security, and the landlord will also want to ensure that any arrears and all costs are paid before the licence is granted. Therefore, it is important that consent is not given inadvertently in correspondence before these matters are dealt with properly.

The landlord—or its agents or solicitors—will need to write to the tenant or its solicitors confirming that the landlord is prepared to consent in principle, but subject to satisfaction of the necessary conditions. The confirmation of consent in principle can inadvertently amount to the grant of consent. In a case in 2002, the Court of Appeal decided that simply heading the correspondence "subject to licence" is not effective to prevent the grant of consent. So solicitors and agents are usually careful to spell out that no consent is given until the licence is granted.

The recent case has gone further. The landlord's solicitors' e-mail included the following statement: "Please note that this correspondence does not constitute the provision of consent by our client. Such consent will only be provided on the completion and delivery of a formal Licence executed as a Deed. Please also note that our client reserves the right to change the form of the draft Licence submitted herewith and to impose new conditions to the grant of their licence in light of any further information received in relation to this matter".

It is hard to see how the solicitors could have made it any plainer that the e-mail was not intended to grant consent. Nevertheless, the court decided that the e-mail did amount to consent. The judge said, "In my view, the expression . . . of the landlord's consent in principle, subject to certain conditions, satisfied the relevant test for landlord's consent laid down by the Court of Appeal. . . . It was consent which was expressed to be subject only to reasonable conditions, and was unequivocal."

Express stipulations within the lease that spell out that landlord's consent can only be given by deed must, we would argue, go a long way towards protecting a landlord from granting consent inadvertently. For example Dechert's standard form lease provides: "Any consent or approval of the Landlord under this lease shall only be valid if given by deed unless the Landlord has by express written waiver dispensed with the requirement for a deed in any particular case or class of cases".

However, a landlord (and anyone acting on the landlord's behalf) should, even with the benefit of such a provision, still be extremely careful not to allow any subsequent action or correspondence to be construed as the giving of unequivocal consent subject only to reasonable conditions and the recording of the same in a deed. Every opportunity should be taken to negate any such implication. All relevant correspondence should be qualified so as to make it clear that, notwithstanding any intimations of approval in principle, nothing therein can, or should, be construed as the giving of unequivocal landlord's consent unless and until a formal deed is entered into. In the case of professionals acting on behalf of a landlord, a particularly effective way of ensuring that no such consent is inadvertently given, is to include the following caveat within all relevant correspondence: "Please note that we have no authority, express or implied, to give or sign a consent on behalf of the landlord".

The case is only a first instance decision, and it might, of course, be held at a later date to have gone too far, but in the meantime it is better to be safe than sorry and adopt caution as the watchword.

Source: *Alchemy Estates Limited v Astor and Another* [2008] EWHC 2675 (Ch); *Aubergine Enterprises v Lakewood International* [2002] EWCA Civ 177.

William Fryzer
Partner
+44 20 7184 7454
william.fryzer@dechert.com

LANDLORD AND TENANT

Waiving or Withdrawing a Break Notice

by **Elizabeth Dale**

Technically, it is not possible to withdraw or waive a break notice once it has been validly given. Attempting to do so can lead to unintended and undesirable consequences.

In the current difficult market, landlords will generally be keen to retain their tenants. So if a tenant exercises a break right, the landlord might be willing to offer concessions to encourage the tenant to stay. If the tenant agrees, the landlord might breathe a sigh of relief and expect the lease to continue as before, except for any concession given. However, though it may be tempting just to tear up the break notice and forget all about it, things are not that simple.

Once a valid notice to quit is served, it automatically brings the lease to an end when the notice expires and, strictly, it may not be withdrawn or waived. If the landlord accepts rent after the notice has expired, or does some other act which indicates that he regards the lease as still continuing, it does not waive the notice, as it would do if the landlord had given notice to forfeit the lease. The landlord's actions cannot cancel the notice, even with the tenant's agreement. However, they may show that the landlord and tenant have agreed a new tenancy.

The notice may be described as withdrawn or waived, but in fact it remains in force, the original lease has ended, and a new lease has been granted. This may sound like just technical nit-picking, but the distinction can have important practical significance.

One of the most important consequences is that any guarantee of the tenant's obligations under the original lease will fall away, unless the guarantor has agreed to provide a similar guarantee in respect of the new lease. Also, if the original lease was granted before 1996, the original tenant would have remained liable to the landlord throughout the term of the lease, even after the lease was assigned. That liability will also fall away.

Another potentially very serious implication is that if the original lease was excluded from the security of tenure provisions of the Landlord and Tenant Act 1954, the new lease will not be validly excluded.

Any provisions of the lease that refer to a year of the term, such as a rent review date in each fifth year of the term, or an obligation to decorate in every third or fifth year, will also be affected by the change in the date on which the lease was granted.

The standard to which the tenant must repair the premises is fixed by reference to the state of the premises at the start of the term, so that too will be affected.

It might also be necessary to obtain consent for the new lease from a superior landlord or a chargee.

It is in both parties' interests to ensure that the terms of the new lease are properly documented so that all these points and any other consequences of the arrangement are fully thought through and not left to chance. The documentation can be dealt with quite simply and might take the form of a short (two or three page) lease incorporating the terms of the old lease by reference and setting out any necessary changes. Unravelling the unintended consequences of failing to document the arrangement properly could turn out to be far more time consuming and expensive.

Source: *Clarke v Grant* [1950] 1 KB 104.

Elizabeth Dale
Associate
+44 20 7184 7599
elizabeth.dale@dechert.com

DEVELOPMENT

When an Easement is Not Enough

by **Alison Lympany**

One of the most important things to get right on a new development is the access to services, but a recent case has shown that the existence of an easement in standard form may not be sufficient to ensure that the necessary connections to services can be made.

The point came to light in a recent case concerning a proposed office development. In 2005, a development site was sold with the benefit of planning permission for the construction of an office building. The transfer to the developer included the grant of an easement to use services running through the seller's adjoining land and to lay new services. The wording of the easement was fairly standard, and the developer would have had no reason to think that it would not be sufficient for its needs.

The difficulty arose because the utility company, EDF, insisted that the adjoining owners grant them a wayleave (a legal right) to install and retain their cables. The adjoining owners had objected to the route originally proposed by EDF for the cable, because it ran through the middle of their back garden, and there had been what the judge described as "long drawn out and hostile negotiations". Eventually, the position of the cable was settled and a trench was dug, but the adjoining owners refused to grant the deed that EDF required, unless the developer settled a claim that it had made against them. EDF refused to go ahead without the deed, so there was an impasse.

It is an established principle that an easement includes ancillary rights that are reasonably necessary for its use and enjoyment. So, for example, a right to use a private road includes an ancillary right to repair the road if necessary. There is also a rule that a person granting a right may not derogate from that right—in other words, they may not do anything that substantially deprives the grantee of the benefit of the right. The developer went to court claiming that the adjoining owners were obliged to grant the deed that EDF required, either because it was an ancillary right necessary for the exercise of the primary easement to use the services, or because failure to do so would be a derogation from grant.

The developer failed on both arguments. The court ruled that neither principle could be used to imply a positive obligation on the grantor, such as to execute a deed of grant. The rules could only be used to prevent the grantor from doing something that would restrict or interfere with the exercise of the rights granted.

There is a statutory procedure that an electricity company can use under the Electricity Act 1989 to enable the Secretary of State to grant it a wayleave where a landowner refuses to do so. However, compensation is payable to the landowner and the developer cannot force the electricity company to invoke the procedure. In this case, the developer did not request that EDF invoke the statutory procedure because of the potential impact on the timing of the development and the cost implications.

The lesson, therefore, is for developers to ensure that when rights to lay services are drafted, they include an express obligation to grant a wayleave if required by the utility company.

Source: *William Old International Ltd v Arya [2009] EWHC 599 (Ch).*

Alison Lympany
Associate
+44 20 7184 7611
alison.lympany@dechert.com

REAL WORLD FOR YOUR INBOX

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realworld@dechert.com

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