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Real World

Finance and Real Estate News

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In this issue

HEADNOTE

REIT on Track

by Ciaran Carvalho

Good news for both the property industry and the country as a whole. The Government's drive to improve the efficiency and flexibility of the commercial and residential property investment markets is well on track. Gordon Brown's 10th Budget announcement of key changes to the REIT proposals triggered hikes in property shares of over 10% as well as a welcoming reception from the industry. Dechert, now well ensconced in its new Blackfriars offices (various shots of which feature throughout this issue), is very much in tune with this spirit of invigoration...

Huge expansion is expected for the UK's £43 billion property sector, with a number of listed property companies already planning to convert as soon as REITs are introduced in January 2007. Those who lobbied for changes in the REIT proposals were delighted to learn that the interest cover test and the required distribution rate will both be reduced. The conversion charge of 2% of the gross market value of the investment properties seems to be a sensible approach. More developments for the sector are also on the horizon, with authorised property unit trusts (APUTS) poised to receive the same tax transparency as REITs by January 2007. The new area of property derivatives is developing rapidly, as appreciation grows of the advantages of total liquidity for a sector often castigated for the illiquidity of its assets.

This issue of Real World covers the implications of recent energy-saving regulations on developers and property owners, as well as the House of Lords' landmark decision in *Avonridge* (landlord and tenant), the curious case of *Stroude v. Beazer Homes* (planning), the progress of the European CMBS market, and a more detailed follow-up to our introductory article on Islamic Finance contained in the previous issue of *Real World*. I hope you find it a useful and informative read.

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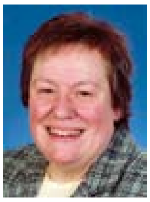
ENERGY EFFICIENCY

Greening Our Buildings – What Must Developers and Owners Do?



by Peta Dollar and Caroline Mortimer

Energy efficiency is the flavour of the month; recycling waste, reducing petrol consumption and even saving water usage is on the menu. The Kyoto Protocol requires the UK to achieve a 12.5% reduction in the 1990 levels of greenhouse gas emissions in the period 2008-2012. The Government has also committed itself to domestic targets for energy saving, and is in the process of implementing the Energy Performance of Buildings Directive. So what does this mean for building owners and developers?

Changes to the Building Regulations

On 6 April 2006, amendments to Part L (Conservation of Fuel and Power) of the Building Regulations came into force, which aim to improve the energy efficiency of buildings. Developers will have only one year to come to terms with the new regime. According to the Government, "Tackling climate change is one of the biggest long term challenges we face. That is why on this occasion we need the building industry to comply with the new regulations much more rapidly than normal."

From 6 April 2006, all building work must comply with the new Part L, unless:

- Full building regulations approval under the old regime was obtained before 6 April 2006 **and** building work commences before 1 April 2007; or
- Full building regulations approval was not required **and** contracts were entered into before 6 April 2006 **and** building work begins before 1 October 2006.

Dechert's ground floor reception area.

Changes have also been made to Part F (Ventilation).

These changes will mean that new buildings will have to be better insulated and make use of more efficient heating systems. Developers will need to make more use of energy-saving insulation and more efficient boilers, and will need to consider using low or zero Carbon Systems, such as solar panels and mini wind turbines.

Implementation of the Energy Performance of Buildings Directive

At the same time, parts of the Energy Performance of Buildings Directive were implemented. When this is fully in force (which is not yet the case), all building owners will have to produce energy performance certificates (EPCs) for their buildings, rating their energy performance and in-use performance. All larger public buildings will have to display such a certificate, and on the construction, sale or letting of any building, the developer, seller or landlord will have to produce such a certificate which must not be more than 10 years old.

Existing buildings with a total floor area of over 1000m2 will have to comply with the energy-saving targets when major building work is carried out. Boilers and air-conditioning systems must be inspected and, where appropriate, improved or replaced.

At first sight the renovation provisions may appear onerous—but the Regulations do provide that targets do not have to be complied with where "not technically, functionally or economically feasible". What is meant by "feasible" is not yet clear.

The Government has yet to comment on how it will implement this part of the Directive, and what the penalties will be for breach. However, EPCs will undoubtedly be a new area for negotiation, and potentially for litigation, in any property transaction. Questions will arise such as: what effect will all this have on rent review? Will improvements in boilers and air-conditioning systems be covered by the service charge and paid for by the tenants? Watch this space...

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LANDLORD & TENANT

The Avonridge Decision – What a Surprise?

by Steven Fogel

It is unusual for a landlord and tenant case to be heard by the House of Lords—issues relating to leases are seldom matters of great public interest. So it is perhaps not surprising that when the case of ***London Diocesan Fund and others v. Avonridge Property Company Limited*** *was heard by the House of Lords the decision came as a great surprise to many and caused considerable controversy.*

The facts in Avonridge were straightforward. Avonridge was the tenant of premises at a substantial rent and granted six subleases of its premises, each at a substantial premium but with a peppercorn rent. Each sublease purported to restrict Avonridge's liability under the landlord's covenants to the period during which Avonridge held the head lease.

Avonridge then assigned the head lease to a purchaser who failed to pay the rent. As a result, the head lease was forfeited and the subtenants were only able to obtain relief against forfeiture on the basis that they paid the arrears of rent under the head lease and were granted new leases subject to a substantial annual rent.

The subtenants sued the purchaser and Avonridge for breach of the covenant to pay the rent reserved by the head lease. Avonridge argued that it was not liable to the subtenants under the landlord's covenants because of the express limitation of its liability. The Court of Appeal held that the effect of the anti-avoidance provision in the Landlord and Tenant (Covenants) Act 1995 was that the limitation on Avonridge's liability was void, but the House of Lords, by a majority of 4-1, disagreed. The purchaser was 'a man of straw', and accordingly the unfortunate tenants had had no recourse.

The 1995 Act had sought to remedy the potential hardship that the original tenant might face as a result of its ongoing liability for performance of tenant's covenants throughout the entire duration of the lease by providing a mechanism for release from tenant's covenants under section 5 of the Act. Although section 6 of the Act contains a corresponding provision for the benefit of landlords, this is not as far-reaching, as the landlord must seek an express release. In the Law Commission's view, it was not appropriate for provisions relating to landlord's covenants to mirror those relating to tenant's covenants because tenants do not usually

Dechert's ground floor reception area.

have control over a sale of the reversion (and also because, as landlords normally undertake fewer responsibilities, continuing liability for covenants would not generally cause great concern). Nonetheless, the House of Lords concluded that the object of the 1995 Act was that, on a lawful assignment of the lease or the reversion, regardless of the terms of the lease, the assignor would have an exit route from future liability. The 1995 Act was not intended to close any other exit route that might already be available to the parties, for example by way of an express agreement regarding limitation of liability, such as the one included in each of the subleases by Avonridge. Although section 25 (the anti-avoidance provision) should be interpreted widely so that the operation of the 1995 Act should not be frustrated, the majority of the House of Lords held that the statute was not intended to exclude the parties' ability to limit their liability under their covenants in whatever way they might agree. The wording of the landlord's covenant was clearly intended to limit the duration of Avonridge's liability.

It remains to be seen whether it will become standard practice for leases to contain a release of the landlord similar to that inserted in the subleases by Avonridge, but certainly it is likely that most, if not all, precedent leases will now contain such a provision. It will then depend on the relative strengths of the bargaining position of landlord and tenant respectively whether such a provision remains in the lease when it is finally completed.

Steven Fogel is one of the authors of Leasehold Liability – Landlord and Tenant (Covenants) Act 1995 *(published by Jordan's) and was closely involved in the drafting of the 1995 Act.*

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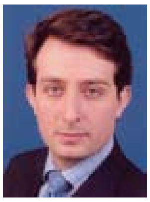
FINANCE

Islamic Finance – The *Ijara Sukuk* and Other *Shari'ah*-Compliant Structures



by Abradat Kamalpour

Following Mike McMillen's introduction to Islamic finance in the last issue of Real World, Abradat Kamalpour looks at the ijara sukuk and other structures in the context of capital markets and compliance with Islamic law. Abradat has recently joined Dechert's Finance and Real Estate team as a partner specialising in capital markets and, in particular, Islamic finance.

One of the key rules of the Islamic law is the prohibition on charging interest (known as *riba*) on money which is lent. Traditional capital market instruments such as bonds, commercial paper and medium-term notes all have a fundamental interest and principal component. This may appear to make Islamic capital market instruments a contradiction in terms, but thanks to the concept of *ijara sukuk*, it is possible to overcome the problems associated with the prohibition on charging interest. However, this approach does not suit all and some innovative structures have been developed to allow greater freedom for investors looking towards the market.

The *Ijara* Solution

The *ijara* (which is a word derived from the term "rental" in Arabic) is a structure that utilises an asset's rental stream to produce a return to the owner of the asset. A classic example would be if two parties, A and B, wished to enter into a financing of an asset. For example, A would like to buy a car but does not have the purchase price. A can approach B (who does have money) and ask B to purchase the car and lease it to A and eventually sell it to A. A and B can structure the arrangement between them so that periodic payments by A to B include both the lease component and the purchase price for the car, which will be fully paid up at the end of the term.

This arrangement works and operates like an amortising loan in many respects; however, Islamic scholars have become comfortable with the arrangement being a sale and lease of an asset as opposed to a loan under which principal and interest are payable. The traditional *ijara* structure was in use for some time before Islamic capital market instruments started to appear in the market. How can the *ijara* structure be used and adopted for an issue of instruments that have similar cash-flow qualities to standard capital market instruments? What if the party seeking the finance does not wish to own an asset but needs financing for other purposes?

Using *Ijara* in a Capital Markets Context

It is perfectly possible to use a form of *ijara* structure in a capital markets context. For example, a special purpose company can be incorporated which issues *sukuks* (a form of Islamic capital market instruments) to investors. The *sukuks* can be listed on a stock exchange. The company then uses the funds raised from investors to purchase land which it then leases to a third party. At the expiry of the term of the lease, the third party has agreed to purchase the land from the company at a price equal to the face value of the initial issue amount of the *sukuks*.

Pursuant to a declaration of trust, the land is held by the company in favour of the *sukuk* holders. All returns made on the land are conveyed to the *sukuk* holders

View from Dechert's London office across the River Thames.

(including lease payments and the final repurchase proceeds to be paid by the purchaser). The cash flow produced is similar to any bond cash flow. The lease payments (which are determined based on a spread over LIBOR google search) are like coupons and the repurchase proceeds paid at the end of the term are like the principal component of a bond. Islamic scholars are comfortable with the use of LIBOR as a lease pricing reference mechanism and not as a means of calculating interest. A floating lease price has been considered acceptable by Islamic scholars as landlords and tenants (in the traditional sense) can agree on raising or lowering lease payments on land over the period of a tenancy.

As trading in debt above or below par would obviously breach the Islamic finance principle of not charging interest and the ability to trade freely in capital market instruments is critical to investors, there is a potential further problem. However, since the *ijara sukuks* represent an interest in the underlying assets and not debts, they can be traded above or below par freely without breaching any Islamic principles.

Disadvantages of the *Ijara Sukuk* Structure

Islamic scholars have broadly accepted the *ijara* structure. Despite its simplicity and broad acceptance, however, it suffers from some major commercial disadvantages for the issuer, namely:

- Not all potential issuers have access to the necessary underlying asset for such a transaction.
- Even if a potential issuer does have access to an appropriate underlying asset, depending on the jurisdiction where the asset is located, stamp duty and taxation costs associated with introducing the asset into the structure could make such a transaction unviable.
- The asset is tied up for the term of the transaction, the owner of the asset cannot divest it freely and there could be negative pledge implications in putting the asset into the transaction.
- There could be ongoing *Shari'ah* audits in connection with the asset. These can be time-consuming and costly for the issuer.

Going Beyond the *Ijara Sukuk*

To overcome the limitations of the *ijara sukuk* structure, more innovative structures can be used. Pooling of investor funds on a *mudaraba* basis (an Islamic financing term referring to participation financing) in order for the funds to be invested in various *shari'ah*-compliant transactions that meet set criteria is an option. The return to the investors will be linked to the underlying *shari'ah*-compliant transactions and their performance.

However, this structure is not viable for many potential issuers that do not have the required *shari'ah*-compliant transaction portfolio for the funds to be invested in. Furthermore, because of the need for some genuine risk participation, the return cannot give investors the certainty of being fixed or floating. On the other hand, while the return on such a structure is based on the performance of the issuer and the underlying transactions, making the return calculation very different to standard capital market instruments, these products can be structured to give a return that is very similar to an ordinary bond.

Alternative structures are being contemplated based upon other well-known Islamic financing methods (such as *istisna*, *musawama*, *murabahah*, *musharaka*). The biggest challenge that these potential structures face is producing an instrument that can be traded freely in the secondary market without breaching the fundamental Islamic principle of not trading in debt above or below par. The *ijara* structure cleanly gets around this problem by producing instruments that represent an interest in an underlying asset that can be traded. To overcome this problem some of the structures being contemplated are extremely complex and document intensive. However, there seems to be a strong will to come up with a structure that will open the Islamic capital markets to issuers that cannot or do not necessarily want to provide assets to their borrowing structures.

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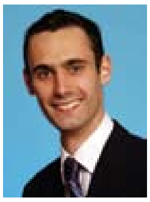
PLANNING

Stroude v. Beazer Homes



by Justin True and Matthew Foy

The recent case of Stroude v. Beazer Homes Limited (High Court, November 2005) serves as a great example of why in join-venture situations the parties need to carefully define their obligations and rights towards one another. Failure to do this can lead to all types of unforeseen consequences. This case serves as a sober warning...

The Background

Stroude was a local landowner and went into a joint venture with Beazer Homes. Beazer Homes purchased some of Stroude's land and agreed to apply for planning permission for a large residential development. The development was to cover not only Beazer's land but also land owned by Stroude and a third party, Mr and Mrs Cartwright. The Council granted planning permission subject to completion of a planning obligation being in place.

One of the key provisions of the planning obligation was that all three landowners agreed to be responsible for the building of a bypass. Under the terms of the obligation plans for this bypass were to be submitted to the Council prior to the occupation of a specified number of dwellings. As soon as the plans were approved, the parties would be jointly and severally liable for putting the bypass construction out to tender, appointing a contractor and having it built.

Artist's impression of Dechert's London cafeteria.

The Consequences

Problems arose when Beazer Homes bought the land owned by Mr and Mrs Cartwright. Stroude realised that this act by Beazer Homes could place him in some difficulty. If either party was to submit the initial plans for the bypass (as the parties conceded they could) then Stroude knew he would be contractually obliged to build the bypass. To do this he would need the right to enter the Cartwright land. To protect his position, Stroude applied for a caution to registered at the Land Registry. Beazer Homes objected and the matter went to Court.

The Court Case

The judge held that although this was a planning obligation the matter should be dealt with broadly in the normal contractual manner. The key question for the judge was whether it could be implied into the planning obligation that Stroude had the right to enter the Cartwright land. The judge took into account all the facts, including the specific obligations for the construction of the bypass, and held that Stroude did have the right to enter the Cartwright land and that this right took the form of an equitable easement.

The Moral of the Story

Did the parties ever intend one of them to have the unilateral right to submit plans and then enter the land of each of the other parties to build a bypass? A right that could be carried out without a word of consultation? It has to be doubted that any party ever intended to give the other an equitable easement to enter their land. A licence maybe, an easement unlikely.

The lesson of these events is clear. When you enter a joint venture with another party, make sure what rights and obligations you have to one another and make sure that arrangement is properly reflected in all legal documents. Failure to do this can lead to unexpected consequences, as I am sure Stroude and Beazer would be first to agree!

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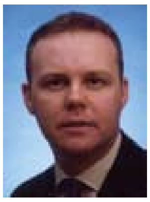
FINANCE

As Easy as A, B, C...



by Andrew Petersen

In the second article looking at the differences in the US and UK Commercial Mortgage Backed Securities (CMBS) markets (the first was published in the Spring 2005/Issue 4 of Real World), Andrew Petersen provides a short insight into the use of subordinate debt in the European CMBS market, a developing topic which raises numerous legal and structuring issues such that the trade body of the CMBS market, the Commercial Mortgage Securities Association, saw fit to recently form a special task force (on which Dechert has a place) to report on the topic during 2006.

The CMBS market in Europe took off in 2005, as new issuance of CMBS reached over €55 billion. In two years, some commentators believe issuance in Europe may outstrip the US CMBS market. Tremendous growth brings changes, and the US practice of using A/B loan structures within CMBS deals is shifting to the UK, with UK CMBS structured deals seeing an increase in the use of B-notes, as opposed to traditional US mezzanine structures (where the security is a pledge of equity interests in the mortgage borrower). In an A/B loan, one mortgage secures two (or more: pari passu senior, super senior or multiple subordinate) notes, each executed by the borrower and each secured by the same collateral. The senior A-note, with its lower leverage, lower risk, is typically part of the securitisation trust, and the subordinate B-note, higher leverage, higher risk is generally held outside the trust by the originator or sold on in a very active B-note market to high yield investors. The mortgagee of record is the A-note holder (thus, the securitisation trustee). The legal relationship between the A- and B-note holders is delineated in an intercreditor agreement, which both limits various rights of, and grants certain important rights to, the B-note holder.

There is an existing tension between the A-note and B-note holders, as in any senior-subordinate split of economic interests. With the B-note serving as 'credit support', the A-note senior lender who may be more willing to rely on the subordination cushion of the B-note (the B-note holder will suffer losses first until wiped out) to take aggressive action against the borrower, while the B-note junior lender may prefer more conciliatory, work-out oriented solutions to credit stresses. These are all complex issues which must be addressed in the intercreditor agreement.

Tensions can also increase when the B-note holder's interests are aligned with those of the borrower, which would occur when a borrower-affiliate owns the B-note. Generally, B-note holders may not transfer all or any part of its interest in the B-note to the borrower or its affiliate, and conflicts may arise from the circular relationship when a borrower—or its affiliate—effectively acts as its own lender. A borrower-affiliate owning the B-note may materially impede the senior lender's rights to recover on its collateral and increase the severity of loss, if the borrower-affiliate were able to appoint the special servicer and have consultation rights or veto rights that delay the inevitable, or be able to repeatedly cure its affiliate's defaults. These rights granted to third-party lenders should not be made available to the borrower's sponsor through the route of the borrower-affiliate.

Another major concern arises from the bankruptcy risk of the B-note holder. US intercreditor agreements usually limit ownership of the B-note to "qualified transferees"—institutional lenders with a minimum net worth of US$250 million and total assets of US$600 million—in an effort to protect against the instability that insolvency of the B-note holder might bring to the debt service cash flow to the A-note. But there is nothing to stop a B-note holder pledging its interest in the B-note if the intercreditor agreement is correctly negotiated.

In conclusion, the increased use, whether in the US or the UK, of A/B loan structures will continue to play a legitimate role in the global liquidity of real estate finance.

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