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New opportunities for sustainable development and growth through the re-use of existing buildings

Commercial landlords await the results of a recently completed consultation in response to government proposals to relax planning permission for change of use orders. There are five main proposals:

- to create permitted development rights to assist change of use from existing buildings used for agricultural purposes to uses supporting rural growth;
- to increase the thresholds for permitted development rights for change of use between B1 (business/office) and B8 (warehouse) classes and from B2 (industry) to B1 and B8;
- to introduce a permitted development right to allow buildings that come under classes A, B1 and D1 and D2, to be used for a range of other specified uses for two years;
- to provide C1 (hotels, boarding and guest houses) permitted development rights to convert to C3 (dwelling houses) without the need for planning permission; and,
- to consider if any updates or amendments are needed to the existing descriptions within the use classes order.

The response to the above proposals has been mixed. For example, the British Property Federation supports the proposal to allow the temporary use of buildings within certain classes for a range of other specified uses for two years. They believe this will help speed up the re-use of high street buildings, and prevent clusters of empty units. However the British Property Federation also points out concerns, which are echoed by other industry figures as to the effectiveness of the above proposal. For example, additional safeguards may have to be implemented to ensure that existing planning conditions are complied with, for example hours of use. This would contradict the intended ease of changing a building's use. The consultation closed on 11 September 2012, and the Department for Communities and Local Government states it will publish its response as soon as is possible.

When is a house not a house?

Commercial landlords will welcome the Supreme Court judgment delivered this October, in two joint cases, referred to here as *Day v Hosebay*.

The judgment, which allowed the appeals from the Court of Appeal, will allay the fears of landlords that *commercial* tenants may be able to acquire the freehold of a property (enfranchise), simply because that property was once designed and used as a house.

Day v Hosebay concerned three properties originally built to be used as houses, but now used exclusively for business purposes, albeit a business purpose which involved people sleeping at the properties.

The Leasehold Reform Act 1967 provides that a house is any building designed or adapted for living, and reasonably so called. What constitutes a house has been considered by the courts on many occasions. In this instance, the Supreme Court paid attention to the physical characteristics of the properties and their use in determining whether the properties were houses.

The Supreme Court, relying upon the original intention of the Leasehold Reform Act 1967, decided that the properties could not be defined as houses. Despite looking like a house, the Court's view was that the properties' use at the relevant date, when notice to enfranchise was served, was "entirely commercial". Therefore the tenants were not entitled to enfranchise.

The decision is extremely welcome for landlords of buildings originally used as houses but now used for commercial purposes. However it will work against landlords of buildings originally used and let on a commercial basis but later used for living in. As a consequence of *Day v Hosebay*, landlords are likely to want to protect themselves by making sure the user clauses in leases restrict the tenant's use of their properties to strictly commercial uses.

IN THIS ISSUE:

LEGAL UPDATES

Update on business improvement districts

Tension can exist between landlords and tenants when a commercial building falls within a business improvement district ("BID"). BIDs are funded by a BID levy, which is a small percentage of a businesses' rateable value. Legislation provides that the tenant, as the non-domestic occupier, pays the levy. The landlords are not liable to contribute, though many do voluntarily, and the British Property Federation encourages landlords to do this.

BIDs are derived from a scheme that was introduced by the Local Government Act 2003. BIDs enable businesses to work with local authorities to improve a defined commercial area. For example, small business can work together to pool resources, or introduce enhancements for the area such as a park and ride scheme or improved CCTV. There are currently 136 BIDs in the UK, of which 74% are in town centres. BIDs last for five years and can be renewed.

Procedure

A strict procedure must be followed in order to establish and pass a BID.

- Firstly, a BID proposal is drawn up, which sets out the aims of the BID. For example, which improvements are to be implemented, and how much the BID levy will be.

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Views...

...continued. Legal updates

- Secondly a consultation is held by the proposers of the BID, to ascertain the views of the commercial occupiers. The commercial occupiers pay the levy, and only they can vote in the ballot.
- If, following the consultation, the proposers are keen to promote the BID proposal, they must submit a notice in writing to the local authority asking them to hold a ballot on the BID proposal.
- The ballot is a secret postal ballot, and there is no minimum turnout threshold. The ballot must be won by both a simple majority of voters AND a majority by rateable value. This protects both large and small businesses.

So far 82.5% of proposed new BIDs have been passed, as have 88% of existing BIDs proposed for renewal.

Structuring commercial real estate transactions

Various vehicles are available to investors looking to acquire commercial real estate in the UK. Here are four of the most commonly used structures.

Private limited companies

Perhaps the most common way of structuring a property investment is through a private limited company, typically a special purpose vehicle ('SPV') set up for the purpose of the relevant transaction. For a buyer, the main advantage of acquiring shares in the SPV, rather than the property directly, is that it will only be required to pay 0.5% stamp duty on the transfer (or potentially no duty at all if the SPV is an off-shore company), rather than SDLT at 4%.

Using an on-shore limited company for property investment purposes may not optimise tax efficiency for a seller, however, as there may be a double tax charge on any asset disposal to the extent that the proceeds of sale are then distributed to the shareholders.

The SDLT saving alone is a strong argument for structuring a transaction in this way and if the company that owns the property is a genuine SPV that has not traded, it should be a relatively straightforward acquisition process.

However, it may be that the target company is not a simple SPV. It may have a trading history that the buyer was not aware of prior to carrying out its due diligence.

It is possible that the risks associated with acquiring an older company (and the costs associated with a more extensive due diligence exercise) may still be outweighed by the expected SDLT saving, but this will depend on the overall deal value.

Limited liability partnerships (LLPs) and limited partnerships

Over recent years, LLPs have gained in popularity; they have the advantages of partnerships (they are treated as being tax transparent, as if the business is carried on directly by the members of the LLP) and companies (the members, as with company shareholders, have limited liability).

An LLP would typically be used as a holding structure for a joint venture, as, despite its advantages, an LLP may not be a particularly attractive structure for a purchaser to actually acquire. A transfer of all or part of an interest in an LLP is not treated in the same way as, say, a transfer of shares in a company or units in a unit trust. A transfer of an interest in an LLP is subject to SDLT, in the same way as a transfer of the underlying property (albeit calculated by reference to the proportionate interest in the LLP).

Limited partnerships are also commonly used for property investments and bring with them many of the same advantages (including tax) and disadvantages as LLPs.

The main difference between the two is that a limited partnership is not (under English law) a legal entity in its own right. A limited partnership is comprised of at least one limited partner and, typically, one general partner. The general partner carries on the partnership business. The limited partners must not be involved in the partnership business otherwise they will lose their limited liability status.

JPUTs

Another popular structure for property investment is the Jersey property unit trust or 'JPUT'.

In essence, legal ownership of a JPUT's assets (i.e. the property) is vested in trustees who hold the assets on trust for the benefit of the unitholders (i.e. the investors).

As with any form of trust arrangement, the trustees have certain fiduciary duties when operating the JPUT. However, beyond this, JPUTs are extremely flexible and are not otherwise subject to the sort of statutory restrictions that one might face with, say, a limited company. In addition, buying and selling units in a JPUT is as simple as buying and selling shares in a company.

They are also tax efficient. A transfer of units in a JPUT does not attract stamp duty or SDLT. A purchaser can therefore make substantial savings by acquiring the units in the JPUT that owns a property rather than acquiring the property directly.

Also, if structured correctly, a JPUT will be treated as transparent for UK income tax purposes, meaning that there will be no income tax charge on rental (or other) income at the JPUT level. Further, a JPUT is treated as a company for UK capital gains tax purposes, so that, provided the management and control of the JPUT is not inadvertently brought on-shore, it may be possible to avoid (or at least defer) tax on capital gains.

Joint ventures

Joint ventures have always been a useful way for parties to share risk and pool resources and this is very much the case in the real estate sector. With less (and more expensive) debt available in the market these days, 'all equity' transactions, structured through joint ventures, are becoming more common.

Joint ventures have their own complications as the vehicle(s) chosen by the parties will be driven by the tax requirements of each party (which will often differ) and may thus be a compromise structure. They are frequently structured through any one or a combination of the vehicles detailed above.

Two key landlord considerations concerning tenant administrations

When landlords face tenants entering administration, there are some recurring questions and issues. We review two of the key issues below.

Is rent payable?

The answer depends on when the rent falls due. Is it before or during the appointment of the administrators? The case of *Goldacre (Offices) Ltd v Nortel Networks UK Ltd* confirms that rent falling due during the administration should be paid in full as an administration expense if the administrators are using the premises for the purpose of the administration. The concept of "use" is wide and is likely to include allowing a purchaser of the tenant's business into occupation under a licence, as frequently happens in pre-pack and other administrations.

However in the subsequent case of *Leisure Norwich (II) Limited v Luminar Lava Ignite Ltd* (in Administration) the court held that a liability that had fallen due before the start of the administration could not become an expense of the administration. Accordingly where rent is payable in advance and falls due before the appointment of the administrators, it appears that the rent will not become an expense of the administration (although the landlord will still be an unsecured creditor).

In the light of this decision, it is now common practice for administrators to be appointed just after a quarter day to minimise the period for which the rent has to be paid as an expense of the administration. Administrators will argue a quarters rent is not due, if they are appointed the day after the quarter day.

Landlords could mitigate the effects of this by charging rent on a monthly basis so that the administrator's use is far more likely to become an expense of the administration.

Forfeiture?

We recently acted for an investment landlord in successfully obtaining an order for vacant possession against The Outdoor Group Limited (in Administration), part of the Blacks/Millets group of companies, of a valuable retail unit in Kensington High Street. Our client had secured a re-letting to a superior tenant, but the administrators were withholding consent to forfeit in order to assist the occupier to obtain a rent reduction.

When a tenant is in administration, the landlord cannot bring proceedings to forfeit the lease unless either: (1) the administrators have consented to the proceedings; or, (2) the court has given its permission. In the case of *Re Atlantic Computer Systems* the court held that generally, if a landlord is entitled to forfeit the lease and forfeiture of the lease is unlikely to impede the administration, leave should normally be given. The courts will carry out a balancing exercise to assess the prejudice that the tenant and the tenant's creditors would suffer if permission to forfeit were to be given.

In the subsequent case of *Metro Nominees (Wandsworth) (No1) Ltd v Rayment,* the tenant in administration of a lease, allowed another party (X) into occupation of the premises. The tenant in administration applied to the landlord to assign the lease to X, but the landlord refused due to X's poor covenant strength. The administrators of the tenant refused to consent to forfeiture of the lease.

The court in *Metro Nominees* granted permission to forfeit by the issue of proceedings. The court held that the administrators' offer to pay the rent did not mean that they could force the landlord to take a tenant that it regarded as unsatisfactory. The court further held that unless the forfeiture proceedings obviously had no real prospect of success, permission to issue forfeiture proceedings should be given and the merits tested at a substantive hearing.

Empty rates relief and recent developments...

Following the introduction of The Non-Domestic Rating (Unoccupied Property) (England) Regulations 2008, properties that had been vacant for more than 3 months (or 6 months in the case of industrial property) no longer benefitted from empty property rates relief.

However, if a property is subsequently "re-occupied" for at least 6 weeks, this allows the owner to claim a further period of exemption. The High Court in *Makro Properties Ltd v Nuneaton and Bedworth Borough Council* [2012] examined the meaning of "occupation" and ruled that the storage of paperwork taking up just 0.2% of the floor space could amount to occupation and trigger a further period of relief once the property became empty. This will be of benefit to commercial landlords wishing to enter into short-term or seasonal lettings.

Facts of *Makro:*

- The tenant occupied an industrial property, a warehouse, for its cash and carry business until June 2009, whereupon the warehouse was cleared and vacated.
- Between 25 November 2009 and 12 January 2010, a period of just over six weeks, the tenant stored paperwork in the warehouse. The paperwork only took up 0.2% of floor space.
- The lease was surrendered on 31 December 2009, after only five weeks. In order to trigger the additional six month rates relief, the landlord and tenant informally agreed that the tenant would stay on as a licensee, so that the paperwork would remain in the warehouse for the required amount of time of six weeks or more.
- The tenant and landlord jointly argued that the tenant had therefore been in "occupation" for just over the six week period between 25 November 2009 and 12 January 2010. The rates had been paid during this time. The local authority argued that no occupation had taken place and that the landlord was therefore not entitled to a further period of relief from business rates.

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News...

...continued **Empty rates relief**

The court examined the meaning of occupation and concluded that the tenant had shown both a use and an intention to occupy. There were three factors for this:

- The **tenant intended to occupy** by storing the documents in the premises, so as to trigger an additional period of rate relief for the landlord.
- The **use was genuine**. This appears to be a low bar as the use of only 0.2% of floor space was considered to be a genuine use of space.
- The **tenant benefited from the occupation.** The tenant was required by law to retain the documents, and therefore had to store them somewhere. The fact the landlord benefitted too was irrelevant.

As a result the tenant was found to have been in occupation for the requisite 6 week period to 12 January 2010 and the landlord was entitled to empty property rates relief for a further six month period thereafter.

The practical benefits for commercial landlords are evident. However it is worth noting that the tenant and landlord in the *Makro* case were part of the same group company. If this had not been the case, it is unlikely that the tenant would have rented a building so much larger than it required. It may also have been more difficult to establish the requisite intention to occupy.

Guarantees and authorised guarantee agreements ("AGAs")

Why relevant now:

AGAs and guarantees are back in the news with The Times recently reporting on an issue arising in the proposed sale of a City of London office block valued in the region of £500 million. The drafting of the lease to the building's main tenant has left the landlord with insufficient control over assignments to group companies, resulting in the possibility of the tenant assigning the lease to a weaker subsidiary. The possibility of losing the covenant strength behind the rent, should the parent tenant assign in this way, has a knock-on effect on the building's investment value. The landlord has been forced to take out an insurance policy against such an eventuality to allay investors' concerns leading up to a proposed sale.

State of the law:

Incorporating a less stringent assignment regime to group companies into leases was more common in the past – the view was that as long as the main parent company always acted as guarantor, the covenant strength of the subsidiary tenant company was immaterial. The landlord could always fall back on the parent guarantor in the event of default.

However, the cases of *Good Harvest Partnership LLP v Centaur Services Ltd* [2010] and *K/S Victoria Street v House of Fraser* [2011] clarified the law on the extent to which a tenant's guarantor can be required to remain liable for the lease obligations following an assignment.

These cases confirmed that (for any "new" leases governed by the Landlord and Tenant (Covenants) Act 1995) any contractual obligation in the lease or other documents, which require a guarantor of the tenant's liabilities to guarantee a future assignee, will be void. Further, any guarantee of an assignee's liability given by the guarantor for the previous tenant, will also be void (even if the repeat guarantee is freely volunteered and there is no obligation to give it in the lease). In an assignment between group companies there is frequently only one strong parent company in the group, and if that company is the guarantor of the existing tenant, they will not be able to act as guarantor for a group assignee. An ability in the lease to assign freely to group companies can therefore leave the landlord without the benefit of the parent company's guarantee.

The cases also strongly suggested that: (1) a guarantor could guarantee subsequent assignee's obligations under the lease but cannot act as guarantor for the immediate assignee; and, (2) a guarantor may guarantee the former tenant's obligations under an AGA through a sub-guarantee.

Practical implications for landlords when negotiating a new lease or considering an application for consent to assign:

- When considering the covenant strength of a proposed assignee, a landlord should ignore an offer by the tenant's guarantor to guarantee the assignee's obligations under the lease, as this will be void.
- The current guidance from the courts is that outgoing guarantors can sub-guarantee any AGAs given by outgoing tenants. So this is an alternative approach to achieving the same end result.
- Landlords could ask that the guarantor becomes a joint tenant (who would then be able to give an AGA on assignment); however, for commercial reasons guarantors may object to this suggestion.
- Landlords should review the restrictions on alienation in future leases (especially in relation to assignments to group companies) to protect their investment value, and certainly avoid "repeat guarantees".
- Landlords may also wish to revalue their properties if problematic lease clauses are discovered, as losing a guarantor affects the value of reversion. Insurance may be available to counter any "repeat guarantee" clauses in current leases.

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