

Keeping up with the Joneses

Commercial property solicitors are facing a number of challenges in the current climate, and they should keep pace with developments to ensure they provide the best service for their clients, say **Eugene McMahon** and **Jeremy Whiteson**

THESE ARE TESTING times for solicitors' businesses, with transaction volumes in many practice areas plummeting in the aftermath of the credit crisis; and the commercial property sector has of course been particularly badly affected. The radically altered trading environment in which clients are operating also presents challenges for practitioners, who face risks if they do not remain abreast of the technical and commercial issues that are being generated by the present crisis. A look at the key issues in four specific sectors of the commercial property market serves to illustrate the environment in which clients – and their lawyers – are trying to survive.

Dealing with tenant insolvency

With insolvencies giving the commercial world a hammering, a sound working knowledge of insolvency matters can no longer be considered a luxury for property solicitors.

When a company runs into financial difficulties there are several options. So far in this recession, the procedure of choice for many has been a pre-packaged administration (where the sale terms are agreed before the administrator's appointment). The first the landlord hears is a communication from the buyer (who is then in unlawful occupation of the premises) requesting assignment of the lease. With multiple outlet retailers, landlords of discarded properties will receive notice that their property is no longer required (often leaving the landlord as an unsecured creditor for arrears with few, if any, effective remedies).

Despite much negative publicity (pre-packs often result in sales to management at surprisingly low prices), the procedure has been approved by the courts (see for instance *DKLL Solicitors v HMRC* [2007] EWHC 2067 (Ch)). Other restrictions and grounds for challenge may still apply (restrictions on any re-use of the company names; wrongful trading; and the need for valuation evidence). Statement of Insolvency Practice 16 (effective



from 1 January 2009) requires that administrators make thorough disclosure to creditors of relevant issues.

Some larger retailers have started to use company voluntary arrangements (CVAs) to vary lease payment obligations. In *Prudential Assurance v PRG Powerhouse Limited* [2007] EWHC 1002 (Ch) the use of this procedure to release a landlord from guarantees given in respect of its subsidiary's leases was successfully challenged as being unfairly prejudicial to the guaranteed landlords. Attempts to vary payment terms and build in tenant's breaks were attempted in the proposal by the Stylo Barratt CVA which was voted down by creditors. A proposal which offered more generous terms to landlords, however, was approved by creditors of JJB Sports in April 2009.

Where an administrator continues to trade a business from rented premises, landlords will often claim the rent during the period of trading by the administration as an expense of the administration. *Innovate Logistics v Sunberry Properties* [2008] EWCA Civ 1321 suggests that such treatment is far from

guaranteed (see Richard Hayes' article 'Crunchtime', *Solicitors Journal*, 153/7, 24 February 2009). This seems likely to be one of several issues which will continue to be litigated in this area as landlords continue to come to terms with the methods being employed by struggling tenants and their insolvency practitioners.

Retail property: making compromises work

The difficult trading market presents retail landlords with income security concerns, while for tenants it is all about cashflow and minimising costs.

Struggling tenants are threatening rental default, pre-pack arrangements and voluntary administrations to negotiate reduced or monthly rents, rent holidays and other concessions. Landlords may make concessions to avoid rental voids and rates liabilities and protect income and values (sometimes re-gearing leases in the hope of longer term benefits).

Practitioners must be alert to the issues raised by such compromises, of which the

following are but a few:

- An understanding of insolvency law and procedure is important: it is not unknown for tenants to make hollow threats with a view to extracting concessions.
- Remember that tenants taking extended leases for reduced rent may incur Stamp Duty Land Tax ('SDLT') liability. The usual documentation options are:
 - (a) grant of reversionary lease for the term of the extension;
 - (b) grant of new lease for the full extended term; or
 - (c) variation of existing lease to extend the term.

Options (b) and (c) both trigger SDLT on rents for the balance of existing term plus extension. According to HMRC, SDLT "overlap relief" only applies to original leases granted on or after 1 December 2003 subject to the SDLT rules. So, if relief can not be claimed, or if the renegotiated rent exceeds that on which SDLT was originally paid, options (b) and (c) can trigger higher SDLT than option (a). The SDLT payment on option (a) might also be postponed by granting an agreement or option for reversionary lease.

Any consideration the tenant may pay for a rent reduction will also be subject to SDLT.

- Landlords should take care to ensure that lease variations agreed for expedient reasons now do not adversely affect future rent reviews under the lease.
- Are any consents required to the concession, e.g. under security documentation? Landlords will be anxious to avoid breaching their banking covenants at present.
- Landlords should also think carefully about lease guarantees – any variation to which a guarantor does not consent could potentially trigger the guarantor's release. Solicitors must ensure that, in their clients' rush to shore up a difficult situation, these and other potential pitfalls are not overlooked.

Investment: protect your client...and yourself

There is a dearth of sales and purchases in the current investment market but the need for property owners to manage investments efficiently and protect values remains acute. One area in which practitioners may be tested to the full is in relation to applications by tenants to assign or underlet.

A tenant who has found a potential assignee or sub-tenant for its unwanted space will put its landlord under extreme pressure to consent to the deal. Where the lease covenants are 'qualified' (i.e. reasonable

consent) the Landlord and Tenant Act 1988 requires landlords, within a reasonable time, to give consent unless it is reasonable to withhold it and to give reasons for refusing consent or setting conditions. Tenants may claim damages for breach of these duties.

Two recent cases, *Landlord Protect Ltd v St Anselm Development Ltd* [2009] WLR (D) 72 and *Lombard North Central PLC v Remax Herbarne Ltd* [2008] EWHC 3161 (Ch) highlight the potential dangers for landlords and their advisers.

In *Landlord Protect* the court found that the landlord's demand (which ultimately enabled the proposed assignee to avoid its purchase contract) that the assignee's guarantor must remain liable until reasonable alternative security was provided on any subsequent assignment constituted an unlawful attempt to improve on its position under the terms of the existing lease. In *Lombard North Central*, the tenant lost a proposed underletting because of the landlord's unreasonable delay in correctly interpreting the lease to conclude that it was not entitled to withhold consent. Consequently, the landlord was liable to compensate the tenant for its financial loss (potentially up to £1m).

These cases make for sobering reading for practitioners: the need to ensure that the landlord acts swiftly and, above all, to get the law right, is made crystal clear. Where they would prefer to refuse consent, landlords will want robust advice from their lawyers – but if they are found to have acted unlawfully they will not be slow to look for a culprit. Solicitors who are not proactive or who make incorrect legal calls can expect to be held responsible – sometimes for very substantial amounts.

Leasehold enfranchisement – calm before the storm?

There are grounds for optimism in this sector where a convergence of legal developments and greatly reduced valuations seems likely to trigger substantial activity when market sentiment concludes that market values are at or near their lowest point.

Since the introduction of the Commonhold and Leasehold Reform Act 2002, it has not been necessary for a tenant to satisfy a residence test to qualify for enfranchisement. The residence test has been replaced with a test of ownership: the qualifying period being two years. As a result of this, commercial tenants who were previously unable to satisfy a residence test were suddenly able to make enfranchisement claims.

This change in the law has led to a number of recent landmark decisions. There are two Acts that the courts have had to consider.

First, the Leasehold Reform Act 1967 ('the 1967 Act'), which gives a tenant of a 'house' the right to apply for the freehold and, secondly, the Leasehold Reform Housing and Urban Development Act 1993 ('the 1993 Act'), which allows a tenant of a flat the right to an extended lease or for tenants of flats to collectively apply for their freehold.

Two recent cases, *Boss Holdings Limited v Grosvenor Estates Limited* [2008] UKHL 5 and *Prospect Estates Limited v Grosvenor Estates Limited* [2008] EWCA Civ 1281 considered the question of whether a property constitutes a 'house' under the 1967 Act. A property will qualify as a 'house', even if it is not fit for immediate occupation, provided it was originally designed or adapted for living in. However, if the building has been predominantly converted for commercial use and is used commercially in compliance with the lease it will not qualify because these are exceptional circumstances which mean it cannot reasonably be called a 'house'.

In two 2008 appeals, *Earl Cadogan v 26 Cadogan Square Limited* and *Howard de Walden Estates v Aggio* [2008] UKHL 44, the House of Lords considered the 1993 Act and decided that commercial head lessees can be qualifying tenants of flats held with other property under a head lease. This means they can apply for extended leases of flats held under a head lease.

As a result of these recent cases, it can be seen that there are opportunities for commercial tenants to enfranchise; although it is very important to ensure that specialist enfranchisement advice is obtained before embarking on the process in order to ensure the chances of succeeding are maximised at the outset.

Challenge and opportunity

These are just a few areas to illustrate the challenges facing property solicitors in the changed economic landscape. Solicitors who do not keep pace with these and other developments cannot provide the best service for their clients – and may risk substantial exposure for getting things wrong. Being properly equipped to help clients to steer a safe path through their present difficulties and to take advantage of those opportunities that do currently exist should be the aim of all property practitioners, as we wait for happier times to return to the sector.

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