

Bearing the burden



The current market continues to keep commercial solicitors busy, and the introduction of the Carbon Reduction Commitment Energy Efficiency Scheme will present a whole new set of challenges, say **Victoria Edwards** and **Janet Matthews**

SIX MONTHS AGO we provided a snapshot of some of the issues which were challenging commercial property solicitors as the effects of the downturn began to bite deeply ('Keeping up with the Joneses', *Solicitors Journal* Property Focus, June 2009). This crisis has been finance-led and there is both good news and bad news for operators in the market as banks have, by and large, elected to work with distressed borrowers rather than pull the rug from beneath them. Money, however, indisputably remains tight.

Unsurprisingly, the woes of the market have prompted a string of cases, and this article highlights some attempts to use the perennial favourite section 2 of the Law of Property (Miscellaneous Provisions) Act 1989 to avoid onerous contracts. Meanwhile, notwithstanding the problems in the market, wider governmental initiatives still move apace and the imminent introduction of the Carbon Reduction Commitment Energy Efficiency Scheme will represent additional financial and administrative burdens on clients while also presenting real challenges for practitioners in addressing the consequences in legal documentation.

The changing face of the lending market

How times have changed! 18 months ago, if a borrower defaulted the bank would be confident of a swift property sale to discharge the debt.

The current static market has been partly

caused by the banks hanging on to properties rather than forcing sales. The banks clearly do not want to have to write down their asset base yet again, go cap in hand to the government (again), be forced into the asset protection scheme or indeed have to rely on their already wearied shareholders with another rights issue.

The key here is the ability of the borrower to service the debt. In the cases where interest is still being paid and any scheduled capital repayments are being met, then most banks (with a few exceptions) will allow the loan to continue subject to various amendments to the facility.

When equity is almost extinguished and cash flow is under increasing pressure, the banks are making already difficult times harder for borrowers by forcing changes to their facilities through increasing margins by a minimum of 50 to 100bps, demanding cross collateralisation in cases of multiple loans and properties, extending personal guarantees and charging excessive arrangement fees in the process. This equally applies if an existing facility has matured or is about to mature. It is seemingly impossible to refinance that facility with another bank. Banks appear to take advantage of this and insist on further equity and increases in margins, 'beef up' security following a full security review (at the borrower's expense) charge large arrangement fees and insist on a full or partial cash sweep leaving the borrower with little or no capex.

These actions are hardly surprising. Given the lack of debt origination and the instability in the market at the moment, how else are the banks to make money?

This climate is good news of course for one particular band of prospective purchasers; those are the purchasers with cash in their pockets who are not in need of bank debt. Cash is most certainly king and will remain so for the next two to three years until the banks' confidence in the market returns. Borrowers can certainly no longer expect to exchange contracts on a property and then arrange bank debt at the last minute, nor will they have the breadth of choice of willing lenders desperate to finance them that they may have experienced in the past.

No, at this time the borrower needs to be a shrewd marketeer and realise the limitations and restrictions in the market; crucially, they must be realistic. What may appear as the ideal proposal to the borrower is now likely to be a no-go for the banks, although there are reputedly up to 20 lenders now willing to re-enter the property market (with Irish banks noticeably absent).

The prudent borrower must therefore adapt to the changing face of the lending market and remember:

- Banks crave long-term relationships and are less interested in one-off debt transactions. They want to provide current account facilities, BACS and forex facilities, hedging, overdrafts and accept deposits.
- Tenant strength is paramount.

- Max 60-65 per cent loan to values.
- Margins of three per cent per annum plus based on LIBOR (not base rate).
- Speculative lending for developments is not available.
- Cross collateralisation will increase.

No bank will be the same, but the common thread among them is one of caution. The borrowers have had it too good for too long and it is time the balance was redressed.

Section 2 to the rescue

As two recent cases illustrate, section 2(1) of the Law of Property (Miscellaneous Provisions) Act 1989 is being more and more relied on by parties who, in the current financial climate, want to seek to avoid their liabilities under an onerous contract for the sale or purchase of an interest in land. It provides that such a contract must be in writing and must incorporate all the terms which the parties have expressly agreed.

In the first case of *North Eastern Properties Ltd v Coleman and Quinn* [2009] EWHC 2174, the claimant had agreed to sell 11 flats to the defendants for £1.21m. The development was delayed and, when notices to complete were served, the defendants claimed the contract was void and unenforceable under section 2(1) because the contract did not incorporate reference to a two per cent discount in the price that had been agreed as a 'finders fee'. This argument was unattractive to the court as, first, the defendants had specifically asked for this discount not to be mentioned in the contract and, second, the contract contained an 'entire agreement' clause. The court therefore held that the two per cent discount was no part of the contract for the sale of the land and the contract was therefore complete and valid and enforceable.

In the second case of *Scrowther v Watermill Properties* [2009] EW Misc 6 (EWCC), Mrs Scrowther had agreed to sell her property to Watermill as part of an equity release scheme where she remained in the property as a tenant. The scheme provided for Watermill to retain £31,250 of the purchase price and for this only to be paid over to Mrs Scrowther if she remained as a tenant for ten years and paid all the rent due during that period. Mrs Scrowther was in financial difficulties and did not pay the rent; she was evicted from the property and Watermill sought to retain the balance of the purchase price.

Unfortunately for Watermill, the purchase contract provided for the full price to be payable as the retention of the balance was dealt with by way of a collateral contract recorded in a separate document. Mrs Scrowther argued that this collateral contract

was unenforceable and void as it provided for a price reduction and related to the sale, and section 2 invalidates any side agreement that contradicts any of the terms of the actual sale.

The court, which had considerable sympathy for Mrs Scrowther anyway as she had clearly not understood what she had agreed to, found that the collateral contract was central to the whole scheme and was void under section 2. It also held that the sale contract remained valid nevertheless and so Mrs Scrowther was entitled to payment of the balance of the purchase price.

In both cases, the court clearly sought to do justice and the judge in the *Scrowther* case gave permission to appeal as he accepted that the law was not clear. What is clear is that, if a party wants to have a clearly enforceable contract for the sale of land, its solicitors need to ensure that all the terms are contained in just one contract and that this contract should have an entire agreement clause.

Carbon Reduction Commitment

The introduction of a compulsory carbon reduction scheme in April 2010 will place further demands on hard-pressed businesses. Until now, implementation of energy saving schemes has been on a purely voluntary basis, but the government issued draft regulations for a mandatory scheme earlier this year and has recently published its response to that consultation. The compulsory scheme will be known as the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) and will affect all public and private organisations on half-hourly electricity meters. If an organisation's annual electricity bill exceeds £500,000 (based on 2008 usage) it will be a full participant in the scheme. Those organisations on half-hourly meters but with lower electricity consumption will still be required to make a declaration and may become full participants in future years of the scheme. The final CRC regulations are due to be put before Parliament before the end of 2009 and CRC registration packs are being issued to all organisations on half-hourly meters in the next few weeks.

During the first 'compliance year' of the scheme (April 2010 – March 2011) participants will simply be required to record all energy usage and submit an annual report. From April 2011 onwards, however, participants will be required to purchase allowances in advance that equate to the amount of energy that the organisation anticipates using during that year. At the end of each year, the organisation will need to ensure that it has sufficient allowances to surrender to cover the energy that it has used.

The first three years of the scheme (2010-13) will be an introductory phase, during which allowances will be purchased direct from the government at a fixed price. The scheme is intended to be revenue neutral and each October the net money raised from the purchase of allowances in April will be 'recycled' back to participants. The proportion received back by each participant will be weighted according to the organisation's position in a league table to reward more efficient energy users. Future phases of the scheme will, however, restrict the amount of allowances available and these will be sold by auction and traded between participants and third parties and inevitably costs are anticipated to escalate.

But are businesses – and their solicitors – ready for CRC? Initially, CRC will only affect the largest businesses and organisations. Many of those have had their own energy reduction schemes in place voluntarily and may already have the resources in place to capture the data required for CRC. For others, CRC will be a new concept and they may face challenges in collating and processing the data required in time for the 2010-11 reports.

For commercial property solicitors, updates to the Commercial Property Standard Enquiries (CPSEs) are planned to deal with CRC implications on the sale or letting of any property. It remains to be seen, however, quite how CRC allowances and recycling payments (which are intended to follow organisations rather than the buildings that they occupy) will work in the landlord and tenant sphere. Energy use will be attributed to the party to the energy contract but this does not fit easily with multi-let buildings where the landlord may supply electricity to a building and re-charge this to tenants. Will landlords be able to pass on the cost of allowances and, if they do, how will these be split between tenants without adversely impacting on rent review? Will the tenants also be entitled to a proportion of any recycling payments available and, if so, how will this be calculated and will this be spent on energy saving schemes? After many years of discussion about 'green provisions' in leases, perhaps CRC might give the momentum for energy saving provisions to be incorporated into leases.

Victoria Edwards is a solicitor in the property finance group and Janet Matthews is a solicitor in the commercial property group at Forsters LLP. They would like to thank partner and head of property litigation Jonathan Ross and commercial property partner Eugene McMahon for their invaluable contribution to the article