

## Real Estate Update

February 2010

### I'm a tenant, get me out of here!

#### RPC Q&A

Dear RPC,

My company has three leases of different offices. Owing to the current economic climate we no longer need all this space. We need your advice! [More...](#)

#### Latent Defects Insurance – an alternative to collateral warranties?

This article summarises what latent defects insurance and collateral warranties are, their respective advantages and disadvantages and concludes with whether latent defects insurance is a suitable alternative or useful back-up to collateral warranties from the construction team. [More...](#)

#### Planning for the future

The Planning Act 2008 replaces the current multiple and overlapping consent regimes for major infrastructure projects with a new single consent system for all Nationally Significant Infrastructure Projects (NSIPs). [More...](#)

#### Case note

##### Update – virtual assignments are not virtual reality

Following the edition of our July Real Estate Update, which you can access by [clicking here](#), where we reported the High Court decision of *Clarence House Limited v National Westminster Bank PLC*, the Court of Appeal has now overturned that decision. [More...](#)

#### Round-up

##### Good news for landlords: rent will usually be an expense of administration

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##### Business Rates

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#### Any comments or queries?

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As part of our commitment to corporate social responsibility we are proud to support The Anthony Nolan Trust as our current Charity of the Year ([www.anthonynolan.org.uk](http://www.anthonynolan.org.uk)).

This is a summary of recent developments. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the authors.

# I'm a tenant, get me out of here!

## RPC Q&A

Dear RPC,

**My company has three leases of different offices. Owing to the current economic climate we no longer need all this space. We need your advice!**

**Q - The first office is in a nice location and we have found someone who wants to take the lease. They are an established company with a good trading record. We have applied to the landlord for consent to assign but have heard nothing. Is there anything I can do to speed things up as I am worried our assignee may start to look elsewhere?**

First, we should check your application has been correctly served on the landlord. Your application should have been made in writing and be as detailed as possible; at the very least it should include the proposed assignee's accounts, references and, if applicable, details of proposals for any guarantors and rent deposits. We should also check the lease and make sure you have satisfied any conditions set out in the assignment clause.

Provided the lease permits you to assign it there is a statutory duty on the landlord to give consent unless it is reasonable for him not to do so. He must also give you his answer in a reasonable time. This will vary depending in the facts of each application, although we should certainly be thinking more in terms of days or weeks. If you are worried the proposed assignee may walk away then we should make this clear to the landlord. If the landlord requests more information, we should provide it as soon as possible (being careful the correspondence could not be construed as a fresh application).

We can then consider our tactics as to whether we hassle the landlord for a response or allow the reasonable period in which he has to respond to elapse. In the circumstances above the preference will probably be to hassle him for a response. Obviously the best outcome is to get the consent to the assignment and avoid any disputes.

**Q – In our second lease we are no longer using the space. We did look to try to assign the lease but the rent we are paying is much higher than the open market rent so no one is interested. We thought about underletting to try to recover at least some monies, but the underletting clause in the lease says that we cannot underlet at less than the rent we are paying. Is there anything we can do?**

Any proposed undertenant would of course need to be satisfactory to the landlord but provided this is the case there are a couple of options to consider here.

We would need to look at the lease but provided it does not say you cannot grant a lease subject to a reverse premium, one option is that you could pay to the proposed undertenant a reverse premium equivalent to the reduction in rent being offered. We would need to discuss how such a premium was paid and whether it can be paid in instalments so as to protect you against the risk of the undertenant disappearing/going bust.



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Another option is for a third party (for example a group company) to indemnify the undertenant for the difference between the passing rent under your lease, and the rent that you have agreed with the undertenant.

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In this scenario, the rent contained in the underlease is the same as that in your lease and, indeed, the tenant is obliged to pay this, so you are not in breach of the underletting provisions in the lease. The third party then agrees that on each quarter day it will refund to the undertenant the difference between the rent under your lease and the rent which you agreed the undertenant would pay for the property. There are definitely issues to be considered with this and the company providing the indemnity would certainly need to be a strong covenant (or pay the equivalent of the indemnity upfront into an account) but it is something we can look at.

**Q - We're a little unsure what to do with our third property; we have a break right next year which we may or may not exercise. What do we need to think about now?**

Even if you are unsure whether or not you want to utilise a future break right, it is imperative you look at the lease now and get advice from your lawyers – good planning is essential for a clean break!

The lease may set out certain conditions you need to comply with in order to effectively break the lease, eg a time for serving notice on the landlord, vacant possession, payment of rent and compliance with tenant covenants – these will be interpreted strictly so it is essential you fully understand what is required. The timing of satisfying any condition is crucial. If they are not met, you are at risk of not having exercised your break properly and the costs of being tied to the lease until the end of the term.

Even if you decide not to exercise your break, it can still be used as a strong negotiating tool with your landlord. Often a break date will coincide with a rent review date so opening a dialogue with your landlord early on and using the threat of the break clause may assist in agreeing a more favourable reviewed rent or other benefits, eg a rent-free period, an extended service charge cap, the grant of a reversionary lease with capped rents etc.

**Q - I did have a look at the lease a while ago and vaguely remember seeing something about material compliance with tenant covenants – what should I do?**

If you have a break clause condition which insists on material compliance with tenant covenants you will need to get advice from your solicitor and perhaps also a surveyor as soon as possible to agree an exit strategy. Spending a modest amount of money on advice now will be worth it in the long run when weighed against the potential for arguments with your landlord about whether or not the break has been properly exercised, or the risk of being tied to a lease of space you no longer need for a number of years.

There has been a lot of uncertainty as to what exactly 'material compliance' means. Great care should be taken to prioritise the meeting of this condition. It is not an option simply to leave the premises in disrepair and hope for the best – the break will be ineffective. It may be advisable to enter into without prejudice negotiations with your landlord to agree a schedule of works or indeed make a payment in lieu of complying with the tenant

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covenants in the lease.

**Q - I am concerned about our liability for dilapidations for the three offices, how can I limit our exposure?**

In relation to the first office, if you do manage to assign the lease then any dilapidations claim will be the responsibility of the new tenant. You will not retain any liability in this case.

As for the second office, underletting that property will not have the same result as an assignment and your landlord may, at the end of your lease, have a claim against you for disrepair. However, you should remember that your liability for breaches of the repairing covenants is limited by statute to the diminution in the value of your landlord's reversionary interest as a result of those wants of repair. If your landlord can show no such loss it will not have a claim against you. I should also add that if the property is ripe for redevelopment and there is evidence to show that your landlord may be intending to redevelop then you may well escape any liability.

If your landlord does have a claim against you for breaches of the repairing obligations, you may be able to pass some of that liability to your undertenant. Whether or not you can do this will depend upon the terms of the subtenancy. For example, the undertenant may insist upon having a schedule of condition attached to its underlease limiting its liability for repairs. You will need to avoid this in order to maximise the potential of recovery against the subtenant.

Insofar as the third office is concerned, depending upon the wording of the break clause you may well have to comply with the repairing obligations contained in your lease in order for the break to be effective. Certainly if the break is conditional upon material compliance with the tenant covenants you will have to put the office back into a good state of repair. Any insignificant breaches of the repairing covenant in number, value and nature ought not to invalidate the operation of the break.

## Latent Defects Insurance – an alternative to collateral warranties?

**This article summarises what latent defects insurance and collateral warranties are, their respective advantages and disadvantages and concludes with whether latent defects insurance is a suitable alternative or useful back-up to collateral warranties from the construction team.**

### What is latent defects insurance (LDI)?

LDI typically provides protection for building owners and other interested parties, such as tenants and funders, against damage to buildings arising from a defect in the design, workmanship or materials which occurs during the first 10-12 years following practical completion.

To claim, an insured party does not need to prove negligence. Therefore, if an insured defect arises in the building after practical completion, the policy should cover the cost of correcting the defect.



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**Advantages and disadvantages of LDI**

The cost of obtaining an LDI policy has reduced over recent years and it can be a useful way of providing long-term protection because:

- Defects may be corrected even where the contractor or consultant becomes insolvent, which is a significant risk in current times
- It can be amended to suit the requirements of most commercial, residential or mixed-use developments and the Council of Mortgage Lenders will accept LDI as an alternative to NHBC cover on residential buildings

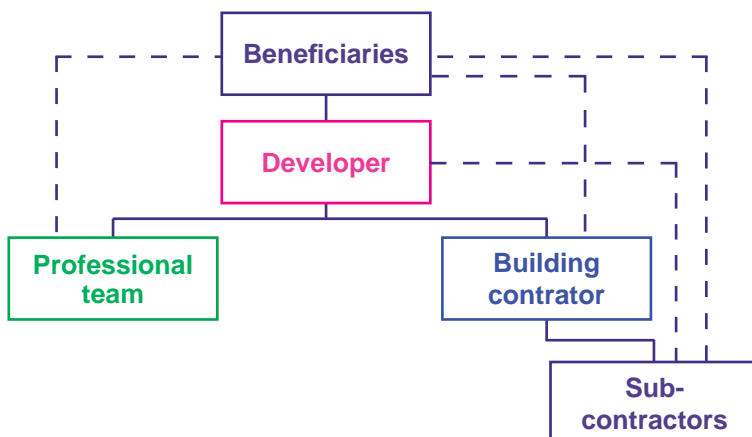
However, the significant drawbacks of LDI include:

- LDI adds between 1% and 3% to construction cost, for example to fund technical audits required by the insurer throughout the construction phase
- Defects which do not result in physical damage to property are often not covered by LDI
- There is often a total exclusion for consequential and economic losses (eg loss of rent or loss of profit)
- The policy is limited to a maximum sum insured and any claim will be subject to a deductible or excess. Further, insurers may refuse to respond to a claim where there has been a non-disclosure, misrepresentation or where the policy wording gives rise to an ambiguity over whether a claim is covered

**Collateral warranties**

Put simply, a collateral warranty is a contract under which a professional consultant or contractor warrants to a third party beneficiary (eg the developer, purchaser, tenant or bank) that it has carried out services or works in accordance with a specified standard of skill and care. Consequently, if a defect arises for which the warrantor is responsible, the third party will have a contractual right to recover damages.

By way of example, the diagram below shows the collateral warranties which may be granted on a typical project. On a large project with multiple beneficiaries, a high number of collateral warranties will be executed.



- - - = collateral warranties

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A carefully and clearly drafted collateral warranty will ultimately put the third party in a more certain and perhaps a stronger position than it would otherwise have had under a LDI policy.

However, collateral warranties also have their drawbacks:

- They often contain limitations or exclusions of liability, which may significantly affect the beneficiary's ability to recover damages
- The beneficiary must prove the warrantor was in breach of its contractual duties
- The insolvency of a warrantor liable for a defect may preclude recovery (however, the warrantor's professional indemnity insurance may resolve this to a degree)

### **LDI or collateral warranties?**

It is clear that neither LDI nor collateral warranties can offer beneficiaries the perfect solution. The threat of contractor or consultant insolvency remains a significant risk in the current economic climate and LDI may provide a useful layer of protection where collateral warranties are unavailable. Although LDI is not particularly popular in the UK, it is compulsory in some European countries.

However, LDI is unlikely to be an effective substitute for a collateral warranty package which is well drafted and robust. From a bank's perspective, in addition to affording a right of action against the construction team, a collateral warranty may also provide a right of step-in if the developer defaults under its loan agreement prior to completion of the works.

It would therefore be prudent for those considering developing or investing in new commercial property to investigate both options fully before making an informed choice; or, for the seriously risk averse, to ask for both!

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## **Planning for the future**

**The Planning Act 2008 replaces the current multiple and overlapping consent regimes for major infrastructure projects with a new single consent system for all Nationally Significant Infrastructure Projects (NSIPs). The Act received Royal Assent on 26 November 2008 and during the course of 2009 the plans to implement the Act started to emerge. In 2010 the changes start to kick in, but what do you need to know? This introductory article untangles the acronyms to give you the key facts and dates going forward.**

### **How will the new consent regime differ to the current consenting process?**

At present, in addition to planning permission major infrastructure projects in the UK require multiple permissions and consents as governed by the relevant statutory regime for the type of project being carried out. Historically this has led to long delays between the start of major projects and their completion as promoters go through the process of obtaining all the consents required for their project.



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The Act consolidates these overlapping statutory permissions and consents into one, single consent called Development Consent. By creating this one-stop shop for project promoters it is hoped that NSIPs will be able to progress more quickly without the excessive red tape that has characterised many major infrastructure projects in the UK in the past.

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### How will applications for Development Consent be decided?

The Planning Act introduces the idea of UK-wide planning policies called National Policy Statements (NPSs) for specific types of NSIPs. When a promoter of an NSIP applies for Development Consent the decision on whether or not that consent will be granted will be based on the policy set out in the NPS for that type of project.

The seven draft NPSs covering Energy and Ports NSIPs were published in November 2009 for consultation. The consultation period ended on 15 February 2010 for the Ports NPS and on 22 February 2010 for the Energy NPSs. It is anticipated that the final Energy NPSs and Ports NPS will be designated in 2010.

Further draft NPSs will be published, consulted on and designated over the next two years:

	Proposed date for publication of draft	Anticipated designation date
<b>Transport</b>		
• National Networks	Autumn 2009	2010
• Aviation	2011	2011
<b>Waste Water, Waste and Water</b>		
• Waste Water	Spring 2010	2011
• Hazardous Waste	Summer 2010	2011
• Water Supply	late 2010	2012

### Who will decide whether to grant Development Consent?

The Act created a new decision making body, the Infrastructure Planning Commission (IPC), to decide applications for NSIPs. The IPC, an independent body, opened its doors on 1 October 2009 and has been providing pre-application advice to promoters of NSIPs since then. The IPC was able to receive the first applications for Development Consent for Energy and Transport from 1 March 2010.

Using the relevant NPS as a guide (and depending on how complex the application is), IPC decisions on whether to grant Development Consent will be made either by a panel of commissioners, or by the IPC Council on the basis of a report and recommendation by a single commissioner. Where there is no NPS in place, decisions on NSIP Development Consents will be decided by the relevant Secretary of State on the basis of a report and recommendation from an IPC commissioner.

### Which projects will the Act apply to?

The new regime will only apply to those projects that exceed the minimum thresholds in the Act. There are 15 categories of projects in the Act, mainly drawn from the energy sector but also covering major water, aviation and transport projects.

The Act will therefore cover a wide variety of projects from new airports and roads to power stations, but always with the overriding aim of facilitating major infrastructure development in the UK.

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## What will happen if the Government changes in 2010? I've heard the Act will be dead in the water.

It is true that, initially, the Conservatives had threatened to abolish the IPC if they came into power. However, the 2009 Conservative party conference revealed that the blanket rejection of the Act that many expected may have been an exaggeration.

The key changes to the Act under a Conservative Government would seem to be:

1. NPSs would need the approval of both Houses of Parliament before being designated; and
2. the IPC would be merged with the Planning Inspectorate and make recommendations as to whether Development Consent should be granted to the relevant Secretary of State.

This hybrid of the master policy of the NPS and a more traditional application determination procedure is interesting, and it remains to be seen what impact the advent of a new Government might have on the implementation of the Act. What is clear, however, is that the system of unified consent and the simplification of the development process has been widely recognised by all parties as a significant step forward; the Planning Act 2008 is here to stay.

Energy and Pipelines Partner, Sarah Cassidy, has produced a series of introductory Alerts on the Planning Act 2008; [click here](#) if you would like to receive links to these Alerts.

### Types of Infrastructure Project covered by the Act:

Generating stations

- Electric lines
- Gas storage
- LNG facility
- Gas reception facility
- Pipelines – gas transporters
- Highway related
- Hazardous waste
- Airports
- Harbours
- Railways
- Rail freight interchange
- Dams and reservoirs
- Water resources
- Waste water treatment

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## Case notes

### Update – virtual assignments are not virtual reality

Following the July edition of our Real Estate Update, which you can access by [clicking here](#), where we reported the High Court decision of *Clarence House Limited v National Westminster Bank PLC*, the Court of Appeal has now overturned that decision. The High Court ruled that a “virtual assignment” breached the usual tenant alienation covenant not to part with or share possession of the premises. This meant that virtual assignments were open to challenge by landlords and the landlord could threaten forfeiture. This would affect many outsourcing and other arrangements using the scheme.

The Court of Appeal applied a wider definition than the High Court and ruled that parting with or sharing possession was giving up aspects of physical control and the word “assignment” included a right to exclude others. This was not the case in virtual assignment as it did not alter the underlying legal relationship between the landlord and tenant or transfer any proprietary right or interest in the premises to a third party to whom the virtual assignment had been made. Neither did the right to receive rents breach the alienation covenant as this was merely a contractual arrangement. An express assignment of rent cannot amount to sharing or parting with possession. The Court of Appeal concluded that the virtual assignment could not transfer any legal estate in the premises and it was a mere contractual arrangement.

The decision will be welcomed by tenants who have been using virtual assignments for managing group property arrangements, or where there are concerns over difficulties with obtaining landlord’s consent. It also provides some comfort to landlords who feared such schemes would alter the tenant/landlord relationship as the landlord has a cause of action against the tenant for non-payment of rent, whether as a claim or as a ground for forfeiture. Some draftsmen have altered their leases to prohibit virtual assignments on the basis that landlords are concerned about an underlease rent being diverted away from the tenant and the effect this may have on the tenant’s covenant strength. However, this is likely to be strongly resisted by tenants on the basis that a landlord should not have any control over what tenants do with their rental income.



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## Round-up

### Good news for landlords: rent will usually be an expense of administration

In December's Real Estate Update, insolvency Partner Vivien Tyrell considered a landlord's ability to forfeit a lease where the tenant is in administration. Closely linked to this is a landlord's ability to recover rent from a tenant which is in administration and the recent decision in *Goldacre (Offices) Limited v Nortel Networks UK Limited (in administration)* will be welcomed by landlords everywhere.

In *Goldacre*, the High Court has confirmed that rent will usually be classed as an expense of the administration. So if a tenant goes into administration and the administrator causes the insolvent company to use the premises for the benefit of its creditors, the administrator must pay the whole of the rent that falls due, as an expense of the administration. The company does not have to be trading from the premises or even occupying the whole of them – in *Goldacre* the administrator was only using a small part of the property from which to run the administration.

The significance of this is that it places the landlord much nearer the front of the administrator's queue – apart from secured creditors and those with a proprietary claims to the company's assets, the administrator must pay the expenses before paying anyone else. Whilst there is still no guarantee that the rent will be paid on time – or at all, as this will obviously depend on the assets available for distribution and the claims of any secured creditors – this case certainly puts landlords in a stronger position. From now on, administrators will have to consider the cost of paying rent at the outset, rather than just waiting for the landlord to demand the rent and/or take enforcement action.

### Business Rates

On 1 April business rates are expected to rise as a result of the 2010 business rates revaluation. Whilst businesses may be able to appeal a new higher rateable value, the appeals process has been limited and in effect businesses may only have one attempt at appealing their 2010 rating.

On the same day, the Greater London Authority (GLA) is introducing a new business rate supplement.

The Business Rates Supplement Act 2009 gave power to county councils, unitary authorities and the GLA to levy a local supplement on business rates of up to two pence in every rateable pound to fund local economic development. To ease the burden on smaller businesses, only those with a rateable value of more than £50k will be liable to pay the supplement.

The GLA has recently announced that it will use these new powers to help fund Crossrail. As of 1 April 2010, it will impose a business rate supplement on non-domestic ratepayers in all London boroughs at the maximum rate of two pence in every pound of rateable value, although the GLA claims that the Crossrail supplement will affect fewer than one in five London businesses.

If a local authority plans to raise more than one third of the cost of its proposed development through the business rates supplement,



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it must hold a ballot, in which all those businesses who would have to pay the supplement have a right to vote – so it is theoretically possible for local businesses to defeat the proposals. It remains to be seen how many other local authorities will choose this method to raise funds and how local communities will respond in the event of a ballot.

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## News

### Welcome to Chhavia Kapoor and Emma Joyce

Chhavia Kapoor and Emma Joyce joined the Real Estate team in January. Chhavia joins as a Senior Associate from Eversheds, specialising in property litigation, and Emma Joyce joins as an Associate from Herbert Smith. Emma specialises in non-contentious construction and projects. Martin Barrett says: *“We’re delighted to welcome these two highly talented lawyers to our growing Real Estate Practice”*.

### Carbon Reduction Commitment Energy Efficiency Scheme – what will it cost you?

On 4 February Mark Lavers and Tim Fogarty spoke at a seminar chaired by Martin Barrett on the CRC Energy Efficiency Scheme, which starts on 1 April. The British Property Federation Consultation Paper on the implications of the Scheme for Landlords and Tenants shows that it is far from straightforward how the cost of the Scheme might be allocated between parties to a lease. The seminar considered these complex points as well as the various rights and remedies for Landlords and Tenants if they cannot agree on cost apportionments – especially where their current leases are silent on the point.

If you were unable to attend the seminar but would be interested in receiving the notes then please [click here](#). Alternatively, please contact [Mark Lavers](#) if you have any questions in respect of the new scheme and how it will affect you.

### MIPIM 2010

Martin Barrett, Sarah Blunn, Anna Butler, Stephen Malley, Michael Blackburne and Matt Bradley will be attending MIPIM between 16-19 March. Please [click here](#) for their contact details. Please contact [Sally Miles](#) to arrange a meeting. We look forward to seeing you in Cannes. Please [click here for their contact details](#)

### Results of Christmas Quiz

Congratulations to James Condliffe at Veolia Environmental Services (UK) plc who won our Christmas quiz and a bottle of champagne. The mystery buildings were:

- A. The Guggenheim Museum, Bilbao
- B. The Pompidou Centre, Paris
- C. 30 St Mary Axe, London – otherwise known as the Gherkin
- D. RPC’s very own Tower Bridge House, London
- E. The Civil Justice Centre, Manchester
- F. Selfridges Store, The Bullring, Birmingham

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