Dechert LLP

Real World

An Update from Dechert's London Finance and Real Estate Group

May 2012

Welcome to the Spring edition of *Real World* from Dechert's London Finance and Real Estate Group, keeping you up to date with recent developments in real estate law and practice. I hope you like our new user-friendly format, which gives faster, easier access to the articles by clicking on the links below.

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April saw the release of first quarter GDP figures showing a "double-dip" recession, following the Budget in March, which was largely disappointing from a real estate viewpoint, and the publication of the National Planning Policy Framework, intended to facilitate sustainable development and so encourage economic growth. In this edition, we provide tax and planning commentary on these developments, and report on recent cases that highlight a trap for tenants exercising lease break rights, show the importance of limitation periods in construction contracts and explain how estate rentcharges work. I hope you find this edition useful and welcome your feedback.

– **Andrew Hutchinson**

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TAX

The Budget: Largely Disappointing for Real Estate

by **Daniel Hawthorne**

The Chancellor of the Exchequer announced the 2012 Budget on 21 March. While aspects of the Budget are clearly favourable to UK business, particularly the reduction in the main rate of corporation tax to 24 per cent from 1 April 2012 with further reductions in the rate to 22 per cent to come by April 2014, the specific measures introduced in relation to real estate are less positive and largely anti-avoidance in nature. As widely predicted, anti-avoidance measures were heavily focussed on Stamp Duty Land Tax (SDLT) planning.

Stamp Duty Land Tax

The principal SDLT announcements were in relation to high value residential property. First, a new seven per cent rate of SDLT was announced (with immediate effect from 22 March), which will apply to the purchase of residential properties where the consideration is more than £2m. However, transitional provisions should, broadly speaking, ensure that the former five per cent rate will apply where a property is sold pursuant to a sale contract entered into before that date. Secondly, in an attempt to target the avoidance of SDLT through the transfer of shares in offshore property holding companies, a significantly higher rate of 15 per cent has been introduced with immediate effect for residential properties costing over £2m purchased through a "non-natural person". This would principally target companies but will also include collective investment schemes such as unit trusts and any partnerships in which a non-natural person is a partner. In addition, it is proposed that residential properties held by non-natural persons will be subject to an annual charge with effect from April 2013, subject to consultation. The proposed charge is staggered, so that residential properties with a value of £2m to £5m held through such vehicles will be subject to an annual charge of £15,000 with the charge rising progressively to £140,000 per year where the value of the property is greater than £20m.

Capital Gains Tax

In a further attack on holding residential property through non-resident companies, the Government has announced its intention to consult on the introduction of a capital gains tax charge on the disposal of such properties. Subject to the outcome of the consultation, this measure may be introduced in the Finance Bill 2013. The Budget announcement does not go into significant detail regarding the potential charge. In particular, there is no mention of a value threshold, but the Budget announcements do refer to gains on sales of shares or interests, which suggests that the charging provisions may be wide.

Capital Allowances

Aside from SDLT, there were some notable announcements regarding capital allowances. The Government has announced the addition of a series of new enterprise zones and trading companies investing in plant or machinery for use within these zones will generally benefit from 100 per cent enhanced capital allowances. In addition, as previously announced, it is confirmed that the Finance Bill 2012 will include provisions to reduce the current rate of plant and machinery capital allowances to 18 per cent for main pool expenditure and eight per cent for special pool expenditure from 1 April 2012, and

to tighten up the rules regarding the provisions for capital allowances made on a sale and purchase of a property.

VAT

The Chancellor also announced certain measures to address VAT anomalies. In particular, with effect from October 2012 supplies of self-storage will be subject to VAT at the standard rate, regardless of whether the operator has opted to tax in respect of the property. This will affect all such businesses which provide their customers with a discrete area of land and which had previously managed to stay outside the scope of VAT by making a supply of land with no option to tax.

REITs

Disappointingly, the Budget failed to announce the consultation into mortgage real estate investment trusts ("M-REITs") which had been widely predicted. Mortgage REITs, which are common in the US, would provide an alternative to existing bank mortgage funding and could potentially free up bank lending capacity. It is to be hoped that continued representations on this issue will keep it on the Government's agenda going forwards.

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CONSTRUCTION

Know Your Contractual Limitations

by **Navpreet Jandaur**

An expired limitation period can operate as a complete defence to a claim, so missing a limitation deadline could be your worst nightmare. The Court of Appeal case of *Inframatrix Investments Ltd v Dean Construction Limited [2012] EWCA Civ 64* serves as a useful reminder of the importance of knowing your contract and when your limitation period expires, but working out the latter is not always straightforward.

Dean Construction Limited (DCL) was a specialist roofing and cladding contractor engaged by Inframatrix Investments Limited (IIL) to undertake works at a factory. The contract was originally prepared by IIL's lawyers but the final executed version reflected DCL's amendments to the proposed twelve year contractual limitation period at clause 17.4 as follows: "*No action or proceedings under or in respect of this Agreement shall be brought against the Contractor after (a) the expiry of 1 year from the date of Practical Completion of the Services or; (b) where such date does not occur, the expiry of 1 year from the date the Contractor last performed Services in relation to the Project.*"

DCL undertook the relevant works between November and December 2008. Snagging items were completed in February 2009, at which point DCL maintained that its works were complete. In October 2009 IIL initiated the pre-action protocol procedure alleging the works undertaken by DCL were defective. A site meeting between the parties took place in March 2010, after which DCL offered to return to the site to carry out further investigative and remedial work. IIL rejected this offer and proceedings were issued in December 2010.

The dispute focused on the contractual limitation period at clause 17.4 and when time started to run. IIL contended that practical completion of the services had not been achieved and, by implication, clause 17.4 (b) would only apply where practical completion "*does not occur because time for occurrence is no longer expected to be achieved by the client*". The Court rejected these arguments. The implied words on clause 17.4(b) were unnecessary and unjustified as it would mean IIL would be able to dictate the point at which time would begin to run. As there was no mechanism for "Practical Completion of the Services" to be certified and the contract did not adequately define what it meant, clause 17.4(b) applied, and time would run out one year from when DCL last performed services. On this point DCL argued that it last performed services in February 2009. IIL disagreed and asserted it was in March 2010 when DCL undertook an inspection. The Court rejected IIL's assertion as the site meeting and investigations in March 2010 were undertaken as part of the pre-action protocol; they were not in the performance of the services under the contract. As a result, the claim was issued more than a year later, and was out of time.

Practical Tips

- Before agreeing to limitation periods shorter than the normal contractual limitation consider whether they could be problematic in the future.

- Ensure contractual limitation provisions are clear on the date when time begins to run. The courts are unlikely to infer the intention of the parties.
- As soon as a potential dispute arises, check the contract and diarise the limitation period. If you are in doubt over which contractual limitation period is applicable, always choose the worst case scenario and plan against the shortest limitation deadline.
- If time is running out before a dispute is settled, either seek the other party's agreement to extend the contractual limitation period, or issue proceedings and seek a stay to allow pre-action protocol steps to be followed.

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COVENANTS

Estate Rentcharges: An Effective But Unpopular Means of Collecting Freehold Service Charges

by **Gillian Baxter**

The Court of Appeal recently heard a rare case about estate rentcharges, a subject which seldom comes before the courts.

A rentcharge is a periodic payment charged on land other than rent payable under a lease or interest. Nineteenth century developers often imposed rentcharges to provide them with a continuing income after the plots on the development had been sold. The Rentcharges Act 1977 prohibited the creation of any new rentcharges of that type but the Act permits "estate rentcharges". An estate rentcharge is a rentcharge created to enable the "rent owner" (that is the person to whom the rentcharge is paid) to enforce the performance of covenants by purchasers of the land, or to collect service charges from them.

Positive covenants, such as an obligation to erect a fence or maintain a road or to contribute towards shared maintenance costs, are not normally enforceable against purchasers of freehold property (as opposed to the person who originally entered into the covenant). An estate rentcharge is one way of circumventing that rule. It works by giving the rent owner a right of entry, that is a right to take possession of the property, if the covenant is not complied with. A rentcharge is therefore a very effective mechanism but it is seldom used in practice because the right of entry is seen as disproportionate and likely to be unacceptable to mortgagees.

A rentcharge of more than a nominal amount is only permitted by the Rentcharges Act if it is a reasonable payment for the performance by the rent owner of covenants for the provision of services, carrying out of maintenance or repairs, effecting insurance or making any payment for the benefit of the land affected by the rentcharge or for the benefit of that and other land. The recent case, *Smith Brothers Farms Ltd v The Canwell Estate Company Ltd [2012] EWCA Civ 237*, concerned the meaning of that provision.

The case concerned a rentcharge used to collect contributions towards the cost of maintaining private estate roads. Smith Brothers owned land on the estate and were required to pay both a fixed contribution towards the cost of maintaining the estate roads and also ninety per cent of the cost of maintaining a road over which they had a right of way. They argued that the rentcharge was void because it was of more than a nominal amount and it was not a reasonable payment because it was unreasonable to have to contribute towards the maintenance of roads over which they had no right of way.

The Court of Appeal upheld the validity of the rentcharge. The court explained that the services were provided for the benefit of the estate as a whole and did not need to benefit the landowner's land directly. To be valid under the Act, the rentcharge could relate to a covenant for the benefit of both the land affected by the rentcharge and other land. As long as the rentcharge was created for the legitimate purpose of contributing to the cost of the performance of a covenant for the benefit of the landowner's land, then it would be valid from the outset once and for all. It would not cease to be valid if the amount

calculated from time to time was not reasonable, but the rentcharge could not be used to recover a particular payment which was not reasonable.

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LANDLORD AND TENANT

Break Rights: A Costly Trap for Tenants

by **Sophie Ogilvie**

In the case of *Avocet Industrial Estates LLP v Merol Ltd*, a tenant's failure to pay interest of £130 resulted in it being tied-in to a further five years under its lease as a result of an ineffective break. The judge concluded that the decision was "harsh" but one that he was obliged to reach.

The Facts

The tenant had a 10-year lease with an option to break on 17 March 2010. The break option was conditional on the tenant having paid a one-off amount equivalent to six months' rent and having settled all sums due under the lease up to the break date.

Under the lease, the tenant was required to pay default interest on any sums paid late during the term. On several occasions the tenant failed to pay its rent on time and the landlord had sometimes (but not always) made demands for default interest.

Seven months before the break date, the tenant served notice to terminate the lease. The notice stated that the tenant was not aware of any outstanding sums due under the lease and that the landlord had not given notice of any breach.

The day before the break date, the tenant sent the landlord a cheque for six months' rent, together with the keys for the premises. The covering letter re-iterated that the tenant was not aware of any outstanding sums due under the lease.

On 7 April 2010, the landlord wrote to the tenant stating that the tenant had not complied with the break clause because:

- the payment of six months' rent had been made by cheque rather than cleared funds into the landlord's bank account; and
- default interest was payable on late rent payments and had not been paid.

The tenant argued that payment by cheque was sufficient and that no interest was due as it had not been formally demanded by the landlord.

The Decision

The landlord was not entitled to reject payment by cheque. The general rule is that payments should be made by legal tender (which a cheque is not). However, this can be varied by the course of dealings between the parties. In this case, the landlord had regularly accepted payment by cheque and there was an implied agreement that the landlord would continue to do so. The payment made by the tenant was therefore sufficient.

Under the wording of the default interest clause, the landlord was not required to have formally demanded interest. The liability to pay interest arose when a payment became overdue and not when a demand was issued. The tenant had not paid the default interest due under the lease and had therefore not complied with the conditions of the break clause. The break was ineffective.

Comment

This is a harsh decision and tenants need to be aware that break conditions will be interpreted strictly. Tenants should try to negotiate break conditions that do not require them to be up to date with payments other than rent (which is the recommended position under the Code for Leasing Business Premises in England and Wales 2007).

If this cannot be achieved, tenants should seek to limit their liability to those payments which have been formally demanded by the landlord in writing at least seven days before the break date.

If it is a condition of the break right that all sums due under the lease have been paid, tenants should carefully check if default interest may be payable on past arrears and push their landlord for confirmation as to whether any sums due under the lease are outstanding.

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PLANNING

The National Planning Policy Framework: Aiming for Growth Through Sustainable Development But With Appropriate Controls

by **Justin True**

The government's National Planning Policy Framework was published on 27 March 2012. The NPPF, which applies only in England, provides a framework within which local plans will be prepared by local planning authorities and it is a material consideration in the determination of planning applications. The Framework came into effect immediately but, during a 12 month transitional period, existing development plan policies adopted since 2004 may be given full weight, even if there is a limited degree of conflict with the Framework.

The Framework sweeps away the accumulated mass of circulars, "policy" letters, guidance notes and policy statements and replaces them with a simpler, more straightforward expression of planning policy. As explained with admirable clarity in Greg Clark's ministerial forward: "The purpose of planning is to help achieve sustainable development. *Sustainable* means ensuring that better lives for ourselves don't mean worse lives for future generations. *Development* means growth."

Presumption in Favour of Sustainable Development

At the heart of the Framework is a presumption in favour of sustainable development. This caused alarm when the draft Framework was first published, with the National Trust in particular fearing that it meant a development "free for all" with no protection for the Green Belt or other open spaces. The final version of the Framework should allay those fears. It still contains statements that local planning authorities should "positively seek opportunities to meet the development needs of their area" and that development proposals that accord with the development plan should be approved without delay, and where the development plan is absent, silent or relevant policies are out of date, permission should be granted. However, those statements apply only "unless any adverse impacts of doing so would significantly and demonstrably outweigh the benefits, when assessed against the policies in the Framework taken as a whole, or specific policies in the Framework indicate development should be restricted". Further, the NPPF does not override the legal requirement that decisions are to be taken in accordance with the development plan unless material considerations indicate otherwise.

Core Planning Principles

Twelve core planning principles should underpin plan and decision making:

- Be genuinely plan-led.
- Not simply be about scrutiny.
- Be pro-actively driven and support sustainable economic development.
- Always seek to secure high-quality design and a good standard of amenity.
- Take account of the different roles and character of different areas.

- Support the transition to a low carbon future in a changing climate.
- Contribute to conserving and enhancing the natural environment and reducing pollution.
- Encourage the effective use of land by reusing brownfield land.
- Promote mixed use developments.
- Conserve heritage assets.
- Actively manage patterns of growth.
- Take account of and support local strategies to improve health, social and cultural well-being.

Town Centres

The protection for town centres is also largely carried through into the Framework. In particular, the Framework requires local plans to support the viability and vitality of town centres. It recognises that it is important that needs for retail, leisure, office and other main town centre uses are met in full and are not compromised by limited site availability. It retains the sequential test which is to be applied to planning applications for main town centre uses (except small scale rural development) that are not in an existing centre and are not in accordance with an up-to-date local plan, so that they are located first in town centres, then in edge of centre locations and only if suitable sites are not available should out of centre sites be considered. Those over a certain size (2,500 sq m where no threshold is set locally) will need an impact assessment including an assessment of the impact on investment in centres in the catchment area and on town centre vitality and viability.

Brownfield Land

The Framework encourages the re-use of previously developed land provided it is not of high environmental value. Local planning authorities may also continue to consider the case for setting a locally appropriate target for the use of brownfield land.

The Green Belt

For those fearing the loss of Green Belt there is no discernable softening of policy. The Framework states explicitly: “the Government attaches great importance to Green Belts” and “when considering any planning application, local planning authorities should ensure that substantial weight is given to any harm to the Green Belt”.

In particular, the construction of new buildings is to be regarded as inappropriate in the Green Belt except in certain very limited circumstances. Inappropriate development in the Green Belt should not be approved except in “very special circumstances” which will not exist unless “the potential harm to the Green Belt by reason of inappropriateness, and any other harm, is clearly outweighed by other considerations”.

There is protection for open spaces outside the Green Belt, too.

Conclusion

The government has made growth its priority and wants planning policy to be used primarily as a tool to achieve that aim, rather than as an obstruction to it. For that tool to be most effective it must be made more accessible. By encapsulating almost the whole of planning policy in one, relatively brief, easy to read document the NPPF appears to have done that. Crucially, however, it appears also to have retained sufficient safeguards to prevent the problems which wholly unrestrained development would bring and to avoid alienating public opinion. Achieving the balance between “development” and “sustainability” will remain the challenge it always has been.

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