

Review

Property@ction



Welcome to the 10th Edition of the Quarterly Review from Squire Sanders Hammonds' Property@ction Team. In this issue we will look at the following:

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- (ii) Are you being ransomed
- (iii) Ssshhh....Landlord's covenants for quiet enjoyment and non-derogation from grant
- (iv) Boundary disputes: can you rely on plans?
- (v) Code of best practice for surveyors on the operation of service charges in commercial property

We welcome all contributions to this review and if you would like to discuss this further please contact any of the editorial team.

Rent Review Assumptions

In good or bad economic times determining the rent payable under a commercial lease is of the utmost importance to both landlords and tenants.

Most commercial leases include extensive provisions for reviewing the rent at regular intervals throughout the term of the lease. The majority of leases value the open market rent by reference to a hypothetical letting: a notional lease based on the actual lease terms but disregarding various items (e.g. tenant improvements).

The standard rent review clause also usually includes the option for the parties to refer the matter to independent arbitration/expert determination if no agreement is reached. In most cases rent review negotiations are dealt with by the surveyors for each party, who also prepare the submissions to the arbitrator/expert.

Whilst this commercial approach is often attractive and may potentially reduce costs, the recent decision in *Cordoba Holdings Ltd v Ballymore Properties Ltd*¹ provides a salient reminder of the pitfalls of the rent review process and the risks of failing to get it right.

The Facts

Ballymore were the landlord of office premises in the Docklands area of London let to Cordoba under three separate 25 year leases. Cordoba used the premises as a data centre. The leases were subject to upward only rent reviews in the 3rd and 8th year of the term. At the time of the second rent review, the parties failed to reach agreement and agreed to refer the matter to an arbitrator in accordance with the terms of the leases. The arbitrator had to determine:

"the rent at which the Premises might reasonably be expected to be let on the open market at [the second review date] making the Assumptions but disregarding the Disregarded Matters..."

Under the definition of Disregarded Matters set out in the leases, the arbitrator was required to disregard any improvements to the premises carried out by the tenant (or its subtenants or predecessors in title). Both sides relied on the evidence of separate expert surveyors in relation to the rent payable.

1 [2011] All ER (D) 114



The arbitrator determined the rent review on the basis that the premises could be used as a data centre, which attracted a higher open market rental level (£2.8 million per annum) than standard office premises.

The disgruntled tenant appeals...

The tenant, Cordoba, sought to appeal the decision on the basis that the arbitrator had failed to properly disregard improvement works carried out by Cordoba (outside of the demised premises) to increase the power supply to the premises in order to allow the premises to be used as a data centre. Its argument was that without these improvements the premises could not have been used as a data centre; and they should have been disregarded by the arbitrator, with the result that the rental value should have been determined on the basis of standard office premises, which would have been lower.

Cordoba's appeal was based on two grounds:

1. that the arbitrator had erred in law by failing properly to disregard tenant improvements undertaken by it to increase the power supply to the premises to its use as a data centre; or, alternatively,
2. if the arbitrator had not as a matter of fact dealt with this issue at all, the award was subject to challenge on grounds of serious irregularity.

Ballymore argued that the onus was on Cordoba to provide evidence to properly demonstrate that tenant improvements had, in fact been carried out to the demised premises and that Cordoba had failed to do so.

The judge decides...

In short, the judge agreed with Ballymore and held that Cordoba's appeal failed on both grounds. Cordoba was under an obligation to demonstrate that the power supply was to be disregarded for the purposes of rent review but had failed to do so in the course of the arbitration process. As a result, the judge held that the arbitrator had acted reasonably (and within his powers under the Arbitration Act 1996) in determining the rent payable by Cordoba under the leases of the premises on the basis that they were to be used as a data centre.

The moral of the story

Cordoba's plight demonstrates the importance for parties involved in rent review in getting the process right. Cordoba's error in failing to properly address the issue of tenant improvements during the course of the arbitration proved a costly mistake and effectively undermined its attempt to appeal the arbitrator's decision.

This decision highlights the need for careful and thorough preparation in rent review proceedings. Landlords, tenants and their advisers should pay heed and carefully consider whether specialist legal advice is required at an early stage of the rent review process, and certainly prior to any third party referral.

Are you being ransomed? Dealing with third party rights which could hold up your development

In the current market, it is hard work getting any development project underway. Every aspect of the proposal needs to be carefully considered to ensure a scheme proceeds. However, we have noticed a recent increase in the number of schemes where third parties with rights such as rights of light or access which could be affected by a proposed development are threatening to take out an injunction to prevent the development commencing unless the developer makes large payments in respect of interference with these rights.

In part, this is due to a recent rights of light case *HXRUK II (CHC) Ltd v Heaney*² where a beneficiary of a right to light which was affected by proposed development was found to be entitled to compensation based on a percentage of the increase in value created by the proposed development. This is similar to the more commonly known ransom strip calculation where providers of access to development land benefit from a share in the uplift of the value of that development land through the provision of the access.

A solution?

In response, developers and local planning authorities (LPAs) are investigating ways to avoid both the risk of injunctions preventing development and 'ransom' payments to third party owners of rights. You may have seen recent press comment regarding the City of London's willingness to assist Land Securities in building their 'Walkie-Talkie' development by using their planning powers to deal with surrounding owners' rights of light, and we are currently working on a number of projects where local planning authorities are considering using these powers to assist in achieving development.

In the past, we have also been involved with major town and city centre regeneration schemes where the LPA has utilised these powers, often in conjunction with a compulsory purchase order.

s.237 of the Town and Country Planning Act 1990 allows third party rights to be overridden and development to proceed subject to the following requirements

- The development must be in accordance with a planning permission
- In order to use this power, the LPA must have acquired or appropriated the land for planning purposes – ie they must hold or have held some interest in the land for planning purposes.
- The use of the power must secure an outcome which contributes to their planning purposes and objectives.

These powers offer an opportunity to remove the risk of injunctions preventing the development going ahead.

Costs

The solution is not cost free - a third party owner who has their rights affected is entitled to compensation for the reduction of the value of their property due to this interference. The compensation is calculated on the same basis as compulsory purchase compensation. Importantly, though, they are not entitled to any proportion of the increase in development value of the land which benefits from the LPA's use of its powers. The LPA may also require an indemnity for their costs in exercising their powers.

Statutory compliance

Questions have been raised by a number of people regarding the use of these powers, and whether this use by a local planning authority could constitute State Aid to the developer. We have been considering how this risk could be mitigated or removed in relation to a number of cases with which we are involved. It is vital to ensure that both the planning policy basis and the decision making process are clear, transparent and procedurally correct.

In addition, because the acquisition of an interest by a local planning authority will often require a subsequent disposal of an interest to the developer, the LPA must be certain, and able to demonstrate, that the disposal to the developer is not below the best consideration reasonably obtainable. Appropriately structuring the property agreement, and accurately assessing the 'consideration' offered by the developer for the land interest, is vital in ensuring the transaction does not fall foul of these statutory requirements, whilst providing the developer with sufficient control to fund and develop the site.

What is the impact on you?

Developers - these powers could free your development from the risk of third party interference.

Local Planning Authorities - These powers offer an opportunity to pursue your planning objectives without incurring costs.

Investors & Financers – these powers could reduce costs and risks for developments you are funding

Property owners – if development is occurring near you, it could affect your property rights.

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Ssshhh...Landlord's Covenants for quiet enjoyment and non-derogation from grant

A landlord's covenant for quiet enjoyment is a standard feature in modern leases and indeed is implied where not expressly provided. The covenant of non-derogation from grant is implied. This article examines the meaning and effect of those two covenants.

Covenant for quiet enjoyment

What is it? Contrary to popular belief the covenant for quiet enjoyment has nothing to do with noise levels at the premises. It means that the tenant has a right, not just to occupy the property, but to use the property in a lawful way without interference. If substantial interference is suffered the tenant can claim damages and/or obtain an injunction against the landlord to prevent the interference from continuing.

Who and what does it cover? The usual covenant will cover the landlord, his agents, or any other person claiming their title through the landlord. Some leases contain an unqualified covenant, which also covers the actions of any superior landlord. All actions of the landlord, lawful or unlawful, can be a breach of the landlord's covenant to the tenant. However, only lawful actions of the landlord's agents and third parties are covered – the landlord cannot be held responsible for another's unlawful act.

What is "substantial interference"? Whether an act amounts to "substantial" interference will depend upon the facts of the case. Historically the interference had to have a physical aspect, but more recent findings have expanded the scope of interference to non-physical acts. Activities that have been found to be "substantial interference" include:

- cutting off the gas and electric supplies to the tenant's property;
- permitting an escape of water from the neighbouring property which damages the tenant's buildings;
- continuous loud noise which interferes with the tenant's enjoyment of his property;
- putting the tenant in fear and intimidating him into leaving the premises.

Activities cannot amount to substantial interference if they occurred or were in existence prior to the start of the lease, because the tenant is deemed to have taken the lease in the knowledge of the interference. Similarly, a temporary disturbance that does not seriously interfere with the tenant's occupation of the property is unlikely to breach the covenant. Finally, the covenant for quiet enjoyment cannot be used to imply a positive duty on the landlord to repair the property, or operate to give the tenant rights over neighbouring property that he would not otherwise have – a tenant cannot, for example, use the covenant to argue for a right to light which otherwise would not exist.

Obligation not to derogate from grant

This principle embodies the concept of fair dealing between the parties – if the landlord has granted a lease for a particular purpose he may not then use the adjoining land so as to frustrate the purpose for which the lease was granted. If the landlord does derogate from his grant the tenant may again claim damages and/or obtain an injunction against the landlord.

As with the covenant for quiet enjoyment, the derogation must be substantial: letting adjoining premises to a business rival is not sufficient, nor is it sufficient for the landlord to act in such a way that the intended use of the tenant's premises is more expensive than it would otherwise be. However, activities such as turning the end wall of the tenant's premises into a party wall so that the tenant is forced to block up his windows, interfering with access to the tenant's premises and causing the tenant to be in breach of a licence to manufacture explosives are examples of breach of the landlord's obligation.

The covenants for quiet enjoyment and obligation not to derogate from grant are very much standard features of the landlord-tenant relationship. Because they are not positive obligations, they are rarely seen as an issue for landlords when deciding to grant a lease. Landlords should be aware, however, that in certain circumstances these obligations can operate to restrict their use of adjoining land and can even impose responsibility on them for the lawful actions of others.

Boundary disputes: Can you rely on plans?

In practice, boundary disputes sometimes arise when neighbours compare plans of their property to the position on the ground and find discrepancies. Usually, however, it is not appropriate to rely solely on plans in order to investigate the legal boundary of the property.

As far as Land Registry plans are concerned, the reason is that most land is registered with general boundaries only. This means that the red edging on a title plan only shows the general position of a property's boundary and not the exact line. Further, black lines on a title plan represent boundary features such as walls, hedges, fences or buildings. These derive from Ordnance Survey maps. It is usually inappropriate to seek to establish a legal boundary derived from the Ordnance Survey: first, because the boundaries shown are merely physical (and not legal) boundaries, secondly, because the scale used of 1:2500 is inadequate. As one Judge put it: "*if a plan is intended to control the description, an Ordnance map on a scale of 1:2500 is worse than useless*".

So how does one establish the legal boundary of a property?

Often this will involve consideration of a number of factors, with the starting point being the parcels clause in the conveyance describing the relevant land and any plans attached to such documents, but also considering physical features on the ground may be appropriate.

Even when a plan has been prepared, care needs to be taken. It is not unheard of for the description of a property in a title deed to conflict with a plan attached to that deed, which sometimes leads to dispute. Often, one will need to consider on what basis the plan has been prepared.

For example, if a plan is limited by the phrase "*for identification purposes only*" the description in the title deed will prevail where there is conflict. The phrase should only be used to show the general location of land but not its precise extent. That said, it can be used to supplement a verbal description which is not clear. The surrounding physical circumstances can also be taken into account. Note that plans which are described in this way will generally be rejected by the Land Registry.

Where the phrase "*more particularly delineated or described on the plan*" is used, the plan holds more sway. If the wording in the contractual document differs to the plan, the plan will usually prevail.

The emphasis to be given to a plan was considered in the November 2011 Court of Appeal Decision of *Brown v Pretof*³. In that case, a parcels clause in a conveyance placed a garage within the plot but did not officially identify the boundary. The clause referred to the plan but the plan was stated to be for identification only. There was a conflict between the plan and the transfer clause in that based on what the plan showed, the garage was partly within the relevant plot and partly outside it. It was recognised that this was an absurd result. On appeal, the court recognised that the whole of the garage was within the plot and, to that extent, the plan did not show the correct boundary. It was necessary to look at evidence of the actual and known physical condition of the land at the date of the conveyance with the attached plan in one's hand, and to construe the conveyance against the background of the surrounding circumstances, which included knowledge of the objective facts reasonably available to the parties at the relevant date.



Latin Quarter - In rem/in personam

"In rem" means "against a thing". An action in rem is directed towards a piece of property rather than against a person ("in personam"). The phrases are of relevance in possession proceedings, particularly against squatters. The order made in possession proceedings is that possession be delivered up to the claimant, who must therefore be the party entitled to possession. For example, in the event of squatters occupying a shop which is the subject of a lease, then it is for the tenant – as the party entitled to possession – to bring proceedings; whereas, if the shop is vacant, then it would be for the landlord to sue. Either way, the order made would be that possession be handed over, rather than against a particular party.



Code of best practice for surveyors on the operation of service charges in commercial property

The RICS (Royal Institute of Chartered Surveyors) has recently published a revised Code of Practice (“the Code”) setting out best practice for the operation of service charges in leases of commercial property. Although compliance with the Code is not compulsory, it is best to practice and may provide evidence of negligence if not followed.

Those Affected

Managing agents:

- in their day to day management activities and the way they keep accounts;
- in the handover arrangements when properties are sold or the managing agent changes;
- by embedding a requirement for better communication with tenants over service charges; and
- by requiring transparency over the calculation of management fees.

Legal advisers:

- in their drafting of leases; and
- in their advice on whether or not items of expenditure are chargeable to the service charge.

Accountants:

Since the format of the service charge account and estimates is more prescriptive.

Landlords:

The Code makes it very clear that landlords:

- are not intended to make a profit from the service charge;
- should aim to achieve value for money; and
- must contribute for void units and credit to the service charge account any interest earned on advance payments.

Tenants:

Since the Code should make it easier both to budget and challenge items in the service charge accounts.

Contractors who provide services:

Since the requirements for regular benchmarking or re-tendering of service contracts are more clear.

Core principles

Service costs

Services should now represent “appropriate” value for money. Appropriate is a new concept and is not defined. Owners should not profit from supply of services.

Certification

The Code introduces requirements that certified accounts must be true and accurate and high standards of care must be demonstrated towards owners/occupiers who may rely on such accounts.

Communication

The Code requires the manager to consult occupiers on the services but clarifies that it is the owner who has the right to set the standard. It now requires "manifest demonstration of compliance" and in the Proportionality section, directs all parties to seek to comply with the core principles at all times.

Financial competence

Compliance with this standard may require managers to use more senior or experienced staff, which will affect the cost of management.

There is now an obligation to use the industry standard cost headings in the accounts and reports. This was advisory in the earlier Code.

Dispute resolution

All leases are required to provide for use of Alternative Dispute Resolution. The Code also encourages the parties to use ADR even where the lease does not so require.

Timeliness

The earlier Code provided that certified accounts should be produced in a timely manner and by the latest within four months of the end of the service charge year. This has been watered down to a requirement to produce only detailed statements of actual expenditure, albeit along with accounting policies and other explanatory text, within that timeframe.

Value for money

Service quality is to be appropriate to the location, use and character of the property.

Flexibility

The Code is flexible in that it allows the parties to depart from its principles for various good reasons. This might be justified because of the size or type of property, or the level of the overall service charge. Small properties or those with few occupational tenants can avoid the full force of the Code. Similarly, the Code states that the lease provisions should be relevant and appropriate to the length of term and wording of other leases for the property. If an old-style service clause allows a landlord to bill "reasonable" costs, an astute tenant is likely to use those qualifications in the Code to argue that some items are unreasonable.

Changes to sale contracts

There is a concern at the moment that sale contracts do not encourage a prompt handover to the incoming agent of the information required to ensure a seamless transition. Subsequently incoming agents are left floundering and tenants become exasperated at inconsistencies in service charge management such as double charging.

For properties with several occupational leases and substantial service charge expenditure, the Standard Commercial Property Conditions should be amended in line with the Code to include the provision of:

- an estimated reconciliation of the current year's service charge and a final version (within four months after completion);
- a final reconciliation of all past service charge years with same four month period;
- an obligation to hand over any service charge account credit balance;
- an obligation on the seller to supply information about how the service charge is run; and
- meaningful sanctions if the seller breaks these obligations. The Code suggests a liquidated damages clause.

There is flexibility as to how certain parts of the Code can be adopted in leases going forward. Compliance is not compulsory but failure by RICS members to adopt its principles may provide evidence of negligence. This may mean that surveyors push clients and their lawyers into changing commercial leases and sale contracts so as to be more even handed.



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