TANFIELD

Mixed-use development schemes

A presentation to The Property Litigation Association Autumn Training Day in London on 6 November 2019

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Philip Rainey QC

Philip is a specialist in property litigation. His practice straddles the commercial/residential divide; it encompasses all aspects of real property and commercial L&T, as well as the residential L&T (particularly enfranchisement and service charges) for which Philip was at one time best-known. Philip has appeared in many leading cases in the property field and has a wealth of experience at the highest level; he has taken a number of cases to the Lords/Supreme Court, most recently ***Sequent Nominees v Hautford*** **[2020] AC 28** and numerous others to the Court of Appeal.

Philip has extensive experience in mortgage and guarantee claims, rent review, dilapidations, easements, restrictive covenants (recently obtaining a modification of an office-only user covenant to allow permitted development to 114 flats in ***Shaviram Normandy v Basingstoke & Deane BC*** **[2019] UKUT 256**), boundary disputes, property-insolvency and contracts for sale. He knows his way around a party wall and the 1996 Act. Philip is experienced in arbitration and expert determination, both as advocate before the third party and in challenging the award or determination in court. He also undertakes a range of work which shades into the commercial arena, including overage and clawback, profit sharing, aspects of banking law, economic torts, fiduciary duty claims, freezing injunctions etc. His clients range from landed estates, listed property companies and banks to individual tenants.

Philip has a keen, apolitical interest in law reform in the field of landlord and tenant law. He has presented papers to the All Party Parliamentary Group on leasehold reform, and he has assisted the Law Commission with its project on Leasehold Reform as well as the earlier “Event Fees” project in the retirement housing sector. Philip is a regular speaker on property law issues.

Introduction

1. First of all, if you are reading this, thank you! Secondly, about these notes: The notes are intended to underpin the session rather than set out a script; the chances of me adhering closely to the notes (completed on 25 October) when I come to deliver the session on 6 November are quite low. The session is also too short to go through every point in the notes. My intent is that the notes include useful background and some basic material and that the oral presentation will be value-added.

2. I have also attempted to "weight" the session towards those issues affecting mixed-use where there have been recent, or recent-ish, developments in the law.

3. With that introduction:-

4. Residential occupiers have the benefit of a whole raft of rights and protections which are not available to commercial tenants. The rights and obligations of commercial tenants are largely governed by the terms of their lease. In the case of residential tenants, the lease is only the beginning.

5. In this session we will look at some of the statutory rights residential long leaseholders have which developers must be aware of when deciding how to structure a mixed use development. With some careful planning some of the more extensive rights of leaseholders can be avoided. We will also consider recent developments in the law concerning management and what can and cannot be done with a mixed-use development once completed.

6. In particular, we will consider:

    (i) Issues to be considered prior to completion

    (ii) Management issues at mixed use developments

    (iii) Disposal of Interests in mixed use developments

Issues to consider before completion

Collective Enfranchisement

7. The Leasehold Reform, Housing and Urban Development Act 1993 allows the leaseholders of a block to compulsorily purchase, through a nominee, the freehold of the block and thereby deprive the landlord of its asset altogether. The price to be paid for the block is determined in accordance with a valuation exercise that is prescribed with the Act. As is commonly the case with statutory valuations, the exercise is to be undertaken with reference to an open market sale but subject to certain assumptions.

8. The advantage to leaseholders in enfranchising is that they take over control of their block and thus can determine (subject to the terms of the leases under which the flats are held and any applicable statutory regulation) the timing and nature of any works. However, in acquiring the block, the leaseholders will, in addition to acquiring the freehold to the flats also acquire the freehold of the commercial units (subject to the right of the freeholder to require a leaseback of the units). Whilst the value of these units may make the exercise of enfranchisement commercially unviable for the leaseholder (e.g. if they are let on short leases at a rack rent), nevertheless the right to acquire them (subject to the option of a leaseback) exists.

9. The developer may, of course, wish to retain the development as a long term investment or it may wish to carry out further development on the site. The risk of enfranchisement can be avoided with some careful thought at the design stage. This can be achieved through (1) the structural design of the building itself and (2) the legal design of the way in which the residential units are held.

10. Two particular issues arise in relation to the question of whether the premises themselves qualify for enfranchisement:

    (i) do the premises consist of a “self- contained building or part of a building” within the meaning of the Act?

    (ii) does the extent of the commercial space exclude the premises from enfranchisement rights?

Self-contained building

11. The starting point for qualification is that the premises must consist of a self-contained building or part of a building (section 3(1)(a)). A building is self-contained if it is structurally detached. The criteria for this is set out in section 3(2).

12. Important recent case on this: ***CQN RTM Co. Ltd v Broad Quay North Block Freehold & Anor*** **[2018] UKUT 183 (LC); [2019] HLR 9**. Structurally independent, but physically abutting, structures, were held not to be self-contained buildings. And why couldn't a claim be made to the whole? Part is a hotel; non-residential floor areas could become an issue (see later).

Self-contained part of a building

13. Crucially, to be a self-contained *part* a vertical division is required – which means what it says. Anything more than a *de minimis* deviation is not vertical: see ***Re 1-16 Finland Street*** **LRX/138/2006** (minor deviation in underground car park – fatal) and compare that with the (failed) "one brick deviation" defence in ***West End Investments v Birchlea*** **[2016] 4 WLR 4** (dividing wall which was a party wall for only some of its height). This was the reason why a "self-contained part" claim could not be made in ***CQN*** – the division was dog-legged over the car park entrance ramp.

14. And importantly, the Law Commission's reform proposals presently propose retaining the basic physical qualifying criteria for enfranchisement.

15. Accordingly, by designing overlapping buildings so that there is no vertical division of one part from the other, the risk of enfranchisement is reduced because the individual blocks cannot be enfranchised in isolation.

16. It would still be possible to enfranchise a whole set of overlapping blocks, see ***Palgrave Gardens Freehold Co Ltd v Consensus Business Group (Ground Rents) Ltd*** **[2019] L&TR 17 (cc)**. However, an appeal over definition of 'self-contained building' is due to be heard at the High Court in March 2020.

17. But do the tenants have the numbers? Might the overlap be with a hotel (say) thus breaching the 25% non-residential limit? (See CQN). Might the overlap be with the affordable housing block where the registered provider may well have no interest in assisting a claim (if indeed they qualify).

18. The building will also not qualify if its services are not independently provided to those provided to the occupiers of the remainder of the building or could not be so provided without involving the carrying out of works likely to result in significant interruption in the provision of such services to those other occupiers.

19. NB: this is a purely "physical" test; it does not matter whether there are *legal* rights to split the services not would it matter whether anyone would actually bother: ***St Stephens Mansions RTM Co v Fairhold NW Ltd*** **[2014] UKUT 0541**

Non-residential areas

20. The right to enfranchise will not apply if any or parts of the premises are neither occupied for residential purposes nor comprised in any common parts of the premises and the internal floor area of those parts exceeds 25 percent of the internal floor area of the premises (section 4(1)).

21. As to "common parts" see ***Westbrook Dolphin Square v Friends Life*** **[2014] L&TR 28** – note that this is the only Law Report which includes the relevant passages from the judgment. WLR does not.

22. Occupation for residential purposes is wider than occupation as a residence. Areas of the building which are used for a purpose ancillary to residential use (for example, a garage or storage area) will be deemed to be residential – s.4(2). It also to be noted that the provision applies to premises that are intended to be occupied for residential purposes as it does to those that are in actual occupation for that purpose.

23. So by ensuring that at least 25% of the internal floor area of the development is "non-residential", the building will not qualify for enfranchisement at all. In the simple case (subject to the ratios), a development with shops at ground floor level and two floors of flats above, will not be susceptible to collective enfranchisement (although have regard to rights of enfranchisement under the Leasehold Reform Act 1967 and the test for "a house reasonably so called" as set out in the decision of the Court of Appeal in ***Jewelcraft v Pressland*** **[2015] H.L.R. 48**).

24. NB: Residential areas may remain residential areas for the floor area tests even if let on a commercial lease: ***Gaingold v WHRA RTM Co*** **[2006] 1 EGLR 81 (LT)**.

Appurtenant Land

25. In addition to acquiring the freehold of the self-contained building, in a collective claim leaseholders are also entitled to acquire appurtenant land, such as a garden, or communal property used by all tenants of the property. Even if the use of communal areas is by licence only, that may entitle the lessees to acquire the freehold on a collective claim: ***Trinity House v 4-6 Trinity Church Square Freehold*** **[2018] EWCA Civ 764 [2018] 1 WLR 4876**.

26. On a mixed-use estate one must beware allowing residential leaseholders permission to use areas which may be important to the commercial units.

Qualifying tenants

27. Section 5 of the Act defines a qualifying tenant as the tenant of a flat under a long lease (granted for a term exceeding 21 years), however the tenant will not need to have owned their flat for over two years. If the same person owns more than three flats in the block, there will be no qualifying tenants of those flats s.5(5).

28. There must be two or more flats held by qualifying tenants and the total number of flats they hold must not be less than two thirds of the total number of flats contained in the premises – s.3(1)(c).

29. The size of the flat makes no difference to amount of qualifying tenants, as it will be regarded as one flat regardless of how many rooms it has.

30. Smaller flats may also be more "affordable". So: another potential "anti-enfranchisement strategy is to include a PRS element, lots of studio/1 bed flats, and do not let them on long leases. Then they do not qualify for any enfranchisement /lease extension rights.

31. It is still possible to grant fairly long terms to savvy investors e.g. a lease of 21 years (less a day for total comfort) coupled with the grant of a separate reversionary lease starting the day after the occupational lease ends. Almost 42 years; but no rights.

Disincentivising enfranchisement

32. The usual incentive for enfranchising is to eliminate ground rents and ensure that tenants do not have a wasting asset in the form of a short lease. By granting a long lease at a peppercorn in the first place, the tenants may have little incentive to acquire the freehold.

33. Another incentive for enfranchising is to gain control. Again this incentive can be minimised by putting in place a structure which gives the leaseholders control in the first place. For example, there could be a tripartite lease with a lessee-controlled management company dealing with the residential management within the development.

34. Ensuring that the tenants' management company Articles incorporates a "Morshead Mansions clause" may minimise s/c disputes and possibly disincentive enfranchisement.

35. ***Morshead Mansions v di Marco* [2009] 1 P&CR 23**. In *Morshead Mansions*, it was held that a management company was entitled to claim sums of money from a leaseholder, pursuant to the resolutions and articles of association which the leaseholder had signed up to as a member of the management company. The sums claimed were not a "service charge" within the meaning of the Landlord and Tenant Act 1985 s.18.

36. Include a developer "golden share" to prevent removal of the clause?

37. Another way to look at it is this: the tenants can only override a tripartite management company by exercising RTM. But if they do, they will lose the benefit of the Morshead Mansions clause and leaves the RTM potentially facing s/c disputes in the tribunal which the old tripartite company did not.

Construction of Service Charge Clauses

38. In an ideal world, a service charge regime would be logical and 'fair' (or at least acceptable to the various parties) and, most importantly, the service charge provisions would clearly define the parties' obligations so that: (i) the parties understand their respective repairing obligations; (ii) the costs of performing those obligations can be recovered in full; and (iii) the apportionment of the costs between the respective parties is clear. In practice, all too often, the drafting of the leases is poor leaving room for uncertainty and dispute.

39. A key feature of service charges which falls for consideration is the provisions which allow for the landlord to recover the costs of works from tenants. However this has given rise to conflicting results.

40. In ***Arnold v Britton*** **[2015] UKSC 36; [2015] AC 1619**, the Supreme Court rejected a submission that service charge clauses are to be construed restrictively. It held that service charge clauses are not subject to any special rule of contractual interpretation. The case concerned the proper interpretation of a clause which provided that the service charge was a fixed sum with a fixed annual increase. The alarming consequence of the court's interpretation was not a convincing argument for departing from the natural meaning of the clause.

41. There is no presumption that a landlord is entitled to recover 100 per cent of his costs: see ***Rapid Results College v Angell*** **[1986] 1 E.G.L.R. 53.**

42. Generally, in a residential context, any lack of clarity is likely to be resolved in favour of the paying party: see ***Jollybird v Fairzone*** **[1990] 2 E.G.L.R. 55** and ***Paddington Basin Developments Ltd v Gritz*** **[2013] UKUT 0338**. The distinction between residential and commercial leases in this context was also specifically remarked upon by the Chancellor in ***Wembley Stadium Ltd v Wembley (London Ltd)*** **[2008] 1 P.& C.R. 3** at [44].

43. Commercial tenants often struggle to argue that they should not contribute to the same articles of expenditure as the lessees of flats where the service charge provisions are similar. This is so, even where the clause provides that the tenant is liable to contribute towards the cost of maintaining and repairing these areas which it "uses and enjoys", regardless of the commercial premises being self-contained and the tenant may not have access to the common parts of the residential block.

Statutory controls

44. Applicable to residential lessees. What is "residential"?

45. S.18 L&T 1985: service charge means an amount payable by a *tenant of a dwelling*. Dwelling means: building or part of a building occupied or intended to occupied as a separate dwelling (s.38). Tenant of a dwelling means: a tenant to whom a dwelling is demised whether or not the demise includes other property, e.g. common parts or commercial property: ***Oakfern v Ruddy*** **[2007] Ch. 335.**

46. In the case of truly mixed use units (live-work units etc.) whether it is residential may depend on degree of integration: ***Buckley v Bowerbeck Properties Ltd*** **[2009] 1 EGLR 43**

Apportionment problems

47. There are a number of methods of apportionment: a specified fixed percentage, ratable value, floor area, number of bedrooms or "living space factor". All have their advantages and disadvantages and all will produce, to some extent, winners and losers. Alternatively, the lease might provide that the tenant is to pay a "fair and reasonable" proportion, as determined by the landlord, its managing agent or its surveyor (acting reasonably). Some leases provide for a combination of methods.

48. The apportionment of service charges can be a complex matter in a building with a variety of modes of occupation (business, leisure, residential) or as between

different buildings on a large estate. Different contributions may be appropriate to different users and there may be more than one fair or reasonable method which may be adopted.

49. The RICS Real Estate Management Standards, 3rd Ed. (October 2016) states at para 3.1.9:

"The basis and method of apportionment of service charges should be demonstrably fair and reasonable, to ensure that individual occupiers bear an appropriate proportion of the total service charge expenditure, reflecting the availability, benefit and use of services. The method of apportionment should be clearly agreed within the lease provisions. Examples include:

- *floor area apportionment*
- *value apportionment*
- *weighting.*

In many cases, particularly buildings with a variety of different users, not all the occupiers will benefit from the services to the same extent. In such circumstances, you should divide the service charges into separate parts to reflect the availability, benefit and use of services, with each part being individually apportioned between occupiers according to the core principles."

50. It is often desirable, particularly in large mixed-use developments, for the freeholder/head lessee to retain an amount of flexibility when apportioning costs. Thus, the discretion to determine a "fair and reasonable" proportion is common. What is "fair and reasonable" is a matter of construction and will depend on the circumstances of each case.

51. In the commercial context, where a landlord carries out expensive and long- term repairs rather than short-term patch repairs and the unexpired term of the lease is short the tenant's fair proportion of those costs should be determined by reference to fact that the tenant enjoyed the benefit of the repairs for a short period of their lifespan: see ***Scottish Mutual Assurance Plc v Jardine Public Relations Ltd* (1999) EGCS 43**.

52. The test of reasonableness is a two-stage test. *Service Charges & Management* (4th Ed., Tanfield Chambers, Sweet & Maxwell), paragraph 14-04 says as follows:

> "In ***Waaler v Hounslow LBC*** **[2017] 1 WLR 2817**, the Court of Appeal said in the context of s.19(1)(a) that "reasonableness" has to be determined by reference to an objective standard, not by the lower standard of rationality. The landlord's decision-making process is a relevant factor but this must then be tested against the outcome of that decision. The fact that the cost of the relevant works is to be borne by the lessees is part of the context for deciding whether they have been reasonably incurred. Where a landlord has chosen a course of action which leads to a reasonable outcome, the costs of pursuing that course of action will have been reasonably incurred even if there was a cheaper outcome which would also have been reasonable.
>
> The meaning of the phrase "reasonably incurred" was also considered by the Lands Tribunal in ***Forcelux v Sweetman*** **[2001] 2 EGLR 173**. It accepted the landlord's submission that what the subsection required was consideration of the decision making process. However, this could not be a licence to charge a figure which is out of the market norm. There was therefore a two stage test:
>
> (1) Was the decision making process reasonable?
>
> (2) Is the sum to be charged reasonable in the light of market evidence?"

53. Where this test is not met, the landlord will not be able to vary service charges.

54. A lease may provide for the tenant's contribution to be varied in certain circumstances or, more generally, at the landlord's discretion.

55. A key problem with apportionment in mixed-use developments is jurisdictional: residential lessees can challenge apportionment in the tribunals; commercial lessees cannot. But if the residential apportionment is altered, that affects the commercial lessees. And what about the usual "conclusive determination by landlord's surveyor" clause?

56. So far as residential lessees are concerned, conclusive certification / landlord surveyor clauses are <u>completely</u> void by reason of s.27A(6) of the Landlord and

Tenant Act 1985: ***Windermere Marina Village Ltd v Wild*** **[2014] UKUT 0163 (LC) [2014] L&TR 30**; ***Gater v Wellington Real Estate*** **[2014] UKUT 561 [2015] L&TR 19** as approved by the Court of Appeal in ***Oliver v Sheffield CC*** **[2017] 1 WLR 4473.**

57. Completely void means that the tribunal starts with a clean sheet to decide what is reasonable in an apportionment. There is no margin allowed for the landlord or his surveyor; it is not a review to decide whether the landlord's apportionment is a reasonable one. But so far as the non-residential lessees are concerned, the clause remains valid and binding. There is a risk of inconsistency in decision. If an apportionment is referred to the FTT, only residential lessees can do that.

58. So the Upper Tribunal suggests that the commercial lessees should be joined as a party to any FTT / UT proceedings which challenge apportionment between the residential and non-residential parts.

59. Another take-away is that it may be better to prescribe the apportionment in the leases, with a provision to vary it, rather than provide for a "fair and reasonable apportionment" which is "open season" in the FTT. However, even a variation clause could end up in the tribunal. In ***Fairman v Cinnamon (Plantation Wharf) Limited*** **[2018] UKUT 421**, there was a clause which empowered the lessor or its surveyor to vary the service charge percentages in certain scenarios "or for any other reason". The UT held that the effect of s.27A(6) was that the tribunal was able to exercise this power and it was the tribunal which would determine the new apportionments.

60. Alternatively, include a provision in the commercial leases which require the commercial lessees to accept any decision of the FTT or UT as to the apportionment. Because otherwise, there may be a more serious problem than a risk of inconsistent decisions: if the lease specifies that any adjustment must be certified (usually by the landlord's surveyor), a failure to comply with such a requirement will result in any variation being ineffective: see ***Warrior Quay Management Company Ltd v Joachim*** **LRX/43/2006 (Land Tribunal, unreported, 2008)** where the s.27A(6) point was not taken; the thrust of the

decision remains applicable to a commercial lease. Yet another possible angle on this is that, presumably, if the FTT ruled that the correct apportionment was "x", then the landlord's surveyor could formally make the same (or the mirror image) determination for the commercial lessees thus satisfying the contractual machinery and that would be difficult for the commercial tenants to challenge.

Consultation

61. Section 20 of the Landlord and Tenant Act 1985 requires that leaseholders be consulted before any qualifying works are carried out by a landlord, where it is estimated that the contribution which will be expected from tenants towards the costs of the works are expected to amount to £250 or more. In addition, there must be consultation on any "qualifying long term agreement" (QLTA), being an agreement for a period of more than 12 months (see the recent clarification in ***Corvan Properties v Abdel-Mahmood*** **[2018] EWCA Civ 1102**).

62. Those thresholds are the statutory maximum that the leaseholder has to pay by way of a contribution to "qualifying works" or a "qualifying long term agreement" unless consultation requirements have either been complied with or dispensed with by, or on appeal from the Appropriate Tribunal (the FTT in England). The procedure for consulting under section 20 of the LTA 1985 is governed by the Service Charges (Consultation Requirements) (England) Regulations 2003 ("the Regulations").

63. The consultation requirements are contained in the Schedules to the Regulations. There are four Schedules and they apply as follows:

    (i) Schedule 1 prescribes the requirements for QLTAs for which public notice is not required.

    (ii) Schedule 2 prescribes the requirements for QLTAs for which public notice is required.

    (iii) Schedule 3 prescribes the requirements for qualifying works under a QLTA and agreements to which regulation 7(3) applies.

    (iv) Schedule 4 (which is divided into 2 parts) prescribes the requirements for qualifying works for which public notice is required (Part 1) and for which public notice is not required (Part 2).

64. Helpfully, in ***BDW Trading Ltd v South Anglia Housing Ltd*** **[2013] EWHC 2169 (Ch) [2014] 1 WLR 920** it was held that consultation requirements in respect of qualifying long term agreements ("QLTAs") do not apply to agreements entered into in relation to buildings which have not yet been constructed or which are not let at the time of the agreement. Section 20 did not apply because the definition of a QLTA in s.20ZA referred to "the landlord", denoting an existing tenancy.

65. But note the recent decision in ***Aldford House v Grosvenor (Mayfair) Estate*** **[2019] 1 WLR 1489**. In ***BDW*** the building had not been built at all at the relevant date, so the case was factually simple. In ***Aldford House*** (an enfranchisement case), things were more complicated. Fancourt J held that flats may exist before physical completion. Coupled with off-plan sales contracts, there is a risk that qualifying tenants may come into being earlier than you may expect.

QLTA issues

66. We know that an "estate management deed" may be a QLTA: ***Paddington Basin Developments v West End Quay Estate Management*** **[2010] 1 WLR 2735.**

67. Might a commercial lease be a **QLTA** as far as the residential tenants are concerned?

68. I think the answer is "yes". A lease is an agreement. Questions to ask: crucially, does the commercial lease include any element of "reverse service charge" payable by the landlord which the landlord seeks to recharge in part to the residential tenants? Particular dangers arise in respect of shared areas e.g. forecourts, car parks, communal entrances to hotels / flats.

RTM overlap

69. Leaseholders may take over management of their block under the 2002 Act through allowing leaseholders to form an RTM company made up of leaseholders and incorporated for the purpose of managing their block. Once the right to manage is acquired, the RTM company takes over the landlord's "management functions" under the leases. These functions are those with respect to services, repairs, maintenance, improvements, insurance and management – s. 96(5). They do not include collecting ground rent.

70. There are key differences between the rights held by a landlord and an RTM company:

    a. The RTM company cannot forfeit a lease
    b. The RTM company can only take over management functions from the date it acquires them and would not be able to sue for arrears
    c. The RTM company does not take over the management functions of the landlord in relation to flats or units not held by a qualifying tenant. The company cannot manage flats retained by the landlord and let on short leases or commercial units within the building. The landlord of a mixed use development will therefore retain its obligations in relation to these units.

71. The 2002 Act is not well drafted. The "overlap" is the so-called *Gala Unity* issue, after ***Gala Unity v Ariadne Road RTM Co* [2013] 1 WLR 988 (CA).**

72. In short, if a residential block acquires RTM, then it will also acquire RTM over all the property appurtenant to the block, even if shared with other blocks or commercial lessees. There is no statutory mechanism for division of management responsibility. This prospect is "not a happy one": ***Fencott Ltd v Lyttleton Court RTM Co Ltd* [2014] UKUT 27.**

73. An attempt to overturn *Gala Unity* was made recently, and failed: ***Firstport Property Services v Settlers Court RTM Co* [2019] UKUT 243**, but the point may be being pursued further.

Variable estate rentcharge as an answer to estate management issues?

74. It is not uncommon to administer estate service charges through a variable estate rentcharge (validated by Rentcharges Act 1977 s.2(3)(c)). It works if units on an industrial estate (say) are sold freehold.

75. It is possible to apply the same logic to mixed use estates. Place the blocks and the estate in different SPVs, and encumber the block freeholds with a rentcharge in favour of the estate management company. This rentcharge should survive enfranchisement (see s.34(6)(b) of the Leasehold Reform Housing and Urban Development Act 1993) and RTM, because the "rent owner" is not the "landlord" and is not relying on a lease.

76. The leases will include an obligation to indemnify the freeholder against the rentcharge liability. Query if that is even a "service charge", but if it is, a RTM Co would not be able to refuse to administer it.

77. And at present, challenges to the reasonableness of variable estate rentcharges can only be brought in court.

Variation of leases

78. The Landlord and Tenant Act 1987 allows a party to a long lease of a flat to apply to vary the terms of the lease if it fails to make satisfactory provision for various matters. These include repair and maintenance, insurance, the provision of services and computation of service charges. Where an application is made to vary a lease, any other party to the same lease can make a counter-application to the tribunal for the variation of other leases in the block so that they all have similar provisions. However, there is no power to vary commercial leases.

79. There are two procedures available in Part IV of the 1987 Act. Section 37 governs applications which are desired by a majority of the leaseholders. Section 35 allows the FTT to vary leases which fail to make "satisfactory provision".

80. The FTT can only order variations under s. 35 on very specific grounds. For example, one of the grounds is that the lease fails to make satisfactory provision for the recovery by one party to the lease from another party to it of expenditure incurred for the benefit of the other. Where, however, a landlord applied to vary leases to allow the recovery of a management charge on the basis that some leases in the block provided for the recovery of such a charge and others did not, the application was refused. The Upper Tribunal (George Bartlett QC, President) said that requiring all the lessees to pay for the landlord's managing agent would be of no benefit to the landlord: ***Cleary v Lakeside Developments Ltd*** **[2011] UKUT 264 (LC)**.

81. The Act also allows for variation of the service charge percentages in the leases but only if the aggregate of the service charges for the block do not add up to 100%. So where the service charges add up to 100% but the landlord adds an additional flat on the roof, the FTT would have no jurisdiction to amend the percentages of service charge payable. The same applies if there is a fixed apportionment between commercial and residential lessees, which the residential lessees believe is loaded against them.

82. The Tribunal must not make a variation where the variation would substantially prejudice any respondent to the application or any person who is not a party to the application and an award of monetary compensation would not be adequate. Again the power is discretionary, and the Tribunal can refuse an application where it would not be reasonable in all the circumstances: s.38.

Forfeiture

83. There are severe restrictions on forfeiture of residential leases:

84. Restriction on forfeiting for unpaid service charge or administration charge unless amount admitted or determined. Restriction applies to service of s.146 notice: **s.81 HA 1996:**

    i. Applies to "premises let as a dwelling"
    ii. Doesn't require long lease
    iii. Does exclude leases under Pt.II L&T Act 1954

85. A similar but more generally applicable restriction on service of a s.146 notice before determination (or admission) of breach was introduced by **s.168 CLARA 2002:**

    i. Applies where to a landlord "under a long lease of a dwelling"
    ii. Prohibits service of s.146 notice unless breach admitted or determined
    iii. Excludes leases under Pt.II of L&T Act 1954 (s.169(4))
    iv. Doesn't apply to non-payment of service charge/administration charge (s.169(7))

86. What about a conversion from commercial to residential in breach of covenant? 2002 Act does not say "*lawfully* let as a dwelling". It appears that in order to forfeit for such unlawful change of use, the s.168 procedure would have to be followed first.

Disposal of the landlord's interest in mixed use properties

Tenants' Rights of First Refusal

87. Part 1 of the Landlord and Tenant Act 1987 requires the landlord of a building containing flats and to which the Act applies to serve notice on the qualifying tenants of that building before entering into a contract to make a "relevant disposal".

88. It applies to premises if they consist of the whole or part of a building, they contain two or more flats held by qualifying tenants and the number of such flats exceeds 50% of the total number of flats contained in the premises.

89. The Act does not apply where:

    i any part or parts of the premises is or are occupied or intended to be occupied otherwise than for residential purposes; and

    ii the internal floor area of that part or those parts (taken together) exceeds 50 per cent. of the internal floor area of the premises (taken as a whole);

and for the purposes of this subsection the internal floor area of any common parts shall be disregarded.

Note the difference between 50% here and 25% in the similar provisions of the 1993 Act.

90. For the purposes of the Act, a "relevant disposal" refers to the disposal by the landlord of any estate or interest (**whether legal or equitable**) of any premises to which the Act applies, including the disposal of any such estate or interest in any common parts of the building. Disposal includes the surrender of a tenancy and the grant of an option or right of pre-emption. The most obvious disposal would be the sale of the freehold but the grant of a number of lesser interests such as a lease of the common parts would also be caught.
91. The grant of any tenancy under which the demised premises consist of a single flat is an exception and is not caught by the Act.

92. The landlord for the purposes of the Act is the person in relation to the premises consisting of the whole or part of a building who is the **immediate landlord** of the qualifying tenants of the flats contained in those premises.

93. A qualifying tenant ("QT") is a tenant of a flat. The term is much wider than for instance the 1993 Act as there is no requirement for the tenancy to be a "long" tenancy. The term includes sub-tenants and persons holding under an agreement for lease. It also includes a Rent Act 1977 statutory tenant but not an assured tenant – specific exclusion. But a tenant whose **landlord** is a QT of the flat cannot be a QT himself – there can only be one QT per flat. If a person is a tenant of 3 or more flats then he ceases to be the QT of any of them.

94. The notice served by the landlord must contain particulars of the principal terms of the disposal by the landlord and must state that the notice constitutes an offer by the landlord to enter into a contract on those terms, which may be accepted by the requisite majority (>50%) of the qualifying tenants of the constituent flats.

95. If no notice is served, the landlord may commit a criminal offence (s.10A). It seems to be common belief that no one has been prosecuted for this, but that has to be an unwise assumption especially with the rise of Solicitors specializing in private prosecution, and the personal criminal liability of directors under s.33.

What is a building?

96. Section 1(2) of the Act refers to a premises consisting of the whole or part of a building. Unfortunately the Act does not define a "building", so the first problem is what is a "building"? What on the face of it is a simple question is not so simple to answer.

97. "Building" may include the appurtenances of the building (***Denetower Limited v Toop* [1991] 1 WLR 945**). However, neither building nor appurtenance is defined.

Several buildings

98. Another problem, which has arisen in more than one case is what the landlord should do when he intends to dispose of several buildings on the same estate. The Act does not make adequate provision for this fairly common situation.

99. Although it might be more convenient to deal with the estate as a whole, the wording of the Act and older case law suggests that each building must be dealt with separately i.e. the landlord must sever the proposed transaction and serve a notice building by building. This can lead to problems in that the tenants of several blocks which share the same amenity space may have competing claims to appurtenant property such as gardens, roadways and paths.

100. This point was considered by Geoffrey Vos QC sitting as a Deputy High Court Judge (as he then was) in ***Long Acre Securities Ltd v Karet* ([2004] EWHC 442 (Ch), [2005] Ch. 61**. The case concerned four blocks of flats on a predominantly residential estate. The landlord wanted to dispose of his

leasehold interest in the whole estate, and served s. 5 offer notices on the residential tenants, treating all the blocks as though they were a single building. The tenants objected to the notice saying that the transaction should have been severed and that four forms of notice should have been served, one form for each block. The Deputy Judge held that, because the tenants of each flat were entitled to use the communal roadways and grounds, the same appurtenant premises, all four blocks should be regarded as a single building for the purposes of the Act.

Commercial Premises

101. A "disposal" is defined in s.4(1) as a disposal by "the landlord" of *any* estate or interest (legal or equitable) in premises to which the Act applies. "Disposal" is further defined in s.4(3) as the creation or transfer of an interest. Thus the grant of a lease is a form of disposal caught by the 1987 Act; see ss.4(1) and 4(3).

102. "Common parts" is partially defined in s.60 of the LTA 1987: "*common parts, in relation to any building or part of a building, includes the structure and exterior of that building or part and any common facilities within it*". Whilst not comprehensive, it extends the words to ensure that they include structure, exterior and common facilities.

103. The danger of a breach of the Act if a commercial unit includes any structure or exterior is obvious.

104. One presumes that the parliamentary intention behind Part 1 of the 1987 concerns "reversionary interests" which directly affect their flats and the rights/obligations arising under the flat leases and not "subsidiary" interests in other parts of the building.

105. Otherwise, it is unclear whether a lease of a commercial unit is a disposal for 1987 Act purposes. The problem is, there is no specific exclusion for commercial units, which contrasts with the express exclusion of leases of a single flat. Perhaps the draftsman thought that it was obvious that the disposal

of a commercial unit was nothing at all to do with the subject matter of the 1987 Act. The question is usually raised in the context of voluntary leases, but what about 1954 Act lease renewals. Does the 1987 Act not apparently require the residential lessees to have the right of first refusal over the new 1954 Act lease…???

106. Overlap with conflicting rights such as under this is avoided if the 1987 Act is construed such that a disposal of the lease of a commercial unit is not a disposal to which the Act applies.

Avoiding Part 1 of the 1987 Act

107. It is not possible to contract out of the Act. But: It is possible to arrange matters so that the Act does not apply. It is much easier to do this at the development stage than later on.

108. There is a solution to this conundrum which exploits the fact that a "relevant disposal" must be a disposal by "the landlord". If there is a head lease of the residential parts and a separate head lease of the commercial parts, then any disposition by the head lessee of the commercial parts will not be a disposal by "the landlord" which is defined as the immediate landlord of the QTs.

109. Common avoidance methods:

i. Act does not apply until there is a building containing flats held by QTs – if in shell form Act does not apply BUT see the recent decision in ***Aldford House*** as to what is a flat. It need not be finished!
ii. Before QTs are granted it is possible to put a lease structure in place i.e. a lease of all commercial parts (possibly including structure) which does not cover the residential flats – any disposal (by sub- lease) would not be by the QT's "landlord".
iii. Or a residential head-lease; which is the QT's landlord and thus leaves the freehold free for disposal
iv. Development constructed in such a way (no vertical division) that commercial elements form part of same building

v. Make disposal prior to completion/sale of flat leases – enter into contract/grant option is the relevant disposal (s4A and 4(3))

vi. Have in place a two-year associated company which can in the future acquire the interest and its shares sold and/or grant sub-leases

vi.. Create superior individual flat leases so that the persons disposing is no longer "landlord"

vii. Make use of the trust exemption (see below)

110. An exemption which has come under recent scrutiny is the "trustee" exemption:

> "(g) a disposal consisting of the transfer of an estate or interest held on trust for any person where the disposal is made in connection with the appointment of a new trustee or in connection with the discharge of any trustee."

111. ***Artist Court Collective v Khan*** **[2017] Ch 53.** It was held that this exemption extends to the termination of a trust; where the trustee / bare legal owner transfer the legal interest to a beneficial owner. Importantly, the first transaction in time was not simply a disposal of the beneficial interest; it was a transfer away of the legal interest on trust for [x]. That was a relevant disposal, but useless to the qualifying tenants as they would have become trustees. The legal interest was then transferred again to the beneficiary [x] (the transaction which was impugned unsuccessfully because of subsection (g)). This analysis was reached despite there being a declared price on transaction #1. This analysis seems to provide a clear route to emasculate the Act.

112. Very recently, two of the other exemptions were considered in, ***York House (Chelsea) Ltd v Thompson*** **[2019] EWHC 2203 (Ch):**

> (e) a disposal by way of gift to a member of the landlord's family or to a charity;…..
>
> (h) a disposal consisting of a transfer by two or more persons who are members of the same family either—
>
> (i) to fewer of their number, or
>
> (ii) to a different combination of members of the family (but one that includes at least one of the transferors);

113. The case involved the grant of leases by husband and wife joint landlords, to husband or wife, for no consideration. This was an avoidance scheme, intended to prevent valuable areas of the block being acquired by the tenants on enfranchisement. It was held that a "gift" could include the creation of an estate for no consideration as well as a transfer, and, of some general importance, that a lease could be granted for nil consideration / a gift notwithstanding the mutual covenants. It was also held that despite subsection (h) referring to a "transfer" rather than (wider) a "disposal", that a "transfer" in subsection (h) included a lease.

If one can dispose of leases without offending the 1987 Act, what about surviving enfranchisement?

114. We come full circle in the session, back to enfranchisement, courtesy of ***LM Homes v Queen Court Freehold*** **[2018] UKUT 367 (LC)**.

115. Note that the (partial) definition of "common parts" in s.101 of the Leasehold Reform Housing and Urban Development Act 1993 is the same as in s.60 of the 1987 Act, so if an internal area is a common part for the purposes of one Act it is likely to be a common for the other:

> "*common parts" in relation to any building or parts of a building includes the structure and exterior of that building or part and any common facilities within it*"

116. In ***Queen Court*** there were three relevant leases. To avoid the 1987 Act they were initially granted by the landlord to two-year associated companies, who then sold the leases to third parties. The second transaction was not a relevant disposal because the lessee company was not "the landlord". The qualifying tenants subsequently brought a collective claim and claimed the three leases, which was resisted by each of the third party holders of these interests.

117. The leases were: (1) airspace (2) basement plant room (3) subsoil.

118. Airspace: There is a lot of case law which has held airspace above a building to be part of the "exterior"; including notably the 1987 Act case of ***Dartmouth Court v Berisworth*** **[2008] P&CR 3 (Ch)** and the 1993 Act case of ***Merie bin Mahfouz UK v Barrie House Freehold*** **[2015] L&TR 21 (UT).** This line of authority was followed and applied.

119. Basement plant room: all of it was a common part because it included common plant, even though that plant and equipment was (as usual) excluded from the demise.

120. Subsoil: held not to be part of the building itself (query that, given the authority of ***City of Victoria v Bishop of Vancouver Island*** **[1921] 2 AC 324 (PC)** which was not cited in ***Gorst v Knight*** **[2018] L&TR 14 (Ch)**) but it was part of the "exterior", by analogy with ***Dartmouth Court***.

121. S.2(3) of the 1993 Act allows for the acquisition of a lease of common parts "…*where the acquisition of that interest is reasonably necessary for the proper management or maintenance of those common parts*…"

122. In respect of all three leases, the UT went on to hold that acquisition of the leasehold interests satisfied that test. A significant reason was that in each lease there was a very widely drawn, developer-friendly development right which would mean that the relevant areas ceased to be common parts after development. That was, no doubt, the raison d'etre of the three leases and the basis for their alleged value, but it had consequences for the right of acquisition. In the case of the boiler room, the plan was to restrict access to the boilers to a very tight little room accessible only through one door which would not permit replacement boilers to be brought in. The sub-soil was to be dug out to create three flats, which would entail the loss of outside planted areas which would be dug out into light wells.