Real Estate Visions

July 2021

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Contents

Introduction

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Welcome to our summer edition of Real Estate Visions, where we highlight key legal topics and trends shaping the real estate market.

The Covid-19 pandemic continues to dominate the headlines and to have a huge impact upon the real estate sector. In this edition our new Real Estate Disputes Partner, Jeremy Stephen, shares his thoughts on what the next twelve months may hold.

As we (hopefully) emerge from the pandemic, we look at options for corporate restructuring schemes in light of recent key cases on CVAs. But while some areas of the real estate market continue to suffer, the UK build-to-rent sector is seeing exponential growth and indications are that this is set to continue. Looking further ahead, the City of London Corporation has released its post-pandemic plans for re-generating the Square Mile.

With COP26 approaching at the end of this year, the UK Government has global climate change firmly on its agenda. What does this mean for commercial landlords and tenants – will we see a shift towards true 'green' leases?

National security threats are also on the government's radar. It recently passed the National Security and Investment Act 2021 which could have a serious impact upon real estate transactions. Cyber crime continues to grow and is an area of future risk for real estate assets as new technologies are incorporated into the built environment.

If you would like to discuss any of the topics covered in this edition, please speak to one of the contacts listed or one of our Clyde & Co real estate partners.

Emerging from the pandemic?

Future trends for the real estate sector

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We asked our new Real Estate Disputes Partner, Jeremy Stephen, to look ahead and give us his thoughts on what the next 12 months may hold for the real estate sector.

How do you think the real estate sector has weathered the pandemic?

It has been a period of time like no other. I remember standing outside Bank Station at 3pm on a Monday afternoon in the middle of April 2020 and not seeing another soul – which would never have entered our minds as even a remote possibility 24 months ago.

Yet despite all the immense changes and challenges brought on by various lockdowns, parts of the real estate sector have proved fairly resilient. The residential market has not only held up but grown – and transaction volumes in the commercial sector have increased significantly in the latter half of 2020 and onwards.

But the unprecedented intervention by the UK Government (including measures such as the restrictions on evictions, forfeiture and corporate insolvencies) has burdened the landlord and tenant sector with huge volumes of debt which, at present, there appears to be no 'grand plan' to resolve.

These measures have stored up a potential backlog of enforcement action that is going to have to be unravelled over the coming months.

How do you think the tenant debt pile is going to be dealt with?

When I first prepared this article only a couple of weeks ago, I suggested that further government intervention felt inevitable – and then lo and behold, the government intervened again.

Forfeiture for unpaid rent has been extended further – but what to my mind is the bigger news is what is going to happen to the Covid debt.

As is usual with the government's announcements, we will need to wait and see what the detail looks like. But on my reading of what has been published, it looks very much like commercial arrears debt relating to periods where premises were closed by order of the government may be exempt from enforcement.

The suggestion from the announcement is that such debts will be ringfenced and unless the parties can agree a settlement the issue will be decided by 'binding arbitration'. It appears that this binding arbitration will be the only mechanism by which a landlord may get its rent in the absence of agreement.

This is a truly astonishing intervention into the real estate sector by the government - and the true implications are not yet clear.

Will we see more insolvencies?

Our Reorganisation and Insolvency Team's article in this edition - CVAs still open for business: do tenants have another plan up their sleeve? – explains very well the significance of the rush of insolvency cases in the last quarter.

The end result is that we now know that the 'retail CVA' model, so unpopular amongst landlords, has been broadly approved by the courts. We can expect more of these without doubt – particularly as tenant occupier companies consider how to deal with their debt piles.

But I suspect that we will not just see tenant insolvencies. Landlords with high levels of arrears and their own debt will be facing a squeeze. I expect we will see lenders, albeit reluctantly, taking enforcement action over real estate assets that can no longer support high debt levels. This is likely to mean a rise in the appointment of fixed charge receivers over such assets, or where appropriate, the appointment of administrators over SPV landlord companies – depending on the debt profile and the ease of realising value in the real estate asset.

Emerging from the pandemic?

Future trends for the real estate sector

What are we likely to see in the lease renewal sphere?

I have to confess that I am quite excited to see what happens with lease renewals in the coming months and years.

We have already seen with the recent WH Smith decision on lease renewals that landlords and tenants can have wildly different views on rent levels in the post-Covid world. Real world comparables will be what produces compelling valuation evidence. Local knowledge of the market will be key and generalisations of nationwide trends may be less persuasive.

There has been lots of talk about turnover rent – but where will this actually lead? It is generally considered that the Landlord and Tenant Act 1954 does not really allow a court to award a turnover rent or, if it does, the machinery of the 1954 Act is not properly suited to the task.

Recently, the Government has again talked of the 1954 Act being reformed and it may be that we will see it updated to allow for more creative rent mechanisms to be awarded.

One valuation issue that I wonder if we will see being aired, particularly if turnover rents do take off, is how to value 'click-and-collect' traffic through retail stores. Many retailers were closed to trade in lockdown periods but were open for click-and-collect. Should those transactions be attributed to that store or were the sales merely attributable to the retailers' online business?

It is likely retailers have dealt with these matters differently – and it will be very interesting to see how this issue plays out.

CVAs still open for business

Do tenants have another plan up their sleeve?

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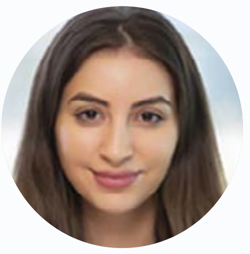

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In three recent key cases, the High Court has demonstrated its support for tenants' corporate rescue plans. Each case involved the compromise of landlord debt and the reduction of future rent. The direction of travel indicated by these decisions will be welcomed by tenants and we expect to see an increase in CVAs as we emerge from the Covid-19 pandemic.

'Landlord only' or 'retail' company voluntary arrangements (CVAs) have recently garnered attention as a tool to compromise the levels of rent that a company is required to pay – both in respect of arrears and future rent. The two high-profile and eagerly awaited CVA decisions in New Look and Regis have, in our view, cemented the role of CVAs in the retail and hospitality sectors, with landlords' concerns almost exclusively being rejected.

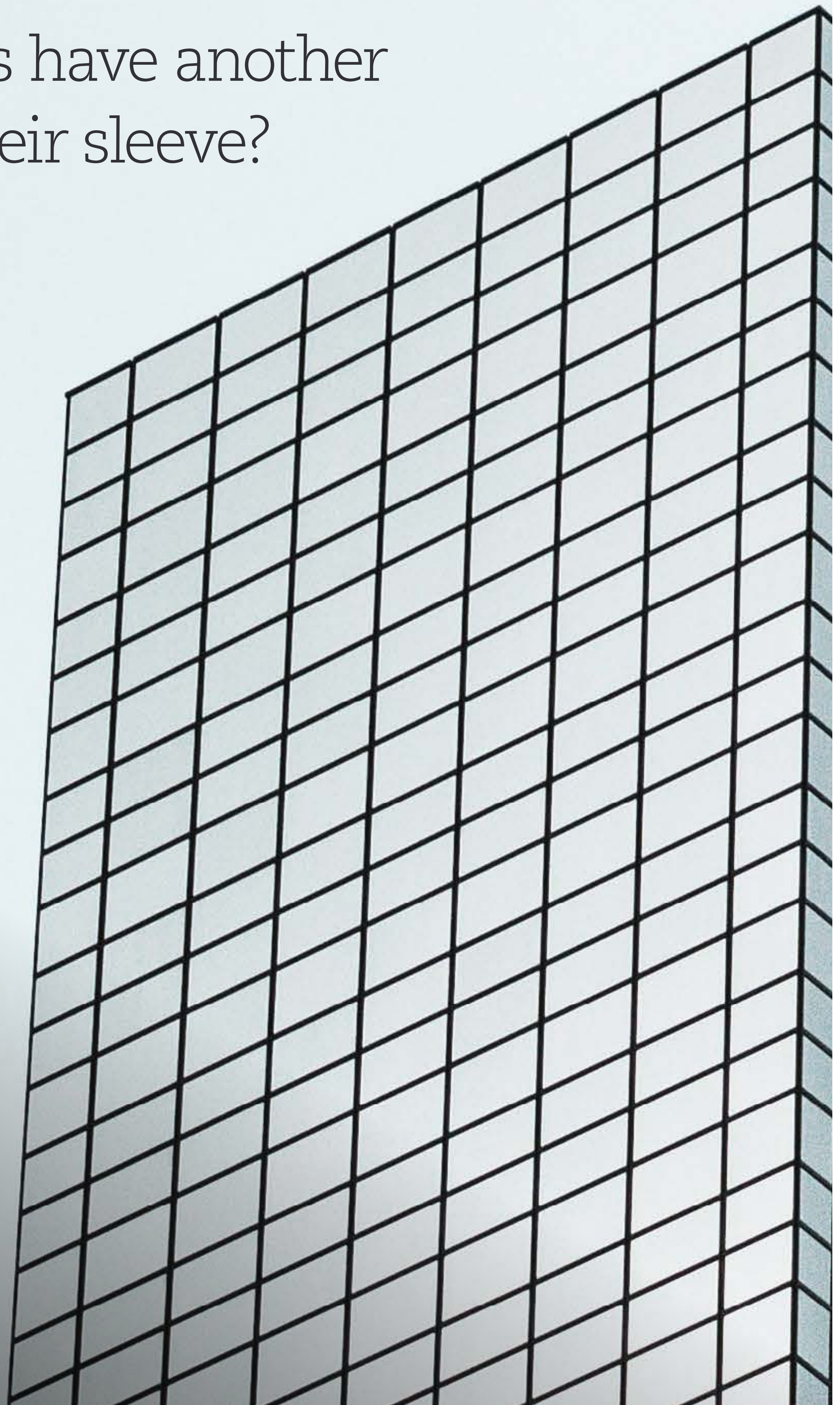
As an alternative to CVAs, the Corporate Governance and Insolvency Act 2000 introduced a 'restructuring plan'; a new restructuring tool constituting an arrangement between a company and its stakeholders to reduce or restructure liabilities.

In tandem with the CVA decisions, Virgin Active was a landmark decision in which the court sanctioned the Virgin Active group's restructuring plans despite strong objections from landlords.

As a result of all three decisions, landlords are encouraged to engage with insolvent tenants early and constructively, with arguments of unfairness largely being overlooked in lieu of preserving the debtor's business.

CVAs still open for business

Do tenants have another plan up their sleeve?



Lazari Properties 2 Limited and others v New Look Retailers Limited, Butters and another [2021] EWHC 1209 (Ch)

New Look entered into a CVA in September 2020, which reduced rent payable on its stores by moving, in the majority of cases, to a turnover based rent. In addition, following an earlier decision in Re Debenhams, compromised landlords were given lease termination rights. A group of landlords challenged the CVA on grounds of material irregularity and unfair prejudice. The High Court found in favour of New Look by rejecting all the landlords' points of challenge.

On material irregularity, the court rejected the landlords' arguments that not enough details around the company's restructuring were disclosed and that an unpopular discount on landlord votes was applied to their claims in order to approve the CVA.

On unfair prejudice, the landlords argued that using votes of unimpaired creditors to pass the CVA was unfairly prejudicial. Whilst he did not set a determinative test, the judge stated that fairness depends on four main factors which New Look was able to satisfy.

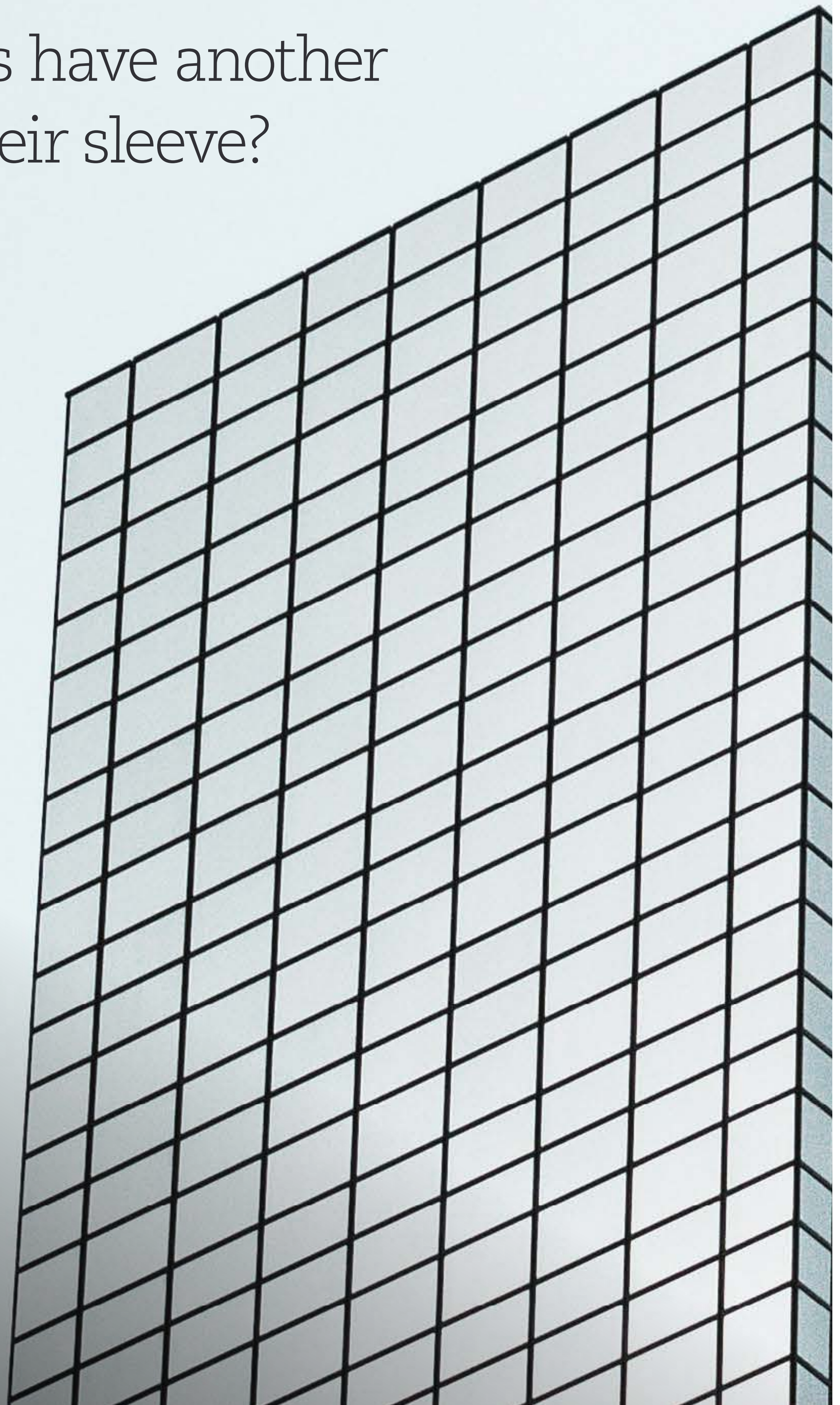
The landlords also claimed that lease modifications imposed on landlords – such as the move to 'turnover only' rents and imposing terms beyond the CVA duration – were inherently unfair. The court held that any potential prejudice was adequately addressed by offering the landlords lease termination rights (provided that the terms offered for the notice period were better than those the landlord would receive in an administration or liquidation).

Interestingly, the judge maintained that the decision in the Debenhams CVA that a CVA should not compromise rent to below market rent, or should only compromise to the extent necessary, was not a 'rigid' rule on the fairness of lease modifications.

This decision has helpfully clarified the position with respect to the disputed fairness of certain provisions and terms that have long been imposed by companies in their CVA proposals yet remained exposed to challenge. Companies considering their restructuring options now have more certainty as to what CVA proposals can or cannot seek to do.

CVAs still open for business

Do tenants have another plan up their sleeve?



Carraway Guildford (Nominee A) Ltd and others v Regis UK Ltd (in administration), Williams and another [2021] EWHC [1294] (Ch)

Regis entered into a CVA in October 2018 that reduced the rent payable on its hairdressing and beauty salons. Landlords were given new, albeit limited, termination rights. The CVA was approved with the assistance of votes of Regis' parent company and a former parent company in their capacity as creditors of Regis under two inter-company loans. The CVA provided that the claims under those loans were to be left unimpaired. A group of landlords raised a challenge against Regis and the nominees/supervisors of its CVA on grounds of unfair prejudice and material irregularity.

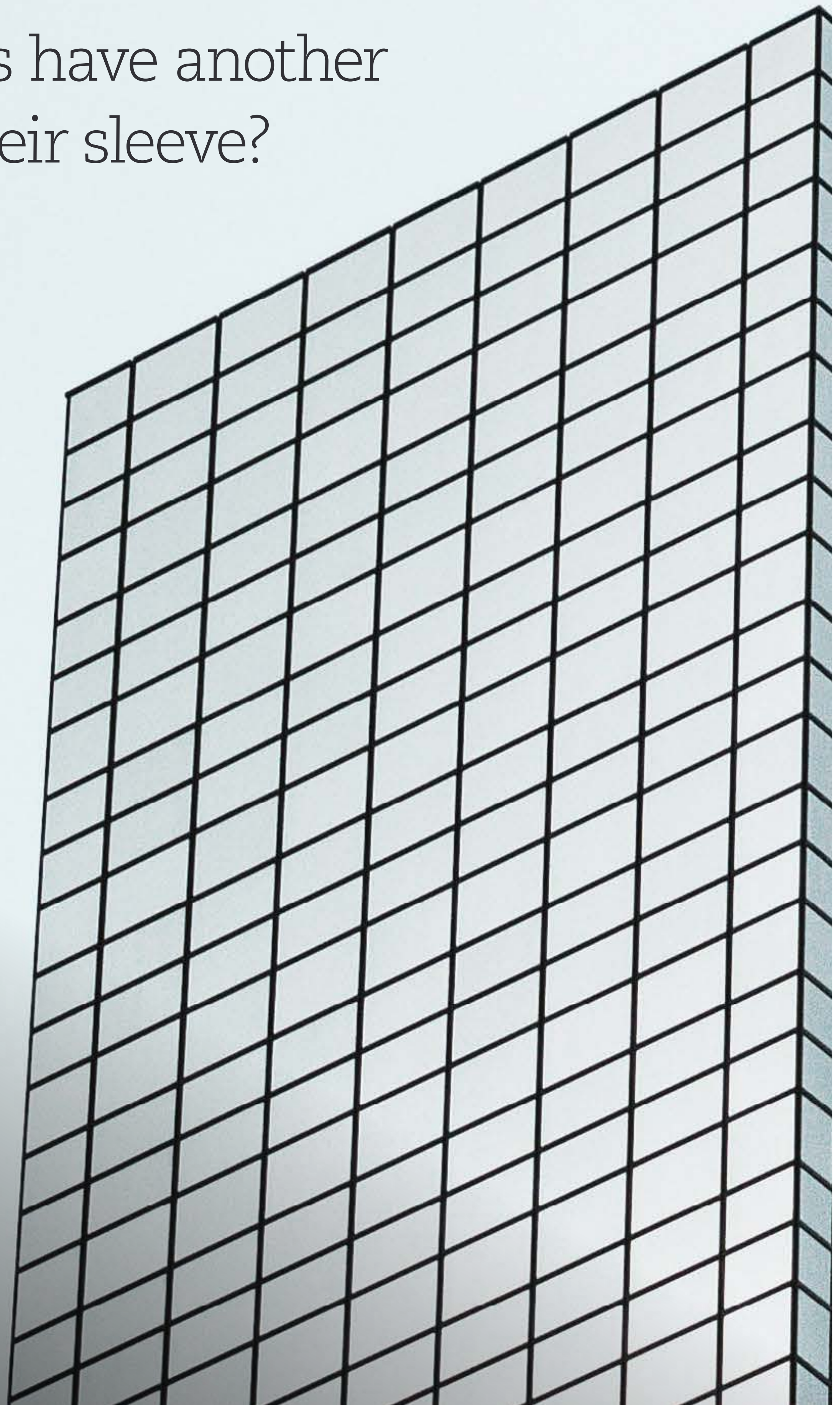
Adopting the same reasoning as in New Look, the High Court dismissed the landlords' challenges on grounds of unfair prejudice, save for one discrete ground relating to the treatment of the inter-company loans, which resulted in the revocation of the CVA.

The court held that the treatment of Regis' parent company as a 'critical creditor' leaving it largely unimpaired (whilst others were treated as impaired) was unfairly prejudicial to the landlords because the creditor in question would be supported by its ultimate shareholder, who stood to gain from the CVA.

On the reduction in rent, the court found that the grant of new termination rights to the landlords would mitigate any potential prejudice in the reduction of rents.

Landlords' arguments on material irregularity were rejected either on the basis that there was no irregularity, or that any possible irregularity was not material.

Despite the 'headline' outcome that the CVA was revoked, since the CVA terminated in late 2019 the revocation finding will have no practical effect. More significantly, the court rejected the landlords' other arguments and the decision largely reaffirmed the approach adopted in New Look.



CVAs still open for business

Do tenants have another plan up their sleeve?

Virgin Active Holdings Ltd & Ors, Re [2021] EWHC 1246 (Ch)

A restructuring plan, introduced under the Corporate Insolvency and Governance Act 2020, is very similar to the existing 'scheme of arrangement' regime, with stakeholders split into different classes in respect of voting and their treatment under the arrangement. However, a restructuring plan allows for 'cross-class cram down', which is a mechanism that binds dissenting classes of stakeholders if the requirements described below are met.

Three companies within the Virgin Active group launched plans to restructure their liabilities owed to seven classes of creditors, including landlords who were split into classes A – F. Landlords were treated either more or less favourably, based upon which leases of club premises the companies wished to retain.

A group of landlords strongly opposed the restructuring plans and the Virgin companies failed to obtain votes in favour from 75% in value of creditors in the majority of creditor classes. The court was therefore asked by the companies to exercise its discretion to sanction the plans using the cross-class cram down mechanism.

Two conditions had to be met:

- none of the dissenting class would be any worse off than they would be in event of the relevant alternative (i.e. administration); and
- the plan had been approved by at least one class of creditors who would have had a genuine economic interest in the relevant alternative.

The High Court sanctioned the plans.

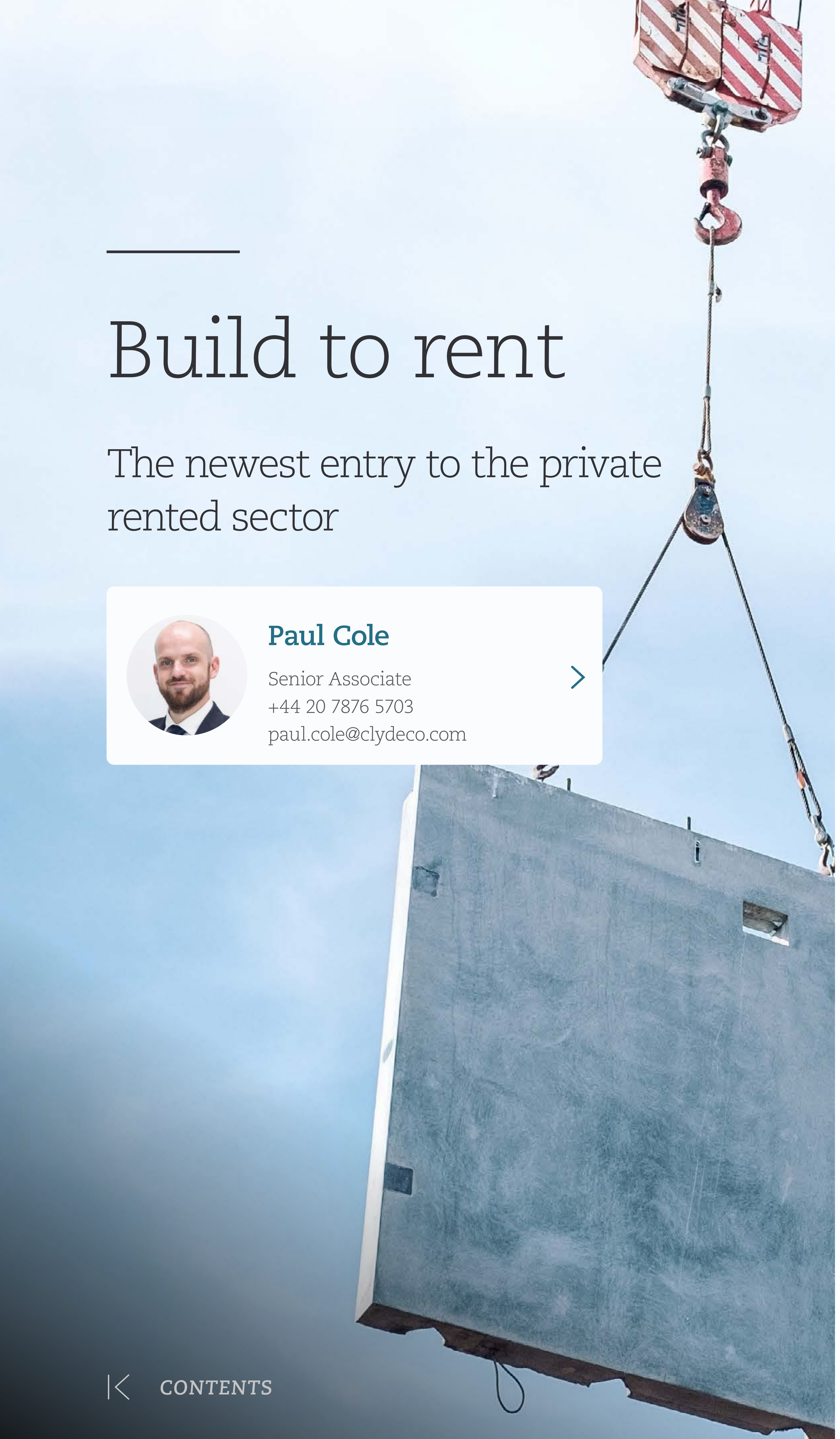
A key factor in the court's reasoning was that the secured lenders and the "Class A" landlords voted overwhelmingly in favour of the plans. It was determined that the return to all creditors under the plans would be higher than in an administration.

Whilst a restructuring plan is presently unlikely to be the tool of choice for smaller and medium sized businesses (where CVAs will continue to play a significant role due principally to cost), this landmark decision is likely to set the scene for larger companies seeking to restructure their leasehold liabilities and is yet another watershed event in the ongoing landlord-tenant battle.

Where does this leave us?

These three cases significantly confine the circumstances of challenge and confrontation. Instead, more often than not, landlords and tenants should work together to find a consensual solution to enable both sides to navigate the months and years ahead as we exit the worst of the Covid-19 pandemic and plan for the future.

Clyde & Co has worked on a number of significant transactions within this fast-moving sector over recent months, so for help with any question about restructuring your landlord debts please contact our Reorganisation and Insolvency Team.



Build to rent

The newest entry to the private rented sector

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Build to Rent (BTR) is the newest entry to the private rental sector (PRS), and it is growing exponentially.

Other real estate markets have suffered as a result of the global pandemic, but the UK BTR sector has continued to grow, with Q3 of 2020 seeing a record £1.84 billion invested in the sector, and experts predicting that this growth will continue.

Factors behind this impressive growth include:

- The desire by consumers to live in safe, secure, high-specification properties in dynamic locations, close to key infrastructure and job opportunities.
- A surge in house prices in recent decades, not matched by salary increases, causing a shift from home ownership to private rented occupation; and
- UK Government schemes to promote development within the sector (eg the £3.5 billion PRS Housing Guarantee scheme), underpinned by a national housing supply shortage.

These facts and figures reveal a fast-moving and fast-changing sector. Below, we explore developments in the structure of deals in the sector and discuss what we expect for BTR in 2021 and beyond.

Developments in BTR structures

As with all real estate sectors, there is no one fixed model: the structure of a BTR transaction often depends on the nature of the asset (eg is it pre-development, mid-development, stabilised, etc), as well as the status and intentions of the parties. Below, we discuss some of the most common transaction models.

Direct acquisition of stabilised assets

As the BTR market matures, investors are starting to identify the existence of stabilised, fully developed BTR schemes which are fully (or substantially) let and managed by an incumbent operator. Larger players may invest in a portfolio or even a platform including a BTR operator.

Forward funding

Investors with greater risk appetite and/or seeking more attractive returns are entering higher up the risk curve, by buying into projects at the beginning of the development phase.

In a forward funding model, the investor will buy the land up front from a developer. Following a development agreement between the parties, the developer will then develop out the scheme in accordance with the agreement, the planning permission and an agreed specification.

The investor will fund the development, usually by reimbursing the developer for actual construction costs incurred, on a periodic basis (eg monthly). Developers are usually obliged to report to the investor on a regular basis and to provide detailed invoices and other evidence of expenditure. Investors will often employ their own monitoring surveyor to oversee the development.

The investor's financial commitment to the project will usually be subject to a maximum cap. The developer will typically receive funding up to a pre-agreed percentage of that maximum, with a profit payment of the balance payable on completion of the build, based on the commercial terms of the deal.

Forward sales

As with the forward funding model, the investor receives a scheme constructed by a developer in accordance with an agreed specification. However, the land remains in the ownership of the developer throughout the build phase and is transferred to the investor only when the development is complete. This means less risk for the investor, but generally the tax position is less advantageous: the investor has to pay stamp duty land tax (SDLT) on the land value including the development (as opposed to forward funding where SDLT is payable on the bare site value only).

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The newest entry to the private rented sector

Joint ventures and partnerships

As the BTR sector grows, developers, investors and/or local authorities are partnering up to ensure a pipeline of supply and opportunities, with developers utilising their site-finding and development skills to attract investors and local authorities, who bring the capital to fund projects.

Hot topics in BTR for 2021 and beyond

Compliance: safety standards

Following the Grenfell Tower tragedy and other recent events, the government has introduced a number of safety regulations in quick succession, including cladding requirements, more-frequent electrical tests, and reducing the minimum height threshold for buildings required to have fire sprinklers.

The signs are that the government will continue to monitor residential developments and regulate where necessary. For example, in early 2021 the government issued a consultation for the proposal that all new-build residential homes (including BTR) must reach certain low carbon and energy efficiency requirements by 2030, with interim targets for 2025.

Developers and investors will need to monitor construction and health and safety legislation and should factor any relevant costs into their appraisals. Owners will also need to ensure they (or their operators) monitor and take steps to comply with all ongoing requirements.

This increase in compliance and legislation may result in a faster shift from older PRS buildings to BTR.

Taxation: a new tax on residential property developers

In April 2021 the government opened a *Consultation on a new residential property developer tax*, aimed at taxing the largest residential property developers (ie those with profits exceeding £25m), with the specific intention of helping cover the cost of cladding remediation work following the Grenfell Tower tragedy.

The consultation remains open and the proposals are thin on detail (including the specific rate of tax and exemptions), but if approved the tax (which will capture the BTR sector) will be introduced during 2022.

Political factors: ensuring housing supply and protecting the vulnerable

In recent years, the government has consulted on abolishing landlord powers under section 21 of the Housing Act 1988 (which currently allows landlords to evict tenants for 'no fault' grounds), and in Scotland on rent controls. Whilst these proposals appear to have been dismissed or put on the back burner by the government, their existence highlights the fact that the sector remains subject to lobbying from groups seeking to protect tenants' rights and to potential change.

A fast-paced sector

Clyde & Co has worked on a number of significant transactions within this fast-moving sector over the past 15 months. We anticipate that the BTR market will remain buoyant and that the sophistication of the deals will continue to develop. Growth areas to watch are suburban schemes and greater regional spread.

Saving 'The City'

A blueprint for post-pandemic recovery?

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There is no doubt that the COVID-19 pandemic has accelerated changes to urban centres. City-dwellers have moved out to suburban spaces and offices sit vacant as companies have had to embrace working from home. The City of London has been particularly affected by these changes.

Now, the City of London Corporation (the Corporation) wants to turn the page on the pandemic. It has published a new report laying out the Corporation's post pandemic vision for the City. The Square Mile: Future City sets out the Corporation's five-year action plan to regenerate the Square Mile and make it the world's 'most inclusive, innovative and sustainable business ecosystem'.

What is being proposed?

The Report's proposals span three core dimensions, each of which the Corporation considers key to the success of the Square Mile as a global business centre. These are the provision in the Square Mile of: (i) an innovative ecosystem; (ii) a vibrant offer; and (iii) outstanding environments.

The Report makes a number of proposals but the most significant of these include:

- Exploring new ways to use vacant space and the target of at least 1,500 new residential units by 2030;
- Working to develop sustainable, flexible and adaptable buildings which provide opportunities for culture, retail, hospitality and start-ups;
- Accelerating plans to improve the experience of walking by increasing the number of pedestrian priority streets and widening pavements;
- Accelerating the cycle network delivery and providing additional cycle parking;
- Working with providers and operators to future-proof the City's communications, energy and transport infrastructure;
- Providing new and improved public spaces that include opportunities for culture and exercise;
- Curating a portfolio of high-potential tech-led businesses; and
- Introducing traffic-free weekends in summer or 'all-night celebrations'.

How could all this be achieved?

The Report sets out the Corporation's five-year vision for the regeneration of the Square Mile, but it is relatively light on how this will be achieved.

Most notably, although the Report sets an ambition to deliver at least 1,500 new residential units by 2030, it is silent on how these homes will be delivered. Both the Corporation's adopted and emerging local plans seek to retain and protect existing office stock in the Square Mile. Further, residential development is only allowed in specific allocated sites within the Square Mile. These policies could restrict the Corporation's ability to achieve the residential growth identified in the Report. The Corporation's consultation on its emerging local plan closed on 10 May 2021, with consultation responses now being assessed. It is possible that policies in the emerging local plan relating to protection of existing office space and the restriction of residential development in certain locations will be revisited to support the Corporation's ambitions identified in the Report. However, the emerging local plan is fairly advanced, so it seems unlikely that the Corporation will make fundamental changes at this relatively late stage. If this does turn out to be the case, there will inevitably be a tension between the policies in the emerging local plan and delivery of the aims set out in the Report, particularly the Corporation's aspiration to deliver additional homes.

Saving 'The City'

A blueprint for post-pandemic recovery?

A further ambition is the innovative use of vacant space to develop sustainable, flexible and adaptable buildings which provide opportunities for culture, retail, hospitality and start-ups. Changes to the Town and Country Planning Use Classes Order 1987 (as amended), which came into effect on 1 September 2020 last year could greatly assist with achieving this ambition. The creation of a new Class E (commercial, business and service uses) covers shops, restaurants, professional services, gyms, healthcare, nurseries, offices, and light industrial units. Crucially, conversion between these different kinds of use no longer requires planning permission. This gives businesses and landlords unprecedented flexibility and opportunity on how vacant space can be used and readily adapted to cater to different uses without requiring planning permission.

Finally, the Report places particular emphasis on the delivery of excellent public space and improved sustainable transport infrastructure. Again, it is likely that the planning system can help the Corporation fulfil these ambitions. Developer contributions and obligations on new developments (eg under s106 agreements) may be utilised to, for example, achieve delivery of cycle parking spaces, seek contributions towards improvements to the cycle network and pedestrianisation of streets, and provision of public space.

A blueprint for post-pandemic regeneration?

Even though the Report is light on detail and its proposals remain subject to consultation and further debate, the Corporation has already set up a Recovery Taskforce to implement the Report. At a time when many urban centres across the country will themselves be grappling with how to recover and make best use of their city centres in a post-pandemic world, the implementation of the Report's objectives – particularly use of the planning system to deliver outcomes – may well serve as a blueprint for innovative regeneration in other cities, not just London.

Commercial 'green' leases

A new green era?

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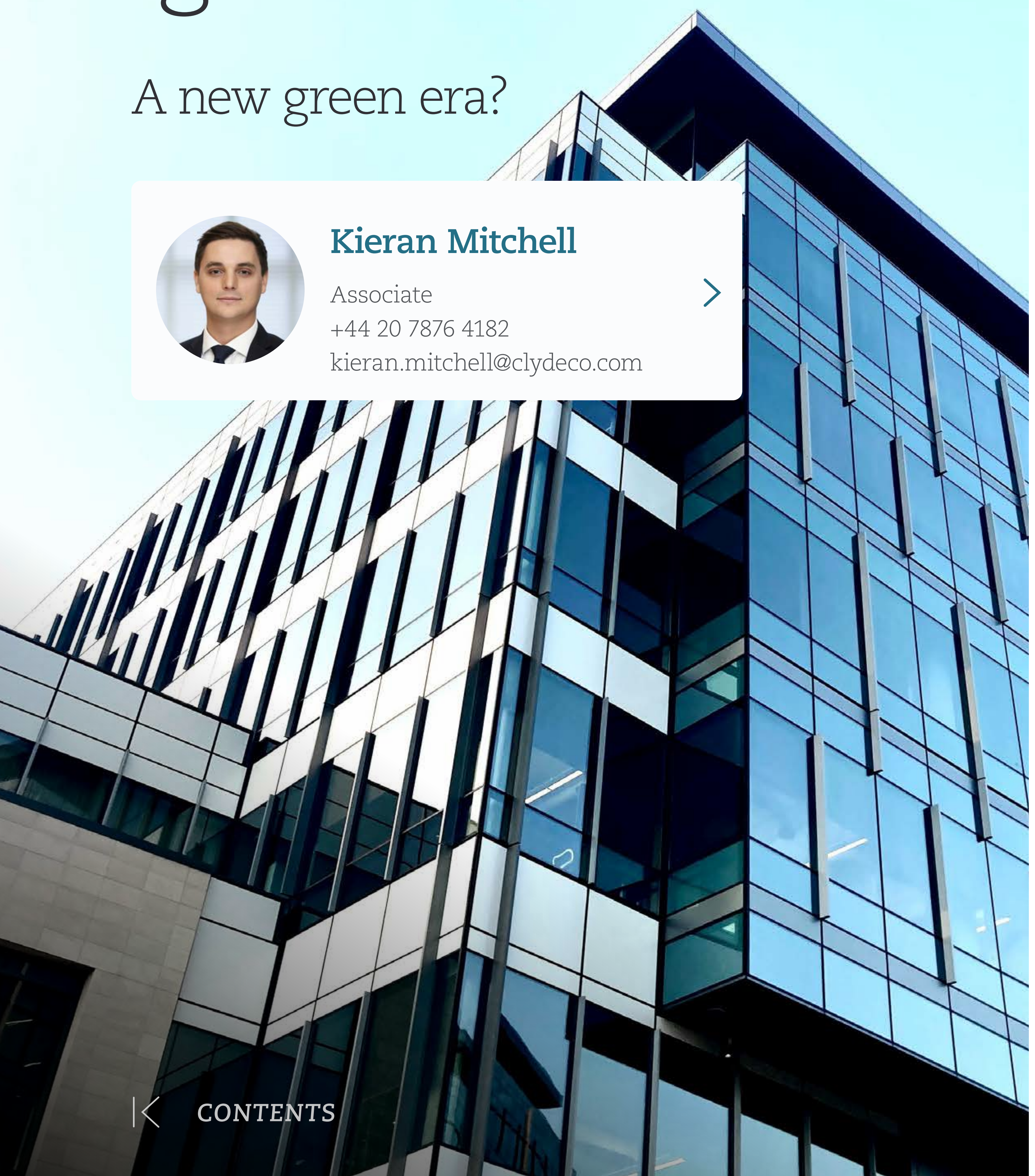


We are all well versed in the pitfalls of diesel cars, the need to separate our plastic from our paper and even the environmental benefits of choosing the vegan option at lunch, but it may come as a surprise to learn that carbon emissions from homes, commercial and public buildings account for almost one-fifth of the UK's total greenhouse gas emissions. But in commercial leases, to date, there has been limited market appetite for 'green' lease provisions.

The UK Government recently announced that its ambitious target of reducing carbon emissions by 78 per cent by 2035 will be enshrined in law. Now is the time for the real estate industry to play its part in achieving a dramatic reduction in carbon emissions from the built environment. Commercial lease provisions can be used to help tackle climate change and we are beginning to see a greater demand from landlords and occupational tenants for greener leases.

Below, we explore what is driving this change in attitude and what 'green' lease provisions may look like in the future.

Tougher minimum energy efficiency standards (MEES) on the horizon

In last year's *Energy White Paper*, the government confirmed that the future trajectory for the non-domestic MEES will be a mandatory EPC B rating by 2030 (subject to permitted exemptions) and it recently consulted on how this target should be implemented. The government's response is expected later this year but the current proposal is for all 1.8 million non-domestic properties in England and Wales to achieve a minimum EPC C rating by 2027, followed by a three-year transition period to a minimum B rating by 2030.

The government also plans to improve the compliance and enforcement process for the EPC B rating requirement by assisting local authority enforcement and tightening exemptions.

With the legislative direction of travel on MEES clear, we can expect to see landlords including provisions in leases to help them meet energy performance targets for their buildings and to pass on or share the burden of compliance with tenants. Examples of these include:

Improving energy performance

It is already usual for leases to include an obligation for tenants to comply with environmental legislation and sometimes also to take reasonable steps to comply with regulations that the landlord may set for the enhancement of environmental performance of the premises. But there is a notable move towards more positive obligations on both landlords and tenants to actively seek out steps to improve energy performance.

These types of obligation can be difficult to enforce, but the risk of being in breach of the lease covenants together with reputational considerations may encourage parties to adopt a proactive approach. Examples include requirements for parties to share environmental data and consult with each other on ways to improve energy performance throughout the lease term.

Alterations

Leases already often prohibit tenants from making alterations that adversely affect the EPC rating, but as the level of MEES increase so too will the burden on tenants to ensure that any plant they install meets higher energy efficiency criteria.

Landlords will need to assess more closely the impact on energy efficiency when considering tenants' alteration consent applications. They may also consider permitting certain tenants' alterations that improve energy efficiency without formal consent – removing obstacles to tenants seeking to make energy efficient improvements themselves.

Commercial ‘green’ leases

A new green era?

Green practices

A building’s energy efficiency is assessed on far more than its level of carbon emissions. If the real estate industry is to contribute fully to the government’s target of net-zero carbon emissions by 2050, leases in the future may need to place positive obligations on tenants to promote and implement specific green practices, eg requirements to minimise waste and water consumption; adhere to recycling policies; and to promote green travel to and from the premises (for example, through the provision of bicycle stations). In return, landlords may be expected to deliver services in a green manner; actively seek to reduce energy consumption in any common areas; and provide appropriate facilities to accommodate green initiatives (such as recycling stations).

Reducing waste and ‘future-proofing’ the built environment

New lease terms generally remain between five and ten years, during which period substantial fitting out works and reinstatement programmes may be required. With the increased awareness around the need to ‘future-proof’ our buildings, lease provisions may begin to target indirect carbon output and the need to reduce waste.

Clyde & Co has been involved with the Chancery Lane Project - a forum for lawyers to discuss climate-conscious issues and work collaboratively to create new model clauses for contracts, including leases, which promote a net zero carbon future. The Project has recently published model ‘Sustainable and Circular Economy’ provisions to encourage landlords and tenants to re-use goods and materials to reduce waste. Green leases in the future may require parties to carry out repairs, decoration and maintenance with repurposed, reclaimed or recycled materials or, failing that, with materials that are sustainably sourced.

Landlords could also consider waiving reinstatement obligations where items could be repurposed for future lettings.

Despite the increased financial burden that obligations such as these place on the parties, there appears to be a growing acceptance of shared responsibility in achieving the net-zero carbon goal.

Offsetting

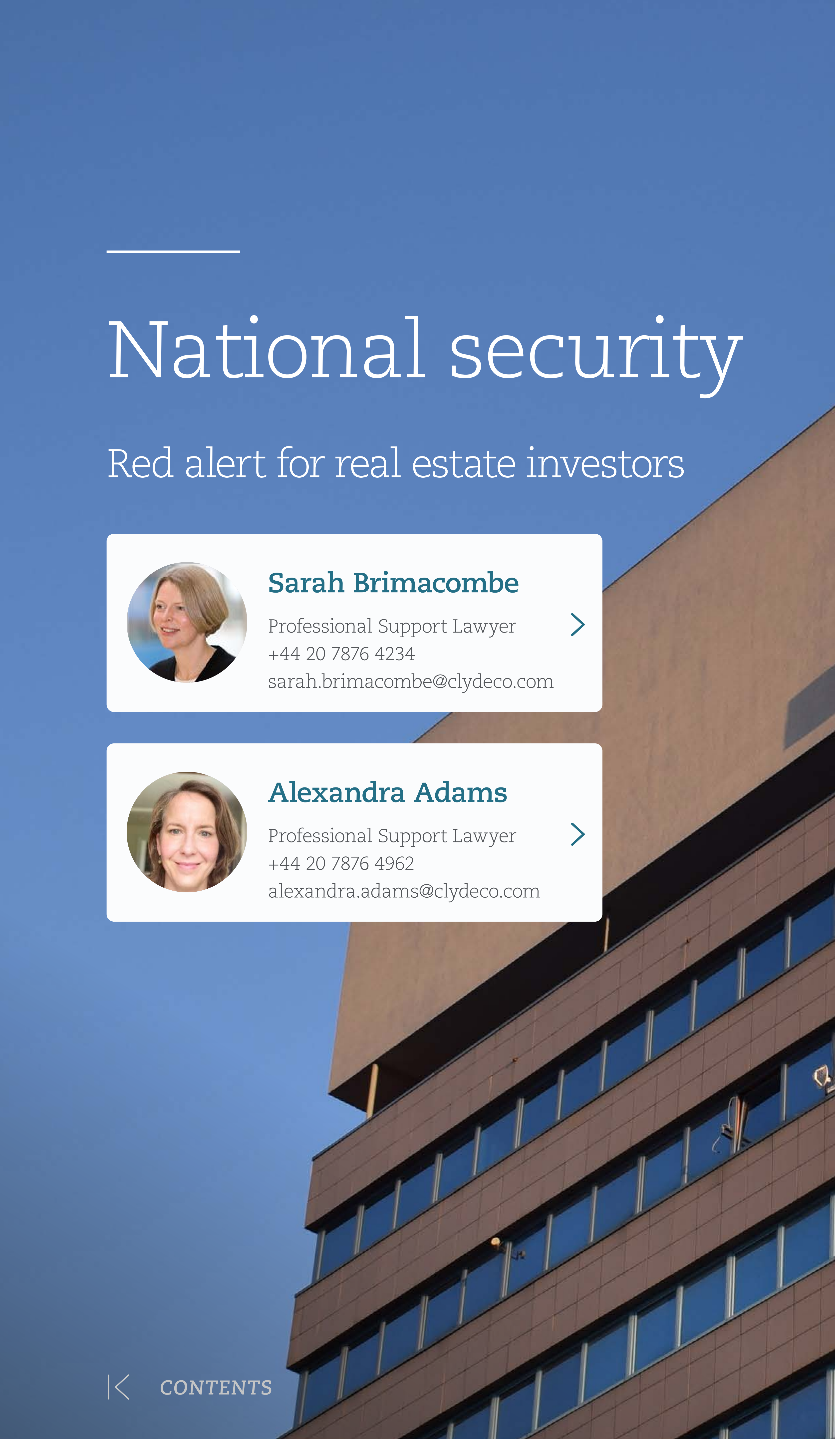
It may take some time for the property industry to react to legislative changes, such as the proposed tougher MEES regulations. Many organisations are looking to boost their green credentials and ESG performance immediately. One option is to implement offsetting strategies to tackle their existing carbon footprint. Companies such as BrewDog and Nando’s have made well-publicised inroads to becoming net-zero operations, with the former even boasting carbon-negative status.

It is quite possible that landlords will view offsetting as a short-term fix whilst they implement plans for long-term energy improvements to their portfolios. As it is tenant occupiers who are responsible for a large proportion of a building’s emissions, landlords may seek to recover offsetting costs via the service charge in a similar way to which they operate sinking funds or charge back promotional costs.

The idea goes to the concept of social responsibility of all interested parties in promoting a greener environment for the benefit of the wider community, regardless of the additional financial burden.

A new green era

As an industry and as a country we are rapidly becoming more aware of the environmental impact of our practices and the era of green leases is upon us. The future, it would seem, is green.



National security

Red alert for real estate investors

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The National Security and Investment Act 2021 (the Act) received Royal Assent at the end of April and heralds the introduction of a new regime in the UK for screening investments on national security grounds.

The advent of the Act is not surprising – it replaces decades-old screening powers at a time when the UK faces a growing range of national security threats – but the reach of the Act is.

The Act introduces a mandatory and voluntary notification regime for investors and gives the Secretary of State 'call-in' powers over certain transactions to undergo national security assessment. The Act catches investment by overseas and UK investors in both UK and certain non-UK entities. It also captures investment in assets, including land. The Act does not include a definition of 'national security', a de minimis threshold for transactions nor a list of exempt acquisitions. Indeed, much of the detail of the Act remains to be filled in by regulations and guidance that are currently only in draft form, and yet the Act is effective now and could have a serious impact upon real estate transactions.

Mandatory notification

Investors acquiring control (i.e. shares or voting rights exceeding defined thresholds) in entities (companies, LLPs, trusts) operating in seventeen 'sensitive' sectors of the economy (including energy, transport, communications, data infrastructure, defence, artificial intelligence and other tech-related sectors) must notify the government in advance and may not complete the transaction until clearance is given.

There are hefty penalties for non-compliance. If no notification is given, the transaction will be void and the acquirer will face significant financial penalties (up to the higher of £10 million or five per cent of turnover) and/or a prison sentence.

This mandatory notification regime is not yet in force. Secondary legislation, which will provide further detail, is awaited. However, acquisitions of assets (as opposed to corporate acquisitions) will not fall within the mandatory regime so pure land deals will not be subject to mandatory notification.

The call-in regime

A wider range of transactions may be called in for review by the Secretary of State, either before or after completion. This includes the acquisition of control in an entity (not already within the scope of the mandatory notification regime) or the acquisition of assets (including land) if the acquisition has given rise to, or may give rise to, a risk to national security.

The Secretary of State may exercise this call-in powerup to six months after becoming aware of the acquisition, provided this is within five years of the acquisition.

Voluntary notification

Where there is a risk of call-in by the Secretary of State, investors may wish to voluntarily notify an acquisition of an entity (which is not within the mandatory notification regime) or an asset (including land) to remove any uncertainty about whether the transaction does indeed pose a national security risk. Investors are invited to do this by contacting investment.screening@beis.gov.uk.

National security

Red alert for real estate investors

What happens if a transaction is reviewed under the NSI regime?

If a transaction is reviewed under the regime, even where no national security risk is ultimately found, there will be a significant impact on the deal timetable. Following a notification (mandatory or voluntary), the Secretary of State will have a maximum of 30 working days to decide whether to call in a transaction to scrutinise it for national security concerns. A full national security assessment could take up to 105 working days (or longer in certain circumstances).

If the transaction is deemed to be a national security risk, the government will have the power to impose conditions on the transaction and, as a last resort, block or unwind it.

How often will the new regime affect real estate deals?

The reality is that very few real estate deals are likely to be called in for a full national security assessment and even fewer will be deemed to be a national security risk – each year across the whole economy, the government expects 75-90 transactions to be called in for further assessment and ten deals per year to require remedies.

The UK Government's draft Statement of Policy Intent (published alongside the draft Bill) on how it expects to exercise the call-in powers, indicates that land is generally only expected to be an asset of national security interest where it is, or is proximate to, a sensitive site. However, it does not define what 'proximate' means (although in the US, it means one mile). The Statement of Policy Intent also provides that the Secretary of State may take into account the intended use of land (presumably, when assessing the sensitivity of a site). Despite this guidance, many real estate deals could be caught by the new regime and so could need to be notified.

Examples could include:

- Acquisitions of an entity operating in the 17 sensitive sectors, involving real estate assets integral to that entity's activities (e.g a company which owns or operates certain data infrastructure, energy infrastructure (such as energy terminals, gas and petroleum pipelines or storage), or public electronic communications networks/services).
- Land acquisitions close to a 'sensitive site' (e.g. a purchase of a piece of land or building adjacent to a sensitive government building such as a Ministry of Defence facility or critical national infrastructure, depending also upon the assessment of the potential national security risk posed by the purchaser).
- The purchase or lease of a sensitive site (e.g land with significant telecommunications equipment, or an electricity substation on site). It would seem unlikely that the government intends to capture this type of lease but this is still an unknown, although we hope further guidance will clarify this.

What does this mean for those who are making real estate deals happen?

Assessing the risk of the regime applying and mitigating for the uncertainty created by its potential application are a big part of the puzzle.

From now on, agents and buyers should routinely be asking whether land is, or is proximate to, a sensitive site and whether target businesses operate in one of the 17 sensitive sectors. Corporate sellers may need to be prepared to warrant this information. Where there is a risk that the regime does apply, legal advisors may need to carry out due diligence on neighbouring sites to establish the owner. Buyers should consider voluntary notification and including an NSI regime condition precedent in the transaction documents, with a suitable long stop date.

The evolution of cyber risks in the real estate industry

Future risks

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Perceived wisdom dictates that technological advancement follows an exponential growth curve. Twenty years ago, only those at the cutting edge of technology could have anticipated the extent to which technology has embedded itself in our built environment. Astute developers, investors and occupiers will have a keen eye on the next generation of technology, but they will need an equally keen understanding of the cyber risks that are inherent in those advances and how they can be mitigated.

Smart Places

In April 2020, Forbes published a list of 25 Technology Trends that would define the next decade. Of particular significance for the real estate industry was (at number 2) The Internet of Things (IoT) and (at number 5) Intelligent Spaces and Smart Places. In fact, both of those trends are inherently linked. The IoT is the concept of connecting physical objects embedded with technology to the internet to enable them to connect with other devices and share data over the network without any human input.

The IoT enables Smart Places to operate: from smart homes, to smart offices, to smart cities.

- **Smart homes** connect and operate domestic devices including thermostats, lights, security systems and even kitchen appliances. Smart fridges are a good example and are already available on the domestic market. They can shop groceries, track expiry dates and provide recipes.
- **Smart offices** enable people to work better and more efficiently and reduce operational carbon. They can inform decisions around optimising space, provide increased connectivity and reduce menial tasks to (so the theory goes) foster greater creativity and innovation.
- **Smart Cities** brings together multiple strands of technology to improve the functionality and the efficiency of towns and cities. By constantly monitoring and processing data they can, for example, reduce traffic congestion, streamline refuse collections, control lighting and even improve the air quality.

IoT networks are becoming increasingly vulnerable due to increased online connectivity, weak security design and the spread of targeted malware. On 29 December 2020, the FBI issued a public service announcement warning users of smart home devices fixed with security cameras and voice capabilities to use complex passwords to protect their accounts.

This followed a spate of hacks on such devices, which were then used to record the police arriving at residences in response to the hackers' hoax calls to the emergency services. The hoax calls suggested an immediate danger or threat to life, their objective being that the police would arrive in force (this practice is known as 'swatting').

The use of smart devices in swatting is a new and disturbing development. It allows the hacker to livestream the results of the hack and even interact with the police as they arrive and is an unintended consequence of poorly secured smart devices designed to do something entirely different (protect a built environment, not endanger it). Where such devices are connected to the internet they provide more access points for a hacker to compromise the central environment, access data, or worse. The security of a device is unlikely to be its primary function. It is a salutary reminder that organisations seeking to capitalise on the opportunities presented by automated data gathering, analysis and action cannot assume that any device can be safely integrated into existing systems and left alone. IoT devices are a fundamentally new and different proposition that demand a re-analysis of an organisation's risk profile and security posture. Security (and privacy) by design is key.

The evolution of cyber risks in the real estate industry

Future risks

Digital Twins

Alan Newbold, Arup's Digital Services Leader for UKIMEA, believes that the future of the real estate industry will be shaped by digital twins. A digital twin is a digital representation of something physical – in the real estate world that includes individual systems, buildings or whole cities. Concepts are tested on digital twins to model their effects and information gathered is used by digital twins to refine them. Digital twins then inform what happens to their real life counterparts to save time and money and to minimise disruption. Newbold uses the example of traditional maintenance cycles to explain the efficiencies: rather than sending in engineers at fixed intervals to test or repair the M&E equipment, the digital twin will model maintenance requirements so that they are targeted, bespoke and efficient. Real life engineers will only be deployed where the digital twin has flagged a need.

As with all digital revolutions, there are inherent risks involved with digital twins. In particular, if hackers (or disgruntled employees) can successfully access and manipulate the digital twin, they could hold it hostage for a ransom or cause malicious damage in the real world. In addition, the digital twin will have been created using reams of valuable intellectual property and other sensitive data. That intellectual property and data will only be as secure as the digital twin's security design and related cyber defences.

Given the potential fall-out from any cyber event, there are some key legal questions that need to be considered as the use of digital twins become more widespread:

- Who is responsible for the integrity of the data that is used to create and manipulate the digital twin and what duties do they have to ensure that it remains accurate and uncorrupted?
- Should tough financial penalties be conditions of those creating, accessing and manipulating the digital twin if those doing so fail to take adequate steps to build into the design all appropriate technical and organisational measures to secure data?
- Given that digital twins are intended to facilitate the whole life cycle of a building should contractual liability be equally enduring?
- Does traditional insurance provide adequate cover against the risks?

Those involved in promoting digital twins will need to come to a consensus on these matters and industry protocols will need to be developed.

Interestingly, because they are intended to be interactive and evolving, digital twins are themselves a useful tool in defending against cyber threats. By modelling different kinds of cyber-attacks on digital twins, real life defence systems and reactions can be refined so that any real life attack can be dealt with faster and with greater success.

Blockchain

Blockchain is a decentralised, distributed ledger that irreversibly records the provenance and history of a digital asset (including information). Not so long ago, blockchain was the word on everyone's lips, but its use in relation to cryptocurrencies seems to have dampened enthusiasm. However, blockchain's potential should not be written off. In particular, it provides the underlying technology used to power smart contracts. These can automate contractual procedures which otherwise rely on human input and have inherent potential when it comes to construction projects and supply chains. For example, smart contracts using blockchain can automatically release payments when technology confirms evidence that construction stages have been reached or that services have been supplied. This is would minimise the exposure of a construction business to late payments and cash flow risks. Equally, if properly implemented, a blockchain at the heart of a project could be used as the sole reference point for all relevant matters and would ensure increased transparency and consistency of dealings.

The evolution of cyber risks in the real estate industry

Future risks

While blockchain technology was previously hailed for its inherent security, there have been a number of recent examples which have exposed its vulnerabilities - in particular to the endpoints, such as digital wallets, that operate at the intersection between the digital and real worlds. However, these risks are unlikely to be the main barrier to widespread use of blockchain within the real estate industry.

Implementation of digital solutions in what remains a fairly traditional and analogue industry seems a more likely sticking point. People will have to be persuaded that a new way of doing things is worth the uncertainty, let alone the potential risks.

A Brave New World?

Those of us who work in the real estate industry enjoy the tangible nature of it and that can sit slightly uncomfortably with the new technology that is moulding our built environment. Talk of cyber threats does little to alleviate those concerns, but must be addressed. The good news is that organisations can be pragmatic about the way forward. Hackers will always seek out the most vulnerable prey, so provided that an organisation has proactively engaged with cyber defence, it is less likely to be targeted.

Newbold says that organisations need to be clear about where cyber risks sit on their corporate risks register and that all organisations should have a chief information security officer (CISO) to anticipate and head off threats. He advises that any cyber defence strategy requires a synergy between people, process and technology. If any one of those elements is not robust, the system will be vulnerable.

The reality is that technology is set to change the face of real estate quickly and beyond recognition. As part of that we will need to learn to live with the inherent cyber risks because, as Newbold observes, “each new evolution of technology opens up new vulnerabilities so the risks can never be ‘locked down’.”

Property developers, investors and occupiers have plenty of experience of heading off physical threats to their buildings. We install fire protection equipment and security alarms and we change locks when tenants move on. Cyber defences are no different; they just operate in the digital world where proactivity is key.

This article was previously published in Estates Gazette as part of a series of three articles on cyber security issues facing the real estate industry. The other two articles can be read here:

When cyber threats get physical

Data and reputational risk

440

Partners

1,800

Lawyers

4,000

Total staff

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