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By email to: propertyandtrust@lawcommission.gov.uk

8th March 2019

Dear Sir/Madam

CLLS LAND LAW COMMITTEE'S RESPONSE TO LAW COMMISSION CONSULTATION ON COMMONHOLD

The City of London Law Society ("CLLS") represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. This response to the Law Commission's Consultation on Commonhold has been prepared by the CLLS specialist Land Law Committee, the details of which are on the CLLS website herewith:

http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=141&Itemid=469

Introductory comments

While this response reflects the views of the Committee as a whole, member firms may have different views on particular questions or aspects of commonhold. The views presented in this response are not intended to reflect the views of any client of member firms of the Committee.

The Committee's response mainly comprises points of principle on the Law Commission's consultation paper rather than responding to particular questions, although the Committee does comment on a small number of questions of particular interest.

A frustration shared by many in the legal profession is that some (but not all) of the mischiefs that commonhold seeks to address could be resolved if the draft Bill included in the Law Commission's report "Making land work: Easements, Covenants and Profits a Prendre" was enacted. The report was published in 2011 and was widely welcomed – the possibility of freehold positive and negative land obligations taking effect as legal interests in land and the key novel point of being able to enforce such positive land obligations against successors in title would remove one motivation for using the versatile leasehold mechanism. It would have been helpful to have seen whether such an enacted change may have reduced the use of leases in conveyancing.

While not specifically addressed, the Law Commission's report alludes to the Government considering wider measures to reinvigorate commonhold such as whether commonhold should be compelled. While the Law Commission's well-crafted report may address some of the deficiencies of the original scheme and commonhold may become a desirable form of ownership, there would be significant concern at the prospect of some form of legal compulsion constraining transactions previously freely entered into.

The Committee considers that the paper's emphasis on first addressing conversion from leasehold to commonhold and later discussing improvements to commonhold itself, is dealing with this in the wrong order. Tenants are unlikely to wish to convert from leasehold to commonhold until commonhold has proved itself in the market for a number of years and lenders will be reluctant to lend on it due to a lack of familiarity and to other reasons highlighted in this response. Therefore, the emphasis should be first to change commonhold to make it more attractive to developers, buyers and lenders. Once that has happened, then the conversion process can be considered including such issues as, the basis on which conversion can happen without 100% unanimity.

The Committee also considers that any commonhold schemes should initially be limited to residential property only, in order to reduce some of the complexities and problems highlighted in this response. When the market has become more familiar with the operation of commonhold schemes in practice, consideration should then be given to the use of commonhold for mixed-use schemes and what particular legal treatment is required.

Treatment of developer's lender

While the paper discusses the position of a buyer of a commonhold unit and a lender to a unit buyer, it does not give detailed consideration to the concerns of a lender to the developer. This is important because without the developer's lender approving the commonhold scheme, there may be no funding.

The developer's lender will have requirements in relation to the security that it will have over the land; its controls over the development; repayment of the loan; and exit strategies if the developer fails during the construction period. The Committee's comments on those issues

follow, but its view is that lenders will resist commonholds for mixed-use buildings or estates. They will instead look to leasehold structures, which offer greater flexibility.

Security

The owner of the land, usually a newly created special purpose vehicle (SPV), will grant the lender a first ranking charge over its freehold interest. The charge is protected by a restriction against dealings. If a traditional leasehold structure is used, the lender's charge over the freehold stays in place until the loan is repaid. Registration at HM Land Registry of any leases granted by the SPV is dependent on the lender providing consent.

With commonhold, it appears that the charge over the freehold will not automatically transfer to the new commonhold title, so the lender will need new security. This is an important deficiency in an insolvency context. The lender will lose the benefit of any hardening period under insolvency legislation in respect of the original charge. This exposes the new charge to challenge until the relevant hardening periods have expired.

On the sale of the first flat, the common parts automatically vest in the commonhold association free of the lender's security. The lender will only have security over unsold flats and commercial units. The likely result is that the lender will insist that registration of the land as commonhold is delayed as long as practical. The lender's consent to the transfer to the commonhold association will likely be subject to a condition that the commonhold must exclude estates common parts, to ensure the lender retains direct control over the development for as long as possible.

Control

With a leasehold structure, the lender's SPV share charge remains in place and the lender retains control until repayment of the loan. With commonhold, the lender cannot take a share charge since the commonhold association does not have shares. In addition to the lack of control over common parts, the lender will lose control over the commonhold association potentially before it has been repaid.

Repayment

In a mixed-use scenario, the commonhold structure fetters an investor's ability to redevelop commercial units. This is because the investor's acquisition of the commercial units is on the basis that it becomes a member of the commonhold association, which would have to be involved in any redevelopment. This constraint is likely to reduce the value of the commercial units. There is normally no such constraint with a leasehold structure.

Insolvency

A very important weakness of commonhold is that the commonhold association can become insolvent. This might happen where the unit holders fail to pay their contributions (and it is difficult to force them to pay). An insolvent commonhold association will potentially reduce the value of an investor's interest and could put the investor in breach of its own facility agreement.

Exit

If the developer becomes insolvent, the lender will wish to deal with the development as it sees fit. The leasehold structure will likely enable the lender to achieve this since, as a result of its security over the freehold and SPV's shares, it can take control. The position is more problematic with commonhold, where, as mentioned previously, the lender will not have security over the common parts, but will have to consult the commonhold association over which it may not have control.

There is also the problem that development rights only benefit a party with an interest in the commonhold. It is very likely that a lender would put only the residential elements of a mixed use scheme into a commonhold and, therefore, the development rights would not benefit a new owner/developer of an adjoining plot on the estate, unless they held an interest in the commonhold. This limits the lender's ability to realise the best price.

Consultation specific questions

Question 17

The Committee agrees that commonholds with sections (which are not individual corporate bodies) should be introduced as a management structure for more complex developments.

It is crucial, however, that there is the ability to allocate different costs to different sets of owners. So if there are 2 blocks of flats, A and B, the owners of the units in block A should be responsible for costs incurred in relation to block A and the equivalent for block B.

The Committee considers it unlikely that commonhold will be used for mixed-use schemes until it has become more tried and tested and mainstream for residential developments. The familiar leasehold structures are more likely to be trusted. Also, commercial occupiers are more likely to want a commercial lease rather than buying the freehold of the unit and that would mean that an investor would have to be introduced into the structure to take the unit and then grant the lease. This adds to the complexity of a mixed-use commonhold.

Question 22

The legislation needs to be clear as to the consequences of units not being used for significantly different purposes and the division into sections not being lawful. Uncertainties may deter the usage of commonhold.

Question 35

Restrictions on the short-term lettings of units could have a negative impact on the private and social rented markets and consequently make commonhold unattractive. Since this measure appears aimed at short-term holiday lets, a preferable alternative option may be to increase the regulation of the holiday let market.

Banning lettings for less than 6 months is too draconian, since they are encountered not infrequently. A ban of 90 days or less may be more appropriate to deal with issues caused by a high turnover of holiday tenants.

Question 65

Long leases also need to be allowed in the context of:

- Investment in social housing providers. The housing association cannot sell the freehold to its housing stock so the investment is often structured via leases.
- Equity release products such as the home reversion plan.
- HMRC approved tax planning schemes.

Question 85

The Committee is also concerned about the proposal in Chapter 14 that a commonhold association should have an automatic statutory charge over commonhold units for the payment of commonhold costs if a unit owner fails to pay their share of the commonhold contributions. It is proposed that any such charge should take priority over other charges such as mortgages and such charge would prevent the unit owner from selling the unit without paying the debt. The charge would also allow the commonhold association to ask the court to order the sale of the unit in order to pay the debt with the balance going to any mortgage lender and then the unit owner.

While the paper highlights that the lender's security is not at risk from forfeiture if there is a commonhold, lenders will remain concerned about the risk of losing priority. Lenders have ways to protect their position in a forfeiture situation which have developed over time. While under the proposals the court would ensure that any lender has been notified of the claim and consider the protections available if the lender had been applying for an order of sale, lenders will need to receive further assurances to address concerns about a perceived undermining of their position under commonhold.

Question 87

The Committee does not agree. With limited exceptions, voluntary termination of a commonhold should only be possible with unanimous support. Forcing a unit owner (especially an owner occupier) to give up their legal interest in the property cannot be justified. Requiring the court's approval is not an adequate solution. Voluntary termination without unanimous support should

only be possible where units have become incapable of occupation, for example, because they have been destroyed.

Question 88

Determination by section could work where each section is a separate building, but could be problematic where the sections are in the same building. How would it work if the commercial section on the ground floor voted for termination, but the upper residential section did not?

Question 90

There should be a statutory requirement that notice of a proposal for the voluntary termination of a commonhold must be given within a specified time to lenders to ensure they have sufficient notice to exercise contractual and statutory rights.

Question 91

The commonhold community statement (CCS) should be required to set out basic principles as to how to ascertain the share of each unit owner in the proceeds of termination. Otherwise, there is uncertainty and potential for dispute and delay. The CCS should provide the opportunity to refer the matter to an independent valuer.

If you have any queries about this response, please do not hesitate to contact us.

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