



For a lender, the principal benefit of commonhold is that it has no lease term and the value of the lender's security should not therefore diminish

– giving details of money owed by the owner – has been paid in full. It will consult with lenders, the Law Society and the Council for Licensed Conveyancers before finalising the requirements. The CML will want to ensure that any requirements do not fall outside the legal profession's practice rules. In most residential conveyancing transactions the lawyer will act on behalf of both the lender and the borrower. To overcome the potential conflict of interests, lawyers must adhere to practice rule 6(3), which specifies exactly what a lawyer can do when acting for two parties. At the moment, it does not contain any provisions regarding commonhold. If this in any way prevents lawyers from acting on lenders' instructions in commonhold transactions, the take up of commonhold properties may be affected. The CML has raised this issue with the Law Society and it is aware that it has recently carried out a review of all of its practice rules.

Commonhold has huge potential, but many lenders will wait until the regulations have been properly incorporated before deciding whether commonhold properties will provide good security.

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Mixed-use developments are a prime candidate for commonhold ownership. Philip Freedman considers its application to a potential scenario

From commonhold to commonplace

Mixed-use development presents a number of management and ownership difficulties under traditional leasehold regimes. Will the introduction of commonhold resolve any of these problems?

This article will consider the following potential scenario. A development company is constructing a building with shops on the ground floor, offices on the first floor, and six floors of flats above, including one floor of affordable housing. All the floors have the same internal area. It is the developer's intention to grant business leases of the shops and offices and to sell off the flats on 125-year leases. Several of the shops have been pre-let, contracts have been exchanged to sell the floor of affordable housing flats to a registered social landlord (RSL) and to sell most of the flats on the other floors to private buyers, off plan. An offer has also been received from a pension fund to buy the completed investment.

Selling the freehold

The sale of a building that includes residential flats raises the question as to whether the residential tenants have rights of first refusal under the Landlord and Tenant Act 1987 (the Act). If so, they must be offered the interest being sold. In general, this applies to a building that contains two or more flats, where any commercial element comprises less than half of the internal floor area and where over half the number of flats are held by qualifying tenants.

In the scenario, the leases have not yet been granted, but the Act provides that "lease" and "tenancy" include an agreement for a lease or tenancy. This can arguably mean that the contracting purchasers of the uncompleted flats are already "qualifying tenants". It can be argued that the Act does not apply until the building has been completed. However, landlords should be cautious when interpreting the Act since, if it applies, failure to serve

an offer notice before selling constitutes a criminal offence.

If a long lease of the entire residential part had been granted, either to a group company of the developer or to a third party, and the flats were individually sold off on long sub-leases, the Act would not have applied to the sale of the freehold.

The Act does not apply to a commonhold. In any event, commonhold units are sold freehold, the common parts must be vested in a commonhold association (CA), and the developer has nothing left to sell once it has sold all the units. However, commonhold is in several ways a more regulated regime than leasehold and it would not be appropriate in the scenario if the RSL intended to use the affordable housing flats for a shared-ownership scheme, owing to the current restrictions on residential lettings of commonhold units.

A fund buying a multi-occupied building may expect 100% recovery of service costs. In the scenario, the leases provide for full recovery. However, in relation to the residential tenants, it is not possible to exclude the statutory tests of reasonableness and the requirements for consultation. These apply to any service charge payable by a tenant of a dwelling where the charge varies according to costs of services, repairs, maintenance, improvements, insurance and/or the landlord's costs of management. Only a small category of landlords are exempt.

Lack of clarity

Even if a headlease had been granted of the entire residential part, with the flats being sold individually on subleases, both the freeholder and the headlessee may still need to comply with the Landlord and Tenant Act 1985 (the 1985 Act) in relation to the residential subtenants. There is a lack of clarity as to how the consultation rules apply in such circumstances. The freeholder may need to

consult both the headlessee and the individual subtenants; and the reasonableness test may apply to service charges claimed by the freeholder from the headlessee as well as those claimed by the headlessee from the individual residential subtenants.

Setting up the development as a commonhold would avoid these limitations because the service charge, called the “community assessment” under commonhold, is not subject to a reasonableness test. However, the services would be arranged by the CA rather than by the developer or the fund, thus giving them normally no opportunity to earn insurance commissions or management fees.

How to take the management over

Tenants of flats who pay service charges covered by the 1985 Act can establish a residents association and demand of the landlord to recognise it. The association can also require the landlord to consult it on the choice and appointment of managing agents for the building.

Further, residential tenants may be able to take over the management through a right to manage (RTM) company, provided that two conditions are satisfied: (i) the qualifying tenants must hold at least two-thirds of the flats in the building; and (ii) the qualifying tenants of at least half the total of flats must participate. If the residential part of the building is not structurally self-contained, this right will extend to the entire building, including its commercial element, unless that comprises more than 25% of the internal floor area of the building. In this case the right will not apply. That exemption would not arise in the scenario and the fund would be seriously concerned that the residential tenants could take over the management of the building.

Buying the freehold

A fund would have even greater concern that the residential lessees may have a right of collective enfranchisement enabling them to buy the freehold. The types of building to which this applies, and the criteria for participation by qualifying tenants, are similar to those for the RTM. However, for the purpose of collective enfranchisement, a lessee holding three or more flats is not considered as a qualifying tenant. In the example, this would exclude the RSL. The number of other flats in the building then becomes critical to the right of collective enfranchisement.

If collective enfranchisement is exercised, the freeholder can insist upon taking back a 999-year lease of the commercial parts of the building and also, if it wishes, the RSL flats,

A fund would have even greater concern that the residential lessees may have a right of collective enfranchisement enabling them to buy the freehold

at a peppercorn rent. Alternatively, it may insist that the enfranchisement should include them and have this reflected in the valuation of the freehold. However, many funds would not wish their investment to be reduced from the freehold of the building to just a long lease of the commercial elements.

The position under commonhold would in some ways be quite similar to the outcome of enfranchisement or the exercise of the RTM. Under a commonhold, the common parts, which in the case of a multi-unit building must include the structure, are to be vested in the CA as from the transfer by the developer of the first unit. They must also be insured and maintained by the CA, whose duty it is to manage the property. Anyone purchasing a unit, whether commercial or residential, and whether as an occupier or as an investor, will automatically acquire the freehold of that unit. The new owner will become a member of the CA, but it will be under an obligation to abide, in most cases, by a majority rule, including decisions on maintenance and even on changes to the commonhold community statement (CCS), which sets out the rights and duties of the unit owners. Individual unit owners will be able to veto only those changes that would affect their units or the rights attaching to them. Although owners of commercial units will have the option to let them on any terms they want, the tenants will be required to abide by any relevant provisions set out in the CCS, such as those imposing duties as to the use of the unit and of the common parts.

Particular arrangements

No rule seems to prevent a developer from arranging for the CA to enter into a long-term “sweetheart” contracts with the developer or persons nominated by it for the ongoing management and insurance of the building. These contracts could be put in place while the developer remains in control of the CA. This option would not be effective in the case of collective enfranchisement or the exercise of the RTM, and thus may be an area where a developer or fund might prefer commonhold to those regimes.

A fund investing in property may insist on keeping the control and the management

of the entire building. But this may not be possible under some mixed-use situations (subject to possible “sweetheart” contracts), and thus the fund will regard the investment as unacceptable.

Individual investors or small private pension funds, however, may see matters differently. They may be attracted by the possibility, under commonhold, of buying the freehold of part of a building – perhaps a floor of offices or one or more shop units – and they could share the government’s view that owners of units should manage their own buildings. It will be interesting to see how quickly commonhold becomes commonplace.

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Mixed-use: the main points

Selling the freehold Lessees of flats may have a right of first refusal over the freehold if: the building contains two or more flats; any commercial element is less than 50% internal floor area; and over 50% of the flats are held by qualifying tenants; but not if there is a residential headlease or an exempt landlord.

Service charges Lessees of flats can challenge service charges if: costs have been unreasonably incurred; works or services are not carried out to a reasonable standard; or statutory consultation procedures have not been observed.

Management Lessees of flats can take over the management of the whole building if: qualifying tenants hold at least two-thirds of the flats; the qualifying tenants of at least half the flats participate; the residential part of the building is not structurally self-contained; and the non-residential part is 25% or less of the internal floor area of the building.

Enfranchisement Lessees of flats may have a collective right to buy the building if: qualifying tenants hold at least two-thirds of the flats; the qualifying tenants of at least half the flats in the building participate; the residential part of the building is not structurally self-contained; and the non-residential part is 25% or less of the internal floor area of the building.

However, the freeholder has the option to take back a 999-year lease at a peppercorn rent of any lettable parts of the building that are not let to qualifying tenants, or to include them in the sale of the freehold.

Commonhold

- Commonhold involves selling the flats freehold and transferring the common parts to a commonhold association (CA).

- A CA manages its building and is controlled by the buyers of the flats and other units.

- The community assessment is not subject to a reasonableness test, but is levied by the CA.

- Individual owners can only veto changes to the community statement that would affect the extent of their units or affect the rights attaching to them.

- Units can be let: commercially, on any terms but residentially, for not more than seven years and tenants must observe relevant provisions of the community statement.