It's Criminal

If a landlord owns a block of flats which are let out on long leases and wants to sell its freehold interest, then it will usually have an obligation to first offer it for sale to its tenants. This is known as the "tenants' right of first refusal" and is set out in the Landlord and Tenant Act 1987 ("LTA") as amended by the Housing Act 1996. Failure to comply with this law is a criminal offence - so pretty serious.

WARNING

This edition of IT’S THE LAW is a very brief canter through the relevant legal principles involved. It comes with this HEALTH WARNING: the LTA is generally accepted to be one of the most difficult to follow bits of legislation relating to property that we have. Whilst this note gives you a "heads up" in terms of what to be looking out for, so as to avoid accidentally committing a breach, you do really need to take detailed advice from a solicitor (preferably us) each time you are thinking about a transaction that might possibly be caught. Seriously, give us a call.

The Basic Law

In overly simplistic terms, the law could be summarised as follows:

A right of first refusal arises in favour of "qualifying tenants" when the landlord of premises comprising a number of flats wants to make a disposal affecting the whole or part of the premises. The landlord is not allowed to make that disposal unless it has served an offer notice on all (or almost all) of the qualifying tenants. The offer notice sets out the terms of the proposed disposal. The qualifying tenants then have the right to accept that offer. If they do, then the landlord is bound to dispose of the premises to a nominee of the tenants on those terms. If the offer is not accepted by the tenants, then the landlord can, within a period, proceed with the disposal it originally wanted.

It's Complicated

Now we get to the complicated bit. We'll break the above simplistic statement into bite-sized chunks and look at the detail.

What landlords are caught?

(Or, more accurately, what landlords aren't caught?)

Certain landlords are specifically exempt from these provisions. Everyone else is caught. The exempt ones are:-

Most housing authorities (including local councils, development corporations made under New Towns legislation, Mayoral development corporations, urban development corporations), housing trusts which are

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charities, the Homes and Communities Agency, non-profit private registered providers of social housing, registered social landlords, and fully mutual housing associations which are neither private registered providers of social housing nor registered social landlords.

If you work for one of our Registered Provider (“RP”) clients, you may be thinking that you can stop reading now and put your feet up or, maybe, make a nice cup of tea. Not so fast. The issue crops up on ‘RP transactions’ more often than you might think. Many RPs operate group structures with some RP entities and some non-RP entities. If they are developing in the wrong entity, they may be caught. Joint ventures are increasingly common and joint venture entities are rarely RPs.

Resident landlords are also excluded, sometimes. A resident landlord is someone who has lived in a flat in the building (as his only or principal residence) for at least the 12 months prior to the disposal. But this exclusion doesn’t apply to purpose-built blocks of flats.

There are a whole series of additional provisions, complications and exceptions which apply if the Crown is involved. To republicans, these may not seem very logical and we don’t propose to even attempt to summarise them here. But basically, if you are the Queen (or part of the Crown Estate or a Government department) you can stop reading now and put your feet up. If it’s after 10am, why not have a gin and Dubonnet?

What does premises mean?

For the right to apply, the premises must pass the following four tests:

Firstly, the premises must comprise the whole of a building or a part of a building. Building is not defined in the LTA and that can sometimes lead to a lack of clarity but there are oodles of cases to [help clarify/help confuse]* the issue.

Secondly, the premises must contain two or more flats owned by qualifying tenants.

Thirdly, the number of flats in the premises held by qualifying tenants must exceed 50% of the total number of flats in the premises.

Fourthly, if the use of the premises is only partly residential (say the building in question comprises flats above a parade of shops) the internal area of the residential parts must represent 50% or more of the total internal area.

*Delete option depending on your level of cynicism.

Getting the right qualifications

We’ve used the expression ‘qualifying tenants’ a few times. It’s a very important expression for two reasons. Firstly, because the right doesn’t apply unless there are at least two qualifying tenants. Secondly, because if the right does apply, it only applies in favour of the qualifying tenants - even if there are other tenants in the building.

Rather than defining what a qualifying tenant is, the LTA says it’s all tenants other than ones that the LTA then proceeds to list. So the following are non-qualifying tenants:

- A tenant under a protected shorthold tenancy;
- A tenant under a 1954 Act business tenancy;
- A tenant under a tenancy terminable on termination of their employment;
- A tenant under an assured tenancy (including assured shortholds);
- A tenant under an assured agricultural tenancy;
- A tenant who is a tenant of three or more flats in the building (but excluding any flats that have already been excluded under the above exclusions). When counting up to three, ‘associated companies’ are lumped together;
- A tenant whose landlord is themselves a qualifying tenant. This avoids there being more than one qualifying tenant for the same flat; and
- A sub-tenant of any of the tenants listed above.

What does disposal mean?

Any disposal of an estate or interest affecting the premises will be a ‘relevant disposal’ for the purposes of the LTA unless it is specifically excluded by the LTA.

So the following would be included:

- A straightforward sale;
- The grant of a lease;
- A surrender;
- The grant of an option; and
- Entering into a contract for the above, whether conditional or not

...and the following are excluded by the LTA:

- The grant of a lease of a single flat;
- The grant of an easement;
- The creation of a rentcharge;
- Giving a mortgage;
- Certain disposals related to the Compulsory Purchase Order process;
- A gift to a family member or to a charity;
- A disposal pursuant to a contract (so entering into
the contract is covered by the LTA - but, once you’ve entered into the contract, you can complete the contract without worrying about the LTA again); and

- Certain disposals between ‘associated companies’.

The above is not an exhaustive list of exclusions. That actual list goes on. And on. And on. But the above gives you an idea of the most common exclusions.

Now you’ve established the LTA applies, what next?

The above goes someway to explaining whether the right applies. The next section of this edition of IT’S THE LAW deals with what you have to do once you’ve established that it does. Remember, failure to comply with the LTA can be a criminal offence.

A landlord can’t make a relevant disposal unless it has first offered to dispose to the qualifying tenants on the same terms.

So the first step is to make that offer. This is done by what is known as a ‘section 5 offer notice’.

What: oddly the LTA doesn’t prescribe a particular form of this notice. But it does go into quite a lot of detail as to what needs to be included and, in giving that detail, it distinguishes between a number of different possible types of disposal: a contract, a sale at public auction, the grant of an option or pre-emption and a conveyance not preceded by a contract.

The common themes across all the types is that the notice must set out the principal terms of the proposed transaction, explain that the requisite number of qualifying tenants are entitled to accept those terms (and proceed with the transaction proposed) and specify how long the tenants have to accept the offer.

When: the LTA is also not particularly clear on the subject of when the notice must be served. The LTA bites when the landlord proposes to make a relevant disposal but, in the world of lawyers, ‘proposes’ is not a precise word. In one case, a judge said that it describes the state of mind “somewhere between mere consideration of a possible course of action at one extreme, and a fixed and irrevocable determination to pursue that course of action at the other.”

Who: you might expect that the notice would need to be served on all qualifying tenants. Oddly, no. If there are 10 or more qualifying tenants then that landlord will have been deemed to have complied if they serve notice on at least 90% of them. If there are fewer than ten, then the landlord will be deemed to have complied if it serves the notice on all but one of them.

How: as you may have guessed by now, the LTA does not go into great detail as to how the notices must be served. As a minimum, the landlord should check what the lease says. We’d also suggest you play it safe. Maybe service by email is effective, maybe it isn’t - but why take the risk? Use good old fashioned paper. Whatever method a landlord chooses, they should keep a clear record of the time, place and method of service. Keep photocopies of the actual signed notices too.

The acceptance

The section 5 offer notice must specify the period during which the tenants are entitled to accept the offer. The LTA specifies that this must be at least two months starting from service of the notice - but the landlord could decide a longer period.

If the qualifying tenants wish to accept the offer then the ‘requisite majority’ of them must both (a) serve what’s known as a ‘section 6 acceptance notice’ and (b) nominate a person to purchase the property on their behalf.

The following rules determine what a requisite majority is:

It’s one vote per flat (so if someone is the qualifying tenant of two flats they get two votes).

The vote must be passed by ‘more than 50%’. That is more than 50% of possible votes (i.e. all the qualifying tenants). Not more than 50% of those that voted.

The qualifying tenants who want to proceed must nominate a purchaser. Commonly, they will set up a limited company to hold the property on their behalf and they’ll each take shares in that company. Under English law there can’t be more than 4 registered legal owners of a piece of land - but if you have 4 or fewer qualifying tenants, it’s not unheard of for them to nominate themselves. There is nothing preventing the qualifying tenants from nominating a single person. But, in practice, that can cause headaches for the qualifying tenants if the nominated person then doesn’t operate as they want them to.

If the requisite majority do not serve a section 6 acceptance notice in time and/or fail to nominate a purchaser, then the landlord may proceed with the disposal, as he originally wanted, as long as it satisfies the following conditions:-

- The disposal must be completed within 12 months. Oddly, the LTA doesn’t accurately specify within 12 months of what!
- The disposal must be of the same interest in land as that specified in the section 5 offer notice.
- If the section 5 offer notice referred to a disposal by auction, then the landlord must dispose by auction; and if the proposed disposal referred to in the section 5 notice was by way of contract, option or straight to transfer then the deposit...
and consideration must not be less than that stated in the notice and the other terms must also be as specified in the section 5 notice. If the requisite majority of tenants do serve a section 6 notice and do nominate a purchaser then the LTA sets out a detailed timetable as to what then happens. This includes provisions which mean that:-

- The landlord can withdraw (or be deemed to have withdrawn) from the transaction. Depending on when that happens, the landlord may have to pay certain costs to the tenants.
- If the landlord withdraws (or is deemed to have withdrawn) then they are prevented, for 12 months, from disposing or proposing to dispose of the same property.
- The tenants can withdraw (or be deemed to have withdrawn) from the process.
- If, instead, all goes well - the landlord is to issue a form of contract and the nominated purchaser is to return that contract (with a deposit) and the landlord is to accept that contract and deposit. From then on in, the matter is dealt with under the contract in accordance with normal contract law. Slightly different rules apply on auction sales and options.

Doing the wrong thing: What happens if the landlord doesn’t comply with their obligations under the LTA?

It's criminal - literally. The landlord commits a criminal offence if it fails to comply with its obligation referred to above. On conviction, the penalty is a fine up to a level 5 fine on the standard scale (up to £5,000). Where the landlord is a corporate body (e.g. a company or a community benefit society) a director, manager, secretary or other officer may also be liable to prosecution. In addition to having the police knocking on the door, the landlord may find they are at the sharp end of a civil legal action. The Court can order the landlord to make good the default.

If the landlord has disposed of an interest in contravention of the LTA (for example selling the freehold) then the LTA does not void that transaction. It’s still a valid transaction and the buyer will still be the new owner. But the qualifying tenants may be able to force the new owner to transfer the premises to them. So whilst the new owner will not be guilty of a criminal offence, they may still be made pretty miserable by the whole affair. So if you are buying a block of flats, you’ll want to make sure that the LTA doesn’t apply or that it’s been complied with. This can be done by raising appropriate pre-contract enquiries. Alternatively, the LTA includes a procedure whereby a prospective purchaser can serve notices, to clarify the position, directly on the qualifying tenants (or most of them). But we reckon you’ll probably have had enough of the LTA by now - so we’ll leave that for another day.

We'll finish with a trap and a trick.

The trap

Imagine a block comprising 10 flats and a small shop. For simplicity, let's assume we've gone through all of the details above and concluded that the tenants’ right of first refusal applies to the block. What happens if the landlord wants to grant a lease of the shop? Do they have to serve a section 5 offer notice on the qualifying tenants in the 10 flats?

You might assume no - since the disposal is not of residential accommodation. But you’d be wrong. If it’s all part of the same building then the grant of the shop lease would amount to a disposal of an interest in part of the building to which the LTA applies. On new schemes that are like this, it is not uncommon for a landlord to grant a very long lease of the shop unit to a group company before any residential leases are granted so that they can effectively separate the shop unit ownership from all the complications that come with the LTA.

The trick

A common scenario we come across on joint ventures between RPs and private sector developers is for the property to be developed whilst it is in the ownership of the joint venture vehicle with the intention that once all of the apartments are sold off on long leases, the freehold will be transferred to the RP for nominal consideration so that they can manage the development into the future. The problem here is that that transfer may trigger the tenants’ right of first refusal. The trick is to exchange contracts to transfer the freehold to the RP before 50% of the flats are sold off. That way, the rights haven’t started to apply yet and once you’ve exchanged contracts, the subsequent transfer pursuant to that contract is not a relevant disposal for the purposes of the LTA.

The tiny print

This is one of a series of leaflets published by Devonshires Solicitors LLP’s Real Estate & Projects Department aimed at our developer clients. No action should be taken on the matters covered by this leaflet without taking specific legal advice.

Find out more

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