K&L GATES

OVERRIDING INTEREST

September 2014

Highlighting developments and issues in the real estate industry

OVERRIDING INTEREST

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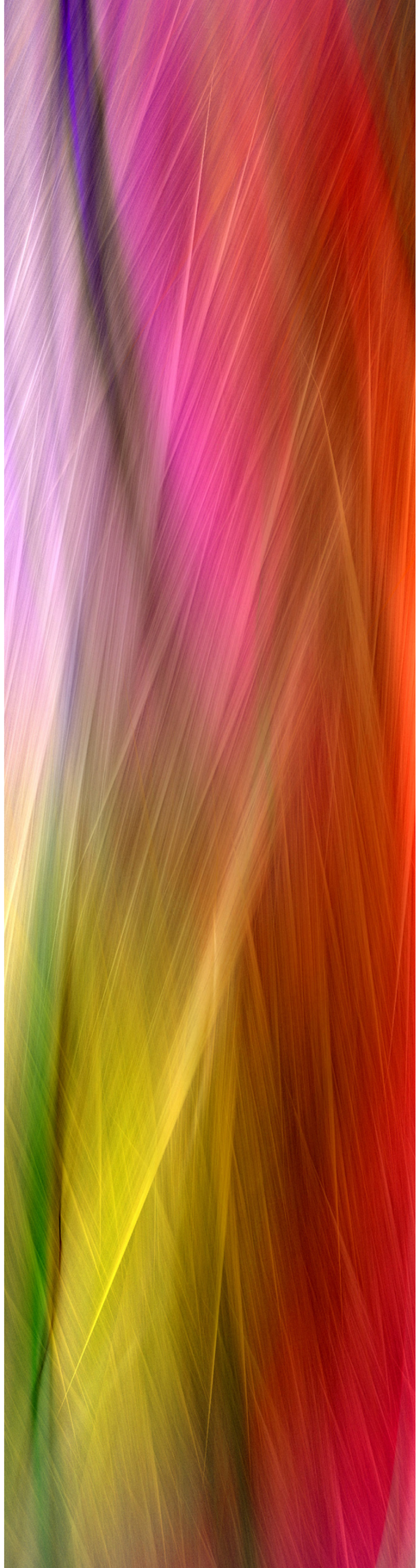


Islamic Real Estate Finance: Getting The Deal Done

The background

The past six years have seen the growth of real estate finance transactions which combine conventional and Islamic facilities in one deal. In the UK, the Islamic financial institutions have used the retreat of traditional real estate lending banks to take up market share and assist their Middle Eastern customer base in gaining a strong foothold in the London commercial and residential property market.

Growth trajectory

Islamic-compliant financing is on a growth trajectory based on demographic trends, rising investible income levels and progress towards harmonisation of global regulation. Whilst the economies of developed economies are under strain, real estate market participants are looking to funding alternatives such as Islamic finance. Islamic banks originating in the countries of the Gulf Cooperation Council could emerge as forces to be reckoned with in the new global order of finance.

On current estimates, 26.4% of the global population will likely be Muslim by 2030 against 23% in 2012. The proportion of Muslims in Europe is around 5% of the population. This creates a large market and investor base to consider. The level of harmonisation is increasing between conventional and Islamic banking regulation, thus eroding barriers to entry. Islamic banking services are available in 39 countries on four continents. There are also significant growth opportunities given that the global penetration of Islamic banking is currently below 2% in real estate finance and the Islamic debt market or Sukuk accounts for only approximately 1% of global debt issuance.

The United Kingdom has enjoyed an in-built advantage in its attempt to become the hub of Islamic finance in Europe. This is due to English law often being the governing law of international Islamic finance transactions. An Islamic finance transaction might involve a Swiss bank and a Middle Eastern counterparty, but they may well choose to use English law to structure their documentation in order to give flexibility and certainty to both sides.

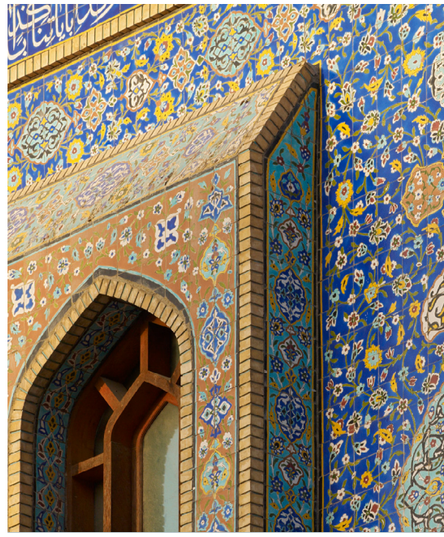
UK Government Sukuk

The UK government issued a £200m government Sukuk on 25 June 2014. It is backed by UK Government real estate assets. A Sukuk is a bond-type instrument that is compliant with Islamic principles and is therefore attractive to investors that wish to invest in accordance with their religious beliefs. This is the first Sukuk to be issued by the national government of a G8 member country.

With Islamic finance growing 50% faster than conventional finance, and with global Islamic investments set to reach $2.1 trillion in 2014, the Sukuk is symbolic of wider efforts by the UK government to foster growth in the Islamic finance sector in the country. This move could lead to more national governments outside the Islamic world looking to tap the Sukuk market.

Combining two techniques: A UK real estate financing case study

A transaction we worked on in the United Kingdom involved the use of conventional and Islamic compliant financing to finance the purchase of a major department store. The investor group had incorporated



two special purpose vehicle companies - Holdco and Propco, Holdco being the parent of Propco. Holdco was to receive the Islamic compliant finance and Propco to receive the conventional loan. There was therefore an immediate structural separation between the tranches of finance. However, this deal must be seen on its own facts as other Islamic compliant financiers may immediately have an issue with a subsidiary of its customer taking on conventional debt.

The Islamic financiers comprised the investors and a special purpose vehicle company incorporated for the purpose of the transaction (the SPV). The Islamic financiers had their own board of scholars who approved the whole transaction. However there was a representation in the documentation that a party that itself abided by Islamic principles should not seek to later rely on this status to avoid or disclaim a contract: “Insofar as it wishes or is required for any reason to enter into transactions, agreements

Islamic Real Estate Finance: Getting The Deal Done

and arrangements which comply or are consistent with the principles of the Shari'a ('Shari'a compliant' or 'Shari'a compliance'), each party has made its own investigation into and satisfied itself as to the Shari'a compliance of this agreement and all necessary action to confirm that this agreement is a Shari'a compliant agreement has been taken (including the obtaining of a declaration, pronouncement, opinion or other attestation of a Shari'a adviser, board or panel relevant to it where required)."

The investors put their cash into the SPV. Then the SPV and the Holdco entered into a tawarruq (or reverse / monetizing murabaha). This is a technique whereby the SPV funded Holdco in order for Holdco to buy an asset (in this case a quantity of platinum) on a deferred repayment basis (plus an agreed mark up). Holdco immediately resold the platinum on the spot market for cash to a third party. This transaction meant that Holdco had an amount of funds in order to make a shareholder loan into Propco. That shareholder loan was interest bearing, which was approved within the context of this transaction; however, an equity investment or non-interest bearing loan by Holdco into Propco may have been required in other circumstances.

Propco then borrowed conventionally from a non-Islamic bank and used that loan and the shareholder loan from Holdco to purchase the investment property.

The terms of the conventional finance documents controlled Propco's cash flow so that rental and other income from the property was paid into an account controlled by the conventional bank and went first to service payments due in respect of the conventional loan. In addition, the conventional finance documents limited Propco's ability to distribute funds to its parent, Holdco. Dividend payments were restricted so that they could only be made in certain circumstances, such as while no default was continuing under the conventional finance documents. Holdco's shareholder loan to Propco was formally subordinated in a subordination deed between the conventional bank, Propco and Holdco. Whether purely as a result of the structure and the conventional bank's control of cash flow, and/or by a formal subordination deed, the effect was that the Islamic compliant finance was subordinated to that of the conventional bank.

Propco granted conventional security over the property and its other assets to the bank. In addition, Propco entered into a sale undertaking in favour of the SPV, which gave the SPV the right to call for the real estate to be transferred to it. This may seem broadly analogous to third party security for Holdco's payment obligations under the tawarruq, but there were crucial differences:

- The sale undertaking was not expressed to be granted by way of security.
- The SPV's rights pursuant to the undertaking were not exercisable only when Holdco defaulted.

Given the second of these points, the conventional lender required comfort that its security had priority over the SPV's rights under the sale undertaking.

In this transaction, the effect of registering the conventional lender's security at the Land Registry gave rise to a restriction on the title. This meant that the sale undertaking could not be exercised without the conventional lender's written consent. That ought to remain the case, whether or not the sale undertaking was registered as an option over the land in question, provided there was sufficient evidence of the parties' intentions that the sale undertaking was to be subject to the conventional lender's security.

Conclusion

As this type of co-financing becomes more common, investors, financiers and their advisers will need to be adept at understanding and combining finance tranches with contrasting structures.

For more information on the K&L Gates Islamic Finance practice please visit www.klgates.com/islamic-finance-and-investment-practices/.

Jonathan Lawrence, Finance Partner and Co-Head of K&L Gates' Islamic Finance practice (jonathan.lawrence@klgates.com)

The UK government issued a £200m government Sukuk on 25 June 2014...This is the first Sukuk to be issued by the national government of a G8 member country.

Announcements and Events

New Joiners

Joyce Mok – Hong Kong

Joyce is Counsel in our Hong Kong office's Real Estate practice group. Joyce advises property developers, landlords, tenants, corporate investors and lenders on all aspects of commercial and residential real estate transactions including:

- acquisitions and dispositions;
- cross-border investment and transactions;
- real estate financing;
- leasing and sale-leaseback; and
- real estate equity investments and joint ventures.

Joyce frequently assists clients to evaluate and implement their real estate investments in Asia, particularly in Hong Kong and China.

Patryk Galicki – Warsaw

Patryk is Of Counsel in the Warsaw office's Real Estate practice group. Patryk has a vast experience and knowledge in the areas related to M&A, real estate, corporate law and civil law.

Nearly nine years after admission to the Bar, Patryk has over thirteen years of professional experience (including domestic and international markets at Polish and UK law firms).

Brian Wildstein – Charleston

Brian is an Associate in the Charleston office's Real Estate practice group. Brian has experience originating mortgage and mezzanine loans on behalf of portfolio lenders, as well as representing institutional lenders and investment funds in structured finance workouts and UCC foreclosure sales of regional malls, destination resorts, and full service casino resorts. He has also assisted local and national developers, institutional lenders and funds, Fortune 500 landlords, and nonprofit organizations in development, acquisition, disposition, financing, restructuring, and leasing (including ground leases) of commercial properties, full-service hotels, destination resorts, real estate portfolios, office/retail assets, and mixed-use developments.

Recent Events

AFIRE European Conference

Partners from the London, Berlin, and Frankfurt offices recently attended the annual Association of Foreign Investors in Real Estate (AFIRE) European Conference in London. As the official voice of the foreign real estate industry in the United States and the pre-eminent global real estate organization, AFIRE represents the interests of nearly 200 investing organizations from 21 different countries.

A panel of real estate industry specialists presented at this conference, focusing on the European economic recovery and how it compares with the U.S. recovery. They also discussed the opportunities presented to the European markets that have participated in the recovery.

London partner Piers Coleman, Berlin partner Georg Foerstner, and Frankfurt partner Matthias Grund attended this two-day conference, which provided an opportunity to network with industry professionals and showcase the firm's global real estate practice. Other companies that attended the conference included Cushman & Wakefield, Starwood Capital, Russell Investments, Pramerica Rea Estate Investors, and TPG Capital.

Property Race Day

The Property Race Day is in its eighth year and has established itself as a key date in the property calendar. The principal aim is to fund raise for selected charities and offers a perfect opportunity for networking within the sector whilst enjoying a day at one of the finest racecourses in the world.

The event took place at the world-famous Ascot Racecourse. The day included seven races, a live and silent auction and a post racing live band. Chris Major is on the organising Committe of the Property Race Day. He and members of the London Real Estate team attended this year. For further information please contact Chris Major (*christian.major@klgates.com*).

Upcoming Events

EXPO REAL—International Trade Fair for Property and Investment

6–8 October 2014

EXPO REAL has been held every October since 1998 in Munich Germany and is the biggest B2B trade show and networking platform for property and investment in Europe. EXPO REAL which originally was a German fair with focus on the retail sector has changed over the years and now represents all sectors of the real estate industry all over Europe, including Eastern Europe. More than 1,600 exhibitors present their products and services for property professionals and investors, whilst the more than 36,000 participants represent the whole value chain of the real estate and real estate related finance sector.

A cross disciplinary Real Estate team from the firm's various European offices attend this event. Like every year the K&L Gates EXPO REAL team will host a dinner event for clients and interesting contacts, which will take place on Monday, 6 October. For further information please contact Felix Greuner *(felix.greuner@klgates.com).*

MIPIM UK

15–17 October 2014

MIPIM UK is the 1st UK property trade show to gather professionals that are looking to close deals in the UK property market: investors, developers, local authorities, occupiers, hotel groups, agents and business service providers; covering office, industrial, residential, retail, healthcare, sports & leisure and student accommodation.

Confirmed speakers include Boris Johnson, Greater London Authority; Mark Clare, Barratt Developments PLC; Pete Redfern, Taylor Wimpey; and Tony Pidgley, Berkeley Group.

Members of the London Real Estate team will be attending this years event, for further information please contact Bonny Hedderly *(bonny.hedderly@klgates.com).*

AFIRE European Conference

Government Consultation on Energy Efficiency Improvements to the Private Rented Sector

Introduction

In July 2014 the Government launched a consultation which sought public opinion on its proposals to improve the energy efficiency of privately rented buildings in England and Wales. This followed the passing of the Energy Act 2011 by Parliament, which placed an obligation on the Secretary of State to improve energy efficiency.

The consultation set out the Government's proposals to introduce new regulations to address energy efficiency in two separate documents - one for the domestic sector and one for the non-domestic sector. The consultation invited views on various aspects of the regulations, including scope, possible exemptions and funding. However, the draft regulations were not actually issued with the consultations. In summary the regulations provide:

- From April 2016 at the latest: greater freedom for tenants of domestic property to make changes to it to improve its energy efficiency, despite restrictions in their lease.
- From April 2018 at the latest: an obligation on landlords of the least energy efficient property (both domestic and non-domestic) to consider (and in most cases implement) changes to it to improve its energy efficiency.

How does the Government intend to improve energy efficiency?

The Government's main proposal is the introduction of minimum standard regulations that set the minimum energy efficiency standard at an E EPC rating. This will apply to both domestic and non-domestic rented properties that are required to get an EPC rating. If introduced, all properties falling within the scope of the regulations will have to reach a minimum of an E EPC rating before the landlord can let them out to a tenant.

Exemptions

There will be exceptions however, and the Government is considering including a number of exemptions in the regulations. The most prevalent of these is the "Golden Rule Exemption". This ensures that a landlord will only be required to make energy efficiency improvements if the cost of doing so is less than the expected energy savings made in the year following the improvements. It is also proposed that a landlord will not have to make improvements if the consent of a tenant or superior landlord cannot be obtained, or in the unlikely event that the improvements would result in a devaluation of the property.

Despite the above, landlords will not be exempt permanently and it is proposed that the exemption will only be valid for a "reasonable period". The Government has suggested a time-frame of five years, but is open to further suggestions from the public on this point.

When would these regulations come into effect?

The consultation sets out the Government's preferred method of a phased introduction of the new regulations. If this approach is adopted, the regulations will apply to new leases to new tenants from 1 April 2018, but with a hard "backstop" at a later date applying the requirements to all leases. The Government is currently proposing a backstop date of 1 April 2023 for non-domestic properties and 1 April 2020 for domestic properties, which they feel reflects an adequate period of transition.

Non-Compliance

Local Authorities and Trading Standards Officers would enforce the regulations. However, the consultation acknowledges the potential difficulties in distinguishing between compliant F and G rated properties (with a valid exemption) and F and G rated properties that are rented out in breach of the regulations. The Government discusses a number of possible solutions to this, including the certification of exemptions and the power to request evidence of compliance from landlords.

In the event that a landlord breaches the regulations, the landlord would incur a fine under the proposed regulations. The fine is likely to be calculated using a percentage of the rateable value of the property (non-domestic) or the rent payable for the period of non-compliance, subject to a minimum fine of £1,000 and a maximum fine of £5,000 (domestic).

Additional Regulations for the Domestic Sector

For the domestic sector, the Government is also proposing to introduce regulations from 1 April 2016 that prohibit landlords from denying their tenant's request for consent to make energy efficiency improvements to their homes, provided that the landlord will not suffer any net or upfront costs. The tenant may make a request at any point during their tenancy, unless the tenant has given notice to quit or the landlord is pursuing court action against the tenant for breach of their tenancy.

The tenant must obtain an EPC or Green Deal Assessment and secure quotes for funding before making the request to the landlord. The consultation refers to a number of funding options that are available to tenants such as Green Deal Finance, Energy Company Obligation, grants from the Local Authority and, of course, the tenant's own sources.

Unlike the minimum standard regulations, these regulations will apply to properties regardless of their EPC rating or whether they have an EPC certificate at all. The Government does not propose to exclude those properties that do not have an EPC, but would need to have one if sold or let, from the tenants' improvement regulations.

The Government has suggested a number of circumstances in which landlords will have a right of reasonable refusal. These include where a landlord has previously offered the tenant a similar package of improvements and the tenant refused consent; or where the landlord has already evidenced plans to develop or undertake refurbishment that includes energy efficient measures within one year of the tenant's initial request. The consultation also seeks views as to whether landlords should be permitted to also offer a counter proposal in their response offering alternative improvements.

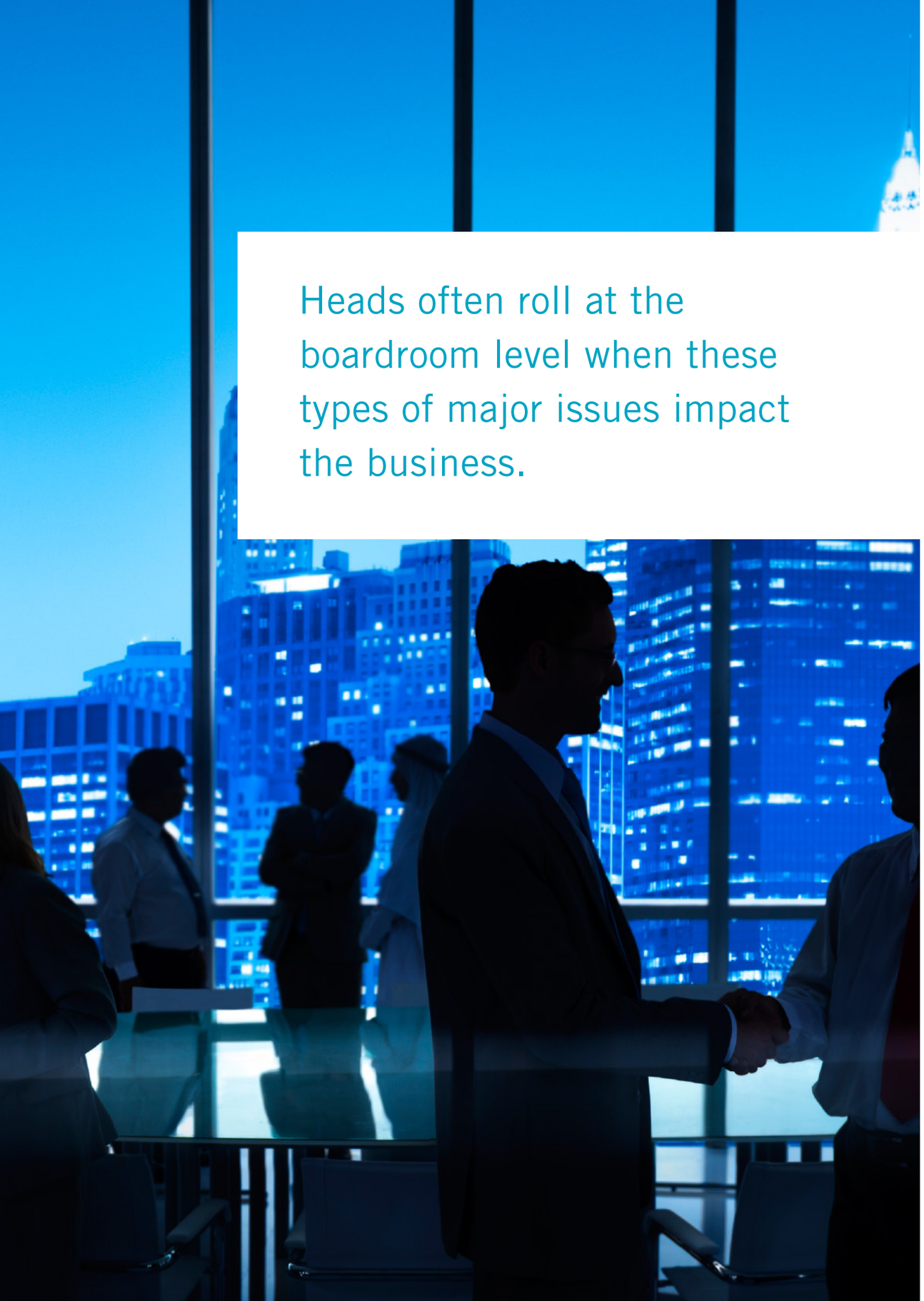
In the event of a dispute between the landlord and tenant over a request and if any issues cannot be resolved, the regulations will make provision for a tenant to take the matter to a tribunal to request a ruling whether the landlord's response is reasonable.

Conclusion

The consultation does raise some issues which deal with how the regulations would actually be implemented in practice, but there is still a great deal of uncertainty as to how that implementation would work. Various working parties were active in putting across their view to the DECC, prior to consultation being issued, so we do expect the results of the consultation to be comprehensive.

By Josie Marsden (josie.marsden@klgates.com)

If you are interested to learn more detail about the proposed regulations then please contact a member of the London K&L Gates Sustainability Team, Steven Cox (*steven.cox@klgates.com*) or Bonny Hedderly (*bonny.hedderly@klgates.com*).



Heads often roll at the boardroom level when these types of major issues impact the business.

K&L Gates launches Global Boardroom Risk Solutions to assist businesses in managing and mitigating their risks

Board directors have found their conduct being subject to even greater degrees of scrutiny by regulators, authorities, activist shareholders, liquidators and the media. Where major incidents have impacted businesses, whether a fraud investigation, a regulatory infringement, allegations of anti-competitive behaviour, accidents or data breaches, board directors have frequently found their positions untenable. On occasions, they have been personally implicated in time-consuming and expensive investigations and even criminal prosecutions. In today's climate, board directors as a whole need to ensure that corporate risks and exposures are addressed head on to ensure that the company's (and consequently their own) best interests are properly protected. Heads often roll at the boardroom level when these types of major issues impact the business.

Building on decades of experience in the service of companies and their boards as trusted legal advisors, K&L Gates has developed a new, unique, international, multidisciplinary approach to risk mitigation. Working collaboratively with directors and management, K&L Gates assists in identifying, evaluating, mitigating, and responding to legal risk in its various forms. We help our clients to understand the nature and extent of legal risk; to avoid, reduce, and mitigate risk; and to take fast, aggressive, and effective action when risk materialises.

We advise on all aspects of legal, regulatory and compliance risk or any combination of risks that can affect an organisation and its board. From fraud, corruption

and employment and workplace safety to corporate governance, competition issues and cyber risks, our firm can bring great insight and assistance to our clients. Our multidisciplinary approach gives our clients access to sophisticated lawyers familiar with the full spectrum of legal, regulatory, and compliance issues. We also advise on regulatory and criminal investigations and insurance coverage issues. Our advice can cover domestic and international issues.

We know cost matters—and so does cost avoidance. By providing an integrated service tailored to particular client circumstances, very often with the benefit of legal professional privilege, K&L Gates helps companies and directors to anticipate and deal with risk effectively and efficiently. Our advice falls into two categories, risk mitigation and risk response. Risk mitigation advice includes identifying danger hotspots and helping clients to tackle them; reviewing internal procedures, guidelines or policies; and providing training to teams. Risk response advice includes advice to clients on responding to emergency situations such as dawn raids, environmental incidents, criminal investigations or data breaches, as well as helping to maximise recoveries from insurers, which in many instances will even also cover our own legal costs.

For further information about our Global Boardroom Risk services, please get in touch with your usual contact at K&L Gates or our London Administrative Partner, Tony Griffiths at tony.griffiths@klgates.com.

Cyber Risk and Global Security Issues: is your business fully prepared?

As part of our Global Boardroom Risk Solutions programme, we are hosting a Cyber Risk seminar on Thursday 2 October 2014 from 14:00 - 18:00 in our London office. Cyber-attacks are on the rise with unprecedented frequency, sophistication and scale. They are pervasive across industries and geographical boundaries, whether a one off event or a sustained attack over a period of time. A panel of global partners will discuss the impact of data breaches and cyber attacks on organisations, from both the U.S. and EU perspectives.

For more information or to attend this event, please email *eventslo@klgates.com* or call +44.(0)207.360.8248.

Refit and refurbishment projects - mind the (insurance) gap

Is there existing buildings insurance and how does it inter-relate with any separate contract works cover?

Is the contractor aware of their insuring responsibilities?

Will a landlord's buildings policy cover a tenant's refit?

On any construction project there should usually be a suite of insurance policies in place such as a contractor's all risks policy (CAR), a public liability policy and professional indemnity policies. This is a non-exhaustive list.

Buildings insurance becomes highly relevant when an existing building is undergoing refurbishment works as opposed to a situation in which a new build scheme is underway. There is of course no building to protect or insure at the start of a new build project.

On a refurbishment project it is important to have regard to how separate contract works policies inter-relate with any existing buildings insurance policy (most likely to have been taken out by the landlord or freehold owner).

Depending on the nature and extent of the construction works it may be possible to extend the buildings insurance policy to cover the works and potentially also the contractor. However, each party needs to take care to avoid gaps between their potential liabilities and the insurance coverage which that party benefits from.

JCT contracts

JCT contracts have three standard insurance options - A & B (which typically apply to new builds) and Option C for existing structures. In its standard form Option C requires the employer to take out insurance that covers both the works and the existing buildings. The insurance has to be in the joint names of the employer and the contractor. Furthermore, insurers must waive all rights to bring subrogated claims against the contractors and any sub-contractors in the event of any damage caused during the works.

The coverage to be obtained by the employer in respect of the works under Option C is for physical loss or damage to the works and site materials as well as reasonable costs of debris removal / shoring up which is to operate on an "All Risks" basis but this does not include coverage for wear and tear or losses due to defective design, materials or workmanship.

The coverage which the employer is to obtain for the existing structure under Option C is for the full cost of reinstatement, repair or replacement of loss or damage to the existing structure due to the occurrence of "Specified Perils" such as fire, flood and escape of water.

While the coverage is broad, it is not extensive as, for example there will be no coverage for consequential losses (i.e. loss of rents / profits) or damage to existing structures by perils other than those specified in the JCT contract. This leaves the contractor / sub-contractor exposed to claims by the employer and, if different, the owner of the building to recover such losses. This is one reason why it is important that the contractor maintains its own liability insurance sufficient to cover a total loss event.

Tenant's Works

Option C may seem the obvious choice for tenants who are engaging contractors to carry out refurbishment or refit works. However, in many cases a tenant is unable to comply with the requirements of Option C. This can be for a number of reasons:

1. It is often the case that the landlord or head leaseholder will take out the insurance covering the existing building and the tenant has no control over the terms of the building policy.
2. The tenant only has an insurable interest in its own demise and may not have any interest in the whole building in which case the tenant cannot obtain insurance cover in relation to the rest of the building.
3. Tenants may be prevented under the terms of their lease from taking out insurance in relation to the existing building.
4. While the tenant may be covered for its demise under the landlord's buildings policy, landlords are increasingly not prepared to extend coverage under the buildings policy to the tenant's contractors / sub-contractors. This is principally because landlords are unwilling to bear the cost of damage caused by contractors that will lead to increased premiums under the buildings insurance in the future.

Where a tenant is the employer under the JCT contract, careful consideration should be given to whether the tenant can comply with Option C and, if not, to make it clear during the contract tender process that the contractor(s) will not benefit from the buildings insurance or a waiver of subrogation by insurers under the buildings policy.

In this type of situation, consideration will need to be given to alternative insurance arrangements, for example, by the employer insuring the works only and requiring the contractor to maintain appropriate third party / public liability insurance with an appropriate level of indemnity to cover damage caused to the building by the works. This in itself may not be a comprehensive solution as contractor's liability insurance is only likely to respond when the contractor is liable in negligence or for breach of statutory duty, and is not an "All Risks" type cover.

Tenants are therefore advised to be sure what type of All Risks policy they take out to cover the works and to check that it complies with the building contract. A tenant also needs to consider, in conjunction with the landlord and the contractor, whether a buildings insurance policy or the contractor's public liability policy covers the risk of damage to the rest of the building caused by the works.

By Sarah Emerson
(sarah.emerson@klgates.com)

Example scenario:

A tenant's contractor is carrying out refit works to the tenant's expensive office space located on the top floor of a multi-occupancy building. The contractor causes damage to pipework during these works and floods the entire building.

The landlord may choose to sue the contractor and/or the tenant (if there is no waiver of subrogation) for the cost of repairing the damage and for consequential losses such as loss of rent/profits. There may be claims from other tenants in the building too.

Under the terms of the construction contract, the parties selected the standard JCT Insurance Option C which required the tenant, as employer, to obtain insurance coverage in respect of loss/damage to the contract works and damage to the existing structure caused by the works. However, the Landlord was unprepared to cover the constructor under the buildings policy which also excluded loss or damage to the building due to refurbishment works. The tenant therefore failed to comply with Option C and faces indemnity claims from the contractor due to the tenant's breach of contract in failing to obtain relevant insurances protecting the contractor.

K&L Gates Asian Outbound Investment Practice

Asian investors are increasingly seeking international real estate investment opportunities as a way to diversify domestic risk and achieve better returns. Our lawyers are at the forefront of this trend, assisting Asian companies to grow their real estate portfolios in international markets.

We focus on alleviating the challenges faced by our clients when expanding into new markets by helping them to navigate government policies and regulations associated with foreign real estate investments.

7 Asia offices and 200 real estate lawyers across 5 continents

Our strong relationships with local real estate agents, accountants, financial institutions, builders and project managers around the world ensure our clients are not only provided with seamless advice throughout the life of an investment but can be introduced to new networks to expand their operations.

With a dedicated global Real Estate group, and drawing upon our full service capability, K&L Gates can help you grow your international real estate portfolio with detailed analysis of the local markets, enabling you to make better decisions and achieve greater results.

We assist clients with all types of international real estate investments

Drawing on our knowledge of the local markets and connecting to new networks

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Legal Update - TUPE

Latest case on the application of TUPE in a commercial property context

A recent decision of the Employment Appeal Tribunal (EAT) has provided further guidance on the circumstances in which TUPE will apply in a commercial property context.

As a reminder, TUPE applies where there is a "relevant transfer". A relevant transfer can either be a transfer of a business as a going concern or a "service provision change". Service provision changes usually take place in an outsourcing situation and occur where services are first outsourced from a client to a contractor, taken back "in-house" by the customer or where one contractor is engaged to replace another.

In 2012, the Court of Appeal decided that for a service provision change to take place when one contractor replaces another, the activities which are carried out by the different contractors must be carried out on behalf of the same underlying client.

For example, if the owner of a building decides to replace one security company with another, TUPE will usually apply so as to transfer those employees employed at the building by the outgoing contractor to the new contractor since the underlying client, the owner of the building, remains the same.

However, where the buyer of a property engages its new managing agent on the same day as completion of the acquisition of the building, TUPE will not apply so as to transfer the outgoing managing agent's employees to the incoming agent because the underlying client (the owner of the building) changes at the same time as the service provider.

This decision has limited the application of service provision changes (and therefore TUPE) in the commercial property context since changes in subcontractors often take place at the same time as a change in ownership or management of the property.

In the recent case of *Horizon Security Services Ltd v Ndeze*, Mr Ndeze worked as a security guard at a serviced office complex owned by the London Borough of Waltham Forest and managed by Workspace plc. Workspace subcontracted security to the PCS group. Workspace gave notice of termination of its contract with PCS since the office complex was due to be demolished and replaced by a supermarket. Workspace advised PCS that if it wished to continue providing security services at the site following the expiry of their contract up to the demolition, then it would need to enter into a new contract directly with Waltham Forest. PCS tendered for the contract with Waltham Forest, but was unsuccessful, and the contract was instead awarded to Horizon Security Services Limited.

Mr Ndeze was dismissed and claimed that his employment should have transferred to Horizon under TUPE. The Employment Tribunal decided that TUPE applied since the underlying client for whom the security services were provided ultimately stayed the same, namely, Waltham Forest.

The EAT overturned this decision. PCS had its contract with Workspace and had no direct relationship with Waltham Forest. It decided that the Employment Tribunal had not been entitled to decide that security

services were being provided on behalf of Waltham Forest simply because it owned the building. The EAT ruled that PCS' client was Workspace and Horizon's client was Waltham Forest. Therefore, since the underlying clients were different, there was no service provision change and TUPE did not apply.

This decision is consistent with previous cases and is a very good example of when TUPE will (and will not) apply in a commercial property context. It also demonstrates how owners of property can effectively prevent TUPE from applying to themselves by ensuring that, at all times, services are carried out by subcontractors. Managing agents and subcontractors, who have previously been used to the application of TUPE, may find that they are now left with unexpected redundancy costs at the end of contracts as a consequence of the current case law. This may be something that they will need to consider building into pricing when bidding for contracts.

By Paul Callegari (paul.callegari@klgates.com) and Emma Thomas (emma.thomas@klgates.com)

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