LKP Proposal to Secure Private Sector Funding for Cladding & Associated Fire Safety Defect Remediation: Briefing Documents

Endorsed by the UK Cladding Action Group (UKCAG)

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UKCAG: WHY CLADDING AND FIRE SAFETY VICTIMS NEED
THE LKP FINANCIAL SOLUTION TO REMEDIATION

Summary

On 10 February, the Secretary of State for Housing, Communities and Local Government, Robert Jenrick, announced an additional £3.5 billion of funding for cladding remediation works. However, this funding will be distributed for cladding removal only and not for remediating the fire safety defects, which usually account for the majority of the remediation costs. Further, only buildings over 18 metres in height are eligible, the minority of affected buildings. Leaseholders in buildings between 11 metres and 18 metres will have loans forced on them to pay for cladding remediation (up to £600 per annum) and buildings under 11 metres will receive nothing. After months of assurance by the Government that leaseholders would not have to pay the cost of remediation, our members are devastated. They face an inability to get credit, negative equity, *bankruptcy and homelessness.*

The introduction of the EWS1 form has exposed the extent of mass fire safety defects in apartment buildings. The bills have been piling up for interim fire safety measures and extortionate insurance premiums, and, as shown by the case of Haley Tillotson, the bankruptcies have now started. We are also sadly aware of recent suicides. UKCAG has spent over three years pleading with government and industry to do the right thing by leaseholders, who are the victims of systemic regulatory failure and corporate malfeasance. Despite years of promises, they have not. If the government does not intervene, tens of thousands (and potentially hundreds of thousands) of leaseholders *will go bankrupt*. The situation is acute; demands for payment for remediation works are now being widely issued to leaseholders across the UK. We are now at the crisis point for millions of leaseholders across the UK.

Data

£49,000: The average cost for building remediation. This cost includes remediating cladding and/or other fire safety defects.

£100,000+ *Inside Housing* found that 15% of survey respondents (1,324 leaseholders) had remediation costs of over £100,000.

£75,000-250,000 57% of flats requiring remediation were purchased for *under* £250,000. Given the remediation costs, this will clearly put huge swaths of flat owners into negative equity.

£0-35,000 The household income of 33% of affected flat owners.
£0-50,000 The household income of 59% of affected flat owners.
These household income figures clearly illustrate that it is not possible for flat owners to sustain continued costly interim fire safety measures and excessive insurance premiums. It is also clear that a £600 annual loan repayment

would absolutely not be affordable for many and would prevent several members from being awarded credit due to affordability criteria. Worst, the remediation bills are wholly unaffordable and will push many into bankruptcy/homelessness.

17% Percentage of Inside Housing survey respondents currently exploring bankruptcy.

23% The percentage of those respondents who had considered suicide or self-harm among leaseholder survey respondents to UKCAG's Cladding & Internal Fire Safety Mental Health Report 2020.

Inside Housing's survey may *under*state the risk of bankruptcy for hundreds of thousands of leaseholders. Many of the demands for payments are based on estimates for costs of works; the costs frequently rise once the cladding is removed and the scale of the fire safety defects becomes clear.

Is there No Recourse for Leaseholders?

Leaseholders have no legal claims once their buildings are more than six years old. There is a strict six-year limitation period for the most likely claims in relation to building defects. The six-year time limit in which to bring claims runs whether or not leaseholders are aware of any defects. Even where claims are still within time, litigation is often impossible because developers form special purpose vehicles which are liquidated once flats are sold. It is extremely costly for leaseholders to fund litigation against large developers. Litigation is also a risky and lengthy process.

Claims against developers, builders and building inspectors typically fail; in one recent cladding-related case it was determined that the law deems that those parties do not owe any duty to avoid causing pure economic losses.[1] In addition, building insurers will typically not pay replacement of cladding and fire safety remedial work because they are regarded as falling outside the losses covered by the policies.

There have been no cases to date of leaseholders successfully suing the NHBC for payment of fire safety defect or cladding remediation claims. There have been several reports of the NHBC refusing claims for cladding and fire safety defect remediation because either the Building Control work was not performed by an NHBC Approved Inspector or because the NHBC claims the warranty does not cover the remedial work because there is no immediate risk to life or because the work is not structural in nature.

One warranty provider, East West insurance, which assumed a portfolio of latent defect insurance policies previously written by Zurich, went into administration in October 2020,

[1] See, e.g. the decision in *SportCity 4 Management Limited and Others v. Countryside Properties (UK) Limited* [2020] EWHC 1591 (TCC) and *Robinson v. PE Jones (Contractors) Ltd* [2012] Q.B. 44 in relation to builders and *Murphy v. Brentwood District Council* [1991] 1 A.C. 398 in relation to building inspectors.

owing an estimated £210 million to creditors, being leaseholders who bought their homes thinking they had cover against building defects under these policies. Any claims on those policies will have to be met by the Financial Services Compensation Scheme, assuming the Supreme Court upholds recent decisions that the policies actually cover leaseholders at all.

What Are UKCAG Members Saying?

Quotes from UKCAG members:

"I did everything in my power to avoid going bankrupt. I watched my bank account drain to pennies. I tried to be optimistic, telling myself we'd get the money from the government fund soon. But I just could not afford to keep meeting the monthly payments. I ran out of money and time. Last month, I declared bankruptcy."

"I just need this nightmare to end. It's unbearable. I'm just waiting for my bill. Just feel sick thinking about it. My husband has just been made redundant on top of everything else too! Feels like we have no future."

"I have honestly thought about making a video about the plight we are facing and jumping off a bridge to kill myself. As death (with Grenfell) started this mess, then perhaps death would get people out of it. So my thoughts were if I ended it then maybe others would be saved and free from the mess the government has caused us."

"It is ruining my husband's and my retirement; we can make no plans. I have gone back to work. We are worried about financial ruin and losing our family home. This is the worst of times. We have worked all our lives and we now face ruin."

However, despite this arbitrary three tiers of funding, UKCAG's members are unified in their position that funding must be awarded to remediate all buildings with major fire safety defects.

Conclusion

Leaseholders are more than numbers; they are citizens who worked hard and saved to buy their flats. They are first time buyers; they are families, and they are pensioners. They include nurses, teachers, doctors and social workers, with an average combined household income of less than £50,000. They purchased their flats in good faith and having conducted all the due diligence required. Leaseholders would have never dreamed of the systemic regulatory failure which facilitated manufacturers to fraudulently classify their products as safe. They could have never imagined that developers would leave out mandatory fire safety mitigation measures to further increase profits, that private building inspectors would approve defective buildings, or that insurers and warranty providers would refuse claims against such fire safety defects. Leaseholders, excited to buy their homes, often their

only asset, would have never been able to fathom that they would be left paying the bill for this systemic regulatory failure and corporate malfeasance.

On behalf of millions of leaseholders, we write to implore you to implement the LKP Proposal. As things now stand, it is the only hope that thousands of leaseholders have to not become bankrupt victims of the building cladding and fire defect crisis.

Ritu Saha & Dr William Martins,
UK Cladding Action Group

OUTLINE OF LKP PROPOSAL TO SECURE PRIVATE SECTOR FUNDING FOR CLADDING & ASSOCIATED FIRE SAFETY DEFECT REMEDIATION

Summary

This briefing paper outlines a potential financial and legal solution providing for affected buildings to be remediated quickly; to be financed from the private sector; and to allow flexibility/expansion. The Leasehold Knowledge Partnership (LKP) proposal prevents the financial burden from falling on leaseholders and the taxpayer. The proposal is in line with the stated view of Prime Ministers,[2] Ministers and the Communities Select Committee that the cladding bill should not fall on the leaseholders.

LKP & Authors

The Leasehold Knowledge Partnership (LKP) is a registered charity and the secretariat of the All Party Parliamentary Group on leasehold and leasehold reform. It was established to protect and advise leaseholders on how to navigate the unjust leasehold system. As part of this work, LKP publishes authoritative editorials, and campaigns for legislative and regulatory changes.

LKP's proposal has been developed in consultation with financial and legal professionals, and affected leaseholders. It has been co-authored by Lucy Brown-Cortes and Liam Spender, and led by Dr. Dean Buckner. Dr Buckner has worked in the financial services industry for over 30 years. He spent the last 20 years with the FSA, PRA and Bank of England, retiring from the B of E in 2018. Dr Buckner specialised in derivative and asset valuation, and capital modelling for the banking and life insurance sectors. He is currently a Trustee of LKP, Policy Director at the UK Shareholders' Association and Co-Founder of Eumaeus, a policy project with Dr Kevin Dowd of Durham University.

Current Challenge

While there is no exact data, current government estimates suggest 3 million leaseholders[1] in approximately 13,000 buildings are affected by cladding and associated fire defects, with a potential remediation cost of around £15 billion.[3] The Fire Protection Association reports that thousands are facing impending bankruptcy and homelessness.[4]

This situation is rapidly becoming more acute, as leaseholders are served with section 20 notices this month for upcoming cladding remediation costs, in line with the Building Safety Fund schedule.

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[2] Boris Johnson (PMQs 12 Dec 2020), Theresa May (PMQs Jan 2019).

[3] Building, "Hackitt reveals government is working on changes to Building Safety Bill." November 2020. https://www.building.co.uk/news/hackitt-reveals-government-is-working-on-changes-to-building-safety-bill/5109172.article

[4] "Bankruptcy and Homelessness Concerns Over Cladding Crisis," Fire Protection Association. October 2020. https://www.thefpa.co.uk/news/bankruptcy-and-homelessness-concerns-over-cladding-crisis

Proposal by LKP

1. A single special purpose vehicle to provide about £16 - £20.25 billion of funding for remediation upfront, or to be drawn down over a period of time up to the maximum, with a 50 year maturity at a fixed coupon attractive to pension firms (suggested rate of approximately 0.6%, dependent on the market). Initial feedback from the fixed income market indicates a strong demand for this structure.
2. Managed centrally to minimise administrative costs
3. A 'window' where affected buildings would apply, similar to or connected to the Building Safety Fund
4. Costs to be recovered by a series of levies.
    - The contributors to the levy to be decided, but this paper proposes developers and freeholders first and foremost, possibly others such as non-domiciled foreign buyers, and cladding manufacturers.[5]
5. Costs to be assessed against acceptable risk to life and property.
6. Excess costs, if any, to be recovered by reinsurance arrangement.

The vehicle would be established on a statutory basis, as follows.

a) The managing board to be set up under Act of Parliament, giving the board the power to collect a levy.
b) The factors to be considered in setting the levy to be set out in the Act, supplemented with a statutory instrument.
c) With board power to make rules to collect the levy in accordance with the Act and that statutory instrument.
d) The board to set the levy rules annually, in consultation with the industry and any other relevant stakeholders.
e) The board subject to both ministerial oversight and Parliamentary oversight.
f) The relevant minister to appoint board members, with the board reporting annually to Parliament.
g) In addition to making the Act, Parliament would also review any statutory instrument regarding the matters to be considered in the setting of the levy.
h) Last but not least, the board should be subject to judicial review if anyone affected by its levy rules argues that these are not within the board's power to make.

Thus:

- The SPV would be the mechanism by which costs are recovered in the long term.
- Its statutory powers would impose levy on those who can afford to pay.
- Present value zero or positive, no cost to taxpayer.
- Create a funding model to address the problem of long-term financing for pensions.

[5] Such a levy – on new buildings, though oddly not ground rents, was proposed by Long Harbour (a £2 billion ground rent fund). It was submitted in May 2020 to the MHCLG select committee when it held an enquiry into the progress of cladding remediation. https://committees.parliament.uk/writtenevidence/5232/pdf

Indicative Levy Sources and Revenues:

Levy	**Details**	**Annual Revenue**	**Duration**	**Present Value**
New Build	1-2% of sale price	425m	10 years	4.25bn 8.5bn
Ground Rent	10% of ground rent	30m	50 years	1.5bn
Non-Resident Foreign Buyer	Extra 3% of sale price + removal of first time buyer exemption	375m	10 years	3.75bn
Manufacturer				1.5bn
VAT rebate	Remediation works zero-rated			3bn *(dependent on works)*
Government Contribution	Building Safety Fund			5.0bn *(Building Safety Fund)*
Total				£19bn - £23.25bn

Conclusion

The proposal detailed above is transparent and accountable, and works. It solves a contentious political issue in a just and proportionate way. It enables people to move on with their lives. We underscore that it does not require a 'magic money tree,' as financing could be provided by pension funds and other long term investors and repaid by private sector levies. Further, it has the potential benefit of helping to stabilise the insurance market - specifically with regard to professional indemnity cover and buildings insurance. It

may also bring more certainty to the sales market, reducing risk to the valuer and the conveyancer, and avoiding what appears to be an emerging collapse in the market.

Dr Dean Buckner
Liam Spender
Lucy Brown-Cortes

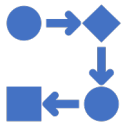
Benefits of LKP Proposal

Immediate, upfront remediation funding

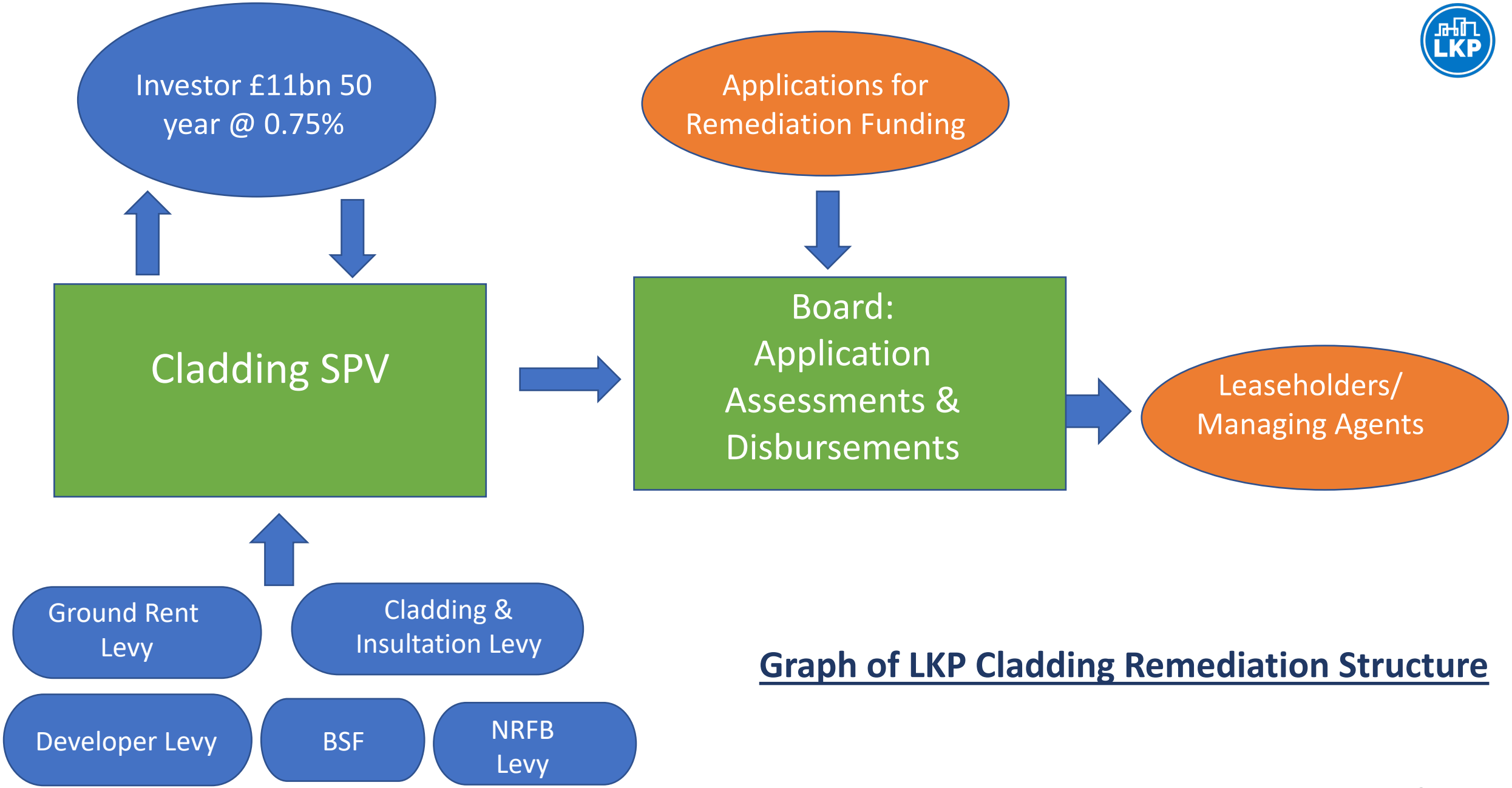
Debt *not* placed on leaseholders

No additional government funding or borrowing required

Flexibility and ease of administration



Accountability & Transparency



Graph of LKP Cladding Remediation Structure

Proposed Levy Revenue Examples

Levy	Details	Annual Revenue	Duration	Present Value
New Build	1-2% of sale price	425m	10 years	4.25bn - £8.5bn
Ground Rent	10% of ground rent	30m	50 years	1.5bn
Non-Resident Foreign Buyer	Extra 3% of sale price + removal of first time buyer exemption	375m	10 years	3.75bn
Manufacturer				1.5bn
VAT rebate	Remediation works zero-rated			3bn *(dependent on works)*
Government Contribution	Building Safety Fund			5bn *(Building Safety Fund)*

Costs Under MHCLG and LKP Proposals

MHCLG	Average Cost	Sub 11m Leaseholder Bill (ave – max cost)	11m – 18m Leaseholder Bill (ave – max cost)	Over 18m Leaseholder Bill (ave – max cost)
Cladding Costs	£23,000	£17,000 - £38,000	Loan repayment	Minimal costs
Fire Defect costs	£29,000	£23,000 - £100,000	£23,000 - £100,000	£29,000 - £100,000
Cost to government	£5 billion + admin costs + borrowing cost			

LKP	Average Cost	Sub 11m Leaseholder Bill	11m – 18m Leaseholder Bill	Over 18m Leaseholder Bill
Cladding Costs	£23,000	0	0	0
Fire Defect costs	£29,000	0	0	0
Cost to government	£1.6bn + admin costs + lost VAT revenue from remediation works			

** Cost estimates based on ARMA and Inside Housing figures*

MHCLG vs LKP Remediation Financial Solution

Item	MHCLG Scheme	LKP Proposal
Who Pays for Remediation	£10 billion leaseholders (at a minimum) £5 billion government £2 billion developer levy	Levies on those responsible for the cladding + fire safety defect crisis, Non Resident Foreign Buyer Levy and VAT Zero rating.
Speed of Funding	Requires loan scheme set up plus legislative changes.	Requires SPV set up.
Risk to Leaseholders	Significant. Leaseholders face negative equity and bankruptcy, particularly in areas of lower property values and those in shared ownership. Leaseholders face paying unaffordable loan repayments. Leaseholders' ability to get credit will be impacted (assessment of credit worthiness) Ongoing cost to leaseholders of interim measures until remediation works are completed.	Limited. Leaseholders' risk is in length of time needed for remediation works to take place, although these will be prioritised on a risk weighted basis. Cost of interim fire safety measures until remediation.
Risk to Housing Market	Significant. Value of flats with outstanding loans will be reduced. Flats unlikely to be sold because of large outstanding cladding and/or associated fire defect remediation bills and works. In buildings with large fire safety remediation bills and low property values, mass bankruptcies are likely.	Minimal. 1-2% developer levy is unlikely to have an impact on new construction given the CIL and profit margin data. Will free up the market due to structure for immediate and assured funding on a risk assessed basis.
Speed of Remediation	Slow or non-existent for buildings sub 18m requiring leaseholders to pay upfront for expensive fire safety defect works (and cladding, for buildings under 18m).	Medium. Will need to be processed through the Board and completed on risk-based priority.

Risks to Leaseholders of MHCLG Proposal: Bankruptcy & Negative Equity

Pre-crisis value of flats impacted by dangerous cladding

Based on 1,324 leaseholder responses to Inside Housing survey, February 2021

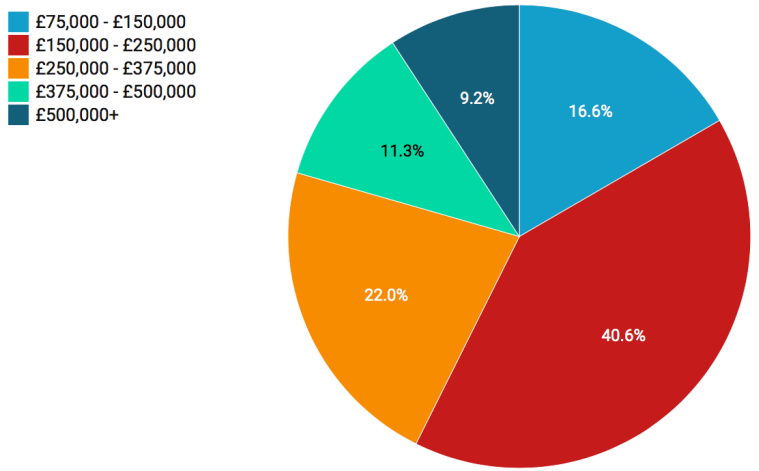


Chart: Peter Apps • Source: Inside Housing • Get the data • Created with Datawrapper

Remediation costs set to be passed to leaseholders

Based on Inside Housing survey of 1,324 leaseholders carried out in February 2021

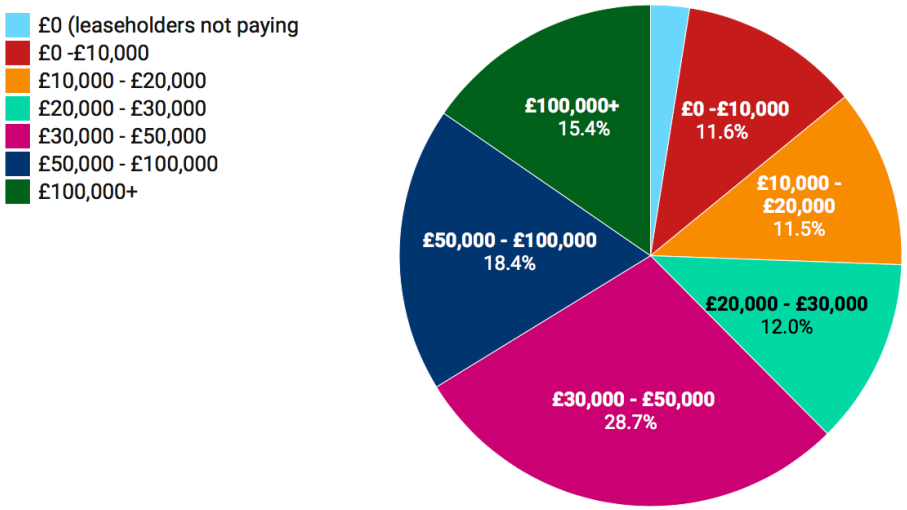


Chart: Peter Apps • Source: Inside Housing • Get the data • Created with Datawrapper

Average household income of impacted leaseholders

Based on responses to Inside Housing survey of 1,324 leaseholders conducted in February 2021

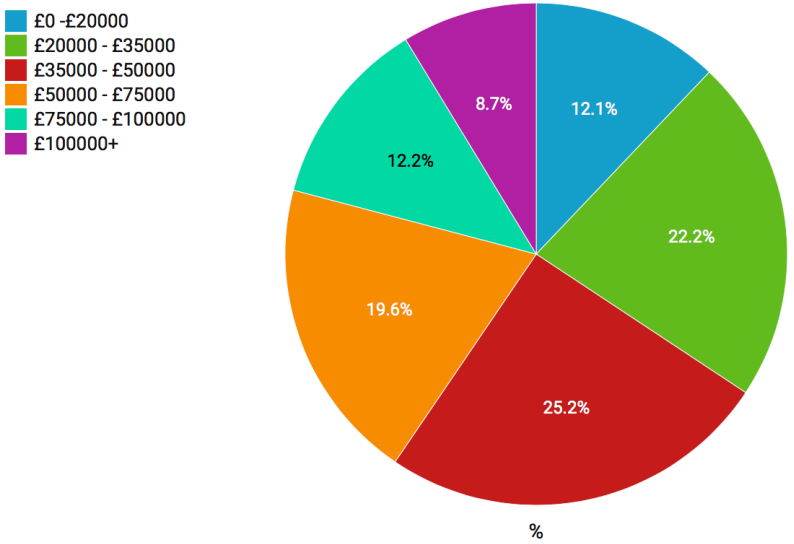
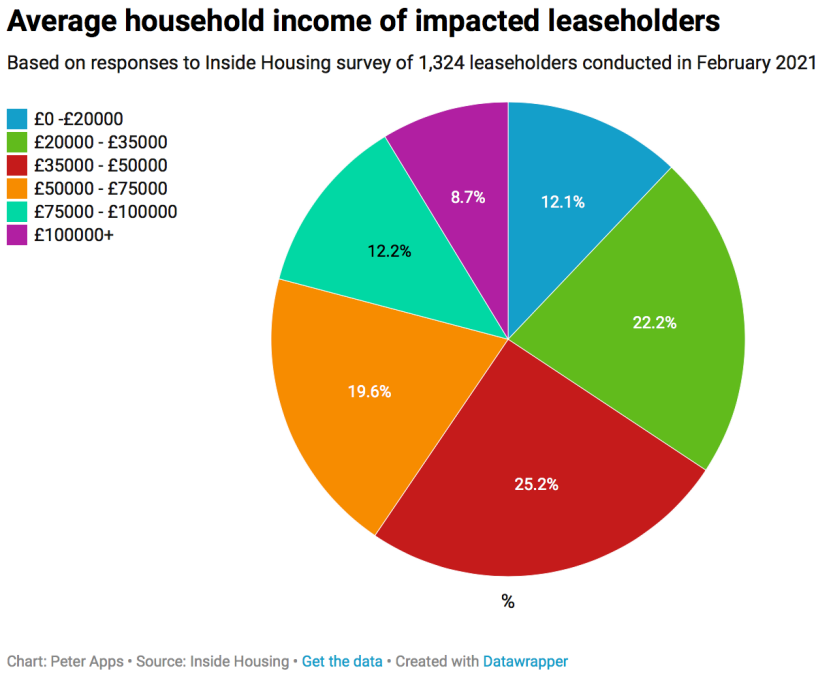
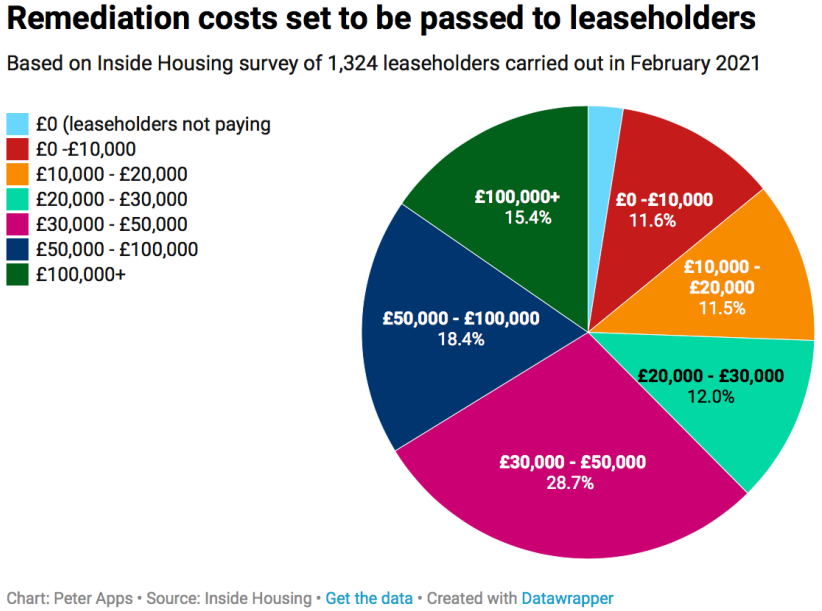


Chart: Peter Apps • Source: Inside Housing • Get the data • Created with Datawrapper

MHCLG Proposal: Costs and Incomes

MHCLG	Average Cost	Sub 11m Leaseholder Bill (Ave – Max Cost)	11m – 18m Leaseholder Bill (Ave – Max Cpst)	Over 18m Leaseholder Bill (Ave – Max Cost)
Cladding Costs	£23,000	£17,000 – £38,000	Loan repayment	Minimal costs
Fire Defect costs	£29,000	£23,000 - £100,000	£23,000 - £100,000	£29,000 - £100,000





** Cost estimates based on ARMA and Inside Housing figures*

Practical and Legal Difficulties in Implementing the Freeholder Loan Proposal

18 February 2020

1. Executive Summary

1.1. This paper identifies and discusses some of the key legal and practical difficulties proposed by the government's loan system to remediate cladding defects in buildings standing 18 metres or less.

1.2. This paper does not discuss other points of principle against the scheme, such as the fact that leaseholders in buildings under 18 metres are being forced to take out loans and thereby forced to pay all of the costs of remediating cladding and non-cladding defects not of their making. It also appears that a forced loans scheme will take time to set-up and administer, further delaying any cladding remedial works and potentially disrupting the housing market.

1.3. The proposed forced loan arrangements will apparently cover only the cost of cladding related works. Cladding remediation costs are estimated to be around £20,000 per affected apartment. Many buildings also require internal works to address defective or missing compartmentation or other fire safety measures. Such works are estimated to cost an average of a further £20,000 to £25,000 per affected apartment.[1] No works will start until all of the necessary money is paid into the building's service charge account. If leaseholders cannot afford the lump sum costs of the non-cladding works then works will not go ahead and the forced loans proposal will not achieve its aim of allowing works to go ahead.

1.4. One of the government's justifications for imposing forced loans on leaseholders is that it will create the space to pursue those responsible by spreading the cost of remedial works to cladding over many years. As explained below, this is not possible where claims are already out of time. In such cases there is no prospect of anyone other than the affected leaseholders paying the loans. Even where legal claims are possible, they are not fit for purpose, precluding leaseholders from claiming many types of loss they are sustaining.

1.5. The Financial Conduct Authority's rules for new mortgages, re-mortgages and other forms of consumer credit, such as credit cards, require lenders to take into account service charge payments when assessing the affordability of repayments. The £50 a month cap on forced loan repayments in the form of a fixed service charge will be factored into affordability assessments. That may preclude some borrowers from new mortgages, re-mortgages or in relation to other forms of consumer credit.

[1] https://www.leaseholdknowledge.com/lkp-response-to-robert-jenrick-cladding-3-5bn-exceptional-intervention-to-cladding-high-rises-today/

1.6. The corporate financial arrangements of some freehold owning companies may prevent leaseholders in those buildings accessing the proposed forced loan scheme. These same arrangements may prevent the government obtaining security over the freeholds in respect of any loans advanced, which poses a risk of loss of funds to the taxpayer.

1.7. The proposed forced loan arrangements may affect leaseholders' ability to challenge the amounts freeholders spend on remedial works. In some cases, leaseholders may lose the ability to pursue contractual arguments they would otherwise have had under their leases that they should not pay anything toward remedial works because they amount to improvements but which are being forced on them because it suits the interests of the freeholder, the managing agent or the building insurer.

1.8. Some buildings where the Right To Manage has been exercised may have poor relations with the freeholder. It appears only the freeholder will be able to take out any forced loan. The Right To Manage company may not be able to access the forced loan scheme if the freeholder does not cooperate.

1.9. The proposed loan scheme may result in new administration charges being imposed on leaseholders. It is also unknown how the government will prevent the misuse of forced loan money for other corporate purposes of freeholders and managing agents.

2. Incorrect that forced loans will create space to pursue those responsible

2.1. During his announcement of the forced loans proposal on 10 February 2021, Robert Jenrick said that the forced loan scheme "*does not preclude any actions by the building or the leaseholders against insurers, those holding warranties or the developers, and those actions should take place*."[2] In other words, the Secretary of State implies that some of the forced loans may be repaid via the proceeds of legal action.

2.2. Mr. Michael Wade, Departmental Advisor to MHCLG, made a similar statement in different terms to the All-Party Parliamentary Group on Leasehold Reform's meeting on 10 December 2020. Mr. Wade went further, implying that voluntary contributions may be forthcoming from developers once the amount of remedial costs is fixed by way of forced loans.

2.3. Both claims are untenable. There are strict time limits for leaseholders (or freeholders) to bring claims in respect of defective buildings. The most likely claims are subject to six-year limitation periods. If a claim is not started by issuing court

[2] Commons Hansard, 10 February 2021, Column 335 in response to Sir Peter Bottomley MP.

proceedings by the last day of that six-year period, it is lost forever. In many cases these strict time limits have already expired.

2.4. The most likely claims are based in contract or in tort, or arise under the Defective Premises Act 1972 or the Consumer Protection Act 1987. Time for contractual claims runs from the date of breach, which is deemed to be the date of exchange of contracts.[3] Time for Defective Premises Act claims is six years from the date the building was completed.[4] The time limit under the Consumer Protection Act 1987 is either three years or ten years, depending on whether there is any claim for personal injury.[5] Time for claims under the Consumer Protection Act 1987 begins to run when the claimant either has knowledge of facts giving rise to the claim or suffers damage.[6] Time for other tort claims is six years from the date of breach of duty, which at the latest is likely to be the date the building was completed and likely earlier.[7] Time for bringing claims under contract, tort and Defective Premises Act claims runs whether the defects are known or not, unless the leaseholder can prove a deliberate concealment of the relevant facts giving rise to the claim.[8]

2.5. Even where claims are possible, the law precludes seeking certain types of damages ("pure economic loss") in negligence claims founded other than on certain duties of care. That restriction includes claims related to defective buildings. Claims against developers, builders and building inspectors typically fail, including in one recent case in relation to cladding, because the law deems that those parties do not owe any duty to avoid causing pure economic losses.[9]

2.6. If the Grenfell Inquiry does eventually make findings relevant to building defects, this will not do anything to improve the position of leaseholders whose claims are

[3] Section 5 Limitation Act 1980.
[4] Section 1(5) Defective Premises Act 1972.
[5] Section 11A Limitation Act 1980. The limitation period of three years applies to claims involving damages for personal injury (section 11A(4). The limitation of period of ten years applies to claims involving damages other than for personal injury (section 11A(3)). The shorter period of 3 years will apply to mixed claims for damages for personal injury and other damage.
[6] Claims under the Consumer Protection Act 1987 are subject to a longstop date of 10 years from the date the product was supplied. This limit in itself will preclude many claims in relation to cladding, insultation and defective buildings.
[7] Negligence claims are subject to a long-stop date of 15 years from the date of breach of duty. Again, this limit in itself will preclude many such claims in relation to cladding, insultation and defective buildings.
[8] This requires an active choice to conceal on the part of the developer, see e.g. *Cave v. Robinson, Jarvis & Rolf (a Firm)* [2003] 1 A.C. 384. Concealment that occurs in the ordinary course of construction (for example, missing or defective fire breaks being covered by floor coverings or stud wall partitioning) do not amount to concealment. Developers are also likely to argue that they are the victims of concealment by their sub-contractors and professionals, such as building inspectors, to avoid limitation periods being extended.
[9] See, e.g. the decision in *SportCity 4 Management Limited and Others v. Countryside Properties (UK) Limited* [2020] EWHC 1591 (TCC) and *Robinson v. PE Jones (Contractors) Ltd* [2012] Q.B. 44 in relation to builders and *Murphy v. Brentwood District Council* [1991] 1 A.C. 398 in relation to building inspectors.

already time barred.[10] Once a claim is time barred it cannot be resurrected, regardless of whether new facts emerge later. That is unless the government is willing to make retrospective changes to limitation periods and changes to substantive rules of law on damages. In the absence of such reforms, any relevant findings of the Grenfell Inquiry are only likely to be useful to two categories of cases. The first is the litigation surrounding Grenfell Tower itself. The second is cases brought within the relevant limitation period and which are already underway at the time of the Grenfell Inquiry's Phase 2 report.

2.7. In most buildings more than six years old, there are therefore no realistic prospects of pursuing anyone for building defects, unless a warranty or collateral warranty is in place.[11] Further, even where claims are possible, leaseholders will have to meet the substantial costs of bringing such actions. The litigation required in such cases is complex and requires expert evidence to prove. Claims will take many years. Costs may run to hundreds of thousands of pounds per building and more. Once a loan is forced onto such leaseholders, there is no prospect that anyone other than those leaseholders will repay that loan, unless the government is willing to alter limitation periods with retrospective effect.

2.8. In all cases, litigation is only worthwhile if there is a solvent party able to meet any award of damages given in favour of leaseholders or the freeholder. New buildings typically have cover against latent defects such as defective cladding and internal fire safety defects. The largest provider of such cover is the NHBC scheme. There are often disputes about whether the cladding and fire safety defects are covered by these warranty schemes. Some of that cover came in the form of insurance policies issued to leaseholders and homeowners. In October 2020, East West Insurance, the insurer standing behind 387,000 building defects insurance policies written between 2003 and 2012 entered administration. East West estimated it owed £210 million

[10] Indeed, where there are claims other than for personal injury in relation to cladding under the Consumer Protection Act 1987 there can be arguments that products with latent defects (such as cladding or insulation) may not be known to be harmful before a fire. Assuming that the Grenfell Tower fire itself was not a sufficient trigger to start time running, claimants who were previously unaware that their buildings had such insultation or cladding may well be prejudiced by the information coming from evidence of falsified testing and misleading marketing as it may be sufficient to start time running. The same knowledge will also be prejudicial to any negligence claims in which the claimant argues he lacks the necessary knowledge to have started time running to bring a claim.

[11] An exception would be if there is a warranty in place (for example, of the type provided by NHBC for new homes), which may extend time to 10 to 12 years after completion or exchange of contracts. Warranty claims are harder to pursue than the other claims discussed above because they must be fought on the terms of the warranty rather than broader general arguments under the other types of claims. Other claims may be possible by the freeholder if there is a collateral warranty in place between the freeholder and the developer. A collateral warranty is generally a contract promising that the party giving the warranty has performed its obligations or duties in full. If the collateral warranty is made by deed then the applicable limitation period is 12 years from the date of breach. Leaseholders would usually be expected to meet the legal costs of any litigation arising under either a warranty or a collateral warranty.

creditors at the start of its administration.[12] Claims against those policies, which run until 2027 in some cases, will only be paid via the Financial Services Compensation Scheme, assuming the Supreme Court upholds the insurer's liability to pay on those policies.

2.9. Mr. Wade's statement on 10 December 2020 that voluntary contributions may be forthcoming from developers and others once costs are fixed by forced loans is impracticable. Directors of companies owe fiduciary duties to shareholders to preserve and improve the company's assets. Those same fiduciary duties are unlikely to be discharged by paying away goodwill payments to leaseholders with no viable legal claims against the company.

2.10. Making loans available to freeholders at their discretion may also cause freeholders to choose not to pursue viable claims. Freeholders may decide it is easier to borrow the money for cladding remediation and have the costs covered by leaseholders forced to repay that loan.

3. Forced loans will depress property prices, will not speed up remediation and will be factored into mortgage affordability calculations

3.1. The housing market is likely to soften following the end of furlough, the stamp duty holiday and tax rises to pay off the government's COVID debts. This will most likely result in reduced competition for leasehold properties on the market. This lack of competition may enable buyers to force sellers to accept reductions equivalent to the full value of any forced loan on a leasehold in a building less than 18 metres. Such reductions may result in negative equity. Those affected are likely to stay put, leading to falling demand for larger flats and houses as people are prevented from moving up the housing ladder.

3.2. The forced loans scheme appears to require legislation to change leases to ensure that the £50 a month cap on payments can be implemented. Legislation may also be necessary to address leases which do not currently allow borrowed money to be recovered via the service charge. It also seems that some sort of bureaucracy will have to be set up to administer the forced loans scheme. This will take time, perhaps some years, to implement fully. Remedial works will not be carried out on buildings under 18 metres until the forced loans money is available and, as explained below, until the money to complete any other non-cladding remedial work is

[12] East West Insurance entered administration on 12 October 2020 following the Court of Appeal decision in December 2019 in relation to liability on a policy issued on a building in Manchester (judgment at *Manchikalapati v. Zurich Insurance Plc (t/a Zurich Building Guarantee and Zurich Municipal)* [2019] EWCA Civ 2163). That decision is currently subject to appeal. Information on East West Insurance's administration is available here: https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/generic/east-west-insurance/ey-joint-administrators-statement-of-proposals-3-dec-2020.pdf

available, adding further delay and impeding sales of flats in sub-18 metre buildings, further disrupting housing market chains.

3.3. Service charges are also taken into account as part of affordability assessments for both mortgage lending, both new loans and re-mortgages,[13] and in relation to other forms of consumer credit, such as credit cards and unsecured loans.[14] Even a £50 a month capped service charge may preclude some borrowers from obtaining new mortgages, re-mortgaging or obtaining other forms of consumer credit. This may adverse consequences for the housing market in particular and the economy generally.

4. Legal and practical difficulties with implementing forced loans

4.1. From the limited detail available from the government, it appears that freeholders of buildings between 11 and 18 metres tall will be expected to take out loans that will then be repaid by leaseholders through a fixed service charge of up to £50 per month. The loans appear to be available only to perform remedial works on cladding.

4.2. The paragraphs below explain why such a forced loans scheme may not work due to restrictions on freeholders' ability to borrow under existing corporate financial arrangements. Some freeholders are also held by publicly traded funds subject to borrowing caps restricting the amount they may borrow. It is also unclear if freeholders take forced loans payable through fixed service charges whether leaseholders will retain the right they would otherwise have had to challenge the cost of remedial works.

Works will still be delayed if the forced loans only cover cladding

4.3. The government's proposed forced loans appear to cover only the costs of replacing cladding. The costs of internal fire safety remedial works, which may be as much or more than the costs of cladding remedial works, will continue to be payable by leaseholders. Public estimates suggest that costs of cladding replacement may be around £20,000 per leasehold. Costs of internal fire safety defects may be a further £25,000 per leasehold, giving a bill of around £45,000 per leasehold. These costs appear not to vary above or below 18 metres.[15]

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[13] See Financial Conduct Authority Mortgage Conduct of Business Rule 11.6 at https://www.handbook.fca.org.uk/handbook/MCOB/11/6.html. MCOB Rule 11.6.10 requires service charges for leasehold properties to be taken into account when assessing affordability.

[14] See Financial Conduct Authority Consumer Credit Conduct of Business Rule 5.2A at https://www.handbook.fca.org.uk/handbook/CONC/5/2A.html. CONC Rule 5.2A.12(4) requires the lender to take into account the effect of the borrower's other contractual commitments on repayment before advancing new credit or increasing an existing credit limit.

[15] See: https://www.leaseholdknowledge.com/lkp-response-to-robert-jenrick-cladding-3-5bn-exceptional-intervention-to-cladding-high-rises-today/

4.4. Freeholders and their managing agents will not start works until all of the funds necessary to complete the works are available in the relevant service charge account. If leaseholders cannot find the money to pay for non-cladding work, then no works will start. In many cases, it is necessary to remove the external cladding to get to the parts of the internal walls requiring non-cladding remedial works. Unless funds are available to complete both sets of work neither set will begin.

Forced loans to some freeholders are impossible due to negative pledges or financial covenants in existing credit facility agreements

4.5. All buildings containing dwellings let on long leases are recorded on registered freehold titles. There may be several buildings on the same freehold title. Only the freeholder has the capacity to enter into a loan agreement attached to the freehold interest. Only the freeholder will be able to decide whether or not to take up a forced loan in respect of any building. No other arrangement will be able to satisfy the government's stated objective of a loan given to the freeholder and passed from one leaseholder to the next.

4.6. It is unknown if the government will insist on taking security over the freeholds of buildings whose owners accept forced loans, or else security over the £50 per month fixed service charge income stream, to ensure that the loans are repaid. Taking such security would seem a prudent precaution to protect taxpayer money.

4.7. There are 63,968 residential leaseholds to which the freehold is held by the ARC Time Freehold Fund.[16] There are approximately 16,600 residential leaseholds to which the freehold is held by the Ground Rents Income Fund.[17] These trusts are publicly traded. At least one of them owns the freeholds to buildings of less than 18 metres in height. Both of the trusts have already entered into loan financing agreements totalling £50 million, one with Santander and one with the Royal Bank of Scotland.[18]

4.8. As part of the security arrangements for that borrowing, the freehold-owning companies within these trusts have granted fixed charge and/or floating charge security over at least some of their freehold interests.[19] Both the fixed charges and

[16] Half-Year Report to 30 September 2020 at page 12 at https://time-investments.com/vault/files/ARC-TIME-Funds-Half-Year-Report-for-the-period-to-30-September-2020.pdf.

[17] Half-Year Report to 31 March 2020 at page 5 (the approximate figure above is 87.8% of 19,000) at http://www.groundrentsincomefund.com/wp-content/uploads/2020/07/2020-07-03-Ground-Rents-Income-Fund-plc-Half-Year-Report_402870_v1.pdf.

[18] The ARC Time Fund has a committed but undrawn £25 million secured facility from Royal Bank of Scotland plc (see 30 September 2020 Half-Year Report, page 13). The Ground Rents Income Fund has drawn £15.5 million of a £25 million secured loan facility from Santander UK plc (see Half-Year Report to 31 March 2020 at page 13).

[19] A fixed charge attaches to defined assets such as property, land or vehicles which are generally not sold during the ordinary course of the company's business. A floating charge attaches to defined classes of asset,

the floating charges contain negative pledge provisions. These negative pledge provisions prevent the relevant freeholding company giving any further security over the secured assets.[20,21]

4.9. If the government wishes to secure its proposed forced loans against the freehold interests or against the £50 per month income stream arising under the forced loans scheme from buildings owned by these funds which are subject to these security arrangements, it will not be able to do so without the existing lenders' consent. Absent a renegotiation of security agreements with the current lenders, any security the government obtains for its loans will be second-ranking security. If the borrowers were to become insolvent, the government would only be repaid from proceeds remaining after first-ranking security had been paid.[22]

4.10. It is also a matter of public record that another large freehold investor, Mr. Vincent Tchenguiz – via his British Virgin Islands trust the Tchenguiz Family Trust – has also granted fixed charge and floating charge security over some or all of his portfolio of freeholds.[23] According to Companies House records, that security also contains a negative pledge of the type described above. A further unknown number of leaseholds will exist under those restricted freehold interests. The negative pledge in question also restricts the creation of new security.

4.11. The Ground Rents Income Fund's accounts disclose that there are financial covenants contained within its secured loan facility with Santander. These are identified as a loan-to-value covenant requiring the outstanding sums due on the Santader loan to be no more than 50% of the value of the secured assets and covenants relating to the money available to pay interest on the Santander loan over several different time periods. The loan facility agreement with Santander may contain additional restrictions on the Ground Rents Income Fund borrowing any

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both present and future, which may be bought and sold in the ordinary course of the company's business. Floating charge security may also be given over bank deposits. The floating charge will not fix onto any specific asset until it crystallises on the occurrence of events defined in the charge or loan agreement.

[20] See, for example, charge granted in favour of Santander UK plc dated 14 May 2018 at clause 5.2, available from Companies House at: https://find-and-update.company-information.service.gov.uk/company/08246696/charges.

[21] In respect of the ARC Time Freehold Income Trust, see the Companies House Charges Register for FIT Nominee Limited and FIT Nominee 2 Limited at https://find-and-update.company-information.service.gov.uk/company/08085694/charges of a floating charge in favour of Royal Bank of Scotland Group plc dated 29 October 2015. Clause 8.1 contains a negative pledge prohibiting the creation of any further security except as permitted under the loan facility agreement.

[22] One solution would be to set up a security trustee structure in which the security was held by a trustee on trust for all lenders, with proceeds from any sale of the secured assets shared in accordance with a fixed order of payments (known as a "waterfall" arrangement).

[23] Dellmes GR Limited is the head company of the Fairhold structure ultimately owned by the Tchenguiz Family Trust. It and several of its group companies granted a debenture in favour of Rothesay Life on 17 September 2018 (see: https://find-and-update.company-information.service.gov.uk/company/09371683/charges/FJhKy5dXqDLBa41hGuFwD5wXbrU). The Debenture contains fixed charge and floating charge security. Clause 6.1(a) contains a negative pledge.

further money except in the ordinary course of business, which may preclude borrowing from the government for cladding remediation.

4.12. The ARC Time Freehold Income Fund's accounts do not set out any details on financial covenants contained in its £25 million secured loan facility with the Royal Bank of Scotland. That is most likely because the facility has not been drawn down, so the financial covenants will not apply. As explained above, in addition to any financial covenants, the ARC Time Freehold Income Fund's loan facility agreement may contain restrictions on taking out further loans other than in the ordinary course of business, which may preclude borrowing from the government for cladding remediation.

4.13. There are other private freehold investment vehicles, for example the Adriatic Land and Long Harbour freehold investment structures managed by William Astor, which do not appear to have any English law security against them. It is unknown if those structures contain the freeholds to buildings less than 18 metres. From the limited information available at Companies House, there appear to be unsecured shareholder loans and partnership loans in place. Such agreements may contain covenants restricting loan-to-value ratios and therefore reduce the amount that could be taken in forced loans. The Adriatic Land and Long Harbour holding structures also appear to involve limited partnerships in Guernsey. The terms of the partnership agreements governing those limited partnerships may restrict the amount of borrowing that can be undertaken by the partnership, which may impede access to any forced loans scheme.

4.14. In addition to the points above about potential corporate financial restrictions, in order to collect loans under the service charge arrangements within a lease, there must be a power under the lease for the freeholder to borrow money before it can be recovered via the service charge. Where this power does not exist, it will have to implied by a new Act of Parliament, as will the £50 cap on loan repayments. It will take at least several months to pass the necessary legislation before the forced loan scheme can become operational.

4.15. The alternative would be to create an agreement outside of the lease between a freeholder and the leaseholder. Such an agreement would only be enforceable against the signing leaseholder personally and would not bind a future leaseholder on the sale of the property, unless the new owner agreed to become a party. That would not achieve the government's stated aim of a forced loan moving from leaseholder to leaseholder on sale.

4.16. It is unknown how the government intends to get forced loan money into the hands of freeholders subject to negative pledge restrictions and loan-to-value covenants. It

would appear that at the very least there will need to be commercial negotiations with the existing secured lenders, who may want a fee for any change in their security arrangements or loan-to-value covenants. Such fees may end up being passed down to leaseholders. There is a risk that if freeholders subject to such financing arrangements are forced to take on substantial new borrowing that commercial lenders will reassess whether they wish to continue lending, which may adversely affect the value of these investment vehicles.

Listed freehold investment vehicles have borrowing caps

4.17. In addition to the borrowing restrictions contained in corporate finance documents outlined above, the Ground Rent Incomes Fund and the ARC Time Freehold Fund also have caps at fund level on the overall amount each fund may borrow.

4.18. In respect of the ARC Time Freehold Fund the cap is 10% of its net asset value, which is approximately £31 million, all of which is currently available, subject to any loan-to-value covenant in the existing loan facility agreement.[24] At costs of £4 million per block for both cladding and non-cladding issues, the cap would only allow borrowing via the forced loans scheme to remediate approximately 8 blocks. There are at least four sub-18 metre blocks with cladding issues within the ARC Time Freehold Fund.[25] The 10% borrowing cap is fixed by Financial Conduct Authority rules.[26]

4.19. In respect of the Ground Rents Income Fund, the cap is 25% of gross assets, or approximately £32 million of which only £16.2 million is currently available in light of existing drawn borrowing from Santander and further subject to the loan-to-value covenant and interest cover covenants in the existing loan facility agreement.[27] The existing borrowing would be enough to remediate only around 4 blocks at an average £4 million per block. It is unknown whether the Ground Rents Income Fund has any sub-18 metre blocks. The 25% cap is a voluntary restriction imposed on the fund by itself. It may be possible to vary this cap, but investors who invested in the fund on the basis of leverage restricted to 25% of gross assets may not wish to continue to invest if the cap is changed.

Tenant controlled Right To Manage Companies may not be able to force a freeholder to borrow or there may be head leases that require loans to be trickled down to leaseholders

[24] See Half-Year Report to 31 March 2020 at page 13 for the 10% cap. Current net asset value stated at 31 March 2020 (page 15) was £307.257 million

[25] All four are located at a development near Canary Wharf in London.

[26] The ARC Time Freehold Income Fund is a Non-UCTIS Retail Scheme ("NURS"). FCA Collective Investment Scheme Sourcebook Rule 5.6.22 applies Rule 5.5.5(1), which requires that NURS borrowing does not exceed 10% of the fund's assets on any day, see: https://www.handbook.fca.org.uk/handbook/COLL/5/

[27] See Half-Year Report to 31 March 2020 at page 2 for 25% cap applied to Total Assets figure on page 12 of the same report less Santander borrowing figure on page 8 of the same report to give the figures above. The Ground Rents Income Fund confirms this £32 million estimate at page 18 of its most recent accounts.

4.20. Leaseholders in some buildings have exercised their Right To Manage ("**RTM**"). Companies have been formed to take over management from the freeholder. RTM does not affect the residual powers of the freeholder under the terms of the lease. For example, even where RTM is exercised, the freehold remains the only one with the right to forfeit a lease. A freeholder also remains the only party with the capacity to enter into a loan affecting the freehold interest. It is possible that an uncooperative freeholder may refuse an RTM company's request to enter into a forced loan agreement. In that case, absent some means of compulsion to make the freeholder to sign the agreement, the RTM company would not be able to access any forced loan.

4.21. In other buildings there may be a chain of intermediaries between the freeholder and the leaseholder. For example, in mixed ownership buildings with both owner-occupiers and shared ownership flats there may be a freeholder who has granted a head lease to a housing association. The head lease will sit between the freeholder and the shared ownership leaseholders. The maintenance obligations may have been given to a third-party agent appointed by the freeholder, who may or may not be a party to any lease or head lease. There will need to be a mechanism to ensure that forced loan principal flows down from the freeholder to whoever is responsible for maintenance of the common parts and that payments flow up from the leaseholder to the freeholder taking out the forced loan. Specific arrangements will need to be made to ensure that the forced loan payments are not subject to set-off or deduction of any kind between leaseholder and freeholder to ensure, in turn, that the full forced loan is repaid when due.

Impossible to challenge fixed service charges at the First-Tier Tribunal

4.22. By section 19 of the Landlord and Tenant Act 1985 leaseholders have the right to challenge service charge expenditure on the basis that it is unreasonable in amount or because works were not performed to a reasonable standard. This right of challenge only applies to variable charges, not fixed service charges of the type the government proposes.[28]

4.23. There may be scope for challenging both the amount charged and/or standard of works carried out to cladding. If works are done badly then it is right that leaseholders should be able to challenge the standard of work. If leaseholders have

[28] See *Anchor Trust v Waby* [2018] UKUT 370 (LC) for a discussion of fixed versus variable service charges. A charge that rises by a defined measure of inflation is deemed to be a fixed charge for the purposes of section 19 of the Landlord and Tenant Act 1985 and therefore not subject to challenge, even if it runs for the length of the lease.

evidence that they have been overcharged, then it is also right that they should be able to seek redress.

4.24. If a freeholder takes out one of the government's proposed forced loans for cladding remediation, depending on the terms of any legislation, it may argue that there can be no challenge to the overall cost or standard of work because it is being repaid by fixed service charge. Leaseholders would therefore have no way of challenging such costs, even if they could prove that the works were sub-standard or that they were being overcharged. The strength of any such argument would depend on how the fixed service charge of £50 per month is drafted and whether it preserves the right to make such challenges. If the legislation is drafted badly, it may preclude both challenges to cladding works and challenges to works not covered by the loans (such as the internal fire safety defect work) but carried out at the same time.

Forced loans may allow some freeholders to bypass contractual restrictions on improvements

4.25. Not all leases require leaseholders to contribute to improvements. Service charges are only recoverable to the extent they are permitted by the lease. Even where leases require leaseholders to contribute to improvements, their interests must be taken into account before the freeholder makes a decision to proceed.[29]

4.26. There is anecdotal evidence that buildings with no internal fire safety defects and with EWS-1 certificates with "B1" or "pass" ratings are being forced to undergo remedial works because it suits the interests of a freeholder or its managing agent, or perhaps in order to obtain insurance cover.

4.27. The leaseholders in such buildings have legal arguments that they should not be required to pay to replace otherwise serviceable cladding before the end of its working life. Those leaseholders may wish to run those arguments because the costs of the works far exceed many years' worth of increased insurance premiums (if any). If the forced loans proposal is implemented by way of fixed service charge, there is a risk that such leaseholders may lose the right to challenge the works being carried out and paid for by forced loan where previously no contractual obligation existed to pay for such works at all.

Other litigation may ensue between leaseholders and freeholders where any implied terms conflict with other provisions of the lease

4.28. Whenever any new term is implied into an agreement it may conflict with other terms. It is possible that in future unforeseen disputes may arise between leaseholders and freeholders over the terms of any lease amended by implied terms,

[29] See Supreme Court decision in *Braganza v. BP Shipping* [2015] 1 W.L.R. 1661 on exercise of contractual discretion by one party against the other party's interest and Court of Appeal decision in *Waaler v. London Borough of Hounslow* [2017] 1 W.L.R. 2817 for *Braganza* test as applied to improvements under leases.

particularly where there is any overlap between works covered by fixed service charge repayments for forced loans in relation to cladding works and variable service charge repayments for non-cladding works.

Freeholders and managing agents may charge administration fees on the forced loans

4.29. It is unclear from the government's announcement what steps it proposes to take to prevent freeholders and managing agents from diverting forced loans money to their general corporate purposes. If that were to happen, leaseholders may end up repaying money that was never used to benefit them. As explained above, because the repayments will be via fixed service charge, the leaseholders will have no way to challenge the amount borrowed which they will have to repay.

4.30. It is also unclear if the government proposes, as with the Building Safety Charge proposed in the Building Safety Bill, to require freeholders and their agents to segregate the forced loan money from the rest of the service charge. The industry has already indicated this will result in further costs of administering a separate client account, issuing separate invoices and processing separate payments and running separate credit control.[30] If the same approach is adopted in relation the forced loans scheme, the costs of this additional bureaucracy will fall on leaseholders, further inflating the bill.

4.31. It is also unknown if leaseholders would be able to force the freeholder to accept repayment of a loan before the end of a term, with or without incurring any form of early repayment charge, or whether leaseholders would be able to avoid a loan being imposed on their leases if they could come up with the up-front money required.

5. The alternative

5.1. The Leasehold Knowledge Partnership has already set out a proposal that would finance the required works through grants paid by levies paid by developers, non-resident foreign buyers and a tax on ground rents. Those levy proposals build on the developer levy announced by the government on 10 February 2021.

5.2. The scheme proposed by the Leasehold Knowledge Partnership would avoid the need to resolve any of the issues above. Grants would be made to remediate buildings with no need to collect payments at building level and no need to vary leases to accommodate a new fixed service charge.

[30] See memorandum of evidence from the Association of Residential Managing Agents to the Commons Housing, Communities and Local Government Select Committee Pre-Legislative Scrutiny on the Draft Building Safety Bill at https://committees.parliament.uk/writtenevidence/11973/pdf/ (accessed 15 February 2020).

5.3. The scheme proposed by the Leasehold Knowledge Partnership would also preserve the ability of leaseholders to challenge expenditure. The proposal suggests that there should be central management and oversight of remedial works by means of a national, risk-based programme as opposed to the current building-by-building solution.

5.4. Any scheme to address the cladding and fire safety works in defective buildings should also set a mechanism to compensate those who have already been forced to pay the costs whilst the government has delayed coming up with a solution to the issues at hand.

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Developer Levy: What Is the Impact on Home Building?

Summary

1. Developers have received massive subsidies from the Gov (e.g. £16 billion from the Help to Buy Scheme)
2. Department of Communities and Local Government found in an earlier comprehensive study that a similar developer levy, the Community Infrastructure Levy, had no 'discernible impact' on the number of planning applications or permissions.
3. There is no reason to expect the levy would be passed on to buyers.
4. The government has already announced it will impose a £2 billion levy over 10 years on developers.
5. The issue with the government's proposal is that developers are only being asked to pay 13% of the estimated £15 billion costs, the taxpayer 33% and leaseholders 54%. As the government has repeatedly pointed out, leaseholders are innocent parties. They should not be paying more than half of the cost of fixing a problem that they did not cause.

Would a Cladding Remediation Levy on Developers Affect Housebuilding?

- It is a common complaint from developers that any new tax on housebuilding will reduce the amount of housing built. There is no evidence to support this assertion.

- MHCLG figures show that between 2013 and 2020, developers received approximately £16.5bn in subsidies via the Help to Buy equity loan scheme. The estimated cost of fixing cladding and fire safety issues caused by those developers is £15 billion.[31]

- By the time the Help to Buy Scheme winds down in 2023, developers are forecast to have received £29 billion.[32] That is nearly twice the estimated cost of fixing cladding and fire safety defects caused by those developers.

- What incentive will developers have to avoid causing problems with building safety in the future if they pay nothing to fix the current issues?

No Known Impact of the Community Infrastructure Levy first introduced in 2010

[31] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/938824/Help_to_Buy_Equity_Loan_2020_Q2_.pdf

[32] https://www.nao.org.uk/wp-content/uploads/2019/06/Help-to-Buy-Equity-Loan-scheme-progress-review.pdf at page 5.

1. **The Community Infrastructure Levy was introduced in 2010 as the UK was recovering from the Global Financial Crisis.**
2. **The Community Infrastructure Levy has had *no impact* on housebuilding. The MHCLG's own numbers show UK housebuilding reached its highest level since 1987 at the end of last year, even with coronavirus.[33]**

3. **The government's own study into the impact of the Community Infrastructure Levy has found it has no impact on house building figures.**

Between 2015 and 2017, the Department of Communities and Local Government commissioned a study of Community Infrastructure Levy (CIL). This study was conducted by the University of Reading and Three Dragons in association with Smiths Gore and David Lock Associates.[34]The Community Infrastructure Levy is defined as "a charge which can be levied by local authorities on new development in their area."

The study found that: "... there does not appear to be any discernible impact on planning applications or permissions, after an initial 'dip' in applications immediately post adoption as reported through the interviews with local authorities." They modelled the effects of the introduction of a CIL and found that it had only "limited impact on development viability and does not make, on its own, a viable scheme unviable." See below the graph of data from 68 local authorities, which shows no identifiable trend with regard to the impact of the CIL introduction.[35]

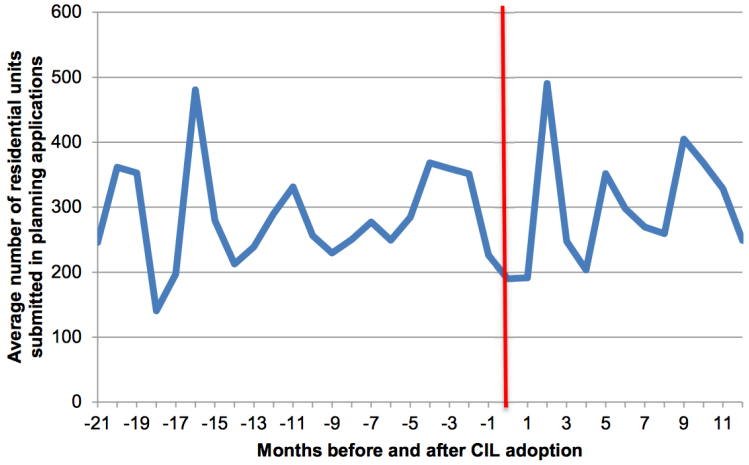

Figure 5.1: Average number of dwellings submitted in planning applications before and after CIL adoption (source: Glenigan)

Will developers pass on any new building levy to buyers?

[33] https://www.gov.uk/government/news/most-homes-delivered-in-33-years

[34] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/589635/CIL_Research_report.pdf

[35] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/589635/CIL_Research_report.pdf

1. **There is no evidence that this will happen. All of the major housebuilders are returning hundreds of millions a year in capital to their shareholders. The largest housebuilders have full order books for the next several years.[36]**

2. **The LKP proposal is that there be a five-year delayed start in collecting the levy to give developers time to adapt their business models to the levy scheme.**

3. **A small levy of 1% or 2% on the sale price would barely affect developer profit margins, which average around 20% (see table below).**

4. **Even if the levy is added to house prices, a levy of 1% would increase the price of a £200,000 house by £2,000, which is negligible in the context of a house purchase. Further, as with the banking levy, a developer levy is designed to act as an incentive for the industry to better regulate itself, thereby aiding future homeowners.**

5. **There are alternative ways of structuring a developer levy. Examples would include adopting a balance sheet levy (as currently done with banks) or charging for building permits (as adopted in Australia). The government itself has recently announced a levy to raise £200 million a year on certain types of planning approval. Other alternatives would be a windfall tax on developer profits since 2011 with payments spread over several years.**

6. **Not imposing a levy on developers because it may affect house prices is a counsel of perfection. What incentive will developers have to change their behaviour to avoid future building safety issues if they are not made to pay for the current crisis? The proposed government levy does not go far enough, leaving the majority of costs with innocent leaseholders and a substantial share with the taxpayer.**

7. **Any levy should also be accompanied with law reform to make it easier to sue developers, approved inspectors and other building professionals to further deter bad behaviour in the future.**

Developers assess whether to proceed with new buildings based primarily on (1) profitability and (2) the availability of financing.

Profit

[36] For example, Persimmon announced earlier this month that it has £1.7 billion in forward sales and over 300 sites under construction (see: https://www.persimmonhomes.com/corporate/media/460682/persimmon-plc-jan-2021-trading-update-final-pdf.pdf). Other large developers are in similar positions, for example, Barratt with £3.4 billion in forward sales of 15,000 properties (https://www.barrattdevelopments.co.uk/media/media-releases/pr-2020/pr-14-10-20).

In 2007, the investment bank BNP estimated developer profit levels were around 15-17%.[37]

As noted by Lord Greenhalgh, developers' profits have risen substantially since the introduction of Help to Buy in 2011. This is part of the reason why the government has imposed its own form of developer levy.

A review of some of the UK's largest high-rise developers show the following profits and profit margins, which suggest an increase of 35% from the 2007 profit margins:[38]

Developer	**2019 Profit**	**2019 Profit Margin**
Persimmon	£1,091,000,000	29.2%
Bellway	£663,000,000	21%
Barratt	£904,000,000	19%
Taylor Wimpey	£843,000,000	19.4%
Redrow	£406,000,000	19.5%
Average	£585,020,000	21.62%

Financing

According to investment bank, BNP Paribas, the main factor in proceeding with new building is financing risk.[39] Developers rarely have sufficient cash reserves to fund builds, so banks will review the level of risk before making loans to enable construction to proceed.

In Victoria, a levy has been placed on construction permits to raise funds for cladding remediation. This introduces extra cost during construction and may affect final returns. The advantage of the LKP proposal is that by charging on the final sale price it gives certainty to both the developer and the government as to the amount of levy payable.

In light of the government's recent decision to impose a levy on developers, there is scope to look again and consider whether the right balance has been struck. The government's proposals leave the bulk of the costs with innocent leaseholders.

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[37] BNP Paribas, Community Infrastructure Levy: Viability Study, 2013, p. 27..
https://www.towerhamlets.gov.uk/Documents/Planning-and-building-control/Development-control/Planning-obligations/ED2.2-CIL-Viability-Study-August-2013-excluding-Appendices-1.pdf
[38] Marketscreener
[39] BNP Paribas, Community Infrastructure Levy: Viability Study, 2013 p. 27.

Leasehold Knowledge Partners' proposal to secure private sector funding for cladding & associated fire safety defect remediation

Frequently Asked Questions

Q1: Will the levy scheme reduce the number of new houses built?

A: There is no evidence that a small levy of the type proposed would have any adverse effect on house building. A recent MHCLG study found no discernible impact from the much larger much larger Community Infrastructure Levy. In fact, housebuilding has set new records every year since its introduction.

In addition, the large developers have consistently made large profits and increased profit margins. Five of the largest developers have made approximately £10 billion in profit post Grenfell and paid more than £4.5 billion in shareholder dividends. All of the levy costs could be paid without passing anything on to new purchasers if the large developers chose to do so.

Q2. *Will freeholders just pass the costs of any levy on them to leaseholders via the service charge?*

A: It is proposed that the law provides that the levy on freeholders is not recoverable in any way from leaseholders by the service charge. This is a simple type of provision that already exists in relation to other leaseholder protections in existing Landlord and Tenant law.

Q3. *Why shouldn't the leaseholders pay? They own the flats so they should bear the costs. That's what the law says.*

A: Leaseholders bought their properties on the basis that would contribute to maintenance of a building that had been constructed properly. The buildings have not been constructed properly. Materials have been used that should not have been used. The Grenfell Inquiry is showing us that the cladding manufacturers at best were negligent and at worse may have committed fraud in the way they marketed those materials. In addition, buildings have been constructed with serious fire defects, such as missing fire barriers. Leaseholders have no recourse against developers in the majority of cases because the law required claims to be brought within 6 years of the completion of the building.

If one buys a car and it turns out the steering wheel is defective in every car of the same model, no-one argues that the purchaser had a contract and should bear the consequences of picking a bad car. The manufacturer recalls the car and fixes it free of charge. The same should apply to leaseholders.

The government's approach looks at leaseholders in isolation from the construction industry and regulatory failure. Leaseholders are only being made responsible for this because every other link in the legal chain has failed.

Q4: Why does the proposal not include any contribution from leaseholders?

A: Leaseholders are already paying the costs of the cladding scandal. Some leaseholders have been paying thousands of pounds a year for the last 3 years to cover the costs of waking watches. Other leaseholders have already paid to have cladding removed. Leaseholders are the victims of regulatory failure, of systematic poor construction and of regulatory failure.

Q5: Will this take a long time to set up?

A: There will be some set-up time. It is unlikely to take any longer than the government's proposed forced loans scheme, perhaps less. The government could establish a shadow body (as it did with the Financial Conduct Authority before that gained its formal powers) to save time. It is not expected that this proposal will take any longer to set-up than the government's proposed loan scheme. It may even be quicker.

The government could also establish an SPV now and lend money to it, as happened with the bail-outs of Northern Rock and other banks and buildings societies in 2008-9, before the loans were transferred to an SPV, which still exists, called UK Asset Management. If the government chose this option, the borrowing and accrued interest could be repaid by the bond issued by the SPV so there would be no overall cost to the taxpayer. The SPV would then pass the costs of that initial borrowing via the levy scheme we are proposing.

Q6: Is it right to have a flat levy on all leasehold property developers? Shouldn't the money come from Health & Safety fines instead?

A: The idea of a flat rate levy is to send a message that if your industry breaks something, it owns it. That's whether any one builder built at bad building or not. It might be possible to allocate a portion of Health and Safety fines to the fund. However, the difficulty with getting any real recovery from that is two-fold. First, the Health & Safety fines will only be levied for breach of Health & Safety legislation. Builders/architects etc may be dragged into criminal proceedings around Grenfell but there are unlikely to be any criminal proceedings around buildings with defective cladding. Secondly, Health & Safety proceedings rarely generate fines of even seven figures and that's only in extremely bad cases. There may be scope for suggesting, as already happens with the "Victim Surcharge" in criminal cases, that there is a 10% uplift on all Health & Safety fines related to any building safety matter paid into the fund to encourage safer building.

Q7: If any levy were to be linked to any stakeholders' past behaviours what is stopping the current freeholders putting their freehold investment entities into administration, buy back the assets (via pre-pack or otherwise), and leave the liabilities relating to the levy in the entity?

In relation to developers, the levy would be a fixed percentage of all new properties built by any developer (perhaps with a *de minimis* floor and excluding councils and housing associations). Legislation should require developers to report the number of properties built and the price paid and then to pay the assessed levy accordingly. The PLC developers already collect and report this information as one of their KPIs, so this should not be a new collection exercise. If levied on the PLC reporting the numbers, like Corporation Tax etc, it should be difficult to avoid paying the levy other than by reducing the number of properties built or else by committing reporting fraud.

An alternative would perhaps (like a windfall tax) be to levy a percentage of each developer PLC's balance sheet, as is still happening with the levy on banks. That would be a crude way of making the levy payments proportional to number of properties built past and present.

In relation to the tax on ground rents, we would propose that anyone collecting more than £1,000 per year in residential ground rent must register with the levy body. The levy body would then allocate a registration number and record the registration on a public register, in the same way as solicitors and other professionals. We propose amending the law so that that any ground rent demand issued without a valid registration number is unenforceable unless the freeholder collects less than £1,000 per year in residential ground rent.

It would also be necessary to ensure the legislation contained provisions preventing freeholders from passing on the levy via service charges to leaseholders, but that should be a straightforward provision that can be copied from existing anti-avoidance provisions in e.g. the Landlord and Tenant Act 1985.

Q8: Who is the gatekeeper for which claims are valid against the fund?

A: A form of risk assessment is proposed which will distinguish pure remediation from improvement. Clearly anything that improves the block relative to its previous condition should be paid for by freeholders as an improvement to their building. Some leases may require leaseholders to contribute to those costs.

The fund would set eligibility criteria and freeholders would then come along and apply for a grant to do the works. There is already existing machinery in place through the Building Safety Fund grant programme, which could be expanded and funded appropriately.

Q9: Eg if a PV gap of £500m opens up how is it determined whether that is +£5m immediately, recouped over 100 yrs, or £50m recouped over 10 yrs?

The principle would be to spread costs as far as possible, but not indefinitely. It is envisaged that a managing board comprising all the usual stakeholders be established. One feature that may not be in the December proposal is for a forward start on the levy at year 5. Any excess would logically be piled on at the end of year 20 or beyond. Some form of excess

reinsurance against totally unforeseen costs, which should be cheap if the excess is high enough, should also be explored.

The legislation underpinning the SPV board would give them a statutory objective to manage the levy yield to avoid surplus/shortfall over the life of the underlying bond/s.

Q10: How can there be a five-year delay between people lending money to the SPV and the SPV making the first repayments?

A: The SPV is structured so that the 'present value' of all interest payments is equal at the end of every year to the present value of all receipts. At inception, the assets of the fund are drawn down to pay for the first five years of expenses, including interest, but are recovered from year 5 onwards so that all money, including interest, is repaid at maturity.

Q11: How can it be ensured that there is enough money available?

A: We propose that the SPV board sets eligibility criteria in partnership with the government to target resources at the highest risk buildings. The government should issue new guidance to reduce demand on the fund by adopting a risk-based approach to determining which buildings require works.

The SPV would develop its own business plan forecasting costs and income. The plan and the levy would be updated annually to ensure sufficient funds were available. The fund would have the power to borrow additional funding up to a limit set by the new law. That additional borrowing would be repaid via the same levy scheme.

Q12: How can claims for unnecessary works be prevented?

A: The freeholder levy is an integral part of preventing freeholders, their agents and contractors making money out of this. If costs go up beyond projected limits then the freeholders will bear a share of that via the levy scheme. It is therefore not in their interests for freeholders or their agents to inflate costs that freeholders will end up sharing.

There are a variety of cost-management techniques that can be employed, for example setting out a pricing schedule for common types of work and requiring freeholders to justify departures from that schedule. This is the same way dentists are paid in the NHS.

All spending will be audited and the body would have powers to claw back money from freeholders and to issue financial penalties if projects turn out to have been padded or unnecessary.

It is proposed that all claims granted by the fund are published in full so that leaseholders can audit costs for their buildings and compare them to other similar buildings and challenge their freeholders on costs.

Q13: Can this solution sustain increased claims as more fire safety defects are uncovered?

A: Yes. The levies can be adjusted to increase funding and there is nothing preventing the Government from providing additional funding. The SPV can accomodate greater investment as necessary.

Author Biographies

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Dr Buckner has worked in the financial services industry for over 30 years. He spent the last 20 years with the FSA, PRA and Bank of England, retiring from the B of E in 2018. Dr Buckner specialised in derivative and asset valuation, and capital modelling for the banking and life insurance sectors. He is currently a Trustee of LKP, Policy Director at the UK Shareholders' Association and Co-Founder of Eumaeus, a policy project with Dr Kevin Dowd of Durham University.

Liam Spender
Liam Spender is a Solicitor-Advocate and Senior Associate at Velitor Law.

Liam is an experienced commercial litigator with wide-ranging experience of shareholder, banking and corporate insolvency disputes arising in many different commercial circumstances. Liam has worked for FTSE 100 clients and high net worth private individuals on High Court, Court of Appeal and Supreme Court cases. Liam also has experience of cross-border and multi-party disputes in both arbitral proceedings and in courts in Canada, France, the United States and the Caribbean.

Graduating with a degree in Philosophy, Politics and Economics from St. John's College, University of Oxford in 2004, Liam spent five years working in local government. During that time Liam attended night school to complete the Graduate Diploma in Law conversion course. Liam undertook the Legal Practice Course at BPP Law School in London and was then a paralegal, trainee solicitor and Associate at Herbert Smith Freehills for five years. Liam also spent five years as an Associate at Debevoise & Plimpton before joining Velitor Law as a Senior Associate in January 2021.

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Lucy started her career as an analyst for North South Trade & Investment in Mexico, the United States and Canada, later moving into lobbying for the oil and gas sector. She has spent the last 20 years working in the City as a headhunter placing individuals with several of the largest global investment banks, such as Credit Suisse and J.P. Morgan, and with blue chip hedge funds and private equity firms. Lucy is co-founder and co-head of a London and New York based executive search firm, which focuses on recruitment of senior financial services individuals. The firm specialises in the use of quantitative predictors of workplace behaviour for talent selection, team construction and leadership selection. Lucy holds a BA in Economics and Political Science, a BSc in Psychology, and an MA in Political Economy.