



**Law
Commission**
Reforming the law

Leasehold enfranchisement:

A summary of proposed solutions for leaseholders of houses

19 July 2018

THE LAW COMMISSION

About the Law Commission: The Law Commission was set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law. The Law Commissioners are: The Rt Hon Lord Justice Bean, *Chairman*, Professor Nicholas Hopkins, Stephen Lewis, Professor David Ormerod QC and Nicholas Paines QC. The Chief Executive is Phillip Golding.



© Crown copyright 2018

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated.

To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: mpsi@nationalarchives.gsi.gov.uk.

This publication is available at www.lawcom.gov.uk.

Chapter 1: Summary

INTRODUCTION

- 1.1 Houses can be owned on a freehold or leasehold basis. Flats, by contrast, are almost universally owned on a leasehold basis. Freehold ownership lasts forever and generally gives fairly extensive control of the property. Leasehold ownership is time-limited, and control of the property is shared with, and limited by, the freehold owner (that is, the landlord).
- 1.2 Houses have been sold on a leasehold basis for many years, but the use of leasehold as the mechanism for house ownership has been in the spotlight recently. Many people argue that there is no good reason for houses to be sold on a leasehold basis, and that it occurs simply because developers wish to extract an additional profit from homeowners by retaining the freehold. Another criticism by leaseholders, which applies to both houses and flats, is that leasehold ownership generally carries with it an obligation to pay “ground rent” to the landlord. Under some leases, the ground rent obligations can be onerous.
- 1.3 The UK and Welsh Governments have announced various measures to address what have been described as “feudal practices” in the leasehold market. In December 2017, the UK Government announced that it would ban the sale of houses on a leasehold basis, and prohibit developers from selling leases that contain an obligation to pay any money as ground rent. Those measures will only apply to future sales of houses, and to future leases. They do not, therefore, affect existing leaseholders, for whom leasehold ownership, and the obligation to pay a ground rent, will remain.
- 1.4 Existing leaseholders, however, have “enfranchisement rights”, which allow them either to purchase the freehold of their property or to obtain an extended lease of their property. Our project concerns the enfranchisement rights of leaseholders of both houses and flats. In September 2018, we will publish a detailed Consultation Paper setting out provisional proposals for a reformed enfranchisement regime that will apply to both.
- 1.5 As part of its December 2017 announcement, Government said that it would consider further measures that could assist existing leaseholders of houses. To complement that package of measures, we were asked by Government to prioritise enfranchisement solutions for existing leaseholders of houses, and to set out those solutions before summer recess 2018.
- 1.6 The enfranchisement rights of leaseholders of houses cannot be addressed entirely separately from those of leaseholders of flats. As we will explain in our Consultation Paper, one of the significant problems with the existing enfranchisement regime is that unnecessary and incoherent distinctions are made between leaseholders of houses and of flats. Our proposals will seek to minimise such distinctions and eliminate some of the complications which arise as a result.

- 1.7 This Paper therefore looks ahead to our wider proposals for reform of the enfranchisement regime for both houses and flats, and summarises how they will provide solutions for leaseholders of houses. We are not at this stage inviting views on the potential solutions for leaseholders of houses set out in this Paper. If you would like to comment on our proposals for leasehold houses, we invite you to respond to our September Consultation Paper. We shall then review our proposals in the light of consultees' comments on them. We are keen to receive comments from as many stakeholders as possible, whether they agree or disagree with our provisional proposals.

TERMS OF REFERENCE

- 1.8 Our Terms of Reference (set out more fully at paragraph 2.22 below) require us:
- (1) to provide a better deal for leaseholders as consumers;
 - (2) to simplify the enfranchisement regime;
 - (3) to promote transparency and fairness; and
 - (4) to set out options for reducing premiums paid for enfranchisement, whilst ensuring sufficient compensation is paid to landlords to reflect their legitimate property interests.

PROPOSED SOLUTIONS FOR LEASEHOLDERS OF HOUSES

- 1.9 Leaseholders of houses face problems under the current enfranchisement regime because the process can be lengthy, costly and difficult to navigate, and the outcome can be uncertain, unsatisfactory and, at times, arbitrary. The procedure encourages unhelpful tactical “gaming” and litigation, which creates unnecessary conflict, cost and delay. Enfranchisement is an inherently complex topic, and the causes of these problems – and the possible solutions to them – are in many cases highly technical. Nevertheless, we are confident that the solutions that we outline in this Paper and develop in our Consultation Paper will make a real difference to those who seek to enfranchise their leasehold houses.
- 1.10 For leaseholders of houses, we shall provisionally propose the following reforms to the enfranchisement process:
- (1) removing technical barriers and complexities in the rules governing eligibility for enfranchisement rights where these unjustifiably prevent some leaseholders of houses from exercising enfranchisement rights;
 - (2) replacing the current right of leaseholders of houses to purchase a one-off 50-year lease extension at a high ground rent, with a right to purchase unlimited longer lease extensions without a ground rent – we will consult on the period of the extension, which could be, for example, 125 years or 250 years;
 - (3) enhancing enfranchisement rights for owners of leasehold houses on estates with shared services, through proper provision for the continuation of such services and the additional ability for the estate to be enfranchised as a whole;

- (4) removing the requirement that leaseholders must have owned the lease of their house for two years before making a claim, thereby allowing the owners of leasehold houses to make claims immediately and avoid premiums increasing while they are waiting; and
 - (5) improving and simplifying the enfranchisement procedure, so that it contains fewer traps for the owners of leasehold houses, is easier to operate, and is less likely to result in protracted and costly disputes between the parties.
- 1.11 Bringing an enfranchisement claim will lead both parties to incur legal and other costs even if there is no dispute that needs to be resolved by a court or Tribunal. At present, leaseholders of houses are required to contribute towards those non-litigation costs incurred by their landlord. We will be inviting views on whether leaseholders should be required to make such a contribution in the future. We will also be seeking views on a range of options for determining the level of any contribution that might be required, and on an outline of a fixed-costs regime that would allow homeowners to know the amount of non-litigation costs that they will have to pay at the outset, and to avoid potentially expensive litigation if they wish to challenge unreasonable costs.
- 1.12 We set out two broad options that would meet the objective set out in our Terms of Reference of reducing the price (known as the “premium”) that leaseholders of houses must pay to their landlords:
- (1) Option 1: the introduction of a simple formula for calculating the premium, which is not based on the market value of the interest being acquired by the tenant. It has been suggested in a Private Member’s Bill that a formula could be based on ten times the ground rent, but there are alternatives; for example, 10% of the value of the property. Introducing a simple formula would remove professional valuation costs and uncertainty about how a premium will be calculated. In many cases, a simple formula (depending on how it is set) would reduce premiums, although there is a risk that the level of the premiums would be arbitrary.
 - (2) Option 2: adopt an approach that more closely resembles the current regime, with a premium based on market value, but which (a) would involve removal from the calculation of one element (“marriage value”)¹ that currently increases the premium payable, and/or (b) would involve the prescription of standardised rates to be used in the calculation. Prescribing rates at any level would avoid professional valuation costs and remove uncertainty about how the premium will be calculated. And prescribing rates at particular levels would also reduce the premiums that are payable by leaseholders.
- 1.13 Our Terms of Reference (set out at paragraph 2.22 below) require us to keep in mind the interests of landlords who would be affected by reforms which lower the premium. They refer to the need to ensure that “sufficient compensation” is paid to landlords. We note at paragraph 4.4 below that any changes to the law that Government takes forward will have to comply with human rights legislation and take account of the impact of reform. And while some changes – in particular the options that we have been asked to

¹ “Marriage value” comprises the additional value an interest in land gains when the landlord’s and the leaseholder’s separate interests are “married” into single ownership. The aggregate value of those two interests held separately is often significantly less than the value if they are both held by the same person.

present to reduce the premium payable by leaseholders – will inevitably benefit leaseholders at the expense of landlords, that is not the case across the board. Many of our proposals to simplify the law and make it more efficient will help all those involved in the enfranchisement process to avoid unnecessary cost, conflict and delay.

Chapter 2: Introduction

LEASEHOLD HOME OWNERSHIP

What is ownership?

- 2.1 Many people own, or aspire to own, a home. But what does “ownership” mean? When an estate agent markets a house or flat as being “for sale”, what is the asset on offer? In England and Wales, property is almost always owned on either a freehold or a leasehold basis.
- (1) Freehold is ownership that lasts forever, and generally gives fairly extensive control of the property.
 - (2) Leasehold provides time-limited ownership (for example, a 99-year lease), and control of the property is shared with, and limited by, the freehold owner (that is, the landlord).
- 2.2 So we refer to “buying” or “owning” a house or a flat. But when we buy on a leasehold basis, we are in fact buying a house or flat for a certain number of years (after which, subject to any statutory intervention, the property reverts to the landlord). A leasehold interest is therefore often referred to as a wasting asset: its value tends to reduce over time, as its length (the “unexpired term”) reduces.
- 2.3 In addition, leasehold owners often do not have the same control over their home as a freehold owner. For example, they may not be able to make alterations to their home, or choose which type of flooring to have, without obtaining the permission of their landlord. The balance of power between leasehold owners and their landlord is governed by the terms of the lease and by legislation. As well as a division of control, a landlord may have different interests from the leaseholders. For instance, the landlord may see leasehold solely as an investment opportunity or a way of generating income, while for leaseholders the property may be their home, as well as a capital investment.
- 2.4 As a consequence of these features of leasehold ownership, legislation has been enacted that gives leaseholders “enfranchisement rights”.
- 2.5 Broadly speaking, enfranchisement rights give leaseholders the right to purchase the freehold of their property or to obtain an extended lease of their property. Enfranchisement rights differ between houses and flats, and both will be covered in our forthcoming Consultation Paper. This Paper, however, only concerns enfranchisement rights in respect of houses.

Why leasehold?

- 2.6 The number of residential leasehold properties (houses and flats) that are owned on a leasehold basis is the subject of some debate. On any basis, however, it is clear that leasehold ownership is a matter that directly impacts on the lives of millions of people and families.

- 2.7 Flats are almost universally owned on a leasehold, as opposed to freehold, basis. That is because, for historic reasons, certain obligations to pay money or perform an action in relation to a property (such as to repair a wall or a roof) cannot legally be passed to future owners of freehold property.² These obligations are especially important for the effective management of blocks of flats. For instance, it is necessary that all flat owners can be required to pay towards the costs of maintaining the block. There are therefore good reasons, under the current law, why flats are sold on a leasehold basis.
- 2.8 But leasehold ownership is not limited to flats. Sometimes houses are (and for many years have been) sold on a leasehold basis. The first piece of enfranchisement legislation enacted in 1967 – the Leasehold Reform Act 1967 (“the 1967 Act”) – granted enfranchisement rights to leaseholders of houses. More recently, concerns have been raised about the sale of new-build houses on a leasehold basis, and the UK Government has announced its intention to ban the sale of leasehold houses.³
- 2.9 The reasons for selling houses on a leasehold basis are less apparent than those for leasehold flats. One reason might be the need to impose positive obligations on house owners in relation to the upkeep (management) of the estate, but that does not apply in all cases. The reasons why, for legal purposes, houses may be sold on a long lease do not, however, require the lease to provide income streams to the landlord, beyond those needed to maintain the property or the estate.

THE BACKGROUND TO OUR PROJECT

- 2.10 In July 2016, we launched a public consultation asking which areas of law should be included in our Thirteenth Programme of Law Reform. We identified residential leasehold law as an area which might benefit from reform and sought views on the problems being faced in practice. We received over 150 responses to our consultation from a wide range of stakeholders which supported a review of one or more aspects of residential leasehold law.
- 2.11 Following discussions with Government, a project on residential leasehold and commonhold reform was included in our Thirteenth Programme, published in December 2017.⁴ In the first instance, our project focusses on reform to enfranchisement and commonhold. Following further discussions with Government, a review of the Right to Manage has been added to our project.

² The Law Commission has previously recommended the creation of a new interest in land (“the land obligation”) which can be positive or negative and will bind future owners of the land. However, the needs of freehold flats and other multi-occupancy developments will not be met satisfactorily by this new land obligation. See *Making Land Work* (2011) Law Com No 327, paras 1.10, 5.17, 5.18, 5.90 and 5.91.

³ Department for Communities and Local Government (now Ministry for Housing, Communities and Local Government), *Tackling unfair practices in the leasehold market: A consultation paper* (July 2017) available at <https://www.gov.uk/government/consultations/tackling-unfair-practices-in-the-leasehold-market>, and *Tackling unfair practices in the leasehold market: Summary of consultation responses and Government response* (December 2017) available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/670204/Tackling_Unfair_Practices_-_gov_response.pdf.

⁴ Thirteenth Programme of Law Reform (2017) Law Com No 377, available at <https://www.lawcom.gov.uk/project/13th-programme-of-law-reform/>.

LEASEHOLD REFORM IN THE SPOTLIGHT

2.12 Residential leasehold has, for some time, been hitting the headlines and is the subject of an increasingly prominent policy debate. Concerns have been raised about many aspects of the leasehold market. For example:

- (1) high and escalating ground rents, with a particular concern about the imposition of ground rents which double at periodic intervals (generally ten years) during a lease;
- (2) leasehold homes being unmortgageable as a result of high and escalating ground rents, making the properties unsaleable and trapping the owners in their homes;
- (3) the charging by landlords of unreasonable permission fees to carry out alterations to a property; and
- (4) close relationships between property developers and particular conveyancers which may threaten the latter's independence in advising clients seeking to buy leasehold properties from the referring developers.

2.13 Many of the concerns that have been raised affect leasehold flats as well as houses. In relation to houses, however, the criticism is compounded by the fact that it is not always apparent why the house was sold on a leasehold basis. As we have explained above, there is not the same imperative to sell houses on a leasehold basis as there is for flats. Indeed, sometimes the house was originally offered for sale on either a leasehold or – for a higher price – a freehold basis. In the absence of an imperative to sell houses as leasehold, concerns have been raised that leasehold is being used for no reason other than for developers to extract a profit from owning the freehold (particularly by collecting ground rent and enfranchisement premiums).

2.14 Where a leasehold house was originally offered for sale on a leasehold or freehold basis, it may be said that the leaseholder has chosen to buy on a leasehold basis. That is, however, too simplistic a response. The choice may have been directed by affordability, and by assurances that the freehold could be purchased at a later stage. In practice, many who have tried to purchase the freehold later have found that the price has increased substantially from the time of the original sale. Further, we have been told that many prospective purchasers of houses – particularly first-time buyers – do not have a full understanding of the terms of the lease or of the implications of owning a leasehold property. In some cases, buyers may not even realise when purchasing a leasehold house that they will not become its outright owner. As one stakeholder said to us, people have set their heart on a home and are measuring for curtains and furniture before the lease is explained to them.⁵

2.15 Improving and facilitating home ownership is a priority for Government, and – as part of that – reform of residential leasehold law has become an increasing priority. In December 2017, following a consultation, the Ministry for Housing, Communities and Local Government announced various reforms, including proposals to ban the sale of

⁵ See our discussion of “behavioural biases” in *Event Fees in Retirement Properties* (2017) Law Com No 373, at para 2.5 and following, and *Residential Leases: Fees on Transfer of Title, Change of Occupancy and Other Events* (2015) Law Commission Consultation Paper No 226 para 4.16 to 4.26.

houses on a leasehold basis, and the reservation of ground rents with any financial value when homes (whether houses or flats) are sold on a leasehold basis.⁶ Measures to address problems faced by leaseholders have also been announced by the Welsh Government.

OUR FORTHCOMING CONSULTATION PAPER

- 2.16 As part of its December 2017 announcement, Government said that it would consider further measures that could assist existing leaseholders of houses. To complement that package of measures, we were asked by Government to prioritise enfranchisement solutions for existing leaseholders of houses, and to set out those solutions before summer recess 2018.
- 2.17 This Paper does not contain the Law Commission's final recommendations for reform. In September 2018, we will publish our Consultation Paper on enfranchisement. Our Consultation Paper will provisionally propose a new, single regime for leasehold enfranchisement designed to benefit leaseholders of houses and flats. Those provisional proposals will then be subject to full public consultation. Our final recommendations for reform will take account of responses to that consultation.
- 2.18 This Paper looks ahead to our provisional proposals for enfranchisement reform, and summarises how they will provide solutions for leaseholders of houses. We are not at this stage inviting views on our proposed solutions for leaseholders of houses, but rather ask for responses to our forthcoming Consultation Paper which will propose a reformed enfranchisement regime covering both houses and flats.
- 2.19 We understand that, for those directly impacted by abuses within the leasehold market, reform cannot come quickly enough. We have heard of people's lives being deeply and directly affected by their inability to move home or enfranchise because of onerous terms in their leases. The urgency of reform must, however, be balanced by the need to ensure that the reforms proposed are right. Only by doing so can we ensure that the leasehold system works for all leaseholders and that abuses within the current system are not simply replicated in any reformed regime.

CRITICISMS OF THE CURRENT ENFRANCHISEMENT REGIME

- 2.20 We have heard numerous, and often detailed and technical, criticisms of the enfranchisement regime. Underlying some criticisms is the view that leasehold ownership is inherently unfair for leaseholders. That perceived underlying unfairness then exhibits itself during the enfranchisement process. Other specific criticisms of the enfranchisement regime are as follows.
- (1) It is inconsistent, disjointed and unclear: the current enfranchisement regime is the product of over 50 Acts of Parliament, totalling over 450 pages. There are numerous anomalies and unintended consequences resulting from piecemeal changes over time. There are different rules for leaseholders of houses and of flats, often with no logical reason for the distinction.

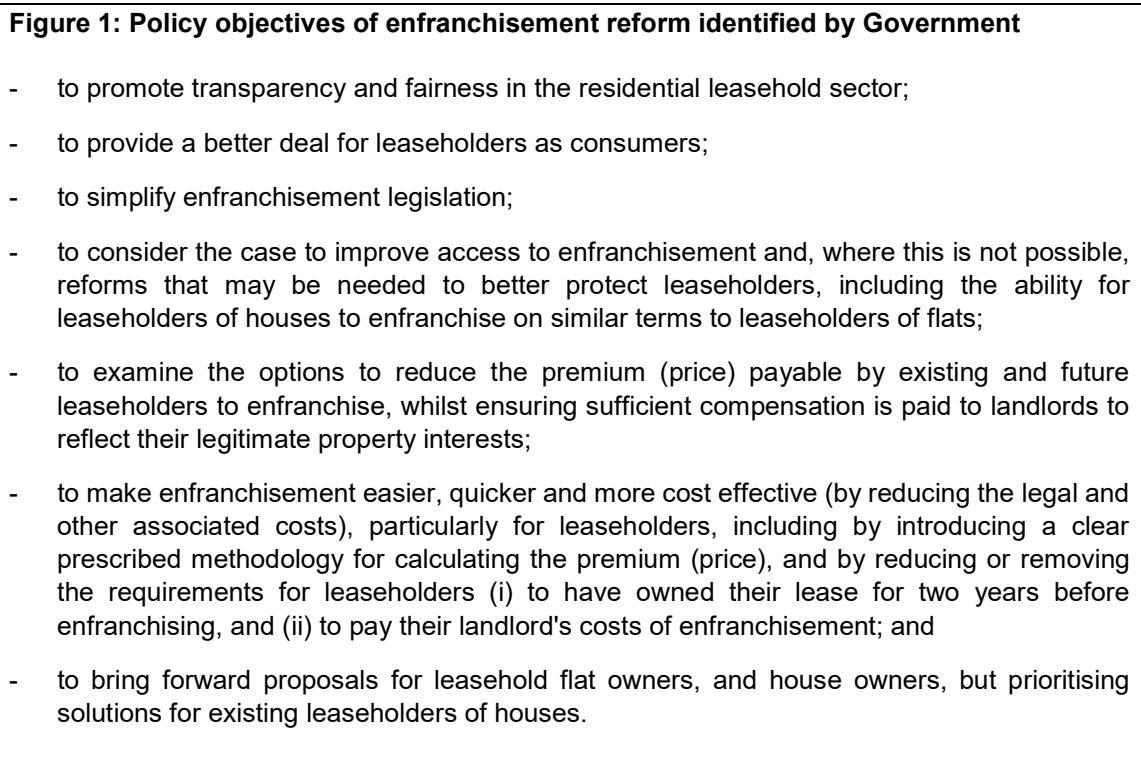
⁶ See n 3 above.

- (2) It is complex and uncertain.
- (3) It is costly for leasehold homeowners to exercise enfranchisement rights.
- (4) It encourages an unhelpful tactical “gaming” approach to negotiations, which tends to favour more experienced landlords over leaseholders.
- (5) It encourages litigation.

2.21 These problems with the current regime cause unnecessary conflict, stress, uncertainty, costs, and delay. Ordinary leaseholders tend to be less able to shoulder the costs and delays than landlords.

OUR TERMS OF REFERENCE

2.22 The Law Commission’s role is to ensure that the law is fair, modern, simple and cost-effective. While we are working independently from Government, our project is designed to pursue certain policy objectives, which have been decided by Government and which are set out in our Terms of Reference. The objectives of reform that we have been asked to achieve are set out in Figure 1.



2.23 In summary, our project is designed to provide a comprehensive review of enfranchisement with a view to improving the position of leaseholders as consumers.

2.24 While there have been abusive practices, and leasehold has been used in circumstances where it clearly or arguably was not needed, there are many landlords of leasehold houses who operate fairly and transparently. And, whatever the background, the fact is that many houses are owned on a leasehold basis. Enfranchisement offers the opportunity to turn a leasehold interest into a freehold

interest, and so escape the problems of leasehold. But enfranchisement is the purchase of the freehold, or of an extended lease. There is no suggestion that existing leaseholders should be able to obtain a freehold or lease extension without paying the landlord an appropriate price; our task is to propose reforms to improve the enfranchisement process, and to set out the options for reducing premiums that are payable by leaseholders while ensuring sufficient compensation is paid to landlords.

2.25 The remaining chapters of this Paper summarise the enfranchisement reform proposals on which we will shortly be consulting, in so far as they concern leasehold houses.

Chapter 3: Proposed enfranchisement solutions for leaseholders of houses

OUR PROPOSED NEW ENFRANCHISEMENT REGIME

3.1 In our Consultation Paper we will set out proposals for a new coherent and streamlined enfranchisement regime. Central to our proposals is that the same regime should apply, insofar as possible, to enfranchisement of leasehold houses and flats. In setting out our proposals for reform, we will ask consultation questions on four key issues:

- What should the enfranchisement rights be?
- Who should be entitled to exercise enfranchisement rights?
- How should enfranchisement rights be exercised?
- What should it cost to enfranchise?

3.2 In this chapter we briefly set out key features of our proposed new regime as it will apply to houses in respect of the first three issues. In the next chapter we address in more detail the fourth issue: the cost of enfranchisement.

WHAT ARE THE ENFRANCHISEMENT RIGHTS?

Existing rights and problems

3.3 Leaseholders of houses who meet certain qualifying criteria have two enfranchisement rights.

3.4 First, they have a right to purchase their freehold. Exercising this right means that there is no longer a landlord and that the house owner now has an ownership right that lasts forever.

3.5 The legislation does not, however, cater for the needs of many modern housing estates. For example, services that are provided across a wider estate should continue to be provided, and paid for, for the benefit of the house owner and his or her neighbours after there has been an enfranchisement. But the legislation makes no provision for an ongoing relationship. Similarly, where a house is on an estate (which might comprise only houses, or a mixture of houses and flats) the leaseholders of all of the homes on the estate might wish to join together to acquire the freehold of the entire estate from their landlord.⁷ Currently, legislation only allows a group of leaseholders to purchase a freehold interest in their properties collectively if they are leaseholders within a single block of flats. It does not allow the leaseholders of a wider estate – whether it includes houses or not – to acquire the freehold of the whole estate.

⁷ Doing so can provide the leaseholders with the ability to control the management of their estate, as well as providing them with long-term security in their homes (overcoming the problem of owning a wasting asset).

- 3.6 Second, leaseholders of houses have a right to a single 50-year lease extension, which provides them with longer-term security in their home. No premium or purchase price is paid for the lease. While that may suggest that a lease extension is attractive, that is not in fact the case. The lease is granted at what is known as a “modern ground rent”, which can be very high. In effect, the modern ground rent means that what would have been paid as a premium is instead paid over time in rent. By contrast, leaseholders of flats have a right to a 90-year lease extension without an obligation to pay a ground rent. Moreover, for leaseholders of flats, there is no limit on the number of lease extensions that can be obtained.

Proposed solutions

- 3.7 In our Consultation Paper we will set out proposals for a new coherent and streamlined enfranchisement regime which will no longer turn on the distinction between houses and flats. It will have the effect of enhancing and adding to the rights available to leaseholders of houses. Leaseholders will have a suite of comprehensive rights, which are standardised, practically useful and coherent.
- 3.8 Leaseholders of houses will enjoy three key enfranchisement rights.
- 3.9 **First, a right to acquire the freehold of their house, similarly to the current law, but removing some of the technical problems that we have identified.**
- 3.10 **Second, a right to a longer lease extension – for example, 125 or 250 years – with no ground rent.** There would be no limit on the number of lease extensions that can be obtained. While many leaseholders of houses will want to acquire the freehold, a lease extension will be appropriate in some cases. This proposal will ensure that leaseholders of houses can obtain a long lease without expensive annual ground rents. Our proposals will therefore be aimed at ensuring that consumer choice is maintained, while providing that the lease is on more favourable terms than under the current law.
- 3.11 **Third, leaseholders of houses will also be able to participate in a new enfranchisement right enabling leaseholders on an estate comprising multiple buildings to purchase collectively the freehold of the estate** – whether those buildings are houses or blocks of flats or a combination of the two. We will also consult on introducing a new right for leaseholders who did not previously participate in a collective enfranchisement (for example, because they could not afford to do so) to do so at a later date. Where an estate-wide freehold acquisition has already occurred, leaseholders of houses who did not originally participate could have a right to do so at a later date.

WHO IS ENTITLED TO EXERCISE ENFRANCHISEMENT RIGHTS?

Existing qualification criteria and problems

- 3.12 The current legislation setting out the various criteria that leaseholders of houses must satisfy in order to qualify for enfranchisement rights is complex. The relevant provisions are scattered across several statutes and subject to many exceptions, provisos and qualifications. The criteria can also be difficult to apply in practice. For example, eligibility for enfranchisement rights and for a particular valuation basis may depend on historic rateable values, which can be difficult to find, and which for some properties do not exist at all. Leaseholders may be required to satisfy the “low rent test”, which is set

out in a number of convoluted, confusing statutory provisions. More fundamentally, certain terms in the legislation create much uncertainty, and scope for litigation. There is still no clear definition of a “house”, despite the issue having been considered by the highest appeal court on five occasions. These difficulties can lead to additional costs and delay for leaseholders seeking to enfranchise, who may need to obtain specialist legal advice, or even in some cases to assert their rights through litigation.

- 3.13 It has also been said that the qualification criteria can be arbitrary or lead to unfair outcomes. For example, leaseholders must have owned a house for two years before they can make an enfranchisement claim. During this waiting period, the price to be paid by the leaseholder to enfranchise might rise. There are also distinctions between the qualification criteria which must be met by leaseholders of houses and those which apply to leaseholders of flats, for which there is not always a good justification.

Proposed solutions

3.14 Our proposed regime will simplify the current law. We will propose:

- (1) **the replacement of the current two-track approach to the question of availability of enfranchisement rights (which requires premises to be categorised as a “house” or “flat”) with a single coherent set of criteria** (based around the new concept of a “residential unit”, which can be applied to any leasehold premises). This proposal will overcome the difficulties encountered in the current law in determining whether a building is a house;
- (2) **the abolition of qualification criteria based on financial limits** – both the “low rent test” and limitations based on historic rateable values. The regime will therefore be simpler, easier to understand, and practically workable; and
- (3) **the removal of the requirement that the leaseholder must have owned the lease for the last two years before making a claim.** Leaseholders will not therefore be required to delay their claim, and watch the premium rise, while they are waiting to satisfy a minimum ownership requirement.

HOW DO YOU ENFRANCHISE?

Existing procedure and problems

3.15 An enfranchisement claim begins by the leaseholder of a house giving a notice to his or her landlord. The requirement sounds simple, but can give rise to significant difficulties, all of which give rise to uncertainty, delays and costs. For example:

- (1) inadvertent mistakes in the notice might render the claim invalid;
- (2) landlords can be difficult to identify or to locate, creating problems for a leaseholder trying to work out where to send his or her notice; and
- (3) there can be disputes about whether notices have been properly served (and received) by landlords.

- 3.16 The procedure for leaseholders of houses to exercise enfranchisement rights is complicated, which has two consequences.
- (1) There is plenty of scope for parties to disagree, or to argue different positions. The threat of litigation about those points, and the time it can take to resolve disputes, can be used tactically against a party who is seeking to complete the process speedily and at minimal cost. This consequence can be an incentive for leaseholders to agree to voluntary informal lease extensions (that is, outside the statutory regime) which can expose them to significant risks, such as onerous terms in the new lease.
 - (2) Few can operate the procedure without professional assistance, which can be costly. Both legal and valuation costs can be significant, and can be disproportionate to the property value. In some cases, the costs involved actually exceed the premium payable. These costs are borne by both leaseholders and landlords, though leaseholders are required to pay their landlords' reasonable "non-litigation costs" so will often feel the burden of costs more acutely.⁸
- 3.17 Many leaseholders object to having to pay their landlord's non-litigation costs. They also criticise the level of non-litigation costs claimed by some landlords, and the expense of contesting the sums claimed. Leaseholders can find themselves stuck between a rock and a hard place. If leaseholders or their solicitors think that the costs claimed by a landlord are unreasonable, leaseholders must make a claim to the Tribunal, wait for the outcome of that claim (which they may win or lose), and pay their own solicitors' costs. It will often be quicker and easier simply to pay the costs claimed by the landlord, even if they are unreasonable.
- 3.18 The powers to deal with disputes or issues that arise during an enfranchisement claim are divided between the county court and the Tribunal. The division can be confusing for the parties, and can lead to a number of separate applications having to be made during the course of a claim, causing the parties further unnecessary costs and delays.

Proposed solutions

- 3.19 In our Consultation Paper, we will propose **a single simplified procedure that would apply to all residential units (whether houses or flats) regardless of the enfranchisement right being claimed.** The key features of this proposed procedure would solve problems under the current law by:
- (1) **providing standard, and simpler, forms for commencing an enfranchisement claim,** making the process easier and simpler;
 - (2) **allowing leaseholders to give claim notices to their landlord at specified categories of addresses, and deeming the landlord to have been properly served at such an address.** Leaseholders will not, therefore, have to take time-consuming and costly steps to locate their landlord where they have not been

⁸ Bringing an enfranchisement claim will lead both parties to incur legal and other costs even if there is no dispute that needs to be resolved by a court or Tribunal. For example, the parties might incur legal costs when serving notices on the other, and in completing and registering the grant of a new extended lease or the transfer of the freehold to the leaseholder. The parties might also incur professional valuation costs. We refer to these costs as "non-litigation" costs.

provided with up-to-date contact details. And nor will leaseholders be faced with assertions that landlords have not been properly served;

- (3) where leaseholders are unable to give claim notices to their landlord at a specified category of address, **allowing them to apply to the Tribunal so that the claim can still proceed;**
- (4) **requiring landlords to provide their proposed draft transfer (or other document giving effect to the enfranchisement claim) with their response notice.** Later stages of the enfranchisement process would therefore be frontloaded, and areas of potential dispute can be identified at an earlier stage;
- (5) **limiting the circumstances in which the validity of notices can be challenged.** Arid, costly and time-consuming debates about whether a notice complies with the numerous technical requirements would therefore be avoided; and
- (6) **providing that all disputes arising during an enfranchisement claim should be dealt with by the Tribunal.** Leaseholders would therefore no longer have to navigate the complex division of responsibility between the court and the Tribunal, and disputes will be resolved more quickly, and in one go.

3.20 **We will also consult on whether leaseholders should be required to contribute to their landlord's non-litigation costs of dealing with a claim. If that requirement is retained, we will set out options for reforming the way in which any such contributions might be set, and will also outline a potential fixed-costs regime.** A fixed-costs regime would allow leaseholders to know at the outset the amount of costs that the landlord will be entitled to claim, and will prevent leaseholders from feeling compelled to accept having to pay unreasonable costs.

Chapter 4: Options for reducing enfranchisement premiums for leaseholders of houses

Figure 2: Valuation glossary

Deferment / deferment rate: deferment refers to the need to reflect, by way of discount, the fact that money due to be received in the future will instead be received now. A deferment rate is used to calculate a capital sum which, if invested now, would provide an amount equivalent to the value of the property when the lease was due to expire.

Capitalisation / capitalisation rate: capitalisation refers to the calculation of a capital sum which reflects the right to receive income in the future. A capitalisation rate is used to calculate a capital sum that reflects the value of that income stream.

Relativity: the relative value of (a) a leasehold, and (b) a freehold interest in a property.

Premium: the sum the leaseholder must pay to the landlord for the transfer of the freehold or the lease extension. The premium is also referred to as the “price”.

Marriage value: the additional value an interest in land gains when the landlord’s and the leaseholder’s separate interests are “married” into single ownership. The aggregate value of those two interests held separately is often significantly less than the value if they are both held by the same person.

Hope value: a deferred form of marriage value. If the freehold interest is sold to someone other than the leaseholder, marriage value will not be realised. But the purchaser might “hope” that a future transaction with the leaseholder will realise marriage value. The additional value paid by a purchaser to reflect that hope of a future transaction is referred to as “hope value”.

Term and reversion: the right of the landlord to receive the ground rent during the term of the lease (“the term”) and the right of the landlord to recover possession of the property on the expiry of the lease (“the reversion”).

THE COST OF ENFRANCHISEMENT

4.1 When a leaseholder exercises the right to enfranchise, the total cost to the leaseholder is comprised of two distinct components:

- (1) professional costs, namely fees paid to lawyers and valuers; and
- (2) the premium, or the price the leaseholder needs to pay the landlord for the extended lease or the freehold.

4.2 In order to calculate the premium, the value of the interest being obtained from the landlord must be calculated. Valuation therefore refers to calculating the price to be paid, separate from any professional costs incurred. Lower premiums are therefore beneficial to leaseholders, at the expense of the landlord who receives less money for the lease extension or the freehold. The interests of landlords and leaseholders are diametrically opposed.

- 4.3 The question of whether premiums should be reduced is not solely a question of law; it involves considerations of law, valuation and, ultimately, political judgement. Our Terms of Reference require us to:
- (1) set out options for reducing the premium payable by existing and future leaseholders to enfranchise, whilst ensuring sufficient compensation is paid to landlords to reflect their legitimate property interests;
 - (2) produce options for a simpler, clearer and consistent valuation methodology; and
 - (3) make enfranchisement easier, quicker and more cost effective (by reducing the professional costs), particularly for leaseholders, including by introducing a clear prescribed methodology for calculating the premium.
- 4.4 Expanding on (1) above, human rights considerations are a significant part of determining what constitutes sufficient compensation. We will be developing our human rights analysis of the valuation options available to Government over the course of the project. In taking forward reform, Government will also need to take account of the impact of reform on the parties affected and the wider property market.

CURRENT APPROACH TO VALUATION

- 4.5 As noted in paragraph 3.6 above, no premium is paid when the leaseholder of a house enfranchises by obtaining a 50-year extension of the lease. Instead, the cost of the lease is paid through the modern ground rent.
- 4.6 In relation to acquiring the freehold of a house, there are different bases of valuation.⁹ Which basis of valuation applies is dependent on a number of factors. The general approach to valuation is contained in sections 9(1A) and 9(1C) of the 1967 Act, and is designed to ascertain the market value of the landlord's interest in the property. A significant number of claims, however, are valued under the "original valuation basis" contained in section 9(1) of the 1967 Act, which is intended to apply to low value houses. Section 9(1) provides a more favourable basis of valuation for leaseholders, but it is also more complicated and difficult to operate.
- 4.7 Throughout this chapter, we refer to three sample enfranchisement claims to demonstrate the effect that the various options for reform might have on the premium payable. The examples are based on valuations under section 9(1C) of the 1967 Act. The full calculations are set out and explained in the Appendix. Figure 3 below summarises the figures that those calculations produce.

⁹ The four bases of valuation are sections 9(1), 9(1AA), 9(1A) and 9(1C) of the 1967 Act. However, all section 9(1AA) really does is to amend the assumptions in section 9(1A), in particular circumstances, and it might be said that section 9(1C) is really no more than an amended version of s 9(1A).

Figure 3: sample enfranchisement premium calculations

House A

Value on a freehold basis: £200,000

Details of existing lease:

- Unexpired term: 130 years
- Ground rent: £250 per annum
- Value of lease: £198,000

The premium would be the value today of the future ground rent income (£3,571) plus the value today of the freehold interest in House A in 130 years (£480). **Total: £4,051.**

House B

Value on a freehold basis: £200,000

Details of existing lease:

- Unexpired term: 60 years
- Ground rent: £250 per annum
- Value of lease: £160,000

The premium would be the value today of the future ground rent income (£3,510) plus the value today of the freehold interest in House B in 60 years (£12,353) plus half of the "marriage value" (£12,068). **Total: £27,932.**

House C

Value on a freehold basis: £400,000

Details of existing lease:

- Unexpired term: 241.5 years
- Ground rent: £295 per annum doubling on 1 January 2020 and every 10 years thereafter until 2060

The premium would be the value today of the future ground rent income (£60,758) plus the value today of the freehold interest in House C in 241.5 years (£5). **Total: £60,763.**

PROBLEMS FOR LEASEHOLDERS OF HOUSES

- 4.8 From the point of view of leaseholders of houses, there are three main criticisms of the current approach to valuation.
- 4.9 First and foremost, many leaseholders consider that the premiums payable in order to acquire the freehold are too high. An appropriate balance is not necessarily drawn between the competing interests of landlords and leaseholders. The 1967 Act, which contains the valuation formula used for purchasing the freehold of a house, was passed primarily to meet the anxieties of ordinary householders in areas where long leases of houses were widespread. But in practice those who derived most benefit from it in financial terms were relatively wealthy leaseholders of houses in expensive areas of London. The various amendments that have been made to the 1967 Act (including in relation to valuation) have shifted the balance between landlord and leaseholder, so that the subsequently introduced bases of valuation seek to compensate the landlord

in full at a market value. But leaseholders may argue that the premium is too high and does not reflect the fact that the asset they are buying is their home.

- 4.10 The discontent amongst leaseholders has been fuelled by the practice of some developers of selling leasehold properties with rent review clauses leading to very high ground rents, including ground rents that double every ten years (or in some instances at less than ten yearly intervals). Such rent review mechanisms make the need to enfranchise and buy out the ground rent more imperative, whilst significantly increasing the premium payable to do so.
- 4.11 Second, valuation is complicated and expensive. The valuation provisions and methodology are not readily understandable to the lay person and it is difficult to enfranchise without specialist advice. Where the capital value of the property is low, the professional fees may be disproportionate to the price payable. One of the reasons for complexity is that there is a wide valuation margin and a lack of standardisation, which gives scope for disputes and a lack of certainty as to the price that will be payable.
- 4.12 Third, the valuation methodology is both artificial and circular. Both of these criticisms stem from the fact that in calculating the market value various statutory assumptions must be made. In particular, it must be assumed that there are no Act rights attached to the interest; that is, that the leaseholder has no right to buy the freehold or a claim a new lease. But in reality, nearly all leasehold properties benefit from Act rights and therefore the “market value” being calculated is, to an extent, artificial. It is circular because buyers of leasehold properties buy on the basis that the Acts confer the right to buy or to extend the lease. As a result, while the market value determines the price payable under the Acts, the price payable under the Acts determines the market value.
- 4.13 In this Paper we set out options for how the valuation methodology could be reformed in respect of leasehold houses in order to reduce premiums payable by leaseholders. In our Consultation Paper, we will apply these options for reform to leasehold flats and houses, and explain the impact that they will have on the premium paid in respect of flats as well as houses under the new streamlined enfranchisement regime that we will propose. Before setting out specific options, we set out some general considerations that are relevant to how valuation should be reformed.

OVERARCHING CONSIDERATIONS FOR REFORM

Provision of a more consistent valuation methodology for all types of claim

- 4.14 The legislation would be simplified if there were one valuation methodology applicable to all types of enfranchisement claim including houses. That would save leaseholders from incurring professional costs determining which valuation method applies to them, and remove the risk of selecting the incorrect method (and potentially costly consequences that might follow from doing so). A single valuation methodology could not, however, be used for leaseholders of houses who currently benefit from the original valuation basis in section 9(1). As explained above, section 9(1) provides the most favourable valuation for leaseholders, but it would not be suitable to be adopted as the

single method for all enfranchisement claims.¹⁰ If a single method of valuation is introduced, then our Terms of Reference require us to consider an exception for those who would have benefited from section 9(1) as otherwise the premium would be increased for a great many leaseholders of houses. There are two ways in which an exception could be made: retaining section 9(1); or introducing an equivalent (but updated) provision.

Creation of a separate regime for low value cases

- 4.15 Whilst a consistent regime has the advantage of simplicity, there are obvious difficulties in a “one size fits all” approach. In particular, in many claims the freehold value of the house, the length of the lease and/or the level of ground rent, are such that the premium is modest. In such cases, the professional costs may exceed the premium.
- 4.16 Some stakeholders have therefore suggested that a separate regime should be applicable to low value – or straightforward – claims. Such an approach can be found in Scottish legislation.¹¹
- 4.17 The need for a separate approach for low value claims is dependent on the general approach taken to valuation. If one of the simple formulae – set out under Option 1 below – is adopted for all claims, then the need to separate low value or straightforward claims falls away. If any other option is adopted, however, then separating low value claims merits consideration.

Differential pricing depending on the identity of the leaseholder

- 4.18 The original policy intention of enfranchisement was to enable people to extend the lease or buy the freehold of their homes. However, rights to enfranchise are no longer confined in this way; for example, as a result of the removal in 2002 of a residence requirement, enfranchisement rights are available to most leaseholders whether they are buy-to-let investors or owner-occupiers.
- 4.19 Currently, the premium payable in respect of any one property is the same regardless of the identity of the person exercising enfranchisement rights. One option, however, would be to adopt different valuation formulae which produced lower premiums where the right to enfranchise is being used for its original purpose: to enable a person to extend the lease or purchase the freehold of their home. There are, however, strong arguments against differentiating between leaseholders, not least because it would add a layer of complexity to the law.

Prescribing rates

- 4.20 Valuation often involves the use of rates to determine “capitalised” or “deferred” capital sums, and for “relativity”, in order to create a current value of what is being purchased, taking account of all the features of the lease. These rates are explained in Figure 2 above. Identifying the appropriate rates can be contentious. The rate used can make a significant difference to the premium that will be paid. In addition, professional costs are

¹⁰ It is based on factors (such as rateable value) which are historic. In policy terms, the formula reflects the idea that the original lease was a building lease, so that the leaseholder had built the house; nowadays, most leases are granted of houses that have already been built.

¹¹ See paragraph 4.32 and Figure 5 below

incurred. Any option for reform that continues the need for these rates could be combined with putting in place a process for prescribing the rates. The rates could then be prescribed in a manner favourable to leaseholders, so that premiums are reduced. In addition, leaseholders and freeholders would benefit from saving professional costs.

Provision of an online calculator

4.21 In order to make enfranchisement easier, quicker and more cost effective (by reducing the legal and other associated costs), we provisionally consider that the valuation provisions could be supported by an online calculator. A calculator would use various inputs that reflect the individual characteristics of the lease (such as the level of ground rent) and would calculate the enfranchisement premium payable. Depending on the valuation methodology adopted, an online calculator could limit or even remove the need for expert assistance.

OPTIONS FOR REDUCING PREMIUMS

4.22 Our options for reducing premiums are divided into two categories:

- (1) the adoption of simple formula; and
- (2) options based on, but amending, current valuation methodology.

4.23 Under the new enfranchisement regime that we propose above (see Chapter 3), these options would apply both to the freehold acquisition of a house and to a lease extension of a house. Since the right to a lease extension would be based on a premium and not a ground rent, there would no longer be a high “modern ground rent” during the extended lease as there is at present.

OPTION 1: SIMPLE FORMULA

4.24 **It would be possible for enfranchisement premiums to be set by reference to a simple formula with prescribed figures.**

4.25 Current valuation methodology seeks to arrive at a market value.¹² Examining market value will inevitably involve variables, and therefore uncertainties, and associated professional fees. Indeed, we think that it would be impossible to come up with a valuation approach that is based on market value, but at the same time is calculated solely by reference to set figures. A simple formula, such as a ground rent multiplier, would move away from market value. The difficulty of doing so, however, is that the premium payable is less likely to reflect the actual value of the asset being taken from the landlord, presenting an increased risk of the approach not providing sufficient compensation and being challenged (for example, by landlords arguing that their right to peaceful enjoyment of their possessions under human rights legislation has been infringed).

¹² That is also the case with many other similar statutory valuation approaches, for example, in compulsory purchase, although they may have nuances and different ways (and different assumptions) to ascertain market value.

Option 1A: ground rent multiplier

4.26 It would be possible to calculate the enfranchisement premium by reference to the ground rent. A Private Member's Bill has been introduced into Parliament to introduce a maximum enfranchisement premium for leaseholders purchasing the freehold of ten times the ground rent:¹³

The Bill's first aim is to introduce a simple and fair scheme, with a clear and transparent statutory pricing model, and the amount for a leaseholder to purchase their freehold would be capped at no more than 10 times the annual ground rent. At the moment, leaseholders are often quoted costs of over 100 times the ground rent to purchase the freehold. We can change this: such a system already exists in many other countries, including Scotland and Northern Ireland, and I believe it is time that people in England and Wales had the same rights.¹⁴

4.27 The effect of using a ground rent multiplier on the valuation of premiums for Houses A, B and C is set out in Figure 4.

Figure 4: valuation of premiums for Houses A, B and C if ground rent multiplier of 10 is used

The premium for House A would reduce from £4,051 to £2,500.

The premium for House B would reduce from £27,932 to £2,500.

The premium for House C would reduce from £60,763 to £2,950.

4.28 Basing a premium on (say) ten times current, or average, ground rent has a number of obvious attractions.

- (1) The valuation approach would be simple and, in many (but not all) cases premiums would be reduced. The ground rent is easily ascertainable in the majority of cases – all a leaseholder needs is a copy of his or her lease, which will specify the ground rent. This becomes slightly more complicated where there are ground rent reviews or where the ground rent is to be determined as a percentage of capital value, for example. If a multiplier were based on current ground rent only, then a recent ground rent demand ought to provide clarity as to what is payable in the event this cannot be easily ascertained from the lease. However, ignoring rent reviews would lead to greater disparity between the price payable on enfranchisement and market value, as to which, see below.
- (2) Once the ground rent is known, the calculation is simple. It can be carried out by the leaseholder without any professional help and there is very little, if any, room for dispute. Consequently, the leaseholder can be certain as to what the price will be and need incur no costs in ascertaining it or agreeing it with the landlord.
- (3) The resulting price will not reflect the market value of the interest being acquired. It will therefore be largely artificial and will still affect the value of short leases in the market. Existing problems about circularity under the current law would not,

¹³ The second reading of the Bill is scheduled for 26 October 2018.

¹⁴ Justin Madders MP, *Hansard* (HC), 7 November 2017, vol 630, col 1384.

therefore, be avoided (see paragraph 4.12 above). However, the calculation requires no hypothetical assumptions to be made and those short lease values will have no impact on premiums payable. Consequently, existing problems about artificiality under the current law would be avoided.

- 4.29 We understand from stakeholders that developers themselves sometimes use a multiplier of ground rent as the basis for offering to sell the freehold of a house both through an informal enfranchisement, and when freeholds are sold to other investors. The multipliers offered (even in relation to the same house) vary, sometimes significantly, over time. We understand, however, that the multiplier is likely to be based on the lease characteristics, in particular, the rent review mechanism, comparable evidence and an interpretation of current investor bidding and market sentiment, which may explain why the multipliers vary over time.
- 4.30 The difficulties with this approach are, first, that it excludes from the enfranchisement premium any reversionary value, which may be substantial, and second, and even where there is no reversionary value, the level of ground rent is largely arbitrary, meaning that the resulting premium upon enfranchisement would be arbitrary. Unlike rents under assured tenancies, for example, the ground rent under a long lease is not set by the market. Further, whilst the freeholder may have extracted a large premium on the grant of a lease in return for a low ground rent and vice versa, there is not necessarily a correlation between the premium paid and the ground rent payable. Indeed, the unsuspecting leaseholder may well find that they have paid a large premium for a lease which provides for the payment of a large ground rent. In any event, the ground rent may bear no relation to the capital value of the property.
- 4.31 Historically ground rents have been low figures: £100 per annum, for example. However, over the last decade pension funds, insurance companies and some unit trusts have moved into the market to purchase high quality, recently developed property, let to leaseholders at long terms with index linked ground rents thus creating a demand amongst landlords for such ground rents.¹⁵ Further, as we have noted at paragraph 2.12 above, there has been a great deal of publicity recently in relation to leases being granted subject to very onerous ground rents.¹⁶ If the ground rent is multiplied by a set figure, not only is no account taken of any reversionary value, no account is taken of the length of the lease or the nature of the ground rent and its attractiveness to the market. The arbitrary outcome is demonstrated by the valuations for Houses A and B set out in Figure 4 above. The enfranchisement premium for both is the same, despite the length (and therefore value) of the two leases being very different. Consequently, a premium based solely on the ground rent will bear no relation to the value of landlord's asset unless there is no reversionary value and even then it might not do so.
- 4.32 **We think that there may be scope for using a simple multiplier (or for a multiplier based on a capitalisation rate, which could be prescribed and changed over time – see further below) in cases where there is no reversionary value to a lease.** This

¹⁵ As found by the First-tier Tribunal in *St Emmanuel House (Freehold) Limited v Berkeley Seventy-Six Limited* CHI/21UC/OCE/2017/0025.

¹⁶ House C is based on the terms of a lease granted by developer Taylor Wimpey.

could be done, for example, by adopting provisions similar to those of the Long Leases (Scotland) Act 2012 or by using the rentcharge redemption formula: see Figure 5.

Figure 5: multipliers in Scottish legislation and in rentcharge redemption legislation

The Long Leases (Scotland) Act 2012 provided for the automatic conversion of certain leasehold interests into outright ownership. The compensation payable to landlords under that Act was based on a capitalised amount of annual rent.¹⁷ However, the Long Leases (Scotland) Act 2012 only applied to leases granted for more than 175 years, with more than 100 years left to run, in respect of houses, and more than 175 years left to run, otherwise.¹⁸ In other words, the qualifying leases had little or no reversionary value. Further, the Act only applied where the annual rent was less than £100.

A rentcharge is an annuity secured on some specified land. The Rentcharges Act 1977 allows the owner of land which is subject to a rentcharge to redeem it by paying an equivalent capital sum to the owner of the rentcharge. The sum payable is calculated according to a formula set out in the Rentcharges (Redemption Price) (England) Regulations 2016. Rentcharges have no reversionary value and so their capital value simply decreases over the course of their term.

4.33 The calculation of compensation under the Long Leases (Scotland) Act 2012 and the rentcharges formula are analogous to a ground rent multiplier. However, they both apply to interests which have no reversionary value and the calculation uses what can be described as “market” rates. Consequently, the interests being valued lend themselves to a simple formula, and the figure produced is more reflective of a market value than that produced if a multiplier of ground rent was used in all cases. However, under the current law, the calculation of the premium in respect of an existing lease with no reversionary value is relatively simple: it is the capitalised value of the ground rent. If a capitalisation rate was prescribed and an online calculator was provided, as to which see above, then the existing valuation provisions could be made as accessible and as easy to apply as the provisions of the Long Leases (Scotland) Act 2012 and the Rentcharges Act 1977.

Option 1B: set percentage of freehold value

4.34 **An alternative simple way to calculate the price payable, yet still on the basis of a simple formula, would be to set the price as a percentage of the capital value of the property.** For example, the premium could be set at 10% of the capital value of the house. This approach could have the advantage of being simple and cost effective depending on how the capital value is to be ascertained.

4.35 The value used could be the value of the leasehold interest itself, using sale/asking prices to determine it. The difficulty with taking sale/asking prices is that those prices reflect, among other things, the length of the lease. Accordingly, a premium based on a percentage of the value of the leasehold interest would *reduce* as the length of the lease reduces, when in those circumstances the premium ought to *increase*. This problem could be solved by using a percentage of the capital value of the freehold. The effect of

¹⁷ Long Leases (Scotland) Act 2012, s 47. The amount is calculated by reference to the sum which, if invested in a 2.5 consolidated stock before the conversion date, would produce the rental amount due under the lease.

¹⁸ Long Leases (Scotland) Act 2012, s 1.

using, for example, 10% of freehold value on the valuation of premiums for Houses A, B and C is set out in Figure 6.

Figure 6: valuation of premiums for Houses A, B and C if 10% percentage of capital value is used

The premium for House A would increase from £4,051 to £20,000.

The premium for House B would reduce from £27,932 to £20,000.

The premium for House C would reduce from £60,763 to £40,000.

4.36 As can be seen, the premiums do not reflect the different lease lengths. They would also fail to reflect any difference in the ground rent payable. Consequently, landlords would be likely to challenge such an approach on the basis that the level of compensation is inflexible, and does not provide sufficient compensation in respect of the landlord's interest. If this option is taken forward, careful consideration will be needed to determine the circumstances in which it is considered to provide sufficient compensation.

OPTION 2: OPTIONS BASED ON CURRENT VALUATION METHODOLOGY

4.37 Our second set of options for reducing premiums involve components of the existing valuation methodology. In order to set out these options, it is necessary first to explain possible reforms to the key current valuation components, and then to consider how some or all of these reforms may be combined.

Valuation components

1. Ground Rent

4.38 **Provision could be made in relation to the treatment of ground rent in any valuation in order to simplify the calculation, and also reduce the overall premium.**

4.39 In what is thought are likely to be the majority of leases, the ground rent will be a low sum, which is easily ascertainable. Providing for such a ground rent to be capitalised (rather than simply multiplied, as in Option 1A) is not a particularly difficult concept or complicated calculation and an online calculator could provide the answer (if the capitalisation rate is set). Consequently, in relation to leases under which the ground rent is low, fixed and ascertainable, we think that that ground rent can be taken into account in calculating the enfranchisement premium.

4.40 Where there are ground rent reviews, the treatment of ground rent becomes slightly more complicated: first, the value of the reviewed rent to the landlord is deferred; second, the quantum of the reviewed rent might not be known (for example, if it is based on an index or the value of the property at the time); third, the review mechanism might change the appropriate capitalisation rate. In order to simplify the treatment of ground rent where there are reviews, a limit could be placed on the number of ground rent reviews which are to be taken into account when calculating premiums. Whilst calculating an average ground rent for the remainder of the term would be an alternative option, not only would this be more difficult to do, it would place disproportionate weight on any future higher ground rent payable.

- 4.41 Some leases provide for the ground rent to be, for example, £100 for the first 25 years, £150 for the next 25 years and £200 for the remainder of the term. In other words, the ground rent is reviewed to a fixed amount. Other leases provide for the ground rent to double every ten or 25 years, for example, which is a review based on a prescribed formula (ie rent x 2). However, in some leases the reviewed rent is not so easily ascertainable. For example, the ground rent might be linked to the Retail Prices Index or to the capital value of the property.
- 4.42 Where a rent is linked to an index, it is possible to estimate the future value of that rent as that is what ground rent investors are currently doing in the market. However, the calculation is fairly sophisticated and not one which leaseholders could be expected to do themselves, although it may be possible to overcome this difficulty with the assistance of an online calculator.
- 4.43 Where the rent is to be reviewed to a percentage of capital value, it could be provided that it is to be treated as being reviewed to a percentage of the current capital value, which is what currently happens in practice.
- 4.44 The ground rent to be taken into account could, in any event, be capped. For example, it could be capped in line with Nationwide Building Society's new lending policy, at 0.1% of the property's value.¹⁹ This would reduce premiums in certain cases, particularly where the ground rent is onerous. Consequently, it would help leaseholders currently liable to pay onerous ground rents to buy out those ground rents at a more reasonable price. Further, it could also simplify the calculation of premiums based on such ground rents.
- 4.45 The effect of the approaches set out above are demonstrated in Figure 7.

Figure 7: Capitalised ground rent for House C

- (1) If the rent for the remainder of the term is capitalised at a rate of 4.5%, as it might be in any valuation at present,²⁰ the capitalised ground rent payable would be £60,758;
- (2) The average ground rent over the term is £7,917.80. If this were capitalised at the same rate of 4.5%, the capitalised ground rent payable would be £175,947;
- (3) If only the first rent review on 1 January 2020 were taken into account, at which point the ground rent rises to £590, the ground rent capitalised at the same rate of 4.5%²¹ would total £12,692; and

¹⁹ See <https://www.nationwide.co.uk/about/media-centre-and-specialist-areas/media-centre/press-releases/archive/2017/5/05-protect-homeowners>.

²⁰ This capitalisation rate is lower than that applied when capitalising the ground rent for Houses A and B. That is because a lease with a ground rent which doubles every ten years is more attractive to an investor than a lease with a static ground rent, the value of which will be eroded by inflation. The more attractive the investment, the more demand there is for it, which drives up the capital value and drives down the rate of return investors receive and are prepared to accept.

²¹ If only one rent review were taken into account then a higher capitalisation rate would be appropriate (see the footnote above), which would further reduce the capital sum. However, to illustrate the effects of the different treatment of ground rent alone, the same capitalisation rate has been applied.

(4) If the ground rent were capped at 0.1% of the property's value, and that value was the freehold value of the house at the valuation date (in other words, the current ground rent of £295 remained payable until 31 December 2019, but it is assumed that from 1 January 2020 the ground rent payable for the remainder of the term is £400 (i.e. 0.1% of £400,000), at the same rate of 4.5%)²² the capitalised ground rent would total £8,740.

2. Capitalisation rates

- 4.46 **It ought, in theory, to be possible to prescribe a capitalisation rate or rates.** If rates were prescribed, the valuation process would be simplified; leaseholders and landlords would not need recourse to specialist advice as to the appropriate capitalisation rate; and inconsistent valuations and costly and lengthy disputes could be avoided.
- 4.47 **Prescribing a capitalisation rate could also be used to reduce premiums:** a lower capitalisation rate produces a higher capital value and vice versa. Consequently, if the prescribed rates were higher than those generally used at present, the premium payable on enfranchisement would go down: see Figure 8.

Figure 8: Capitalised ground rent for Houses A, B and C if capitalisation rate is increased by 1%

House A

If the capitalisation rate is set at 8% rather than 7%, the capitalised ground rent reduces from £3,571 to £3,125.

House B

If the capitalisation rate is set at 8% rather than 7%, the capitalised ground rent reduces from £3,510 to £3,094.

House C

If the capitalisation rate is set at 5.5% rather than 4.5%:²³

(1) Calculated in accordance with current practice, the capitalised ground rent payable would reduce from £60,758 to £40,142;

(2) The capitalised average ground rent would reduce from £175,947 to £143,960;

(3) The capitalised ground rent taking into account only the first rent review would reduce from £12,692 to £10,313; and

(4) The capitalised ground rent capped at 0.1% of the property's value would reduce from £8,740 to £7,125.

²² As above, a higher capitalisation rate would be appropriate in respect of a capped ground rent.

²³ As in Figure 7 above, for illustrative purposes, the same rate of 5.5% has been applied throughout, although a higher capitalisation rate would be appropriate if there was only one review or the ground rent was capped on review.

4.48 The difficulty with prescribing rates is that the appropriate capitalisation rate would ordinarily vary between locations, properties and over time according to various factors. In our Consultation Paper, we will ask how a capitalisation rate – or rates – could be set, and how a prescribed rate should be reviewed periodically.

4.49 In many cases the appropriate capitalisation rate will be reasonably standard and a change of one or two percentage points to the rate will make little difference to the resultant value. However, even if there were more than one prescribed rate, there are likely to be cases where the applicable prescribed rate does not reflect the market rate and (depending on the level at which they are set) may result in premiums that are detrimental to landlords (in some cases) and leaseholders (in others).

3. Deferment rates

4.50 In effect, the deferment rate has been prescribed since the decision in *Sportelli*.²⁴ However, it is still subject to dispute, particularly in respect of properties outside London, and before long it may be argued that changes in the market since the decision in *Sportelli* justify the issue of the deferment rate being revisited as a whole. Consequently, **prescribing a deferment rate ought to simplify the valuation process and, again, can be used as a way of reducing premiums.**

4.51 A higher deferment rate produces a lower premium and vice versa. Consequently, if the prescribed rate was higher than that determined in *Sportelli*, the premium payable on enfranchisement would go down: see Figure 9.

Figure 9: Value of deferred freehold possession for Houses A, B and C if deferment rate is increased by 1%

House A

If the deferment rate is set at 5.75% rather than 4.75%, the deferred freehold value of House A in 130 years reduces from £480 to £140.

House B

If the deferment rate is set at 5.75% rather than 4.75%, the deferred freehold value of House B in 60 years reduces from £12,353 to £6,986.

House C

If the deferment rate is set at 5.75% rather than 4.75%, the deferred freehold value of House C in 241.5 years reduces from £5 to £1.

²⁴ *Earl Cadogan v Sportelli* [2008] UKHL 71; [2010] 1 AC 226, a case which concerned property in Prime Central London and in which the Lands Tribunal directed the determination, as a preliminary issue, of the “proper deferment rate to be applied”. In deciding that preliminary issue, the Tribunal found that the deferment rate for leases with at least 20 years unexpired could be calculated from the addition of a “risk-free rate” of 2.25% and a “risk premium” of 4.5% with a deduction for capital growth, “the real growth rate”, of 2% to produce a generic rate of 4.75% for houses.

4.52 A single deferment rate could be prescribed, or alternatively it might be appropriate for rates to vary according to the location of the property or the length of the lease. In our Consultation Paper, we will ask how a deferment rate – or rates – could be set, and how a prescribed rate should be reviewed periodically.

4. Relativity/No-Act deduction

4.53 **Relativity could be prescribed.** If it were, arguments as to the appropriate graph or the appropriate discount to be applied to reflect the effect of the Act would be avoided and the artificiality arising from the lack of “no-Act building” comparables would become irrelevant. The argument that leases are devalued by lack of rights could also be avoided. As with capitalisation and deferment rates, **relativity could be set in a way that reduces premiums:** see Figure 10.

Figure 10: effect of relativity on premiums

For example, in *Kosta*,²⁵ the lease of the house had 52.45 years remaining. The freehold value of the house was £16,138,743. The landlord’s valuer’s opinion of relativity was 76%, which was based on a graph of relativity produced by Gerald Eve, a firm of property consultants. This led to an enfranchisement premium of £2,763,890. The leaseholder’s valuer adopted a relativity of 86.39% based on what was to become known as the Parthenia Model. This produced an overall premium of £1,925,521. In other words, a ten percentage point increase in relativity led to around a 30% reduction in the premium.

Option 2A: term and reversion

4.54 **The premium could be limited to the value of the term and reversion only.** In other words, the requirement to pay marriage value could be removed altogether (it is currently payable only if the unexpired term of a lease is less than 80 years). Compensation would then be based on what the landlord would receive if the lease ran its course: the capitalised ground rent and the deferred freehold value, but no marriage or hope value. That is the minimum that an investor, bidding in the market, would pay the landlord to purchase the freehold.²⁶ This approach would not only reduce the premiums payable by house owners with leases with less than 80 years left to run,²⁷ it would also simplify the valuation process. Relativity (or a deduction for Act rights) is arguably the most difficult element of the valuation to calculate and, therefore, prescribe. If marriage value were no longer payable, the need to calculate relativity (or an Act rights deduction) falls away.

4.55 Removing the requirement to pay marriage value would reduce premiums, but only in respect of leases which have less than 80 years remaining. If a term and reversion valuation were adopted for all claims, then house owners who would have previously benefited from a section 9(1) valuation would end up paying more. Consequently, it would be contrary to our Terms of Reference to propose that a term and reversion valuation alone should replace section 9(1) valuations. One solution would be to preserve section 9(1) for those who benefit from it. Alternatively, it might be possible to preserve the position of leaseholders who currently have the benefit of section 9(1)

²⁵ *Kosta v Carnwath (re 47 Phillimore Gardens)* [2014] UKUT 0319 (LC).

²⁶ An investor may pay hope value, in addition to the value of the term and reversion, to reflect the hope of being able to do a deal with the leaseholder to release the full marriage value.

²⁷ Leaseholders who have more than 80 years left to run are not required to pay marriage value in any event.

valuations by simplifying and streamlining the qualification criteria for a more favourable valuation, and the basis for calculating it. That is, preserving the favourable valuation obtained by section 9(1), without retaining the provision itself.

- 4.56 Not only would removing marriage value reduce the premium in respect of leases with less than 80 years remaining, it ought to reduce the professional fees of having to value such leases.

Without prescription of rates

- 4.57 If valuation is based on term and reversion only (that is, no marriage value is payable), then the premium payable in respect of House B is set out in Figure 11. No marriage value is payable in respect of Houses A and C as the unexpired terms of the leases exceed 80 years and therefore marriage value is not payable in any event.

Figure 11: effect on valuation of House B if premium were based on “term and reversion” only

House B: the premium payable would be reduced from £27,932 to £15,863.²⁸

With prescription of rates

- 4.58 If valuation is based on term and reversion, and rates are prescribed in a way that is favourable to leaseholders, then the premiums that might be payable in respect of Houses A and B are set out in Figures 12 and 13.

Figure 12: effect on enfranchisement premiums for Houses A and B if marriage value is not payable, and if capitalisation rate is prescribed at 8%

The premium for House A would reduce from £4,051 to £3,605.²⁹ That reduction is caused solely by the prescription of the capitalisation rate.

The premium for House B would reduce from £27,932 to £15,448. The reduction comprises £416 attributable to prescription of the capitalisation rate,³⁰ and £12,068 attributable to marriage value not being payable.

²⁸ The marriage value element of the original valuation being £12,068.

²⁹ The Years Purchase for 130 years at 8% is 12.4994 which multiplied by £250 produces a reduced figure for the capitalised ground rent of £3,125.

³⁰ The Years Purchase for 60 years at 8% is 12.3766 which multiplied by £250 produces a reduced figure for the capitalised ground rent of £3,094.

Figure 13: effect on enfranchisement premiums for Houses A and B if marriage value is not payable, and if deferment rate is prescribed at 5.75%

The premium for House A would reduce from £4,051 to £3,710.³¹ This reduction is caused solely by the prescription of the deferment rate.

The premium for House B would reduce from £27,932 to £10,495. The reduction comprises £5,367³² attributable to prescription of the deferment rate, and £12,070 attributable to marriage value not being payable.

Option 2B: term and reversion, plus marriage value

- 4.59 **The present valuation methodology could be retained. It could be made simpler and professional fees could be reduced by incorporating one or more of the possible reforms to the valuations components at paragraphs 4.38 to 4.53 above.**
- 4.60 None of those approaches, on their own, would necessarily reduce the premiums payable by leaseholders (save for the first approach of limiting the extent to which the ground rent on review is to be taken into account, which would do so).
- 4.61 However, **if rates are prescribed at particular levels, then those approaches would have the effect of reducing premiums for leaseholders**, whilst retaining the present valuation methodology (namely, setting premiums by reference to the term and reversion, and marriage value): see Figures 14, 15 and 16 for an indication of how a 1% change in the rates would effect enfranchisement premiums.

³¹ The Present Value of £1 after 130 years at 5.75% is 0.0007 which multiplied by £200,000 produces a reversionary value of £140 as opposed to £480 at a rate of 4.75%.

³² The Present Value of £1 after 60 years at 5.75% is 0.0349 which multiplied by £200,000 produces a reversionary value of £6,986 as opposed to £12,353 at a rate of 4.75%.

Figure 14: effect on enfranchisement premiums for Houses A, B and C if capitalisation rate is prescribed

The premium for House A (if the capitalisation rate were prescribed at 8% rather than 7%) would reduce from £4,051 to £3,605.³³

The premium for House B (if the capitalisation rate were prescribed at 8% rather than 7%) would reduce from £27,932 to £27,724.³⁴

The premium for House C (if the capitalisation rate were prescribed at 5.5% rather than 4.5%) would reduce from £60,763 to £40,147.

Those reductions would be caused solely by the prescription of the capitalisation rate.

Figure 15: effect on enfranchisement premiums for Houses A, B and C if deferment rate is prescribed at 5.75%

The premium for House A would reduce from £4,051 to £3,710.

The premium for House B would reduce from £27,932 to £25,248.

The premium for House C would reduce from £60,763 to £60,759.

Those reductions would be caused solely by the prescription of the deferment rate.

Figure 16: effect on enfranchisement premiums for Houses A, B and C if relativity is prescribed at 81%

The premium for House A would remain unchanged, since no marriage value is payable.

The premium for House B would reduce from £27,932 to £26,932.³⁵

The premium for House C would remain unchanged, since no marriage value is payable.

4.62 In our Consultation Paper, we will seek the views of consultees representing all the affected interests on each of the valuation approaches summarised above and the way in which they could operate, as well as asking whether there are other approaches that should be considered. In our final report, we will present – with the benefit of consultees' views – the options that we think are available to reduce enfranchisement premiums.

³³ The Years Purchase for 130 years at 8% is 12.4994 which multiplied by £250 produces a reduced figure for the capitalised ground rent of £3,125.

³⁴ The Years Purchase for 60 years at 8% is 12.3766 which multiplied by £250 produces a reduced figure for the capitalised ground rent of £3,094.

³⁵ As 81% the value of the existing lease is £162,000.

Appendix 1: Examples of calculations of enfranchisement premiums

INTRODUCTION

- 1.1 In Chapter 4, we refer to three sample enfranchisement claims to demonstrate the effect that the various options for reform might have on the premium payable. In this appendix, we explain how the way in which the enfranchisement premiums would be calculated under the current law in those three examples.
- 1.2 The examples are all of calculations under section 9(1C) of the 1967 Act. Calculations under section 9(1), which produce outcomes more favourable to leaseholders, are more complicated.

House A

Value on a freehold basis: £200,000

Details of existing lease:

- Unexpired term: 130 years
- Ground rent: £250 per annum
- Value of lease: £198,000³⁶

Calculation of price

The price is based on the value of the landlord's interest in House A. Since the lease has an unexpired term of more than 80 years, no "marriage value" is payable.

Part (i): "the term", which is the value of the right to receive ground rent of £250 each year for the remaining 130 years of the lease.

With a capitalisation rate of 7%, the value today of the future ground rent income is £3,571.³⁷

Part (ii): "the reversion", which is the value of the right to recover possession of House A (worth £200,000) in 130 years.

With a deferment rate of 4.75%, the value today of the freehold interest in Flat A in 130 years is £480.³⁸

The total value of the landlord's existing interest in House A is £3,571 + £480 = **£4,051**.

³⁶ Based on a relativity of 99%.

³⁷ The Years Purchase for 130 years at 7% is 14.2836 which multiplied by £250 produces the figure of £3,571.

³⁸ The present value of £1 after 130 years at 4.75% is 0.0024 which multiplied by £200,000 produces the figure of £480.

House B

Value on a freehold basis: £200,000

Details of existing lease:

- Unexpired term: 60 years
- Ground rent: £250 per annum
- Value of lease: £160,000³⁹

Calculation of price

Since the unexpired term of the lease is less than 80 years, marriage value is payable. The price therefore comprises two elements. First, (similarly to House A) the value of the landlord's interest in House B. Second, "marriage value".

First element: value of the landlord's interest in House B

Part (i): "the term", which is the value of the right to receive ground rent of £250 each year for the remaining 60 years of the lease.

With a capitalisation rate of 7%, the value today of the future ground rent income is £3,510.⁴⁰

Part (ii): "the reversion", which is the value of the right to recover possession of House B (worth £200,000) in 60 years.

With a deferment rate of 4.75%, the value today of the freehold interest in House B in 60 years is £12,353.⁴¹

The total value of the landlord's existing interest in House B is £3,510 + £12,353 = £15,863.

Second element: marriage value

The marriage value is the difference between:

- (i) the value of the landlord's interest and the leaseholder's interest in House B before the freehold is acquired; and
- (ii) the value of the landlord's interest and the leaseholder's interest in House B after the freehold has been acquired.

³⁹ The existing lease value is calculated on the basis of a relativity of 80% being one percentage point below the relativity suggested by the graph produced by Gerald Eve, a firm of property consultants.

⁴⁰ The Years Purchase for 60 years at 7% is 14.0392 which multiplied by £250 produces the figure of £3,510.

⁴¹ The Present Value of £1 after 60 years at 4.75% is 0.0618 which multiplied by £200,000 produces the figure of £12,353.

In this case, it is therefore the difference between:

(i) £15,863 (from above) + £160,000⁴² = £175,863

(ii) £0⁴³ + £200,000⁴⁴ = £200,000

The marriage value is therefore the difference between £200,000 and £175,863, namely £24,137.

The leaseholder is required to pay half of the marriage value, namely £12,068.

Total premium

The total premium is the first element plus the second element, namely £15,863 + £12,068 = **£27,931**.

House C

Value on a freehold basis: £400,000

Details of existing lease:

- Unexpired term: 241.5 years

- Ground rent: £295 per annum doubling on 1 January 2020 and every 10 years thereafter until 2060

Calculation of price

The price is based on the value of the landlord's interest in House C. Since the lease has an unexpired term of more than 80 years, no "marriage value" is payable.

Part (i): "the term", which is the value of the right to receive ground rent for the remaining 241.5 years of the lease.

With a capitalisation rate of 4.5%, the value today of the future ground rent income is £60,758.⁴⁵

Part (ii): "the reversion", which is the value of the right to recover possession of House C (worth £400,000) in 241.5 years.

With a deferment rate of 4.75%, the value today of the freehold interest in House C in 241.5 years is £5.⁴⁶

The total value of the landlord's existing interest in House C is £60,758 + £5 = **£60,763**.

⁴² The existing lease value is calculated on the basis of a relativity of 80% being one percentage point below the graph produced by Gerald Eve.

⁴³ After the freehold is acquired the landlord has nothing.

⁴⁴ After the freehold is acquired the leaseholder has the freehold vacant possession value of the house in its entirety.

⁴⁵ As set out above, the capitalisation rate is lower than that applied when capitalising the ground rent for Houses A and B. This is because a lease with a ground rent which doubles every ten years is much more attractive to an investor than a lease with a static ground rent, the value of which will be eroded by inflation. The more attractive the investment, the more demand there is for it, which drives up the capital value and drives down the rate of return investors receive and are prepared to accept.

⁴⁶ The present value of £1 after 241.5 years at 4.75% is 0.00001358 which multiplied by £400,000 produces the figure of £5.