Leasehold enfranchisement reform: valuation Instructions to Counsel

INTRODUCTION

1.1 Counsel is instructed by the Law Commission for England and Wales. The Law Commission is an independent body set up to promote the reform of the law.

1.2 The Commission is undertaking three projects on leasehold and commonhold reform. Counsel's advice is sought on our project concerning enfranchisement, which concerns the right of leaseholders under the Leasehold Reform Act 1967 and the Leasehold Reform, Housing and Urban Development Act 1993 to:

(1) purchase the freehold of their house;

(2) participate, with other leaseholders, in the collective purchase of the freehold of a group of flats; and

(3) extend the lease of their house or flat.

1.3 In order to exercise the statutory right to enfranchisement, a leaseholder must pay a premium to the landlord in respect of the property interest that the leaseholder acquires. Our Terms of Reference, agreed with Government, require us "to examine the options to reduce the premium (price) payable by existing and future leaseholders to enfranchise, whilst ensuring sufficient compensation is paid to landlords to reflect their legitimate property interests".

1.4 A central issue in determining whether compensation is "sufficient" is whether it is compatible with landlords' right to enjoyment of their property under Article 1 of Protocol 1 ("A1P1") to the European Convention on Human Rights ("ECHR").

1.5 As we explain in more detail below, Counsel's advice is sought on the compatibility with the ECHR of various options for reforming how the premium paid is determined, including options that would reduce the premium payable by leaseholders.

Our Terms of Reference

1.6 Our Terms of Reference for our projects, set out in Appendix 3 of the Consultation Paper, include the following policy objectives for reform (amongst others) identified by Government:

(1) to promote transparency and fairness in the residential leasehold sector;

(2) to provide a better deal for leaseholders as consumers;

(3) to simplify enfranchisement legislation;

(4) to consider the case to improve access to enfranchisement and, where this is not possible, reforms that may be needed to better protect leaseholders, including

the ability for leaseholders of houses to enfranchise on similar terms to leaseholders of flats;

(5) to examine the options to reduce the premium (price) payable by existing and future leaseholders to enfranchise, whilst ensuring sufficient compensation is paid to landlords to reflect their legitimate property interests; and

(6) to make enfranchisement easier, quicker and more cost effective (by reducing the legal and other associated costs), particularly for leaseholders, including by introducing a clear prescribed methodology for calculating the premium (price), and by reducing or removing the requirements for leaseholders (i) to have owned their lease for two years before enfranchising, and (ii) to pay their landlord's costs of enfranchisement.

1.7 In relation to valuation, our Terms of Reference state:

(1) The Commission will seek to produce options for a simpler, clearer, and consistent valuation methodology. The review will include consideration of:

(a) the existing valuation assumptions;

(b) the extent to which the ground rent (including any rent review clause) should feature in the valuation;

(c) the role of yield and deferment rates and whether they could be standardised;

(d) the role of marriage value, hope value, and relativity, and the extent to which they should feature in the valuation;

(e) whether to retain different valuation bases (as currently exist for enfranchisement of houses, depending on historic rateable values);

(f) the valuation of the interest of any intermediate leaseholders.

The Consultation Paper

1.8 Counsel is referred to the Consultation Paper, *Leasehold homeownership: buying your freehold or extending your lease*, published on 20 September 2018. In that Consultation Paper, we set out our provisional proposals for a new enfranchisement regime, and sought consultees' views. Counsel is referred, in particular, to:

(1) Part 1 of the Consultation Paper (Chapters 1-3). Chapter 1 sets out in some detail the background to the project. Chapter 2 summarises, very briefly, the history and current law of enfranchisement. Chapter 3 is a summary of the main problems with the current law and our proposals for reform.

(2) In Part 3 of the Consultation Paper, paragraphs 7.93-7.95 and 8.182-8.191 dealing with who should be entitled to exercise enfranchisement rights.

(3) Chapters 14 and 15 of the Consultation Paper, setting out the current law governing the valuation of the price payable by leaseholders to enfranchise and our options for reform.

(4) The aspects of Part 6 of the Consultation Paper that deal with the valuation of intermediate leasehold interests.

1.9 We had over 1,100 responses to the Consultation Paper, and a further 1,500 responses to our questionnaire for leaseholders about their experience of the enfranchisement process. We are in the process of analysing those responses to the consultation.

1.10 We have therefore tested options for reducing premiums with stakeholders and gathered their views. As part of that process, some landlords have also provided opinions from Counsel that they themselves have obtained, challenging the legality of the options that we have presented. We have provided Counsel with copies of those opinions separately.

Broader context

1.11 We explain the context of our project in Chapter 1 of the Consultation Paper. Our enfranchisement project is just one part of a whole package of leasehold reform work across Government. The Law Commission has two other projects – on the right to manage (the ability for leaseholders to take over the management of their block without buying the freehold) and on improving commonhold (an alternative to leasehold).

1.12 Alongside our work, the Ministry of Housing, Communities and Local Government is carrying out its own work to address issues including onerous ground rents, the selling of new-build houses on a leasehold rather than freehold basis, and the regulation of service charges, event fees, and managing agents. Some of these issues have attracted a great deal of media coverage in recent years.

1.13 The Welsh Government has also announced various leasehold reforms, and has established a Task and Finish Group to consider some of the issues. The extent to which (if at all) the issues we are considering in our enfranchisement project are devolved to Wales has not yet been determined, but our project is being undertaken with the support of both MHCLG and the Welsh Government so it covers the law in England and in Wales.

1.14 The House of Commons HCLG Select Committee has recently published their report, following their inquiry into leasehold reform.[1] Chapter 5 of that report concerns enfranchisement, and paragraphs 107 to 118 deal with human rights considerations of changing the terms of existing leases to remove onerous ground rents. Subsequently, the Competition and Markets Authority has confirmed that it will undertake a market investigation into the extent of any mis-selling and onerous terms in leases.[2]

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1 See https://www.parliament.uk/business/committees/committees-a-z/commons-select/housing-communities-and-local-government-committee/inquiries/parliament-2017/leasehold-reform-17-19/.

2 See https://www.parliament.uk/documents/commons-committees/communities-and-local-government/Correspondence/14-5-19-cma-chair-leasehold-reform-response.pdf and the Select Committee's announcement: https://www.parliament.uk/business/committees/committees-a-z/commons-select/housing-

1.15 In July 2019, the Labour Party published proposals for leasehold and commonhold reform.[3] The publication includes proposals to cap ground rents in existing leases, and to allow leaseholders to exercise enfranchisement rights by paying 1% of the freehold property value. That proposal would appear to be quite similar to Option 1B presented in the Consultation Paper, albeit we explored that option by using an indicative figure of 10%, whereas the Labour policy adopts a figure of 1%.

Advice

1.16 Counsel is instructed to provide an independent opinion on the compatibility with the ECHR of various options for reforming how the premium paid is determined, including options that would reduce the premium payable by leaseholders. The advice should include:

(1) a summary of what A1P1 of the ECHR guarantees, why it is relevant, and the scope of those who are entitled to rely on it (for example individuals, companies (onshore and offshore));

(2) an explanation as to whether and why the options for reform are compatible with A1P1, and the level of risk of a finding (by the domestic courts or the European Court of Human Rights) of incompatibility of any of those options; and

(3) the various considerations which are likely to have a bearing on the legality of our options for reform, which we will also be able to take into account as we work up the detail of our options for reform.

Purpose of advice

1.17 We will rely on Counsel's Opinion in formulating the options for reform that we set out in our final report. We also intend to publish Counsel's Opinion, and these Instructions, so that Government, Parliament and all interested stakeholders can see the legal advice that we have received.

OPTIONS TO REFORM THE VALUATION OF ENFRANCHISEMENT PREMIUMS

Human rights considerations

1.18 There are various criticisms of the current approach to valuation, which our options for reform are designed to address: see paragraphs 14.90 to 14.106 of the Consultation Paper.

1.19 The policy considerations that led Government to pursue options for reducing premiums stem from its own consultation and consideration of leasehold reform.[4]

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communities-and-local-government-committee/news/cma-investigation-leashold-misselling-chairs-comments-17-19/.

[3] "Ending the scandal: Labour's new deal for leaseholders", available at https://omghcontent.affino.com/AcuCustom/Sitename/DAM/124/Labours_New_Deal_for_Leaseholders.pdf.

[4] See the Government's response to its consultation on *Tackling unfair practices in the leasehold market* (December 2017), paragraphs 6, 72 and 86 (available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/670204/Tackling_Unfair_Practices_-_gov_response.pdf).

1.20 Enfranchisement reform will have a significant effect on landlords and on leaseholders, and when it comes to enfranchisement premiums their interests are diametrically opposed. Those two competing interest groups include a very wide range of individuals and organisations:

(1) Landlords come in all shapes and sizes: private family estates (for example, the Grosvenor Estate and Cadogan Estate); charities (for example, the National Trust); developers; pension and other funds; private individuals; investors; and leaseholder-owned companies.[5] From their point of view, they have investments which are being expropriated from them compulsorily.

(2) Leaseholders are also varied: ordinary homeowners (ranging from those with limited means through to very wealthy owners); non-resident owners (such as buy-to-let landlords, those with a second home, those who have invested in property); and some speculative investors and developers who purchase flats with a view to exercising enfranchisement rights and profiting from selling on an enhanced interest. From their point of view, they have properties which are held on a leasehold basis for one of two reasons. That is, because that is the standard method by which flats can be owned in England and Wales, and because developers are insisting on selling houses on a leasehold basis.

Section 9(1)

1.21 In Chapter 15 the first area for reform which we consider is the reform of section 9(1) of the Leasehold Reform Act 1967 ("the 1967 Act"). We explain the current valuation methodology under section 9(1) and the rationale for it in paragraphs 14.79 to 14.89 of the Consultation Paper. In short, a section 9(1) valuation produces a much lower premium than would be produced using the "term and reversion" method because the landlord is only being compensated for the loss of his or her land rather than the building upon it. As explained in the Consultation Paper, this is on the basis that while the land belongs to the landlord, morally the house belongs to the leaseholder, and reflects the position at the grant of a building lease. Some consultees have said that the 1967 Act was intended to apply to houses which were not expected to be standing at the expiry of the lease, which could also explain the calculation of compensation under section 9(1).

1.22 For the purposes of your Opinion, you should assume that qualifying houses will not necessarily have been let on building leases and may well be expected to be standing at the expiry of the lease.

1.23 The responses to the Consultation Paper suggest that outside of London many leasehold houses qualify for a section 9(1) valuation, particularly in areas such as the Midlands and South Wales. In London, particularly Prime Central London, houses which qualify for a section 9(1) valuation are relatively rare. We think that these houses tend to be mews houses, which originally comprised stables or garages with staff

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5 Majority-leaseholder-owned companies are in a slightly different category because, in some circumstances, their interests may more closely align with the interests of the leaseholders. But that will often not be the case, for example, where an enfranchising leaseholder is not a member of the company (because he or she did not participate in the collective enfranchisement that led to the company acquiring the freehold).

accommodation above and were therefore not particularly valuable, but which have now been converted so as to become relatively expensive properties.

1.24 By way of example we have been provided with the details of a number of houses that qualified for a section 9(1) valuation. For confidentiality reasons, we are not publishing precise details of these valuations, but we have used them as a basis for creating two more general examples of houses that would qualify for a section 9(1) valuation. The first example is a terraced house in Prime Central London (not in fact a mews house). The unimproved freehold vacant possession value is £2,500,000, the unexpired term of the lease is 50 years and the ground rent is £250 per annum for the remainder of the term. We have calculated that the premium payable under section 9(1) would be £125,150, whereas the premium payable under section 9(1C) would have been £449,800. Our second example is a terraced house in a village near Swansea with a freehold vacant possession value of £150,000, an unexpired term of 50 years and a ground rent of £15 per annum for the remainder of the term. We have calculated that the premium payable under section 9(1) would be £5,700, whereas the premium payable under section 9(1C) would have been £27,000.

1.25 Section 9(1) is not limited to existing housing stock. Newly built leasehold houses (or newly granted leases of existing houses) could qualify for a valuation under section 9(1) provided that they fell below the relevant financial limits. In practice, it is unlikely that new leases of houses in Prime Central London would fall within these financial limits, but this may well not be the case outside London.

1.26 We discuss the benefits of replacing the qualification criteria and valuation methodology under section 9(1) in paragraphs 15.18 to 15.24 of the Consultation Paper.

Replacing section 9(1): Qualification criteria

1.27 Our view in relation to section 9(1) is that it would be desirable for the current qualification criteria, which are based largely on historic rateable values, to be replaced with a new, simpler but equivalent test of qualification, if this is possible.

1.28 We have been provided with the particulars of a number of houses which currently qualify for a section 9(1) valuation, including the freehold vacant possession value of those houses. We have used these examples to consider the extent to which the different alternative replacement qualification criteria set out in the Consultation Paper, Council Tax banding, capital value and the Find R test, would replicate the results produced by the existing qualification criteria.

1.29 From this it has become clear that it is not possible to identify a test which would mirror the current criteria; in other words, none of the alternatives set out above would ensure that all and only those houses that currently qualify for a favourable valuation would continue to do so under the replacement provision.

1.30 In respect of each alternative replacement qualification criteria, we think that some houses (we cannot currently say how many) which now qualify for a valuation under section 9(1) would no longer qualify under the replacement provision. Those affected leaseholders would have to pay a significantly higher premium than they do currently.

1.31 We also think, on the other hand, that some properties (we cannot currently say how many) which now do not qualify for a valuation under section 9(1) would qualify for the more favourable premium under the replacement section 9(1) provision. Those affected leaseholders would pay a significantly lower premium than they do currently.

1.32 Consequently, if Government wants to replace the current qualification criteria, it will need to make a policy decision as to which houses should and should not qualify for a favourable valuation, since it will not be possible simply to replicate the current position.

1.33 We set out below various measures that we consider could be taken to reduce the impact on leaseholders and landlords of introducing replacement qualification criteria that do not replicate the results produced by the current qualification criteria under section 9(1).

(1) Protecting leaseholders from increased premiums: sunset provision

We suggest that the current provisions of the 1967 Act which relate to qualification under section 9(1) would remain in force for a period of five years following the passing of any new Act, so leaseholders who would currently benefit from a section 9(1) valuation but would not benefit from its replacement under our new regime, would still have the opportunity to take advantage of section 9(1) for a limited period. The sunset provision will provide some protection for existing leaseholders without at the same time preventing the ultimate rationalisation, streamlining and simplification of the current valuation provisions (delivering the benefits identified in paragraph 15.18 of the Consultation Paper) which our reforms are designed to achieve.

(2) Protecting landlords from reduced premiums

We do not think it will be possible to shield all landlords from the impact of reduced premiums in the event that the current qualification criteria for section 9(1) are replaced: there will always be some properties which do not currently qualify for a valuation under section 9(1) but which will qualify under the replacement criteria. However, there are two steps that we think could be taken to reduce the number of landlords affected by the change.

(a) Limiting qualifying properties to houses only

We have provisionally proposed in the Consultation Paper that any new enfranchisement regime should not retain the distinction between a “house” and a “flat”. Instead, we proposed that the terms “house” and “flat” be replaced throughout the enfranchisement legislation with a single term, “residential unit”. This is because, as we explain in the Consultation Paper at paragraph 8.38, defining the term “house” has caused significant difficulty to date and has been litigated considerably in the courts.

If any replacement qualification criteria under section 9(1) were to apply to all “residential units” under the new enfranchisement regime, then this would mean that not only houses but also flats falling within the qualification criteria would qualify for the more favourable valuation basis. This would significantly extend the ambit of section 9(1), which currently applies only to houses. This extension

could be prevented if the qualification criteria under section 9(1) were replaced, but limited to houses only. This could be achieved by retaining the definition of "house" in the context of the section 9(1) provision. However, in order to avoid having to retain the term "house" within the new enfranchisement regime, we would provisionally suggest limiting the scope of any replacement provision for section 9(1) to residential units that qualify for an "individual freehold acquisition". In the Consultation Paper at paragraph 3.10 we introduce two new concepts, an "individual freehold acquisition" being a right for leaseholders to acquire the freehold of a building individually, and a "collective freehold acquisition" being the right for leaseholders to acquire the freehold of a building collectively. We think that limiting the scope of the replacement section 9(1) to residential units which qualify for an "individual freehold acquisition" should have the effect of limiting the ambit of the replacement section 9(1) mostly to houses and should exclude the vast majority of flats. This would closely mirror the ambit of the current section 9(1), although it is unlikely the overlap would be completely identical; in other words, we cannot rule out there being some cases where a property does not currently qualify as a "house" under section 9(1) but might qualify for an "individual freehold acquisition" under the replacement provision, and vice versa.

(b) Limiting qualifying properties to existing leases

Another possible measure to limit the number of landlords affected by replacement qualification criteria would be to limit the replacement section 9(1) provision to existing stock (by which we mean existing leases of existing houses). This would mean that only landlords of existing leases would be affected by the change, but not landlords of any newly granted leases of existing houses or newly built leasehold houses (to the extent that there are any such leases, given that Government has announced an intention to ban the creation of any new leasehold houses).

Effectively, this measure would equate to a very slow, long-term abolition of the more favourable valuation basis under section 9(1), but with an indefinite sunset period which would not expire unless and until all leaseholders of existing properties had exercised their right to purchase the freehold. It would, however, introduce an inequality in that leaseholders of existing leases would pay less to purchase their freeholds than leaseholders of new leases of the same value.

1.34 Counsel's view is sought on the compatibility with A1P1 of replacing the current qualification criteria for section 9(1), given that none of the alternatives suggested above will produce results which are wholly equivalent to section 9(1). As part of this, Counsel is asked to advise whether:

(a) any of the measures set out above for reducing the impact of a replacement provision on leaseholders or landlords are necessary or desirable in order to ensure compatibility with A1P1;

(b) compatibility with A1P1 depends in any way on the volume of landlords who would receive reduced premiums in the event the qualification criteria were replaced, or whether compatibility is more dependent on the overall impact of the scheme on leaseholders and landlords (viewed collectively as a group). In other words, might a scheme to replace the qualification

criteria for section 9(1) still be compatible with A1P1 when the impact of the scheme is viewed in the round, even if individual landlords might lose out by receiving reduced premiums?

Replacing section 9(1): Valuation methodology

1.35 As regards the valuation itself, our view is that it would be desirable to replace the current valuation methodology, as described in the Consultation Paper, with a simplified methodology.

1.36 The replacement methodology we would suggest is based on the value of the term of the lease (the capitalised ground rent) plus a percentage of its reversionary value. This is an extension of the approach we suggested in paragraph 15.24 of the Consultation Paper, which proposed calculating the term and reversion value and then dividing this figure by three. Our research and consultee responses suggest that the method we now propose would produce premiums which are even more similar in amount to those currently produced under section 9(1), since it more closely resembles the current valuation methodology and will take more account of regional variations in value.

1.37 As explained in the Consultation Paper, the calculation of the premium under section 9(1) involves finding the "site value" of a property and valuers generally calculate this as a percentage of the value of the property (that is, house and land) as a whole. Our suggestion is that the percentage of the reversionary value which is to be paid to the landlord should be the same percentage as that currently used to determine site value. For example, in the above examples, the premium payable for the house in London was calculated applying a site value percentage of 50%, whereas the premium paid for the house near Swansea used a site value percentage of 35%.

1.38 In its consultation response the firm Gerald Eve has modelled the effect of such a policy and attached is the result of that modelling. The Gerald Eve model shows, however, that whilst the revised methodology produces similar results to the premiums currently produced under section 9(1), the premiums are not identical. There are instances in which the leaseholder will have to pay slightly more than currently, and instances in which the leaseholder will have to pay considerably less.

1.39 We have carried out further, similar calculations to the Gerald Eve model to gauge what the impact of the revised alternative methodology might be on a higher value house (worth £2,500,000) and a lower value house (worth £150,000) and the results are attached. Again, they show that the revised valuation methodology would not in all cases produce identical premiums to those currently produced under section 9(1).

1.40 Even though some leaseholders may pay slightly more under the new valuation methodology, we do not suggest any form of sunset provision should be applied in this respect. This would add another significant complication into the legislation, and it seems to us that there is a qualitative difference between changing the qualification criteria for section 9(1) which will lead to some leaseholders not qualifying under section 9(1) at all, and changing the valuation methodology which will not mean that leaseholders no longer qualify for a valuation under section 9(1), just that they will have to pay a slightly increased premium. Moreover, our modelling suggests that any increase in premium will be relatively small, and will still mean that the premium payable is significantly lower than under the general approach.

1.41 In the event that the valuation methodology under section 9(1) were replaced as suggested, we would suggest certain rates be prescribed to increase the simplicity of the new methodology, including deferment and capitalisation rates, and the relevant site value percentages.

1.42 Counsel's view is sought on the compatibility with A1P1 of replacing the valuation methodology under section 9(1) as set out above, notwithstanding that, having regard to the Gerald Eve model and the further calculations we have produced, it appears that the premiums produced will not be identical in all cases to those produced under the current valuation methodology. As part of this Counsel is asked to advise whether:

(1) compatibility with A1P1 depends in any way on the volume of landlords who would receive reduced premiums in the event the valuation methodology were replaced, or whether compatibility is more dependent on the overall impact of the scheme on leaseholders and landlords (viewed collectively as a group). In other words, might a scheme to replace the valuation methodology under section 9(1) still be compatible with A1P1 when the impact of the scheme is viewed in the round, even if individual landlords might lose out by receiving reduced premiums?

(2) the same principles apply to considering the compatibility of prescribing rates in the context of a replacement valuation methodology for section 9(1) as apply to prescribing rates under the general approach, or whether different or additional considerations apply.

Retaining section 9(1)

1.43 An alternative to replacing section 9(1) would be to retain it in its current form indefinitely, as an exception to the general approach to valuing the premium.

1.44 In this event the Government could consider the following:

(1) Prescribing some of the current rates and percentages used in the valuation in order to simplify the process of valuation, and enable the use of an online calculator; and/or

(2) Limiting section 9(1) to existing leases of existing houses (in the event this is necessary, given the Government has announced it intends to ban the creation of new leasehold houses). As we note above, the effect of this would be the slow phasing out of section 9(1), whilst allowing all leaseholders who can currently benefit from a valuation under section 9(1) the indefinite right to continue to do so. Eventually, after a considerable period of time, it is likely that all leaseholders who currently qualify for a premium under section 9(1) will have exercised the right to purchase their freehold or their lease will have expired, and section 9(1) will become redundant. The change would, however, introduce an inequality in that leaseholders of existing leases would pay less to purchase their freeholds than leaseholders of new leases of the same value.

1.45 Counsel is asked to advise whether the same principles apply to considering the compatibility of prescribing rates in the context of section 9(1) (in its current form) as apply to prescribing rates under the general approach, or whether different or additional considerations apply.

Abolishing section 9(1) and introducing a new favourable scheme for lower value properties

1.46 Section 9(1) was originally designed to apply only to low value properties. As we note in the Consultation Paper, part of the problem with the current section 9(1) is that it no longer fulfils this purpose: there are houses which were low value historically but are now very valuable, yet they enjoy the section 9(1) valuation basis; by contrast, there are houses which are currently worth far less, but which do not quite fall below the relevant financial thresholds, so the leaseholder must pay a premium based on the mainstream valuation basis.

1.47 In these circumstances, another option that Government might wish to consider is introducing an entirely new scheme which is designed accurately to apply to all low value properties and exclude higher value properties, and which provides leaseholders of low value properties with a more favourable basis of valuation (similar in some ways to the way in which owners of lower value properties pay a lower percentage of Stamp Duty Land Tax than owners of higher value properties). This would give leaseholders of low value properties more assistance in enfranchising than leaseholders of higher value properties.

1.48 Such a scheme might look quite similar to the proposals we make for replacing section 9(1) in relation to qualification criteria: for example, the scheme might provide that to qualify for the more favourable valuation a property would have to fall under a certain capital value or Find R threshold. However, in some ways it might be different: in particular, it is likely that any such scheme would apply to "residential units" ie flats and houses, not just houses (provided that our provisional proposal in the Consultation Paper to use the term "residential units" is adopted).

1.49 In relation to valuation methodology, Government could decide to have an entirely different basis of valuation for low value properties (for example, similar to what we propose as a replacement for section 9(1): term plus percentage of reversion), or it might decide, for example, that premiums for all properties (high and low value) would be calculated using the same basis of valuation but, say, prescribe below-market rates for low value properties and market rates for higher value properties.

1.50 We can see two main options for the way in which such a scheme could be introduced:

(1) Section 9(1) could be abolished and the new scheme introduced with immediate effect. Just as we set out above in relation to the replacement of section 9(1), the introduction of such a scheme in this manner would inevitably have the result of significantly increasing premiums for some leaseholders (because they would no longer qualify for a more favourable valuation) and significantly decreasing premiums for others (because they would suddenly qualify for a more favourable valuation), compared to the current position.

(2) Section 9(1) could be retained for existing leases in its current form either temporarily (for a sunset period of, say, 5 years) or indefinitely (which, as we note above, is likely to equate to a slow abolition). We envisage that the two schemes (section 9(1) and the new scheme) would run alongside one another for as long as section 9(1) remained in force. The rationale behind retaining section 9(1) either temporarily or indefinitely for existing leases would be to ensure that premiums would not immediately increase for leaseholders who currently qualify

under section 9(1), when the new scheme is introduced (if section 9(1) were sunsetted, premiums would only increase after 5 years; if section 9(1) were retained indefinitely for existing leases, premiums would never increase for existing leaseholders). There are two ways that premiums might increase if section 9(1) were abolished immediately on the introduction of the new scheme. First, leaseholders of higher value properties who currently qualify under section 9(1) would not qualify under the new scheme (so their premiums would inevitably increase). Second, depending on the terms of the new scheme, even leaseholders of low value houses who do qualify for a valuation under the new scheme could pay an increased premium compared to section 9(1), unless Government chose a valuation methodology for the new scheme which closely replicated the results produced by section 9(1). For example, if Government chose to introduce a scheme whereby leaseholders of lower value properties under a capital value threshold of, say, £250,000 paid a premium which used more favourable prescribed rates than higher value properties, this may well still produce a premium for lower value leaseholders which is higher than the premium under section 9(1) (since section 9(1) premiums are so favourable to leaseholders). If section 9(1) were retained either temporarily or indefinitely this would allow leaseholders who would have qualified for a section 9(1) valuation but do not qualify under the new scheme (or who qualify under both section 9(1) and the new scheme, but would pay a lower premium under the section 9(1) than the new scheme) the chance to take the benefit of section 9(1) whilst it remained in force.

1.51 Whilst we appreciate Counsel cannot advise on the compatibility of any particular scheme (since no particular scheme is being proposed), Counsel is asked to advise in so far as possible as to whether the introduction of a new scheme of the type set out above, which is designed accurately to capture low value properties and provide leaseholders of such properties with a more favourable basis of valuation than higher value properties, could be compatible with A1P1. As part of this, Counsel is asked to consider:

(1) Whether different considerations would apply in terms of compatibility with A1P1, if Government's purpose in introducing such a new scheme was the creation of a more accurate method of identifying lower value properties and providing them with a more favourable basis of valuation (having taken a policy decision that it wished to provide additional assistance to enable leaseholders of low value properties to enfranchise), rather than Government's purpose being to simplify the complexities of section 9(1).

(2) Which (if any) of the methods for introducing the scheme set out in paragraph 1.50 above would be preferable in terms of compatibility with A1P1.

Human rights considerations

1.52 Counsel will be aware that the original provisions of the 1967 Act, including section 9(1), have been challenged as being an infringement of A1P1 and that the court held that whilst enfranchisement was a deprivation of property, the deprivation was justified as it was a proportionate response in pursuit of a legitimate aim: *James v United Kingdom* (1986) 8 EHRR 123 (App No 8793/79). The court's conclusions in *James* in relation to A1P1 are summarised at paragraph 15.7 of the Consultation Paper. However, in

considering our provisional proposals, Counsel will need to bear in mind the context in which they will be introduced and how that differs from the situation at the time the 1967 Act was originally enacted. Most notably, when the 1967 Act was originally enacted a residence test applied in that only a leaseholder who resided in his or her house could acquire the freehold of it. That test was abolished on the coming into force of the Commonhold and Leasehold Reform Act 2002 and replaced with a requirement that the leaseholder must have owned the house for at least two years (so enfranchisement rights were extended to leaseholders who *do not* satisfy the residence test (because they are not occupiers) and who *could not* satisfy the residence test (eg because they are a corporate body)). We provisionally proposed removing the two-year ownership requirement (for the reasons set out in paragraphs 7.118-121 and 8.75-77 of the Consultation Paper) – which will benefit all leaseholders (both owner-occupiers and investors). The result of these changes is that, unlike in 1986 when *James* was decided, the leaseholder acquiring the freehold may be a company and/or an investor as opposed to an owner-occupier. Further, as highlighted above, changes in the property market mean that in some cases houses, which currently qualify for a section 9(1) valuation and which we propose will continue to qualify for a reduced premium, can no longer be described as "low value".

1.53 Counsel's advice is sought on the compatibility with A1P1 of our suggested reforms in relation to section 9(1) as set out above. We do not seek Counsel's advice on the compatibility with A1P1 of the current regime that applies in section 9(1) cases, save as set out in paragraph 1.45 and 1.51 above.

The general approach: introduction

1.54 Having considered the possible reform of section 9(1), the Consultation Paper goes on to discuss potential reforms to what we have termed "the general approach".

1.55 We currently intend to structure our final Report by setting out first a number of different possible elements of any new scheme and then setting out separately the possible schemes. These instructions will also follow that format. Not all the elements identified can be incorporated into all the schemes proposed. However, they can all be incorporated into more than one scheme and on that basis justify being considered independently of any particular scheme.

The general approach: elements of a new scheme

1.56 The elements of a new scheme, the way in which they could potentially be reformed, and the effect such reform would have on premiums are as follows:

(1) The creation of a separate regime for low value cases: if rates are prescribed and the option of introducing an online calculator were pursued, then we see little need for a separate regime for low value/straightforward cases: the calculator would, in effect, identify these and the valuation would be simple at the point of use. If, however, rates are not prescribed, or an online calculator is not developed, then a separate regime remains an option for Government;

(2) Differential pricing for different types of leaseholder: an option for Government is to provide differential pricing for different types of leaseholder, depending on the overall scheme adopted. As differential pricing will inevitably add complexity to

the law, we think that it may be desirable only if the human rights arguments mean that a significantly lower price could be provided to owner-occupiers;

(3) The prescription of rates: an option for Government is to prescribe rates, either at a market rate or at a lower than market rate to reduce premiums;

(4) The treatment of ground rent: an option for Government is to cap ground rent in calculating the premium, which would reduce the premium payable in some cases;

(5) The discount for leaseholder's improvements: we discuss retaining this discount, so there would be no change to current premiums in this regard;

(6) Development and other additional value: we discuss the possibility of giving leaseholders the option of not paying for this value whilst preserving it for the landlord to realise. Consequently, whilst the reforms we discuss could reduce premiums this is not intended to be at the expense of landlords. We set out how development value might otherwise be included in any new scheme within the discussion of those schemes;

(7) The 80-year cut-off in respect of marriage value: we discuss removing this, which would, in itself, have the effect of increasing the premium payable in some cases; and

(8) The discount for the risk of holding over: we discuss providing that no such discount is to be applied to the freehold vacant possession value, which would, in itself, have the effect of increasing the premium payable in some cases.

1.57 Where we consider that the proposed reform of the above elements may give rise to A1P1 considerations, we refer to them below. Otherwise, we do not consider that any issue arises, either because the proposed reform would preserve the status quo, or have the effect, in isolation, of increasing premiums, even though the premium would be reduced as a result of other options carried forward by Government. However, if, having read the above list, Counsel identifies any potential incompatibility with A1P1 of any of these potential changes to the elements of the valuation, please identify it in your Opinion.

Creation of a separate regime for low value cases

1.58 The Consultation Paper addresses, at paragraphs 15.26 to 15.29, the possibility of the creation of a separate regime for low value cases. We consider that for the purposes of your Opinion, this is perhaps most usefully addressed when considering the simple formulae at paragraphs 15.41 to 15.57 of the Consultation Paper.

Differential pricing for different types of leaseholder

1.59 At paragraphs 15.30 to 15.38 of the Consultation Paper we consider whether the premium which commercial investors must pay to exercise enfranchisement rights should be set differently from that payable by owner-occupiers. It would be helpful in this regard if you could explain whether your Opinion would differ if the class of leaseholder benefiting from the enfranchisement rights was limited in some way.

Prescribing rates

1.60 At paragraph 15.39 of the Consultation Paper we introduce the idea of prescribing rates. We appreciate that it will be difficult to assess the compatibility with A1P1 of any prescribed rate without knowing what that rate might be and how it relates to the rate which would otherwise be applied by a valuer considering the individual attributes of a particular property. However, we would welcome your advice on (a) whether prescribing rates would be compatible with A1P1, when the rate was intended to be a market rate, but prescription would necessarily mean that in some cases less than or more than a market rate may be obtained; and (b) where the rate is intentionally prescribed to be less than a market rate in order to produce a lower premium.

Treatment of ground rent

1.61 The option that we intend to put to Government is that the ground rent to be taken into account in any enfranchisement valuation should be capped at 0.1% of the property's value. This cap is on the basis that any ground rent above this level is now generally considered onerous. (As to what is considered onerous, see paragraph 15.65 of the Consultation Paper; Chapter 3 of the Select Committee's report (above); paragraphs 48 to 52 of the Government's response to its consultation on *Tackling unfair practices* (above).) For many enfranchisement claims this will make no difference to the calculation of the premium, as the ground rent will not be onerous. However, there will be some claims in which the ground rent used to determine the premium would otherwise be higher because it is onerous. In these cases the cap will deprive the landlord of a capital payment to compensate for the rental stream to which he or she would otherwise be contractually entitled (in so far as that rental stream would have exceeded 0.1% of the property's value). We believe that in the majority of these cases the leaseholder will have paid full value for the lease when it was granted. In other words, the leaseholder will have paid a premium on the grant of the lease which is the same as the premium he or she would have paid if there were no onerous ground rent liability. Further, we have been told that in many of these cases the leaseholder was unaware of the onerous nature of the ground rent provisions. However, consultees have suggested that there may be some leases granted at reduced premiums to reflect the onerous nature of the ground rent provisions. Counsel is asked to advise on the compatibility of the proposed cap in both of these scenarios, namely where a lower premium was or was not paid.

Development value

1.62 In paragraphs 15.87 to 15.91 of the Consultation Paper, we invited the views of consultees as to whether it should be possible for leaseholders to elect to take a type of restriction on development (specifically provided for in legislation), rather than pay development value as part of the initial enfranchisement claim. This election by the leaseholders would not require the agreement of the landlord. If the leaseholders, following the acquisition of the freehold, wished to develop the premises, they would be able to negotiate a release from the restriction with the former landlord. The landlord would expect to be paid a premium in order to release the restriction; that premium would be paid instead of the leaseholders having to pay development value when the claim was initially made. Counsel is asked to advise on the compatibility with A1P1 of such a restriction.

The general approach: possible schemes

Option 1 in the Consultation Paper: simple formula

1.63 At paragraphs 15.41 to 15.57 of the Consultation Paper we discuss the possibility of setting enfranchisement premiums by reference to a simple formula. Option 1A would set premiums by using a multiplier of ground rent. Option 1B would set premiums by using a percentage of capital value. Our preliminary view, as expressed in the Consultation Paper, is that such formulas, if of general application, would not be compatible with A1P1 for the reasons we explain in paragraphs 15.41 to 15.57 of the Consultation Paper. However, we would welcome Counsel's view.

Option 2 in the Consultation Paper: options based on "market value"

1.64 The consultation responses received have caused us to re-think how we approach the formulation of our options based on market value. In the Consultation Paper we considered the elements of value, which currently go to make up the premium payable, and asked whether they should or should not be included under any reformed scheme. The approach we now propose to take is to consider the assumed market in which the landlord's interest is being sold, in particular whether the leaseholder is assumed to be in that market either at the valuation date or in the future. We believe that this is a better way of providing options which can truly be said to produce a "market value". Whilst this is a different approach to the reform of the valuation methodology than that set out in the Consultation Paper, it does, in fact, produce similar options.

1.65 In our final Report, we present Schemes 1, 2 and 3. The result produced in each option can be justified as being a "market value" (by reference to the assumed market) and, in that context, no less than a landlord might receive for his or her interest in the absence of enfranchisement legislation: Scheme 1 is what the landlord would receive if the lease ran its course and the leaseholder never chose to extend the lease or acquire the freehold; Scheme 2 is what the landlord would receive if his or her interest were sold to a third party; and Scheme 3 is what the landlord would receive for his or her interest if sold to the leaseholder.

1.66 The options can be summarised as follows:

(1) Scheme 1: it is assumed that the leaseholder is not in the market at the time the premium is calculated and will never be in the market: this produces a premium based on the value of the term and the reversion only, ie not including marriage or hope value and is similar to Option 2A set out in the Consultation Paper. This option on its own would produce the greatest reduction in premiums for leaseholders with less than 80 years unexpired on their leases. For leaseholders with more than 80 years unexpired, it would, without more, make no difference to the premium payable;

(2) Scheme 2: it is assumed that the leaseholder is not in the market at the time the premium is calculated, but may be in the market in the future: this produces a premium based on the value of the term and reversion, plus possibly hope value, but not marriage value, and was not an option put forward in the Consultation Paper. This option on its own would produce the second biggest reduction in premiums for leaseholders with less than 80 years unexpired on their leases. For

leaseholders with more than 80 years unexpired, it would, without more, make no difference to the premium payable;

(3) Scheme 3: it is assumed that the leaseholder is in the market at the time the premium is calculated: this produces a premium based on the value of the term and reversion and marriage value where it exists and is, in effect, the same as Option 2C in the Consultation Paper. This option on its own would not reduce premiums for leaseholders because it reflects the current valuation regime.

1.67 Crucially and in contrast to the options put forward in the Consultation Paper, all of these options could include the payment of development, or other additional, value or compensation. However, any such additional value or compensation would be assessed applying the relevant assumption.

1.68 We set out the differences, in terms of the elements of value included, between the options we now intend to put forward and those put forward in the Consultation Paper.

Option	Option in the Consultation Paper	Scheme	Option to be set out in our final Report
2A	Term and reversion only	1	Term and reversion, plus development, or other additional, value[6]
2B	Term, reversion and marriage value only	2	Term, reversion, hope value, and development, or other additional, value[7]
2C	Term, reversion, marriage value and development, or other additional, value	3	Term, reversion, marriage value, and development, or other additional, value[8]

1.69 All of our proposed options could include a combination of the potential reforms to "elements" above, for example, they could or could not incorporate the prescription of rates. Given our Terms of Reference, our assumption is that the combination of whichever option Government decides to adopt, and of the elements above that are included, will be that the overall premium paid will be reduced. The choice of option, and the elements included, will determine the extent of the reduction in price. Counsel is not asked to advise as to any particular permutation of options and elements. However, further consideration may need to be given to the compatibility with A1P1 of whichever permutation Government is minded to adopt.

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6 Subject to the possibility of the landlord retaining the development value, so it would not be payable by the leaseholder: see para 1.56(6) above.

7 As above.

8 As above.

Scheme 1: Assumption that the leaseholder is not in the market and will never be in the market

1.70 If it is assumed that the leaseholder is not in the market and will never be in the market, then the "market" value for the landlord's interest is simply the value of the term and reversion. If the lease ran its course and the leaseholder never chose to extend it or acquire the freehold, the landlord would get nothing more than the ground rent throughout the term of lease and vacant possession upon its expiry, ie the value of the term and reversion. This assumption would, therefore, mirror that scenario and mean that the landlord would not receive marriage value or anything in respect of the hope of receiving marriage value in the future ("hope value").

1.71 This assumption would reduce premiums where the current lease has less than 80 years unexpired and the leaseholder seeks to extend it or (if a house, falling outside section 9(1)) to purchase the freehold individually or (if a flat) to participate in a collective enfranchisement. It would also reduce the premium on a collective enfranchisement where the leases of any of the non-participating leaseholders have less than 80 years left to run and the participating tenants need to pay hope value in respect of them. This option, however, still produces a market value because there is no guarantee that a leaseholder will ever enfranchise – the lease might just run its course.

1.72 This option is essentially that presented as Option 2A in the Consultation Paper. However, contrary to what was set out in the Consultation Paper as Option 2A, the option presented here is based on making an assumption, rather than explicitly excluding certain elements of value. On this revised basis, the option could include development or other additional value. Any such value would also be assessed on the assumption that the leaseholder was not and would never be in the market.

1.73 Take, as an example, a freehold interest, which includes a basement and assume that the basement could be developed either by incorporating it into an existing ground floor flat or by creating a separate lower ground floor flat. If there was an assumption that the ground floor leaseholder was not in the market, and would never be in the market, then any development value which could only be realised by granting a lease of the basement to the leaseholder could not be taken into account. However, development value which could be realised by independently developing the basement could be. This value would not be the value to the leaseholders as the owners of the freehold post enfranchisement (as they are assumed not to be in the market), but the value in the hands of the current freeholder. In other words, the value would be calculated by reference to what a hypothetical purchaser of the freehold interest would pay the current freeholder in addition to the value of the term and reversion for the potential to develop the basement in the future.

1.74 In the above example, the freeholder would get something on enfranchisement in respect of development value, even though this might be less than would be paid at present. However, where the only means of realising development value is through a deal with one or more leaseholders, the basis of valuation proposed would deprive a landlord of that element of value. For example, where a roof void could be developed, but could only be developed by incorporating it into a top floor flat because that would be the only means of access, the landlord would get nothing in respect of what he might otherwise have been paid by the top floor leaseholder to acquire the roof void.

Scheme 2: Assumption that the leaseholder is not in the market, but may be in the market in the future

1.75 If it is assumed that the leaseholder is not in the market, but may be in the market in the future, then the "market value" for the landlord's interest is the value of the term and reversion, plus potentially an amount to reflect the hope of doing a deal with the leaseholder in the future. This is what the landlord would get in the open market, if the landlord's interest was sold to an investor as opposed to the leaseholder. As the investor would not be a special purchaser, no marriage value would be realised on the sale to the investor. However, the investor would anticipate the possibility of releasing marriage value by a sale to the leaseholder in the future, and may pay something in addition to the value of the term and reversion to reflect the hope of this happening.

1.76 The assumption proposed under this option would reduce premiums where the current lease has less than 80 years unexpired and the leaseholder seeks to extend it or (if a house, falling outside section 9(1)) to purchase the freehold individually or (if a flat) to participate in a collective enfranchisement. It would not reduce the premium in these cases to the same extent as in Scheme 1 above. Further, it would not reduce the premium on a collective enfranchisement in so far as it relates to the leases of any of the non-participating leaseholders who have less than 80 years left to run because the participating tenants at present already need to pay hope value in respect of them. As with Scheme 1, this option produces a market value: it is the market value, which would be paid by an investor.

1.77 Whilst this option was not put forward in the Consultation Paper, it represents a compromise between the two most popular options: Option 2A, which was favoured by leaseholders as being the option which would produce the lowest premiums, and Option 2C, which was favoured by landlords and professionals as producing the highest premiums and being most similar to the current regime. This revised option was also an option suggested by consultees.

1.78 As with Scheme 1 above and Scheme 3 below, this option could also include development or other additional value. Such value would be assessed on the assumption that the leaseholder was not in the market, but may be in the market in the future. In the examples given above of development value in a basement and roof void, which could be released by deals with the leaseholders, this development value would be calculated by reference to what an investor would pay the landlord for the prospect of doing a deal with the leaseholder in the future. This would be less than the development value in the hands of that leaseholder, as a discount would need to be applied to reflect the risk that the leaseholder may never seek to do a deal. In other words, this is another form of hope value.

Scheme 3: Assumption that the leaseholder is always in the market

1.79 The assumption that the leaseholder is in the market leads to a premium which includes the value of the term and reversion and marriage value, where it exists. This option is the same as that put forward as Option 2C in the Consultation Paper and the option which most closely resembles the current valuation methodology.

1.80 Applying this assumption to development and other additional value means that value in the hands of the leaseholder can be considered. The value will always be higher in the hands of the leaseholder than it would be in the hands of any other purchaser, as

there is no need to discount the value to reflect the fact that the leaseholder may never chose to realise it. In other words, there is a value to the leaseholder whether or not he or she chooses to realise it.

1.81 Reference was made in the Consultation Paper to *Padmore v Barry and Peggy High Foundation*,[9] which illustrates the point. The case concerned the collective enfranchisement of two maisonettes which had 61 years unexpired on their leases and were held by a single leaseholder. The Tribunal at first instance found that the value of the landlord's interest included £150,000, being the value of the hope of being able to do a deal with the leaseholder to convert the building into a single house. The landlord did not dispute its entitlement to hope value or the assessment of it, but claimed to be entitled to marriage value in the alternative. Because the leases had less than 80 years left to run, marriage value was payable. In other words, it could be assumed that the leaseholder was in the market at the time the premium was calculated. That being so, it was argued that the leaseholder would have obtained, upon acquiring the freehold, the value of being able to develop the building into a single house, even though the leaseholder did not intend to undertake that development and realise that value. The Upper Tribunal agreed and substituted the £150,000 hope value for marriage value of £194,000.

9 [2013] UKUT 646 (LC).