

# LEGAL

## AND PROFESSIONAL

# ATTEMPTING THE IMPOSSIBLE?

Paul Winstanley addresses the Law Commission's initial proposals for leasehold reform – and the inherent difficulty of balancing fairness to all parties while simultaneously making leaseholders better off

In July this year the Law Commission published an update on its work on leasehold reform of houses. The document is a stepping stone towards a more comprehensive review, due later this month, which will cover proposals for both leasehold houses and flats.

The Law Commission has been tasked by the government to provide proactive solutions for numerous practical issues surrounding existing leasehold house ownership. These include providing a better deal for leaseholders as consumers, simplifying the enfranchisement regime and promoting transparency and fairness.

The more complex objective, though, is to "set out options for reducing premiums paid for enfranchisement, whilst ensuring sufficient compensation is paid to

landlords to reflect their legitimate property interests".

I fully support the review of the leasehold sector and the goal of making a positive difference to the experience of leaseholders. Our tenure structure today is governed by a rich and diverse tapestry of more than 50 Acts of Parliament legislated by numerous governments over many decades, together with periodic case law precedent. The present freehold/leasehold structure is undoubtedly complex and can be highly convoluted; it would certainly benefit from modernisation and streamlining.

I also agree wholeheartedly with many of the very sensible steps proposed by the Law Commission to make leasehold house ownership a better, fairer and less stressful proposition practically. An easier, transparent and more cost-effective process makes

absolute sense. However, the calculations discussed and examples used to reduce enfranchisement premiums feel overly simplistic and unrepresentative for what is a very complex area of property ownership. My fear is that, if enacted, any of the proposed valuation methodology changes would undoubtedly create a raft of lengthy litigation, judicial challenge and market disruption.

### Observations on the proposals

It may just be an unfortunate conflict of policy, but the Law Commission arguably appears to have been set a practically impossible task in reducing enfranchisement prices for leaseholders while at the same time fairly compensating freeholders. In looking to benefit one party (the leaseholder), the other party (the freeholder) must by definition be left worse off. Yet it is difficult

to see how prices paid for enfranchisement today could be considered "unfair", as the present valuation methodology is governed by statute supported by tribunal decisions and not illegitimate market practice. So, it is difficult to envisage how any reduced prices could represent fair compensation.

In its report, the Law Commission does clearly acknowledge and attempt to assess the difficulties it faces in looking at this issue fairly. I would, however, challenge the overriding context on which its proposed solutions are based.

Firstly, the proposals are seeking to find a solution for a single market for ground rents when providing for enfranchisement calculations. Secondly, the examples used as illustrations (see p60) are not representative of the majority of leasehold interests in the UK today.

# LEGAL | LEASEHOLD REFORM

## One single market?

One of the common misconceptions surrounding freehold interests is that there is one solitary market for assets. Based on my experience, I would argue there are at least six distinct investment markets for leasehold houses alone:

- Less than 50 years unexpired leases (low rent);
- Less than 50 years unexpired leases (non-low rent);
- 50 to 99 years unexpired leases (low rent);
- 50 to 99 years unexpired leases (non-low rent);
- 100-plus years unexpired leases with more than £50pa ground rents and often including periodic rent reviews;
- 100-plus unexpired leases with less than £50pa ground rents, typically fixed with nominal rental increases over time.

Each of these highly specialist markets attracts different investors as each bucket offers alternative investment characteristics and return/risk profiles. The shorter the lease, the higher the potential premium for lease extension or freehold purchase and likelihood of tenants wishing to enfranchise. The longer the lease, the more relevant the income stream and rent review provisions (with the exception of very long leases with low ground rents).

In order to provide landlords with "sufficient compensation", it will be essential for any legislative change to reflect adequately the balance between investment drivers of capital receipts versus income. A "one size fits all" solution is unlikely to work.

## The importance of using representative examples

The actual landscape of leasehold house ownership in the UK is very different from the example houses given by the Law Commission in its analysis:

- House A: It is unlikely that a 130-year unexpired term house lease would have a fixed ground rent of £250 pa

## The proposals for enfranchisement premiums

The Law Commission's proposed reforms for enfranchisement pricing are to either:

- (a) Introduce a simple formula for premium calculation – either a multiplier of ground rent or percentage of freehold value; or
- (b) Adopt an approach which more closely resembles the current regime but to

potentially remove marriage value and/or prescribe standardised rates to be used in calculations for deferment, capitalisation and, if relevant, relativity.

For each potential solution, premiums have been calculated under prevailing legislation and compared with the application of the proposed different methodologies.

## The Law Commission's examples

The ground rent provisions of the houses used to illustrate the market are:

- House A: 130-year unexpired term lease. Fixed ground rent of £250pa. Freehold value: £200,000.
- House B: 60-year unexpired term lease. Fixed ground rent of £250pa. Freehold value: £200,000.

- House C: 241.5-year unexpired term lease. Ground rent £295 currently, subject to a doubling rent review every 10 years for 50 years (first review in January 2020), fixed thereafter. Freehold value: £400,000. This is stated to be a Taylor Wimpey lease.

for the duration. For a modern lease, there is much greater likelihood of a rent review provision to RPI or with a fixed 25-year doubling pattern. Very few modern leases have fixed ground rents for the duration.

- House B: It is unlikely that a 60-year unexpired term house lease would have a fixed ground rent of £250 pa for the duration. Assuming an original 99-year lease term, the lease would have commenced in around 1978/79. Ground rents at this time would have been set lower – typically under £50 and rarely subject to any review.

- House C: This is an actual example, based on a Taylor Wimpey doubling 10-year clause. However, the Law Commission's update does not mention that this developer has publicly agreed to compensate investors for converting such leases to 10-year RPI rent review patterns. Also, at £400,000, this example house is significantly above the national average value of UK homes (£214,745, according to

Nationwide in August 2018).

It would be much more helpful in the Law Commission's upcoming report if more realistically representative examples were used to illustrate proposals.

## No simple solution

I believe that the Law Commission is certainly on the right track with its philosophy for leasehold reform. The practical steps proposed are undoubtedly common sense.

However, more work is needed on the mathematical side of the premium calculation. It might also make the Law Commission's task more straightforward if the terms of reference were amended by the government to suggest reforms to "appropriately but more simply compensate freeholders".

That would make it much easier to identify a workable solution and potentially avoid years of dispute over what is and is not sufficient compensation.

And instead of looking to find a "one size fits all"

solution, why not seek to reflect the markets for freehold interests subject to different unexpired lease lengths, rather than size of ground rent? This could be taken as an opportunity to modernise the calculation methods without fundamentally changing them.

For example, could council tax bands replace the low rent test? Could leasehold interests with 100 years or more unexpired have a calculation based on the value of ground rent income linked only to some market parameters (such as gilt rates) with reference to the underlying income stream review pattern and provision?

Could shorter leases have more prescribed parameters for deferment, capitalisation and relativity depending on different lease term characteristics, rather than one single rate or no rate at all? This would avoid a significant amount of negotiation in shorter lease cases and make the process simpler, yet still allow the flexibility for fairness to both leaseholder and freeholder alike.

The specifics of any changes need to be debated by the Law Commission in conjunction with a selection of specialist valuers to ensure compensation remains fair. If this is done carefully and purposefully to modernise each underlying component, it would enable the creation of the online calculator, which the government is understandably keen on. It would also be a clear modernisation of the existing statutory calculations and involve a lot less complex valuation and legal advice for all concerned.

It is crucial, however, that the examples that the government is given to base its final decisions on are representative of the market, rather than the overriding sentiment behind the proposals. This is arguably the biggest issue with the Law Commission's published reasoning to date.

**FOR MORE ON THE LAW COMMISSION'S PROPOSALS, SEE: [WWW.EGL.CO.UK/LEGAL/935402.NW](http://WWW.EGL.CO.UK/LEGAL/935402.NW)**

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