Leasehold enfranchisement reform: non-litigation costs
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 We refer to our previous Instructions concerning valuation reform.[1]

1.3 Counsel's advice is sought on the compatibility with the European Convention on Human Rights ("ECHR") of a further related proposed recommendation, that would run alongside the options for reforming valuation, to remove the requirement for leaseholders to contribute towards their landlords' transactional costs of dealing with an enfranchisement claim.

1.4 Counsel is referred to our Consultation Paper ("CP"), *Leasehold homeownership: buying your freehold or extending your lease*, published on 20 September 2018. In addition to those sections we referred to in our first set of Instructions, Counsel is also referred to Chapter 13 of the Consultation Paper, setting out the current law, problems and provisional proposals for reform in respect of the litigation and non-litigation costs of the parties to an enfranchisement claim.

CONTRIBUTIONS BY LEASEHOLDERS TO LANDLORDS' TRANSACTION COSTS

1.5 At present, leaseholders are required to contribute to their landlord's non-litigation costs. Both the Leasehold Reform Act 1967 and the Leasehold Reform, Housing and Urban Development Act 1993 set out specific categories of work for which a landlord will be entitled to be paid his or her reasonably incurred costs.

1.6 In the Consultation Paper we set out some of the arguments for and against requiring leaseholders to make such a contribution to their landlord's non-litigation costs. Having noted that we thought the arguments were finely balanced, we asked consultees whether such a contribution should continue to be made.

1.7 Having analysed the responses to this question, we have reached a provisional policy conclusion that:

(1) if the premium for enfranchisement claims is to be based on the market value of the landlord's asset (that is, based on Option 2 in the Consultation Paper, and

[1] These instructions can be found at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2020/01/Instructions-to-Catherine-Callaghan-QC-re-valuation-reform-FINAL.pdf.

rates are prescribed in a manner intended to reflect market rates), non-litigation costs should not be recoverable;

(2) if the premium for enfranchisement claims is not based on the market value of the landlord's asset (that is, it is not based on Option 2 in the Consultation Paper, or adopts prescribed rates that are deliberately lower than the market rate), non-litigation costs should be recoverable.

1.8 We have also concluded that, if non-litigation costs are to be recoverable, a fixed costs regime should be introduced. This would allow a landlord who has participated in a completed enfranchisement claim to make the following recoveries.

(1) A fixed base sum. This amount could be the same for all types of enfranchisement claim, or might vary depending upon the type of claim. For example, the fixed sum for collective freehold acquisition claims might be higher than for lease extension claims.

(2) Additional fixed sums ("bolt-on fixed sums") in respect of prescribed categories of additional work undertaken as part of a claim.

1.9 We consider that these prescribed categories should not include all elements of complexity that can arise in enfranchisement claims. Additional work incurred as a result of an integral part of the leaseholder's claim (such as, the need to value more than one type of flat), an election made by the leaseholder (such as, requiring a landlord to take a leaseback of a part of the building),[2] or an argument raised for the (financial or other) benefit of the leaseholder would be included. But additional work incurred as a result of complexities within the building, or arrangement of superior interests (such as, dealing with a common parts lease), from an election made by the landlord (such as, choosing to take a leaseback of part of the building), or from an argument raised for the (financial or other) benefit of the landlord would not be included.

1.10 The basis for that provisional approach is as follows.

(1) Outside of enfranchisement claims the majority of residential property sales are negotiated on the basis that each party will pay their own legal and other costs. The price agreed reflects the fact that both sides will also have such costs to pay.

(2) The premium to be paid on enfranchisement is calculated by reference to valuations carried out on an open market basis; there is no deduction made to reflect the leaseholder's obligation to contribute to the landlord's transaction costs. As a result, the current law of enfranchisement allows the landlord to recover more than he or she would on an open market transaction: the landlord recovers both the market value (that would be received on an open market transaction) and a contribution to his or her costs (which would not be).

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[2] A leaseback is a lease granted by the nominee purchaser to the landlord upon the former's acquisition of the freehold interest in the premises. The leaseback is almost always for a 999-year term at a peppercorn rent.

(3) We considered whether the compulsory nature of an enfranchisement transaction provides a sufficient justification for this more favourable treatment. We considered the comparison between enfranchisement claims and compulsory purchase (where the compensation paid to the party whose interest is to be acquired includes a payment for "disturbance" which can include legal costs and other professional fees).

(4) However, we concluded that the nature of a leaseholder's tenure, and the market treatment of that interest, means that the leaseholder's decision to bring an enfranchisement claim is less voluntary than might at first appear. For example, the very fact that leases are time-limited requires them to be extended to avoid the property reverting to the landlord at the end of the term. And the market will often force a leaseholder to extend the lease at a much earlier stage to ensure that purchasers reliant on mortgage finance are able to acquire it. Indeed, owning a leasehold property brings with it an underlying need to make an enfranchisement claim to escape the inherent limitations of that tenure.

(5) We also rejected the argument that leaseholders have voluntarily chosen a tenure that has such inherent limitations. It is widely acknowledged that in the early part of the 21st century the residential property market featured a historically high proportion of leasehold houses as a result of the adoption of leasehold by the financial sector as a dependable asset class. And the ubiquity of leasehold as the time-limited tenure of choice for flats and maisonettes effectively means that there is no choice other than to purchase these properties as leasehold. As a result, many people were therefore put in a position where they – or whomever they sold the property to – would have to exercise enfranchisement rights.

(6) The obverse is that landlords are – or should be – aware of the market necessity of either lease extensions or freehold acquisitions when either granting or purchasing reversionary interests. In fact, the prospect of an enfranchisement claim being made, and the payment of a premium for any extension or transfer, is often a significant attraction for investors in leasehold reversions. As such, while a landlord is compelled to sell his or her interest at the election of the leaseholder, he or she should be aware that the leaseholder will come under his or her own pressure to enfranchise.

(7) When the commercial necessity of enfranchisement is properly considered, the analogy with compulsory purchase orders – the prospect of which do not loom over ordinary properties in a comparable fashion – is not as convincing as is often supposed.

(8) We therefore concluded that there is insufficient justification for departing from the position that applies to non-litigation costs in open market transactions. A landlord against whom an enfranchisement claim is made should not generally be entitled to recover his or her non-litigation costs from the leaseholder.

(9) However, we also concluded that this argument would not hold if Government adopted valuation options that marked a clear departure from an attempt to capture market value. If such reforms were adopted, the argument that the landlord was being treated more favourably than would have been the case in

the open market falls away. As such, a leaseholder would be required to contribute to his or her landlord's costs.

(10) We have sought to distinguish between valuation options which attempt to capture market value and those that do not. We consider that the options presented within Option 1 in the Consultation Paper do not attempt to capture market value, whereas the options presented within Option 2 do. But we also think that in so far as, under Option 2, prescribed rates are deliberately set at levels which are lower than would be present in the market, this should not be considered to be an attempt to capture market value for this purpose.

1.11 We also have concluded that there should be two exceptions to this general position.

(1) Low value claims. Where the premium payable for the landlord's asset falls below a prescribed threshold, the leaseholder should be required to contribute to the landlord's costs up to a sum that would, when added to the premium payable, be not more than the prescribed threshold.[3]

(2) Additional costs incurred as a result of an election by the leaseholders. For example, our proposed regime allows leaseholders to elect to compel landlords to take leasebacks of all or any part of the premises (other than common parts) which are not let to participating leaseholders. The effect of such a leaseback is to reduce the premium payable by the leaseholders for the acquisition of the freehold. If such an election is made, we consider that the leaseholders should be required to contribute to the landlord's non-litigation costs of dealing with the same.

1.12 We have proposed a fixed costs regime for quantifying any contribution to non-litigation costs that would be required. We believe that this will help limit the costs of enfranchising (on both sides) and provide predictability for leaseholders.

1.13 We would ask Counsel to consider whether these provisional proposals are compatible with A1P1. In particular, we would ask Counsel to consider the compatibility of:

(1) the removal of the (current) ability of a landlord to recover his or her non-litigation costs of dealing with an enfranchisement claim from the leaseholder (in the event that a market-based valuation is adopted); and

(2) the introduction of a fixed costs regime based on the model outlined above (in the event that a market-based valuation is not adopted).

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[3] For example, if the prescribed level were set at £1,000, and the premium for the landlord's asset was £750, the leaseholder would be required to contribute to the landlord's non-litigation costs up to a maximum sum of £250.