House of Lords give landlords some hope

Natasha Rees reviews the Lords' findings in the conjoined Sportelli *appeals*

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The House of Lords decided there should be no hope value in house claims under the 1967 Act or in lease extension claims under the 1993 Act. When it came to collective claims under the 1993 Act they decided that some hope value could be claimed by landlords in respect of non-participating tenants.

Earl Cadogan & ors v Sportelli & anor and two ors and Earl Cadogan v Pitts & anor [2008] began over five years ago when Mr and Mrs Sportelli applied to their landlord, Earl Cadogan, for a lease extension of their flat in Cadogan Square under the Leasehold Reform Housing and Urban Development Act 1993 (the 1993 Act). After failing to agree a premium, their claim was referred to the Leasehold Valuation Tribunal, which was asked to determine the premium payable. It was following the tribunal's decision in March 2005 and a subsequent appeal by Earl Cadogan to the Lands Tribunal that the long journey to the House of Lords began.

In the Lands Tribunal the appeal was joined with a number of other appeals and they became known collectively as *Sportelli*. Since then both the Lands Tribunal and the Court of Appeal have determined various valuation issues in these conjoined appeals. By the time the appeals reached the House of Lords only one relatively minor valuation issue remained, namely whether a landlord is entitled to seek an additional payment in respect of the hope of releasing marriage value through deals with tenants in the future, an expectation known as 'hope value'. In the House of Lords it was joined with another appeal on the same issue of hope value but relating to a claim for the freehold of a house under the Leasehold Reform Act 1967 (the 1967 Act).

On 20 December 2008 the House of Lords decided unanimously that there should be no hope value in house claims under the 1967 Act or in lease extension claims under the 1993 Act. When it came to collective claims under the 1993 Act, however, they were not unanimous in their decision. With Lord Hoffman dissenting they decided that some hope value could be claimed by landlords in respect of non-participating tenants.

The decision has been welcomed by both landlords and tenants. Landlords are now able to seek an additional sum in respect of those tenants who do not participate in a collective claim. Previously they had been unable to do so, giving tenants the ability to manipulate the premium payable by deciding how many of them should participate in the claim. It has also been welcomed by tenants seeking to buy the freehold of their house or seeking to extend their lease, since the landlord will not be able to claim an additional sum in respect of hope value.

Background

Marriage value

The valuation process is complex but can be broken down into a number of elements. One of these elements is known as 'marriage value'. This is the assumption that the value of an unencumbered freehold will be higher than the value of the landlord's reversion and the tenant's interest if valued separately. The 'marriage' of the two interests results in an uplift in value and explains why a tenant will pay more to purchase the freehold reversion than any other purchaser: because they will realise this value. This extra value is the 'marriage value', and the tenant's incentive to bid more is known as the 'tenant's overbid'.

Hope value

Hope value is effectively anticipated marriage value. If a landlord is selling its freehold subject to a lease at a time when the tenant is not in the market there is no immediate prospect of releasing marriage value. However, a potential purchaser may well think that in addition to its investment value the freehold interest carries with it the potential benefit of a possible future sale to the tenant, thus releasing marriage value in the future. It is this additional sum that is known as hope value.

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The appeals

Earl Cadogan had appealed five Court of Appeal decisions: two relating to house claims under the 1967 Act (*Earl Cadogan v Pitts and Wang and Atlantic Telecasters Ltd*), one relating to a lease extension claim under the 1993 Act (*Earl Cadogan v Mr and Mrs Sportelli*) and two relating to collective enfranchisement claims under the 1993 Act (*Earl Cadogan v 27/29 Sloane Gardens and Grandeden*).

In all of these appeals Earl Cadogan was contending that hope value should be taken into account as a component of the price payable by the tenant to the landlord. It was therefore necessary for the House of Lords to consider the question of hope value separately under the relevant provisions of each Act. It is helpful to consider the 1967 Act first because it was from this that the concept of marriage value and the special purchaser, namely the person who will pay more for the freehold or lease extension, ie the sitting tenant, first arose.

Relevant statutory provisions

House claims: the 1967 Act

In his judgment Lord Neuberger looked in detail at the provisions of s9(1) and s9(1A) of the 1967 Act and the treatment of marriage value under these provisions. Tenants with long leases were first given the right to acquire new leases or to buy their freeholds under the 1967 Act, which applies only to houses. Section 9 contained the formula for assessing the price, which in its original form was as follows:

> 9(1) The price payable... shall be the amount by which ... the house... if sold in the open market by a willing seller, might be expected to realise on the following assumptions:
>
> (a) On the assumption that the vendor was selling for an estate in fee simple, subject to the tenancy but on the assumption that this Part of this Act conferred no right to acquire the freehold.

One of the first decisions relating to the 1967 Act was *Custins v Hearts of Oak Benefits Society* [1969], in which the Lands Tribunal decided that the actual tenant could be treated as being in the market as a potential purchaser when assessing the price payable under s9(1). This obviously increased the price payable by tenants because a sitting tenant would pay more for their freehold than other purchasers. It caused a hasty amendment to the Act by parliament. Section 82 of the Housing Act 1969 amended s9(1) as follows [emphasis added]:

> 9(1) The price payable... shall be the amount by which ... the house... if sold in the open market by a willing seller *(with the tenant and members of his family who reside in the house not buying or seeking to buy)*, might be expected to realise on the following assumptions:
>
> (a) On the assumption that the vendor was selling for an estate in fee simple, subject to the tenancy but on the assumption that this Part of this Act conferred no right to acquire the freehold.

The Lords agreed that the purpose of this amendment was to eliminate the consideration of marriage value to the tenant and any hope value to others. This meant that there was no marriage value payable under s9(1). Later a new s9(1A) was introduced by the Housing Act 1974, which included a new formula for assessing the price for higher-value houses:

> 9(1A) The price payable for a *(higher-value)* house... shall be the amount which... the house... if sold in the open market by a willing seller, might be expected to realise on the following assumptions:
>
> (a) On the assumption that the vendor was selling for an estate in fee simple, subject to the tenancy, but on the assumption that this Part of this Act conferred no right to acquire the freehold.

The only relevant difference between s9(1) and s9(1A) was, therefore, the fact that s9(1A) did not require one to assume that the tenant was excluded from the market, therefore allowing the consideration of marriage value. The House of Lords concluded that under s9(1) marriage value cannot be taken into account because the tenant is expressly excluded from the market. Conversely, under s9(1A) marriage value can be taken into account because there is no requirement that the tenant is not in the market.

Over a number of years the Lands Tribunal set the tone for future valuation methods under s9(1A) by deciding that the marriage value should be divided equally between the landlord and the tenant. This equal division was finally set by the amendments introduced by the Commonhold and Leasehold Reform Act 2002, which fixed the marriage value at 50% under a new s9(1C) and provided under a new s9(1D) that no marriage value was payable if the lease had more than 80 years to run.

Lease extension claims

Chapter II of the 1993 Act enables tenants to seek a new 90-year lease in addition to their existing lease. Part II of Schedule 13 sets out the basis on which a price for the new lease is to be calculated:

> (2) The premium payable by the tenant in respect of the grant of the new lease shall be the aggregate of:
>
> (a) the diminution in value of the landlord's interest in the flat as determined by para 3; and

(b) the landlord's share of marriage value as determined in accordance with para 4.

3(2) Subject to the provisions of this paragraph, the value of any such interest of the landlord... is the amount which... that interest might be expected to realise if sold on the open market by a willing seller (with the tenant not buying or seeking to buy) on the following assumptions:

4(1) The marriage value is the amount referred to in sub paragraph (2), and the landlord's share of marriage value is:

(a) to be determined by agreement, or in default of agreement by the Leasehold Valuation Tribunal; or

(b) 50% of that amount, whichever is the greater.

The wording of Schedule 13 means that marriage value cannot be taken into account under paragraph 3 because the tenant is specifically excluded. However, it is then taken into account in paragraph 4.

Collective claims

Chapter 1 of the 1993 Act confers on tenants the right to join collectively with other tenants to acquire the freehold of their block. The price payable is determined in accordance with Schedule 6. The details of the 1993 Act are complicated and have been amended over the years. The key provisions are as follows:

2(1) Subject to the provisions of this paragraph, the price payable by the nominee purchaser for the freehold shall be the aggregate of:

(a) The value of the freeholder's interest as determined in accordance with paragraph 3; and
(b) the freeholder's share of marriage value as determined in accordance with paragraph 4.

3(1) Subject to the provisions of this paragraph, the value of the freeholder's interest... is the amount which at the valuation date that interest might be expected to realise if sold on the open market by a willing seller (with neither the nominee purchaser nor any participating tenant buying or seeking to buy) on the following assumptions:

(a) On the assumption that this chapter and chapter II confer no right to acquire any interest in the building or to acquire any new lease (except that this shall not preclude the taking into account of a notice given under s42 with respect to the flat contained in the building where it is given by a person other than a participating tenant).

(c) On the assumption that any increase in the value of any flat held by a participating tenant which is attributable to an improvement carried out at his own expense... is to be disregarded.

4(1) The marriage value is the amount referred to in sub-paragraph (2), and the freeholder's share of the marriage value is:

(a) the proportion determined by agreement or the Leasehold Valuation Tribunal or

(b) 50% of that amount, whichever is the greater.

(2) The marriage value is any increase in the aggregate value of the freehold when regarded as being (in consequence of their being acquired by the nominee purchaser) under the control of the participating tenants, as compared with the... value of the freehold when held by the freeholder, being an increase in value.

Schedule 6 therefore provides that no tenant of any part of the building is assumed to be in the market at the valuation date, which therefore excludes marriage value, but paragraph 4 then specifically provides that marriage value is to be taken into account to the limited extent of the participating tenants.

Landlord's arguments

The landlord's arguments in *Sportelli* were as follows:

(1) that although marriage value is excluded under s 9(1) hope value is not excluded;

(2) the fact that marriage value is taken into account under s9(1A) does not prevent hope value from being included in addition;

(3) under Schedule 13 the fact that marriage value is specifically included by virtue of paragraph 4 does not exclude hope value; and

(4) under Schedule 6 in addition to marriage value for participating tenants being included as a result of paragraph 4, hope value can be included in relation to participating tenants and non-participating tenants under paragraph 3.

Marriage value is the assumption that the value of an unencumbered freehold will be higher than the value of the landlord's reversion and the tenant's interest if valued separately.

The House of Lord's decision

House claims

The House of Lords was unanimous in deciding that in s9(1) the words 'with the tenant and members of his family who reside in the house not buying or seeking to buy' excluded both marriage value and hope value. This conclusion was based on the natural meaning of the words. The words 'buying' and 'seeking' were not limited to the present. In view of this they concluded that in relation to a valuation under s9(1) a landlord is not entitled to seek hope value.

In relation to s9(1A) the House of Lords agreed with the Court of Appeal that, since the landlord is entitled to half of the marriage value under s9(1C), to include a further element of hope value would be double counting. In his judgment Lord Neuberger stated that the contention that a landlord can have both hope value and half of the marriage value is based on two assumptions. The first is that the two stages of valuation, the investment value stage and the marriage value stage are independent. The second is that the tenant is the hypothetical buyer of the lease.

Lord Neuberger felt that in relation to the second assumption the special purchaser was not necessarily the buyer: the buyer is a hypothetical willing purchaser. This means that if the landlord seeks hope value at the investment stage and then marriage value at the second stage he would be seeking to 'have his cake and eat it'. Essentially, the price he would be seeking for his interest would assume that the tenant was in the market (because he would be seeking half of the marriage value) and also that the tenant was not in the market (because he would be seeking hope value). This is essentially what HHJ Carnwath concluded in the Court of Appeal decision when he stated that taking account of hope value when the landlord is also to receive half the marriage value is double counting. As a result of this Earl Cadogan's appeals in *Earl Cadogan v Pitts and Wang and Atlantic Telecasters Ltd* [2007] were dismissed.

Lease extension claims

The arguments about marriage value and hope value where a tenant is seeking a new lease of its flat under Schedule 13 of the 1993 Act are similar in valuation terms to those relating to house claims, although the valuation is slightly more complex. The words 'with the tenant not buying or seeking to buy' in paragraph 3(2) of schedule 13 have the same force as the similar words inserted into s9(1) by the 1982 Act and therefore have the same effect, namely that they bar marriage value from being included in the valuation, and thus also hope value. As a result of this, Earl Cadogan's appeal in *Earl Cadogan v Mr and Mrs Sportelli* [2007] was dismissed.

Collective claims

The wording of Schedule 6 means that every tenant of a flat of the building, whether participating or not, is deemed to be out of the market. It was on this basis that the Court of Appeal concluded that hope value could not be taken into account under the paragraph 3 valuation, whether attributable to the ability of participating tenants or of non-participating tenants to acquire new leases of their flats. The Court of Appeal's view was that the exclusion of all tenants from the market, whether participating or not, meant that they were all excluded for the purposes of hope value. This was consistent with their conclusion in relation to schedule 13 and it was this conclusion that Lord Hoffman agreed with in his dissenting judgment.

Lord Neuberger and the remainder of the law lords did not, however, agree with this conclusion. Lord Neuberger felt that it would be arbitrary and unfair if a landlord could recover marriage value in respect of the participating tenants' flats but could not recover hope value in respect of non-participating tenants' flats. He felt that since parliament had provided for the participating tenants to pay a true market price for the reversion of their own flats it followed that parliament must have intended them to pay a true market value for the investment part of their purchase, which would include paying for any hope value in respect of the prospect of negotiating new leases of their flats with non-participating tenants.

He also felt that the exclusion of hope value in respect of non-participating tenants would be unfair to landlords because a group of well-advised tenants could ensure that only the minimum number of them should participate in the purchase (having agreed appropriate terms with the other tenants). This would artificially reduce the price they would have to pay for the freehold, as there would be neither marriage value nor hope value in respect of the non-participating tenants' flats. In relation to participating tenants Lord Neuberger concluded that hope value cannot be included because the Act already provides for marriage value.

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Another factor supporting the notion that hope value can be sought in respect of non-participating tenants' flats was, Neuberger claimed, to be found in s18 of the 1993 Act, which requires disclosure to the landlord of any agreements made between participating tenants and non-participating tenants. This, he felt, was an acknowledgement that such agreements could affect an assessment of the price payable for the freehold of the building.

The appeals in *Earl Cadogan v 27/29 Sloane Gardens and Grandeden* [2006] were, therefore, allowed, limited to the extent that the landlord was entitled to claim hope value under paragraph 3 of Schedule 6 in relation to non-participating tenants' flats but not in relation to participating tenant's' flats.

Conclusion

This decision has clarified the issue of hope value and is considered by many enfranchisement practitioners to deliver the most equitable outcome. However, in his dissenting judgment Lord Hoffman stated his belief that the 1993 Act was clear and that the apparent mismatch between the inclusion of marriage value (for participating tenants) and the exclusion of hope value (for all tenants, by the exclusion of all tenants from the market) did not produce such an obvious injustice as to require heroic methods of construction to avoid it.

Although the House of Lords has decided that some hope value may be payable in respect of non-participating tenants it will now be the job of the Leasehold Valuation Tribunal or, on appeal, the Lands Tribunal to decide whether, and if so to what extent, hope value is payable in any particular case. ■

Custins v Hearts of Oak Benefits Society [1969] 209 EG239

Earl Cadogan v 27/29 Sloane Gardens and Grandeden [2006] EWCA Civ 1331

Earl Cadogan v Mr and Mrs Sportelli [2007] EWCA Civ 1042

Earl Cadogan v Pitts and Wang and Atlantic Telecasters Ltd [2007] EWCA Civ 1280

Earl Cadogan & ors v Sportelli & anor and two ors and Earl Cadogan v Pitts & anor [2008] UKHL 71