

# A marriage without hope

*Natasha Rees discusses the Court of Appeal's recent ruling on hope value and the correct deferment rate to be applied when determining the value of the reversion*



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**'Landlords will no longer be able to argue for higher premiums on lease extension claims and collective claims, where the premium will have to be determined solely in accordance with the provisions of the Leasehold Reform, Housing and Urban Development Act 1993.'**

On 25 October 2007 the Court of Appeal gave its long-awaited judgment on five appeals from the Lands Tribunal, collectively known as *Sportelli*. The decision has been eagerly awaited by enfranchisement practitioners because it concerns two issues of general importance in determining the price payable to the landlord on an enfranchisement claim. The issues were first, the correct deferment rate to be applied in calculating the value of the reversion, and secondly, whether an additional payment should be made in respect of the hope of releasing marriage value through deals with the tenants in the future, known as 'hope value'. The Court of Appeal also had to consider a more general issue concerning the status of the Lands Tribunal's decision in relation to future cases in the Leasehold Valuation Tribunal (LVT).

The Court of Appeal dismissed all of the appeals. It decided that the Lands Tribunal was right to reject market evidence in setting the deferment rate, which will therefore remain at 4.75% for houses and 5% for flats as set by the Lands Tribunal in 2006. It also decided that there should be no hope value payable in any type of enfranchisement claim except where it is provided for by statute. In relation to the deferment rate, the only slight glimmer of hope to tenants living outside prime central London was a comment relating to the impact of the Lands Tribunal's decision on future LVT claims. The Court of Appeal suggested that the Lands Tribunal was entitled to provide guidance for future cases relating to properties in prime central London, but that the parties were entitled to call evidence suggesting a different rate outside that area.

## Background

The valuation process is complex, but can be broken down into a number of elements. As part of the process it is necessary to determine the future value of the freehold once the lease or leases have expired, and then to give a discount for the accelerated receipt. This is done by applying an interest rate to the present freehold value or a 'deferment rate'. The level of the deferment rate can have a significant effect on the price of the freehold or lease extension, with lower rates resulting in a higher price. It for this reason that the issue of the deferment rate has been the subject of much dispute between landlords and tenants.

The second issue, known as 'hope value', is closely related to another familiar valuation concept 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 a higher value and explains why a tenant will pay more to purchase the freehold reversion than any other purchaser because it will realise this value. This extra value is known as 'marriage value' and the tenant's incentive to bid more is known as the 'tenant's overbid'. The concept of 'hope value' is closely related to these two issues. Although its meaning differs slightly under each Act, it is effectively anticipated marriage value.

## The appeals

The Court of Appeal considered five appeals, which fell into three categories. There were a total of three collective

## Reference point

For further discussion on deferment rate and the Lands Tribunal's ruling in *Sportelli and Arbib* see Kerry Glanville's article in PLJ179, 6 November 2006, p10.

enfranchisement claims and one lease extension claim under the Leasehold Reform, Housing and Urban Development Act 1993, and there was also a claim to the freehold of a house in Kensington under the Leasehold Reform Act 1967. The landlords involved in the 1993 Act claims, the Cadogan Estate and the Howard De Walden Estate, were appealing the Lands Tribunal's decision that 'hope value' should not be included in the price payable for collective enfranchisement or lease extensions under the

## *The Court of Appeal agreed with the Lands Tribunal's conclusion that hope value is to be excluded from the valuation of the landlord's interest under Schedules 6 and 13 to the 1993 Act.*

Leasehold Reform, Housing and Urban Development Act 1993. The appeal in relation to the deferment rate was brought by the participating tenants of a block known as Maybury Court on the Howard De Walden Estate and the participating tenants of a building known as 27/29 Sloane Gardens on the Cadogan Estate. They were appealing against the decision of the Lands Tribunal to reject market evidence when fixing the deferment rate.

### **The hope value issue**

As set out above, hope value represents anticipated marriage value or the expected product of the 'tenant's overbid' and is a potential element of the valuation. The question is whether the purchase price should take account of hope value, or whether it is to be treated as being reflected in the landlord's share of marriage value.

It is helpful to consider how the statutes have developed to take account of marriage value since the enactment of the Leasehold Reform Act 1967. The 1967 Act originally gave tenants of houses below a rateable value the right to enfranchise. The price was originally determined under s9(1) as:

... the amount which at the relevant time the house, if sold in the open market by a willing seller, might be expected to realise.

Initially, the tenant was assumed to be part of the market so that its 'overbid' could be included in the price. Later, however, the Housing Act 1969 excluded 'the tenant or his family from buying or seeking to buy'.

The Housing Act 1974 extended the right to acquire the freehold to higher-value houses by inserting a new s9(1A) into the 1967 Act. The tenant and their family were not excluded under this new section and it was held by the Lands Tribunal in 1976 that the tenant's overbid was not excluded under s9(1A), ie for higher-value houses. It should be noted at this point that the Commonhold and Leasehold Reform Act 2002 introduced a new statutory provision into the 1967

Act: s9(1D) relates to marriage value and provides that the landlord is entitled to half of the marriage value.

The introduction of the 1993 Act allowed tenants of flats to either extend their leases or collectively acquire their freehold. The key statutory provisions for determining the premium payable on a lease extension claim are set out in Schedule 13 to the 1993 Act. The provisions for determining the premium payable on a collective claim are set out in Schedule 6.

Unlike the 1967 Act, under the 1993 Act 'marriage value' became a distinct element of the price. The landlord was entitled to the value of its interest and not less than 50% of the 'marriage value'. The Act also provided that, in a lease extension claim, the acquiring tenant should be excluded from the market. In a collective claim the Act provided that the nominee purchaser and the participating tenants should be excluded from the marketplace. Later, under the Housing Act 1996, all of the tenants rather than just the participating tenants were excluded. The 2002 Act fixed the landlord's marriage value at 50% and stated that it was

to be disregarded for leases with more than 80 years to run.

### **The Tribunal's decision**

The Tribunal had accepted that hope value was a separate element of value that was capable of valuation, but it determined that it was excluded under Schedules 13 and 6 to the 1993 Act. In reaching its decision it had examined the amendments to s9(1) of the 1967 Act because it felt this shed light on the intended meaning of the provisions under Schedules 13 and 6 that were subsequently introduced.

On appeal, the landlords argued that the Tribunal should have concentrated on the wording of the material provisions rather than their historical analysis. They felt that the wording under Schedule 13 to the 1993 Act requires the valuer to assume that the tenant is not in the market on the valuation date, not that it will never seek a lease extension. For collective claims Schedule 6 requires the valuer to assume that neither the nominee purchaser nor any of the tenants is in the market for the whole of the landlord's interest on the valuation date. They submitted that there was nothing excluding the prospect of individual bids by lessees for lease extensions at the valuation date or in the future.

### **The Court of Appeal's decision**

The Court of Appeal agreed with the Tribunal's conclusion that hope value is to be excluded from the valuation of the landlord's interest under Schedules 6 and 13 to the 1993 Act, although its reasoning was slightly different. It referred to the clear link between hope value and marriage value, and the fact that the 1993 Act differs from the 1967 Act because there is detailed provision for the definition and allocation of marriage value. The issue, it felt, was whether there was any scope for a separate inclusion of hope value. Its conclusion was that there was no scope for this.

### **Lease extension claims**

In relation to Schedule 13 and lease extension claims, the position is clearest. The price is the value of the landlord's interest and 50% of marriage value. The tenant's overbid is to be disregarded, but this is made up by giving it a fixed share of marriage value. The Court of Appeal felt that to include a further element of hope value would involve double counting. The landlord's argument was that the exclusion of the tenant's overbid in

## Relevant parts of the 1993 Act

### Collective Claim – Schedule 6

#### Paragraph 2

(1) ... the price payable by the nominee purchaser for the freehold of the specified premises shall be the aggregate of –

- (a) the value of the freeholder's interest in the premises as determined in accordance with paragraph 3,
- (b) the freeholder's share of the marriage value as determined in accordance with paragraph 4, and
- (c) any amount of compensation payable to the freeholder under paragraph 5 (not in issue).

#### Paragraph 3

(1) ... the value of the freeholder's interest in the specified premises 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...

#### Paragraph 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) such proportion of that amount as is determined by agreement between the reversioner and the nominee purchaser or, in default of agreement, as is determined by a leasehold valuation tribunal to be the proportion which in its opinion would have been determined by an agreement made at the valuation date between the parties on a sale on the open market by a willing seller, or
  - (b) 50% of that amount,
- whichever is the greater.

### Lease Extension Claim – Schedule 13

#### Paragraph 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 tenant's flat as determined in accordance with paragraph 3,
- (b) the landlord's share of the marriage value as determined in accordance with paragraph 4, and
- (c) any amount of compensation payable to the landlord under paragraph 5 (not in issue).

#### Paragraph 3

(1) The diminution in value of the landlord's interest is the difference between –

- (a) the value of the landlord's interest in the tenant's flat prior to the grant of the new lease, and
- (b) the value of his interest in the flat once the new lease is granted.

(2) Subject to the provisions of this paragraph, the value of any such interest of the landlord as is mentioned in sub-paragraph (1)(a) or (b) 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 the tenant not buying or seeking to buy) on the following assumptions...

#### Paragraph 4

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

- (a) such proportion of that amount as is determined by agreement between the landlord and the tenant or, in default of agreement, as is determined by a leasehold valuation tribunal to be the proportion which in its opinion would have been determined by an agreement made at the valuation date between the parties on a sale on the open market by a willing seller, or
  - (b) 50% of that amount,
- whichever is the greater.

Schedule 13 was directed only at the valuation date and not at the future. This meant that it should be able to include hope value to cover the prospect of future bids. The Court of Appeal thought that this interpretation was too narrow and that the words 'the tenant buying or seeking to buy' showed an intention to exclude the tenant's overbid for all time, ie now and in the future. It felt this was the natural reading of the paragraph in context, and was also in line with the interpretation adopted by the Tribunal in the first cases under the Leasehold Reform Act 1967.

### Collective claims

In relation to Schedule 6 and collective claims the Court of Appeal accepted that

the position was more complex because of the different parties involved. They rejected the landlord's argument that the only matter to be disregarded under Schedule 6 is a bid by the nominee purchaser or the tenants for the whole of the landlord's interest, ie the freehold on the valuation date. If this were true, the Act would have excluded a bid by the tenants for a 999-year lease, which is almost equivalent to a freehold. It therefore rejected this narrow interpretation and concluded that the words 'buying or seeking to buy' (Schedule 6, para 3) covered the prospect of acquisition by the nominee purchaser or the tenants of any interests from the landlord, now or in the future. This does give rise to anomalies because under

paragraph 4 of Schedule 6, which provides for the landlord's share of marriage value, only being granted in respect of the interests of the participating tenants. The result is that the landlord only realises its share of marriage value in relation to the participating tenants, but receives nothing for the prospective marriage value of the leases belonging to the non-participating tenants. The Court of Appeal ruled, however, that this must have been a matter of deliberate legislative policy. It felt that there was no basis for the court to seek to redress the balance by bringing back hope value by a different interpretative route, whether generally or, as Howard De Walden argued, only for non-participating tenants.

### House claims

Hope value under the 1967 Act was not in issue in this appeal. However, the Court of Appeal made it clear that its view was that 'hope value' was not payable under s9(1A). The Tribunal had concluded that since the tenant was not excluded from the market (as it is under the 1993 Act), hope value could be included in the valuation of the landlord's interest. The Court of Appeal felt that the Tribunal was wrong to ignore the context of the section as a whole, which should have included the specific provision for allocation of marriage value under s9(1D), a section that was introduced by the Commonhold and Leasehold Reform Act 2002. It therefore endorsed the revised view of the Tribunal as expressed in the case of *Pitts & anr v Earl Cadogan: Earl Cadogan v Atlantic Telecasters Ltd* [2007]. In that case the Tribunal decided that hope value cannot be included as an element in the valuation of the landlord's interest under s9(1A) because s9(1D) provides for a 50:50 split of the marriage value between landlord and tenant.

### The deferment rate issue

The Tribunal has ruled twice on the issue of the deferment rate. In its first attempt, known as the *Arbib* appeals, the Tribunal rejected the traditionally adopted rate of 6%, which had historically been based on settlement evidence, and decided to rely on the evidence of financial experts to assess the appropriate rate, despite a rather significant lack of expert financial evidence. In doing so it concluded that the new measure should be based on index-linked gilts that it adjusted to take account of inflation. The resulting yields were 4.5% for houses and 4.75% for flats. The decision itself advised against reliance on convention or precedents and left many issues open.

It was soon followed, therefore, by a further group of appeals that came to be known as the *Sportelli* appeals. The preliminary issues in these appeals were heard by the Tribunal in August 2006. In *Sportelli* the Tribunal followed the methodology used in *Arbib*. It rejected market evidence and relied upon financial market evidence to determine a slightly higher deferment rate of 4.75% for houses and 5% for flats. It determined that the deferment rate comprised a risk-free rate of return that it derived from an index-linked non-interest bearing gilt. It then

deducted a real growth rate and added a risk premium.

The issue in this appeal was the Tribunal's treatment, or the 'rejection', of the market evidence. This evidence was only adopted by Mr Beckett for the tenants of Maybury Court. Stephen Jourdon, arguing for the tenants, accepted that he could only succeed on this appeal if he could establish an error of law in the Tribunal's reasoning. This would include irrationality, or failure to have regard to a material issue. He felt that the market evidence should not have been rejected. The Court of Appeal felt that despite his persuasive arguments, this was not the case. It felt that the Tribunal's approach was in line with the majority of the experts and that the Tribunal had given Mr Beckett's evidence careful attention. In view of this, the appeal was dismissed.

### The status of the Tribunal's decision

Although this was not strictly an issue in the appeal, the Court of Appeal commented on the precedent effect of the Tribunal's decision. It did not lay down any strict guidelines because the Tribunals Courts and Enforcement Act 2007 will result in a new Upper Tribunal, which should take the lead on this. However, it did differentiate between the precedent effect for properties inside prime central London (PCL) and those outside PCL. The cases that were the subject of the appeal to the Tribunal had related to properties within the PCL area and the evidence was directed principally to the market within that area. Although the issues within PCL were fully examined by the Tribunal, this was not the case with areas outside PCL. In view of this the Court of Appeal suggested that it would be open to tenants of properties outside PCL to try to introduce evidence that may suggest a higher deferment rate.

### Conclusion

This long-awaited decision has, for the time being, clarified the issue of hope value. Landlords will no longer be able to argue for higher premiums on lease extension claims and collective claims, where the premium will have to be determined solely in accordance with the provisions of the 1993 Act. The decision also suggests that hope value should be excluded under the 1967 Act in accordance with the decision in *Pitts & anr v Earl Cadogan: Earl Cadogan v Atlantic Telecasters Ltd*. It appears,

however, that the landlords have not yet given up hope. It is understood that, at the time of writing, both the Cadogan Estate and the Howard De Walden Estate are applying to the House of Lords for permission to appeal.

On the issue of the deferment rate it seems that the Tribunal's decision will remain a definitive statement for properties in PCL. For tenants outside PCL it is open to them to try to push the deferment rate up based on an argument that the risk premium is higher. This will not be easy. A substantial proportion of the evidence before the Tribunal – both financial and market evidence – suggested that location did not impact on the deferment rate. However, if it could be shown that price volatility is greater in the suburbs and outside London than in PCL then that would support the argument that risks are greater. Also, if it could be shown that the values of properties in secondary locations fall faster and stay down longer when there is a recession, this might also support such an argument. The door has been opened slightly to tenants outside PCL and it remains to be seen whether they will be able to obtain the evidence they need to test these arguments in the LVT. ■

#### Arbib appeals:

*James Ashley Arbib v Earl Cadogan*  
[2005] LRA/23/2004

*Earl Cadogan & anr v 55/57 Cadogan Square Freehold Ltd*  
[2005] LRA/62/2004

*Earl Cadogan v Dorrit Moussaieff*  
[2005] LRA/8/2005

*Hugo Benjamin Day & anr v 32 Rosary Gardens (Freehold) Ltd*  
[2005] LRA/87/2004

*Earl Cadogan & anr re: 9 Astell Street and Garage 8 Britten Street*  
[2005] LRA/18/2005

#### Sportelli appeals:

*Earl Cadogan & anr v Sportelli & anr: Earl Cadogan & anr v 27-29 Sloane Gardens Ltd & anr: Earl Cadogan & anr Grandeden Property Management Ltd: Howard de Walden Estates Ltd v Maybury Court Freehold Co Ltd*  
[2007] EWCA Civ 1042

*Pitts & anr v Earl Cadogan: Earl Cadogan v Atlantic Telecasters Ltd*  
(2007) 42 EG 296