Natasha Rees looks at interesting legal appeals in the world of enfranchisement over the past year, including the prominent **Hosebay** decision and its implications

Home truths

Appeals in 2012 covered issues ranging from the deferment rate to the common problem of development value, with the year culminating in the long-awaited decision in the two appeals collectively known as Hosebay, where the Supreme Court considered what constitutes a 'house' under the Leasehold Reform Act 1967.

Development value

When faced with a collective enfranchisement claim, freeholders often seek an extra sum in addition to the premium to compensate them for the loss of any 'development value'. Flat owners resent having to pay development value, because it inflates the premium and is payable even if they have no intention of undertaking the development required to unlock it. Common forms of development include the building of new flats on unused roof space or the conversion of flats into houses.

The sums involved in cases concerning development value can be considerable, especially in central London. There were two notable appeals to the Upper Tribunal (UT) concerning development value last year: Kutchukian v The Free Grammar School of John Lyon [2012] and Cravecrest Ltd v the Sixth Duke of Westminster [2012]. Both concerned collective enfranchisement claims under the Leasehold Reform Housing and Urban Development Act 1993.

In *Kutchukian*, the property was a house on the John Lyon's estate in London that had been converted into four flats. It was also subject to a head lease that contained a restrictive covenant preventing the house from being used as a single dwelling. The UT had to consider whether the same restrictive covenant should be imposed in the freehold transfer and how the development opportunity should be valued. It was common ground that the building was much more valuable if there was no restrictive covenant.

At the date of the claim the difference in value was about £3m. The UT decided that the restriction did not 'materially enhance' the value of other property in the vicinity. The main reason for this conclusion was that there was already an Estate Management Scheme (EMS) in place, regulating the use or appearance of a property within an area by imposing restrictive covenants on freeholders. The existence of the EMS meant that an extra covenant restricting the use of the building would have little impact on the surrounding area. The UT also felt that the freeholder was merely seeking to retain the restrictive covenant for its ransom value. As a result, the freehold was transferred without any restriction.

On the development value issue, the UT had to consider what discounts should be applied to the current value to reflect the risks and uncertainties of realising a development value in 2046, the year of the reversion. It decided that the uplift in value should be discounted by 70%. This comprised a 5% discount for the uncertainty of obtaining planning permission in 2046, a discount of 35% for a change in market conditions making redevelopment less profitable and a further 30% to reflect the legal uncertainties regarding the recovering of possession of the flats.

This case has since been appealed (see Further info), but it does illustrate that when acquiring the freehold, tenants can succeed in removing existing restrictive covenants, although this may have cost consequences.

Cravecrest also concerned development value on a collective claim relating to a house converted into flats. In this case, the underleases only had a few days left to run so the development value was potentially immediately realisable rather than having to wait until 2046. A number of intermediate leases were a complicating factor. It was agreed that the uplift in value in this case was approximately £2m. The main issues on appeal were whether development value could be claimed and, if so, how it should be valued. The UT decided that the nominee purchaser did have to pay something in respect of the ability to convert the building back into a house, even though there were intermediate leasehold interests. The decision also gives useful guidance on how to value the landlords' respective interests.

Deferment rate

Another common valuation issue is the level of the

Image © Alamy

deferment rate to be applied when calculating the premium. The deferment rate is the annual discount applied to the anticipated future value of the freehold to arrive at its current value. A higher deferment rate produces a lower premium.

The rate for leases of more than 20 years was effectively set at 4.75% for houses and 5% for flats by the case known as Sportelli [2007]. Following several subsequent decisions, it has become clear that in areas outside prime central London there is scope to argue a higher deferment rate to reflect the greater risk of deterioration and obsolescence and the prospect of lower growth. It is also possible in all cases to seek a higher deferment rate to reflect the management burden associated with flats.

However, proper evidence is required before a tribunal will move from the generic rate. The case of City and County Properties Ltd v Yeats [2012] UKUT 227 illustrates the level of evidence required. The appeal concerned a lease extension claim of a flat in a building in Horsham, Surrey. The Leasehold Valuation Tribunal (LVT) described the building as unattractive, tired and poorly maintained and determined a rate of 6%.

On appeal, the UT found that the correct deferment rate was 5.5%. It agreed with the LVT that an extra 0.25% should be added for obsolescence and also added 0.25% for the risks associated with residential block management. But it did not agree with the LVT that the rate should be increased to reflect a slower growth rate, believing that the evidence of market movements in Horsham was not strong enough and did not go back far enough to demonstrate a significantly slower growth than in prime central London. The UT said evidence of growth would need to date back at least 15 years, and the best evidence would date back 50.

Hosebay appeals

The *Hosebay* appeals, brought by two central London landed estates, challenged a Court of Appeal decision that a property used wholly for commercial purposes could qualify as a 'house' for the purposes of enfranchisement. In a decision on 10 October 2012, the Supreme Court unanimously allowed both appeals.

The appeals followed the removal of the residence condition for enfranchisement claims in 2003. Before this, the question of whether a building was a 'house' was relatively straightforward, because the tenant had to live in the building. After the residence test was removed, investors and commercial tenants could also seek to enfranchise, which led to claims by tenants of buildings in a variety of uses.

> "The key problem is that many buildings remain designed or adapted for residential use, but are used as offices or hotels

The test of whether a building is a 'house' under Section 2(1) of the Leasehold Reform Act contains two separate parts: the building must be 'designed or adapted for living in', and it must be 'a house reasonably so called'. The Supreme Court stated that both parts of the two-stage test are complementary and overlapping, but both need to be satisfied at the date the notice is served. When considering whether a house is 'designed or adapted for living in', the identity or function of the building based on its physical characteristics must be looked at.

When deciding whether a building can 'reasonably be called a house', it must be considered whether it is a 'single residence', as opposed to a hostel or block of flats and whether it is a place to live, rather than as a piece of architecture or street scene.

On this basis, the Supreme Court judges concluded that the buildings in the *Day v Hosebay* appeal (houses that had been converted into flatlets as short-term student or visitor accommodation) could not reasonably be called houses. That the buildings might look like houses or be referred to as houses was not sufficient to displace the fact that the use was entirely commercial. On the earlier conjoined appeal of Howard de Walden v Lexgorge, concerning a town house in Marylebone sublet as offices to a legal firm, they decided that since the building was wholly used as commercial offices it could not be a 'house reasonably so called'.

The judgment was clearly aimed at closing the loophole that allowed tenants of buildings wholly in commercial use to seek to acquire their freehold. Consequently, numerous claims, including for significant buildings in Mayfair, Harley Street and Chelsea, have been withdrawn.

Practitioners must now consider how best to apply the test in future. The judgment showed it will be necessary to consider the property's internal and external characteristics and its current use at the date the claim is made. If the 'function' is to be lived in, it will be a 'house' for the Act's purposes.

The key problem is that there are many buildings that remain designed or adapted for residential use, but are used as offices or hotels. Since it is the use of the building at the date the notice is served that must be considered, it appears that a tenant need only arrange for such a building to be vacated to make a claim. It is also difficult to see how the test is applied to a mixed-use building, or to one that has been stripped out so that the previous design or adaptation is not apparent.

Another issue that may arise is what constitutes commercial use. Houses can be let out in a number of different ways. In *Hosebay*, the Supreme Court decided that short-term letting of studio flatlets was a commercial use. On this basis, it decided that the buildings could not 'reasonably be called a house'. However, where a property is subdivided into flats that are let for slightly longer periods, at what point does the building become a place to 'live in', rather than a business? Although the judgment is clear that a building wholly in commercial use will not qualify, it is not the final word on 'houses' that everyone had hoped for. ®

Natasha Rees is a Property Litigation Partner at Forsters LLP
natasha.rees@forsters.co.uk

Further +info

As *Property Journal* was going to press, the Court of Appeal gave judgment on the *Kutchukian* appeal. The court dismissed appeals by the nominee purchaser, Mr Kutchukian, and ruled in favour of the landlord, John Lyon's Charity, that the UT had wrongly applied a 30% discount for uncertainty in respect of 'legal problems'. As a result of this decision, the cost of the freehold has almost doubled.

Related competencies include
T048, T083