



SPORTELLI

HAS HOPE YIELDED IN DEFERENCE TO MARRIAGE?

The eagerly anticipated (at least in the world of leasehold enfranchisement) decision of the court of appeal in the case of *Earl Cadogan & Others v. Sportelli and others* [2007] EWCA CIV 1042 was handed down on 25 October 2007. For those expecting something controversial or ground-breaking, it is a disappointment. All the appeals were dismissed and the earlier decision of the lands tribunal (LRA/38&40/2005) stands. However, the issues that the case raised are not easy and the court clearly struggled to deal with them.



Statutory background

Various statutes since 1967 have conferred on owners of long leases of houses or flats rights to “enfranchise” by buying out (individually or collectively with other lessees) the reversionary interests, or simply to extend their leases for defined periods (50 years for houses and 90 years for flats). For ease of reference these rights can be referred to generally as “enfranchisement rights”. The first such statute was the Leasehold Reform Act 1967, which applied to houses. It was followed in 1993 by the Leasehold Reform, Housing and Urban Development Act which applied enfranchisement rights to flats. Over the years, both Acts have been substantially amended, with the intention of reducing the qualifying conditions for the exercise of enfranchisement rights and to make the enfranchisement process simpler. The result is that the legislation is unusually complex, reflecting the draftsman’s attempts to realise Parliament’s not always consistent or indeed understandable objectives within the intricacies of landlord and tenant law. There are now broadly four different rights of enfranchisement.

Under the 1967 Act

1. The right of the tenant of a leasehold house to acquire the freehold
2. the right of a tenant of a leasehold house to acquire an extended lease

Under the 1993 Act

1. The right of the tenant of a leasehold flat to acquire an extended lease
2. the right of the tenants of leasehold flats within a building acting collectively to acquire the freehold of that building.

The Appeals

The Sportelli appeals (and there were four consolidated cases) were concerned with two preliminary issues arising from the rights given to tenants by the 1993 Act, directed by the Lands Tribunal, to determine:

- (i) “the proper deferment rate to be applied to vacant possession value”; and
- (ii) “the proper valuation of any ‘hope value’”.

A further general issue had been raised as to the status of the Tribunal’s decision in relation to future cases in the Leasehold Valuation Tribunal (“LVT”). The LVT has primary jurisdiction to determine valuation disputes in enfranchisement cases with a right of appeal (with leave) to the Lands Tribunal.

The 1967 and 1993 Acts each set out machinery for the assessment of the price at which the freeholder’s interest (or the extended lease) is to be acquired. These are found in section 9 of the 1967 Act and Schedules 6 and 13 of the 1993 Act. In principle

the price is fixed by reference to the market value of the interest, as it would be if unaffected by the existence of the statutory rights (what has become known generally, but not wholly accurately, as “the no-Act world”). This is in practice treated as including 1) the value of the right to receive a rent during the term of the lease and 2) the value of the prospective right to vacant possession at the end of the term. The latter, conventionally, is determined by taking the open market value of the freehold interest with vacant possession at the valuation date, and then discounting that value over the unexpired term of the lease, by application of a “deferment rate”. The deferment rate, in the definition adopted by the Tribunal, is:

“the annual discount applied, on a compound basis, to an anticipated future receipt (assessed at current prices) to arrive at its market value at [the valuation date]”.

That was the subject of the first preliminary issue.

The second preliminary issue derives from the assumption that the market value of the unencumbered freehold in any property will nearly always exceed

WHETHER OR NOT, AS A MATTER OF STATUTORY CONSTRUCTION, THE LEGISLATION ALLOWS “HOPE VALUE” TO FORM PART OF THE STATUTORY VALUATION WAS THE SUBJECT OF THE SECOND PRELIMINARY ISSUE.

the aggregate of the values of the interests of the tenant and reversioner considered separately. That excess is known as “marriage value”. In the real world therefore, a tenant is willing to pay more for the reversionary interest in his property than other potential purchasers – “the tenant’s overbid”. However, it is argued that those other potential purchasers of the reversioner’s interest will pay something more than just the capitalised value of the rent and the value of the right to recover possession at the end of the term because there will be the expectation that, at some point before the end of the lease term, they will be able to sell the freehold or a longer lease to the tenant and thereby release (and share in) the marriage value. That expectation is called “hope value”.

Whether or not, as a matter of statutory construction, the legislation allows “hope value” to form part of the statutory valuation was the subject of the second preliminary issue.

Hope Value

The court considered first the issue of “hope value”. The Tribunal had accepted that in principle “hope value” was identifiable as a separate “element of value” and capable of valuation as such. However, it decided that “hope value” could not, as a matter of statutory construction, be included in the valuation to determine the price to be paid by the tenant for an extended lease under the 1993 Act (the valuation

machinery being set out in Schedule 13 to the Act) or the price to be paid by the tenants collectively for the freehold under the 1993 Act (the valuation machinery being set out in Schedule 6 to the Act). The Tribunal had based its decision broadly on the legislative history of the valuation machinery under the 1967 Act. The Court of Appeal upheld the decision of the Tribunal but for different reasons.

The court stated that hope value and marriage value are directly linked. Hope value represents no more than the anticipation of future marriage value. The scheme of the 1993 Act contains detailed provision for the definition and allocation of marriage value, as a separate element of the price payable to the landlord. The question for the court was whether that left any scope for the separate inclusion of hope value. In the view of the court, it did not.

Schedule 13 1993 Act

Under schedule 13, the price to be paid by the tenant for the extended lease is made up primarily of two elements:

- 1) the value of the landlord’s interest with the tenant excluded from the market
- 2) 50% of the marriage value.

What the court said was that, since the landlord is receiving a share of marriage value under 2), it would be double counting if he also receives “hope value” (determined by reference to anticipated marriage value) under

1). You cannot value hope and the realisation of that hope in the same equation. Furthermore, the words used by the statute to exclude the tenant from the market at the valuation date “the tenant (not) buying or seeking to buy” must be read in a purposive sense, as referring to the acquisition of any interest from the landlord, not only at the valuation date but also at any time in the future. If the tenant is never to be in the market, there can be no expectation of future marriage value and hence no hope value.

This analysis is not without difficulty. Once the court had accepted that marriage value was the additional value to be unlocked only by the tenant, for which he would make his overbid, then the question must arise; additional to what? The answer is the amount to be paid by the third party investor on the assumption that the tenant is not in the market at the valuation date. That third party investor will pay hope value and marriage value is thence the additional amount the tenant will pay above that. It is not double counting but merely moving part of the value from the marriage value (which thereby reduces) to the investment value (which thereby increases). The conclusion that the statutory exclusion of the tenant from the market applies not only at the valuation date but also for all time, requires additional words to be impliedly added in order to give the statute its “purposive” meaning.



Schedule 6 1993 Act

In relation to collective enfranchisement, the court accepted that the position was more complex. Unlike Schedule 13, there is no exact match between the exclusion of the tenants from the assumed market for the value of the landlord's interest and the share of marriage value. All the tenants are excluded from the assumed market, but the landlord's share of marriage value is limited to that arising from the interests of the participating tenants. In relation to non-participating tenants, there is no specific provision for a share of marriage value to be taken into account.

The court pointed out that this was a change from the 1993 Act as originally enacted where only the participating tenants were excluded from the assumed market. Potential bids for lease extensions from non-participating tenants were not excluded from open market value. The court said that the effect of amendments made to Schedule 6 by the Housing Act 1996 seems to have been to leave the position unchanged in respect of participating tenants, but to remove hope value for non-participating tenants. The court took this to be a matter of deliberate legislative policy.

The court accepted (as it clearly had to do) that its decision in relation to collective claims gives rise to anomalies for which it was not able to offer any sensible solutions. First, while the landlord is paid for marriage value in respect of the leases of participating tenants, he receives nothing for the prospective marriage value of the other leases, which the nominee purchaser is left free to exploit without having had to pay for it. Secondly, it is not obviously purposive why a specific exception is made to have regard in the valuation, only to the interests of non-participating tenants who have served a notice under section 42 of the 1993 Act claiming an extended lease. Thirdly, it becomes difficult to explain the purpose of the requirement for the disclosure of agreements under section 18. The court accepted that the requirement to disclose agreements involving non-participating tenants seems to have little purpose if the additional value reflected in such agreements has no effect on the price payable to the landlord. This seems odd given that the whole purpose of section 18 was to provide a landlord with a remedy in those cases where the number of participating tenants is artificially kept to the minimum in order to avoid payment of marriage value.

Section 9(1A) 1967 Act

Although the Tribunal considered the issue of hope value under section 9(1A) of the 1967 Act, this was not part of the appeal. Nevertheless the court expressed a view. In *Sportelli*, the Tribunal had decided that hope value could be part of the statutory valuation under section 9(1A). However, in a subsequent case *Pitts and Wang v Cadogan* (LRA/79/2006, LRA/4/2007), it came to the opposite view and decided that it could not. That case is the subject of a separate appeal to the Court of Appeal. The court nevertheless decided that the Tribunal in *Sportelli* had erred by having regard only to the exclusion of the tenant's overbid under sub-section 9(1A), and ignoring the context of the section as a whole, including the specific provision for allocation of marriage value.

The current position therefore is, save in the specific case of a section 42 notice given by a non-participating tenant in a collective claim under the 1993 Act, hope value plays no part in the statutory valuations under the 1967 Act or the 1993 Act.

Deferment Rate

On the issue of the deferment rate, the Tribunal in *Sportelli* heard evidence from four financial experts and four property valuers, together with extensive legal argument, over a period of 11 days. As the court said "it is difficult to envisage a better qualified panel of experts for the purpose than those called in this case, or of specialist counsel on both sides of the argument". *Sportelli* was heard by a three-member panel of the Tribunal presided over by the President. It followed two earlier cases in the Tribunal on the deferment rate issue: *Cadogan Holdings Ltd v Pockney* (LRA/27/2003, 19 May 2004)

where the Tribunal (N J Rose FRICS) held that a deferment rate of 5.25% in respect of a house in the Prime Central London (PCL) area was not too low and *Arbib v Earl Cadogan* [2005] 3 EGLR 139, where the Tribunal (HH Judge Michael Rich QC and P H Clarke FRICS) considered together five cases and determined a rate for the PCL area of 4.5% for houses and 4.75% for flats.

The Tribunal had rejected the deferment rate (7%) derived from open market evidence given by one of the property valuers in favour of a deferment rate derived by reference to a formula (familiar to financial analysts); $DR = RFR - RGR + RP$ (deferment rate equals risk-free rate minus real growth rate plus risk premium). Applying that approach they had arrived at the following:

1. Risk free rate: 2.25%; less
2. real growth rate: 2%; plus
3. risk premium: (for houses) 4.5%; (for flats) 4.75%; resulting in
4. deferment rate: (for houses) 4.75%, (for flats) 5%. (The higher rate for flats was intended to reflect "the greater management problems associated with flats")

The appeal was on the basis that the Tribunal had erred in law by irrationally rejecting the market evidence which suggested a higher rate. It was however accepted by the court that the market in the real world and the hypothetical market that the Act required for the purpose of the statutory valuation, were substantially different and it could not therefore be irrational for the Tribunal to reject evidence that came from a market which was so different from the market that the Act assumes. The appeal therefore failed.

Effect of Lands Tribunal decisions.

Finally, the court chose to comment on the Tribunal's guidance on the future effect of its decision as a precedent for LVTs. This was not strictly an issue in the appeal, since it did not affect the result but the observations made by the Tribunal on this point in its decision had been the subject of criticism. What the Tribunal did was to invite LVTs to adopt the deferment rates determined by them as the generic rates for the country as a whole, in the absence of compelling evidence to the contrary. As the Tribunal put it:

"This is justified because, as we have explained above, the deferment rate is unlikely to vary according to factors particular to the individual case. Some factors, including in particular the prospect of long-term growth, will not vary from case to case, while other factors, such as location and obsolescence, will already be reflected in the vacant possession value."

The Tribunal had gone on to say that the deferment rate could be treated as stable over time and it would require a trend movement in the risk-free rate, an established change in the long-term prospects for growth in residential property or some other compelling reason for the rate to be different. It was accepted that each case needed to be considered on its own facts but LVT's would need to be satisfied that there

were factors not reflected in the vacant possession value or in the rate itself that would justify a departure from the guidance rates.

The court agreed with the Tribunal that an important part of its role is to promote consistent practice in land valuation matters. It was therefore appropriate for the Tribunal to offer guidance and to expect LVT's generally to follow it. However, the court did think that, having heard evidence solely in relation to properties within the PCL area, there must be an implicit distinction to be made between PCL and other areas. As the court put it:

"That must leave the way open to the possibility of further evidence being called by other parties in other cases directly concerned with different areas. The deferment rate adopted by the Tribunal will no doubt be the starting point; and their conclusions on the methodology, including the limitations of market evidence, are likely to remain valid. However, it is possible to envisage other evidence being called, for example, on issues relevant to the risk premium for residential property in different areas."

This may appear to open a door that had been firmly closed by the Tribunal. However, that may not be easy to achieve. The court has endorsed the Tribunal's general approach to and the methodology used to calculate the deferment rate, and has indicated that the generic rate determined by the Tribunal is to be the starting point. The example given of what might be relevant evidence is the risk premium. The component parts of that, according to the Tribunal, are volatility, illiquidity, deterioration and obsolescence. What evidence is likely to be available of long-term regional variations in these factors? Market evidence, settlement evidence and previous decisions of tribunals on matters of fact and valuation evidence are all discredited as useful evidence and unlikely therefore to be of benefit. It is difficult to think of what evidence might usefully be called.

Is this the end of this particular battle? Maybe, although it is quite likely that one or more of the parties will seek leave to appeal to House of Lords, particular on the issue of hope value. In the meantime the regional valuers will no doubt be trying to find some evidence which can help them wedge open the door that the Court of Appeal has at least unlocked.



Damian Greenish

Direct dial: 020 7591 3350

Email: d.greenish@pglaw.co.uk