LEASEHOLD AND FREEHOLD REFORM BILL

SUBMISSION ON THE NEW VALUATION REGIME (SCHEDULE 2)

by

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On Behalf Of

MARR-JOHNSON & STEVENS LLP, Chartered Surveyors (the Firm)

INTRODUCTION

1. The Leasehold and Freehold Reform Bill 2023 (LFRB) does away with the valuation provisions of s.9 LRA 1967 and Schedules 6 & 13 LRHUDA 1993 and replaces them with (so far as is possible) a single uniform valuation regime, set out in Schedules 2 and 3.

2. As practitioners in Leasehold Reform valuations we have an interest in the proposed legislation being workable from the beginning so that our clients, landlords and tenants alike, can deal with claims under the new regime quickly and efficiently.

3. This submission deals only with Schedule 2; we have no comments in respect of Schedule 3. At the Appendix is a summary of the Firm's observations on the workings of Schedule 2. Please note that the paragraph numbering in the Appendix corresponds to the relevant paragraph in Schedule 2.

4. This submission is an impartial commentary on the workings of Schedule 2. It offers no opinion on the merits or otherwise of the reforms generally.

QUALIFICATIONS & EXPERIENCE

5. Timothy Martin is a qualified Chartered Surveyor and Registered Valuer, with 32 years' experience of valuing residential leasehold property. He has an honours degree in Estate Management, is a chartered surveyor (qualified in 1998) and a RICS Registered Valuer. He is a partner in Marr-Johnson & Stevens LLP, a firm of property valuers.

6. Tim specialises in residential professional valuation work for landlord & tenant, statutory, tax, and family purposes, mainly but not exclusively in London. Of that, the majority of his work relates to the Leasehold Reform Acts.

7. Leasehold Reform valuations are statutory valuations and require a detailed knowledge of not just the relevant Leasehold Reform legislation, but a great deal of other legislation that can impact the valuations as well. In common with many Leasehold Reform valuers, Tim has extensive experience in report writing, negotiation and expert witness work.

8. Prior to joining Marr-Johnson & Stevens Tim spent 11 years as an asset manager with Grosvenor, during which time he qualified as a chartered surveyor.

EXECUTIVE SUMMARY

9. If the established (albeit imperfect) valuation regimes under LRA 1967 and LRHUDA 1993 are to be replaced altogether, it is essential that the new regime works. In our opinion, in order for it to do so further clarification and some amendment is required.

10. We make the following principal points in the Appendix:

    a. If it is advantageous to one or other party to the claim for the valuation to fall outside the Standard Valuation Method (SVM) we can see a fresh area for disputes where none currently arises.

    b. One of those areas of dispute will be in determining what is a Market Rack Rent Lease and what is a Market Rack Rent for the purposes of paragraph 8 of Part 3. The current definitions would benefit from greater clarity. Further, in the case of old leases there will be a need for historical research, an area of work which does not currently arise.

    c. Assumption 1 in Part 4 inevitably includes marriage value in situations where the Market Value is in respect of multiple landlord interests. In case this is not what was intended we suggest a possible amendment.

    d. Assumption 3 abolishes s.3(3) of LRA 1967 to the extent that it applies to the disregard of improvements. This may be deliberate but, if so, we warn that there are situations in which unintended consequences arise.

    e. The provisions in relation to the right to hold over in Part 4 would benefit from clarification. In particular, the right to hold over can arise under different statutes, and it is not clear why only the right to an assured tenancy should be expressly taken into account. Further, in our experience the right to hold over can affect the valuation when there is more than 5 years of the term remaining, and the effect of the proposed time limit is therefore to introduce a somewhat arbitrary cut-off and create a cliff-edge in the valuation. We suggest that extending the cut-off to 10 years would remedy this to a very large extent, as in our experience discounts beyond that point either do not arise at all or are so small as to barely affect the valuation.

    f. Step 1 in Part 5 seems unduly complicated. Further, Assumption 1 could cause rent that is in reality paid to an intermediate landlord to be overvalued.

    g. In respect of the notional rent (0.1% of freehold value), the definition of FHVP value used as the basis for establishing the notional rent would benefit from clarification. Further, we believe the exception to the notional rent in paragraph 23(7) needs to be reconsidered to take account of situations where the consideration for the grant of the lease was non-monetary but nevertheless comprised real value (such as the surrender of a prior lease or an obligation to build). Again, we envisage that this matter could become a new area of dispute generally.

    h. Although the issue of setting the deferment and capitalisation rates is outside the ambit of the LFRB because it is to be done by the Secretary of State by separate regulation, two important points arise.

i. It is critical that when the capitalisation and deferment rates are set in the first round of regulation they must be introduced simultaneously with enactment of the LFRB. This is because upon enactment the LFRB will do away with all the various valuation provisions of s.9 LRA 1967 and Schedules 6 & 13 LRHUDA 1993, but cannot become operable until the rates are set. Thus, if the new rates are not introduced simultaneously there will inevitably be a hiatus during which it will be impossible to carry out any valuations at all (under either the old or new regime), and therefore complete any claims. This would seem highly undesirable.

ii. It seems to us therefore essential that the capitalisation and deferment rates are set before the LFRB is enacted, but it is not clear how far advanced that work is, nor whether such work will delay enactment.

i. Secondly, we believe the proposal to review capitalisation and deferment rates every 10 years will produce an artificial and undesirable 'cliff-edge' in the market. We suggest an alternative approach to implementing the rates that we believe would avoid sudden changes.

j. Thirdly, our reading of the LFRB is that the proposed prescribed capitalisation and deferment rates will only apply to valuations that fall within the SVM. That being so, we believe this will make determining whether a valuation is inside or outside the SVM an area of contention that does not currently exist.

k. We believe the loss suffered by eligible persons in Part 6 needs to be more clearly defined and more valuation assumptions and / or guidance provided.

l. We believe the formulae for capitalising rent in Part 7 is suitable for valuing rent that is paid annually in arrears. Under more modern leases rents are paid quarterly in advance and in those cases the formulae undervalue the rent, albeit not significantly.

m. Finally, we highlight the difficulties in the proposal to determine the capitalisation rate.

11. We hope our comments are helpful.

Timothy Martin BSC (Hons) MRICS
For and on Behalf of
Marr-Johnson & Stevens LLP

19th January 2024

Appendix: Detailed Commentary on Schedule 2 of the Leasehold & Freehold Reform Bill

APPENDIX

LEASEHOLD & FREEHOLD REFORM BILL - SCHEDULES 2 & 3

DISCUSSION OF THE KEY VALUATION POINTS

PART 1		
INTRODUCTION		
PARAGRAPH	**WHAT THE PARAGRAPH SAYS (BROADLY)**	**M-JS COMMENTS**
1(2)		NO COMMENTS
PART 2		
THE MARKET VALUE		
PARAGRAPH	**WHAT THE PARAGRAPH SAYS (BROADLY)**	**M-JS COMMENTS**
		NO COMMENTS

PART 3		
DETERMINING THE MARKET VALUE		
PARAGRAPH	**WHAT THE PARAGRAPH SAYS (BROADLY)**	**M-JS COMMENTS**
Use of the Standard Valuation Method (SVM) & Exceptions		
5(1), (2) & (3)	SVM must be used (whether that be the whole or a part or parts of the property), except in the case of:	Default is that the SVM is compulsory except in specific circumstances. We envisage there will be disputes as to whether the claimant's property falls within or outside the SVM because, if outside, our interpretation of the SVM is that the prescribed capitalisation & deferment rates will not apply. This is of course an area of dispute that currently does not exist.
6	Leases with UXT of <5 years at the valuation date	
7	Home finance plan lease (e.g. equity release, rent to buy [and sharia compliant leases?] etc)	Valuers would not be able to tell whether the relevant lease meets these criteria. This would be a matter for legal advice.
8 (2) & (3)	Market rack rent leases defined as: (a) A lease that was granted for no premium, or one that was low relative to the value of the FHVP of the property at the grant of the lease, (b) A lease that was granted at a market rack rent, and	(a) The definition of a low premium is vague. What does "low" mean? In who's opinion? What if the lease was granted for a low premium because part of the consideration was the surrender of a prior lease, or no premium because it was a building lease? What if the recitals don't make it clear and a later assignee doesn't know the history of the property? The

	(c) The parties entered into with the intention that the rent would be a market rack rent A market rack rent is defined as *a rent which was, or was reasonably close to, a market rack rent at the time of grant*	term 'premium' needs to be defined (the Ground Rent Act defines it as pecuniary consideration which would arguably exclude (for example) a building covenant or a surrender of an earlier lease being taken into account). (b) The definition of Market Rack Rent is vague. What does 'reasonably close to' mean? Is a MRR equivalent to an AST rent? What if the leaseholder has repairing liabilities (e.g. under an assured tenancy or a regulated rent), particularly if that rent has come about after expiry of a lease where a full [or at least not a low] premium was originally paid? The question of what assumptions you make in determining MRR is a notable absence. Whatever, this is a historical exercise that will require the valuer / solicitor to find evidence of FHVP and rental rents at the time the lease was granted which could be many decades ago. It is not clear upon whom the burden of proof will fall.

PART 4

ASSUMPTIONS AND OTHER MATTERS AFFECTING DETERMINATION OF MARKET VALUE

PARAGRAPH	WHAT THE PARAGRAPH SAYS (BROADLY)	M-JS COMMENTS
Mandatory Assumptions (All Cases)		
15(2)	<u>Assumption 1:</u> That the following leases are merged with the freehold:	12. Assumption 1 (A1) and Assumption 2 (A2) are sequential, and thus marriage value is only excluded once A1 is made.

	a) In the case of a freehold enfranchisement, any lease which the claimant is acquiring as part of the enfranchisement b) In the case of a lease extension, any lease which is deemed to be surrendered and regranted as part of the lease extension	13. Although this will achieve its aim of simplifying the process for tenant claimants (but not for landlords), in many cases this approach necessarily means they will be paying some marriage value, contrary to the intention of the Bill. 14. Where A1 is counter-factual (i.e. where in reality there is more than one landlord interest being acquired) marriage value is already implied because the value of a single freehold reversionary interest is always greater than the sum of multiple reversionary interests in separate ownership. In other words, the whole is worth more than the sum of its parts. 15. Examples of why the aggregate value of the parts might be less than the value of the whole are: a. The ground rent under an intermediate leasehold interest (ILI) is likely to be valued using a dual rate (with sinking fund) and possibly a higher capitalisation rate. b. If the ILI has a mid-term reversion it will be valued using a higher deferment rate (the differential in the Nailrile case was 0.5%), c. There could be onerous lease terms in the ILI (e.g. the Klaasmeyer case) or an inconsistency between lease terms that translates into value (e.g. a mismatch of rent (incl review pattern) / alterations / repair / user / service charge shortfall etc etc). 16. Thus, in a situation where there are multiple landlord interests, the effect of A1 is to over-value the freehold and

		the ILI(s). It may be thought that any financial disadvantage arising from the implicit marriage value will be small, and outweighed by the advantage of simplicity that A1 undoubtedly brings to the valuation. 17. While in many cases this may be true, there should be no doubt that there are also many other cases where the element of marriage value *is* significant. 18. Unfortunately, identifying the additional marriage value can only be done by valuing the landlords' interests separately, but it should be noted that this exercise is already required by Part 6 in order to apportion the MV between the eligible persons. 19. Accordingly, if it is the intention of the Bill for *no* marriage value to be paid by the leaseholder at all, A1 could be made subject to a proviso that where the MV is to be apportioned pursuant to Part 6, the MV shall be no greater than the aggregate value of all the eligible persons' interests calculated in accordance with that Part.
15(4)	This paragraph permits other assumptions being made when determining market value "…as long as they are consistent with assumptions 1 and 2 and the other provisions of this schedule."	It is unlikely that this paragraph would permit an assumption to be made that the landlord's interests are valued separately in order to get to MV excluding all marriage value because it would require overturning A1, i.e. that there is a single freehold reversion
Mandatory Assumptions (House Enfranchisement, or LE of House or Flat)		
16(2)	<u>Assumption 3:</u> In respect of a freehold claim for a house, or a lease extension claim for a house or flat, that:	1. Assumption 3(a) overrules the existing assumption under s.9(1A)(c) LRA 1967, but makes it consistent with LRHUDA

	a) The tenant has complied with their repairing obligations under the lease, and b) Improvements are disregarded in respect of the current lease	1993. It hardly ever arises in valuation negotiations so is unlikely to have much impact. 2. Assumption 3(b) overturns s.3(3) LRA 1967 to the extent that it allows improvements to be disregarded under a prior lease. This is made clear in para 16(3). While this change may be intentional, it should be noted that sometimes new leases are granted only *after* significant works have been carried out by tenants as a way of ensuring that the works to which the landlord has consented are done. In such a situation, works carried out by the tenant under the prior lease would no longer fall to be disregarded.
The Right to Hold Over		
19(1)	This paragraph applies where, under the existing lease, there is a right to hold over by virtue of Schedule 10 LGHA 1989	It is implicit from the reference to Sch 10 that this is considered the only (or at least main) means by which a tenant has a right to hold over, but there are rights under other statutes (e.g. Rent Act 1977, Part 2 L&T Act 1954). Unless it is specifically intended to limit the right to hold over to LHA 1989 (and it is not easy to discern why this would be), should the right to hold over be by reference to any statute?
19(2)	Where: (a) The unexpired term is 5 years, and (b) The right to hold over is likely to be exercised The likelihood of that right being exercised must be taken into account in the valuation of the landlord's interest	Sub para (a) seems to be arbitrary. Discounts have been applied in the past to longer unexpired terms Sub para (b) is vague, but there is at least existing case law that can guide valuers.

19(3)	In every other case any other rights under Schedule 10 LGHA 1989 and the likelihood of them being exercise “must not” be taken into account	Although this does perhaps simplify the valuation, a hard boundary like this will create unfairness where there is a body of cases showing that discounts have been agreed in cases where the unexpired term is up to 10 years, and in certain cases up to 20 years. If a hard cut-off is considered desirable, it should be more than 5 years. Perhaps 10 years would be a compromise?
PART 5		
THE STANDARD VALUATION METHOD		
PARAGRAPH	**WHAT THE PARAGRAPH SAYS (BROADLY)**	**M-JS COMMENTS**
Step 1		
22(2)	The rent to be valued is the rent under the current lease (subject to the cap if applicable)	The rent referred to in sub-para 22(2)(b) is the rent that the notional overriding leaseholder will receive from the occupational leaseholder (claimant) once the overriding lease is interposed between the occupational lease and the freehold. By displacing the freeholder as the immediate landlord, the effect is to deprive the freeholder of that income. In pure £ terms the rent now payable to the notional leaseholder is equal to the loss suffered by the freeholder, so this approach produces the right answer, but it does seem unnecessarily complicated. Would it not be simpler simply to value the loss of income to the freeholder? Where in reality the rent is paid to an intermediate landlord, Assumption 1 (that there is a single merged freehold interest)

		effectively causes that landlord's rental income to be overvalued compared to how it would be valued absent the assumption. This is because the rates applied to an intermediate landlord's income (such as dual rates, or higher rates generally) tend to ascribe a lower value than to freeholders.
Rent That is to be Used for Determining the Term Value		
23(4) & (5)	The notional rent is defined as 0.1% of the FHVP value of the property	Para 23(4)(b) could be read in 2 different ways. Does it mean: 1. The notional annual rent is 0.1% of FHVP *only if* the relevant property is subject to the SVM, or 2. Is the FHVP in this context *always* subject to the SVM? Where the FHVP value is determined in accordance with the SVM, parts 4 & 5 of Schedule 2 will apply and therefore (for example) the FHVP will be as unimproved. However, if the FHVP value falls outside the SVM, how is it assessed? Where the property being valued is a flat, the cap ought to be 0.1% of the 990 year lease as a freehold in a flat is a notoriously difficult concept.
23(7)	The notional rent must not be used in Step 1 where: (a) No premium was payable on the grant of the lease being valued, or (b) The lease being valued was granted on the basis that:	(a) What if the lease was granted in consideration of the surrender of a prior lease or in consideration of works, or some other consideration of non-monetary but nevertheless real value? (b) The intention of this provision seems to be that if the landlord can prove he has foregone capital in return for a

	i. The premium was lower, and the rent was higher, than each would otherwise have been, and ii. The value of paying the lower premium was (at the time of grant) broadly equivalent to, or greater than, the capitalised value of the extra rent	higher rent of broadly the same NPV, the cap does not apply. The linkage is important, as if a landlord has forgone value in another way (e.g. surrender of a prior lease) unless there is an equivalence in value, the provision is not engaged. That said, we can foresee arguments arising in respect of the trade-off and what is considered 'broadly equivalent'
23(8)	Para 7(b) is assumed not to be applicable unless it is shown to be applicable.	It is assumed the burden of proof rests with the landlord to show he has foregone capital in return for a higher rent, but proving it could be difficult if no contemporaneous records survive. This could become a whole new area of valuation argument, contrary to the aims of the Bill.
Step 2 (For the Enfranchisement of a House or Block of Flats)		
24(7) (8) & (9)	The deferment rate is to be prescribed by the SoS in regulations to be set out by statutory instrument The SoS must review the deferment rate every 10 years	Although setting the deferment rate is an exercise separate from the Bill, we believe there are significant questions that need to be addressed by the SoS when deciding the rate. In no particular order: • Will there be separate rates for flats and houses per Sportelli? There ought to be as the reasoning in that decision is as relevant now as it was then. • Will rates be varied for region / geography? • Will rates be varied for lease length per Sportelli? • How will rates be varied for obsolescence per Zuckerman?

		• For the purpose of apportioning the 'loss suffered' by an eligible person under Part 6, will rates be varied for intermediate leases per Nailrile? • How will the rate be determined? Using the Sportelli approach or a different one? Will it be transparent? • If the rate is adjusted only every 10 years, there is a danger of a cliff-edge for valuations when claims approach the 10 year review point. Claimants will likely delay their claims if there is an expectation that rates will increase, and vice versa if rates are expected to fall. This could cause market distortions. • As stated below in respect of capitalisation rates, we believe in order to avoid the cliff-edge problem a long term (say 20 year) rolling average rate could be adopted. This would have the beneficial effect of smoothing out changes in the rate. Further, it appears the prescribed deferment rate only applies to the SVM. Para 24(2) says "*Step 2*: for the newly owned premises which are subject to the standard valuation method…" and then details the FHVP value at sub-para (a) and the deferment rate at (b). To us this suggests the prescribed deferment rate at 24(2)(b) and 24(7) only applies to the SVM and not to valuations that fall outside it. After all, if a valuation falls outside the SVM because it is not standard, why would a 'standard' deferment rate be used? If we are correct it would follow that the prescribed deferment rate will not apply to:

		• Leases whose term is < 5 years • Home finance plan leases • Market rack rental leases • LRA 67 cases where parts of the property that were not claimed but nevertheless are included in the transfer by dint of the fact that the tenant owned them under a previous lease • LRA 67 cases where the claimant holds under a lease already extended for 50 years at a MGR • In a collective where the property being valued is not a 'relevant flat'. If the prescribed deferment rate is disadvantageous to one or other party (perhaps because it is at the end of the 10 year review cycle and an adjustment is widely expected), we anticipate that there could be challenges to get the valuation in (or out) of the SVM

PART 6		
ENTITLEMENT OF ELIGIBLE PERSONS TO SHARES OF THE MARKET VALUE		
PARAGRAPH	**WHAT THE PARAGRAPH SAYS (BROADLY)**	**M-JS COMMENTS**
Entitlement and Calculation of Share		
27(1)-(3)	Where there are 2 or more 'eligible persons', each person is entitled to a share in the market value in direct proportion that their loss bears to the aggregate losses of all eligible persons.	It is not clear what is meant by 'loss suffered'. Several points arise: a. Although the SVM is compulsory for determining the market value of the freehold or notional lease (i.e. the hypothetical merged interest), it is not clear whether it is *required* it to be used for the purposes of Part 6. There are arguments for and against the SVM being used here, and this simply highlights the need for clarity. b. On the one hand it could be said that the loss suffered *is* intended to be assessed by reference to Parts 3, 4 & 5 of Schedule 2 because: • No other valuation approach is given. If it isn't this approach, what is the correct one? • Not valuing in accordance with Parts 3, 4 & 5 would seem to be inconsistent with the rest of Schedule 2, • At para 30(2) there is an explicit instruction to use Assumption 2 (the disregard of MV), strongly suggesting an intention that this is the correct approach even though it is not expressly stipulated.

		c. On the other hand it could be argued that the existence of the explicit assumption at para 30(2) and the absence of any others is deliberate and no other assumptions are intended to be made.
The Loss Suffered		
30(2)	In determining the loss suffered Assumption 2 must be made, so that no marriage or hope value is taken into account in determining the loss.	As discussed above, under Assumption 1 marriage value is already implicit in the market value.
30(3)-(4)	In determining the loss suffered, the value of the eligible person's relevant interest must not be increased by reason of any transaction or alteration etc, entered into after: (a) In respect of a freehold claim under LRA 1967, 15th February 1979, or (b) In respect of a collective freehold claim or a new lease claim under LRHUDA 1993, 20th July 1993, or (c) In respect of a new lease claim under LRA 1967, 27th November 2023.	This follows LRA 1979 and LRHUDA 1993 (Sch 6 para 3(5) and Sch 13 para 3(6)), but it only applies to the calculation of the 'eligible person's' interest for the purposes of apportioning the premium. The requirement to make Assumption 1 (the single merged freehold interest) effectively renders LRA 1979 and LRHUDA 1993 (Sch 6 para 3(5) and Sch 13 para 3(6)) inoperable in the assessment of MV because the interest(s) whose creation transfer or alteration cause value to increase are ignored. However, if the interests are valued separately and LRA 1979 and LRHUDA 1993 (Sch 6 para 3(5) and Sch 13 para 3(6)) operate as intended, the aggregate MV for the combined interests could be significantly lower than its equivalent when Assumption 1 is applied. This reinforces the point we have made above in respect of Assumption 1 that a single merged freehold interest will inevitably contain marriage value.

PART 7		
DETERMINING THE TERM VALUE		
PARAGRAPH	**WHAT THE PARAGRAPH SAYS (BROADLY)**	**M-JS COMMENTS**
Lease Not Subject to a Rent Review		
33(3)	The formula is for calculating NPV for a term certain with immediate effect	The formula as written assumes the rent is payable annually in arrears. More modern leases provide for rent to be payable quarterly in advance so in those cases this formula undervalues the rent, albeit not significantly.
Interpretation (Capitalisation Rate)		
36	The capitalisation rate is to be prescribed by the SoS in regulations to be set out by statutory instrument The SoS must review the cap rate every 10 years	We appreciate that prescription of capitalisation rates will also be a separate exercise from the Bill, but the issue is nevertheless worthy of comment now. We refer to our comments above at 24(7), (8) & (9), but also: 1. The cliff-edge problem will also exist if the capitalisation rate is only reviewed every 10 years. Again, we believe the principle of a long term rolling average rate would smooth out changes and could therefore be a better approach. 2. The paragraph refers to the "applicable capitalisation rate", suggesting only one rate is to be used. If that is the case, how do we: a. Adjust for risk in a rent review where a different rate might be applicable to the reviewed rent (e.g. by using

		a 50bps uplift)? Is it likely the SoS will introduce multiple rates? b. Account for unusually onerous or beneficial lease terms (ditto)? c. Differentiate for all the characteristics of the income set out in Nicholson v Goff that vary from property to property? (longevity, security & quality of the income, prospects for growth, cost of collection etc). Given the very particular issues in respect of capitalisation rates, we think the SoS will have to set more than one rate (or at least vary it), for example: • A 'base rate' for rents with no reviews, • (Even if simplicity is the priority), a 'standard' adjustment to reflect the risk associated with a rent at review (little or none when the reviewed rent is known, & a risk premium where the rent is uncertain [e.g. geared to rental or capital values]) However, • We think Assumption 1 prevents an adjustment for an IL even though there can be significant differences in cap rates between an IL and a freeholder, and • It would be impossible to set standard rates or adjustments for all the characteristics in Nicholson v Goff even though it will almost certainly lead to individual cases of unfairness

		Finally, it should be understood that at the point the Bill is enacted it will do away with all the various valuation provisions of s.9 LRA 1967 and Schedules 6 & 13 LRHUDA 1993. However, even if the Bill is enacted, it will not be operable unless or until the capitalisation (and deferment) rate is set by regulation. Therefore, if there is any delay between enactment of the Bill and issue of the first regulation there will be a hiatus during which there will be no means for claims to be settled or determined. It is therefore vital that there is no delay between enactment and issue of the initial regulation.