Conclusions from the latest Parliamentary findings on the future of residential leasehold

March 2019 saw the publication of the House of Commons Committee report on Leasehold Reform (HC 1468, 19.03.19). The invisible first word in its title is "Residential". Real Estate professionals should have sensed a minor tremor across the legal landscape with this new arrival, and it may be the precursor to a larger quake in the future. Although not much notice was taken in the commercial real estate industry, it should not be ignored. Inexorable growth of mixed use and pure residential schemes, all founded on favourable investment value of residential property (particularly compared, say, to retail), means that this report is relevant to everyone.

It is only the first step towards legislating the future of residential ownership. There is no immediate White Paper, and much to work out before that. Some points in the report touch on human rights. There is even a suggestion that real estate-based traded investment assets are extinguished, perhaps without full value compensation being given (read on!). The report is forthright and in some places radical. The conclusions arise from what the committee sees as clear evidence of serious problems with how things are. The report stretches to 108 pages – and whilst there is much worthy of note, there are three standout points…

**Leasehold Criticised**

There is criticism of how leasehold residential ownership works in practice. This may not be a new accusation, but the focus of the committee is on long leases rather than "tenancies" such as assured shortholds (these have been the subject of separate parliamentary focus recently). The problems cited might easily be guessed: evidence of some bad landlords performing a poor service in property management, then administration and other fees being exorbitant, plus the issue of ground rents.

This raises a question about whether current leasehold enfranchisement legislation already deals with this. Maybe some of the stated woes would be solved if long leasehold flat owners buy their freeholds and "go co-op". The law already allows for this, as of right. But residential flat owners and their advisors are faced with some of the thickest and densest of legal textbooks when considering whether to take on the currently...
available options: leasehold enfranchisement, lease extensions or exercising the "right to manage". The process is neither cheap nor risk free for tenants, and it can lead to unpalatable litigation.

Leasehold enfranchisement does not remove the landlord and tenant relationship, but installs as landlord a company owned by the applicant tenants. All the old problems still exist: a long lease is a wasting asset, which then needs to be extended, and which can sometimes be forfeited by that landlord for breaches, such that it disappears entirely. If the complaint is that "landlord and tenant" is intrinsically adversarial, the problem isn't solved by leasehold enfranchisement. The outcome of enfranchisement may be a situation that is better, but is sometimes worse. The landlord entity, owned and controlled by a rump of flat owners, may have to deal with financing and supervising major repair works. The minefield of service charge regulation that applies to all residential landlords applies equally to owner-enfranchised blocks – so a dissident tenant may still play games or litigate to try to avoid contributing to costs.

Then there is enfranchisement's underperforming sibling, namely the statutory "rights of first refusal" for tenants to buy their landlord's interest, at the point when the landlord is about to sell it to someone else. The governing Act (the Landlord and Tenant Act 1987) is badly drafted. It had it teeth sharpened by the Housing Act 1996, so that landlords are more likely to comply with it when selling their reversions, but there has been not a single criminal prosecution for non-compliance by landlords with its terms - despite the potentiality that breaches have occurred. The 1987 Act's effectiveness as an opportunity for tenants can be side-lined by entirely legitimate means, such as landlords selling by disposing shares in a landlord SPV company rather than a property sale of the asset itself.

None of this is lost on the parliamentary committee. So what is the answer - commonhold?

…Commonhold?

Allowing the "market to decide" hasn't worked for commonhold since it first arrived with us in 2002, and it is now old enough to drive. Commonhold is such an obscure word that it still comes up as "unknown" on my PC's spelling checker. By way of introduction or reminder, commonhold is our equivalent of a condominium ownership structure. Flats within a commonhold scheme are each held, as registered freehold, by their respective flat owner, who is called a "unit holder". There is no landlord anywhere. Common parts are owned as registered freehold by a private company, limited by guarantee, and each unit holder (and nobody else) owning a share of the company. So, no wasting asset leases, none of the usual problems of enforcement of positive freehold obligations against successors in title, and a self-determined common parts owner governed by the unit holders.

By virtue of the committee report, commonhold is now put front and centre. Parliament's aspirations for the future are reminiscent of those it has for electric cars – a timeline for eradicating the old norm is upon us, or at least the idea that there will soon be a timeline. Should leasehold ownership of new development flats be banned completely, and commonhold made compulsory? Should existing leasehold flat ownership automatically be converted, now, into commonhold? The committee's answers are "likely yes" and "possibly yes".

The committee accepts that commonhold doesn't work well right now, particularly for mixed use schemes. As the report points out, the original idea of Commonhold was for it to work on modest developments. The landscape has, literally, changed in 17 years, so a renaissance commonhold would need to deal with highly integrated mega-schemes, attractive to developers and residents alike. Immediate points would arise. For example, an investment owner of a large mixed use scheme with a residential component may find out that it has no control over a motivated group of residential unit holders in a centrally-located block, with their own ideas about standards of repairs, control of user, and the like. Equally importantly, lenders have to trust it. It is not clear that they currently do: some don't lend on it. A difficulty is that the commonhold company may become insolvent and there is concern about how then to maintain the quality of the investment upon which the lenders have secured their loan. They also don't like it, witnesses said, just because it is so untested. Those points are both understandable and in reality hard to fix – the committee does not offer a solution except to refer back to the Law Commission which itself put forward suggested reforms in 2017. "Act
quickly”! the report says to Government in its paragraph 42 - and incentivise the country to convert and adopt, by cutting out some of the benefits to developers of leasehold, and in particular…

Ground Rents

The long history of ground rent is not one that reflects its current bad fame. Around since Roman times, when it was known as solarium, by the middle ages it was well-established as an annual sum payable to landlord additional to the premium at the start of a tenancy, to reflect the value of the land (the "ground") underneath the building being rented. Over hundreds of years, ground rent did not keep pace with inflation and became nominal, dropping down to £10 or £20 a year. The philosophy was sound – a tenant would accept that there needed to be something that kept the landlord interested in the building with which it had for most other purposes parted company. For the landlord, there was a touchpoint annually when the tenant paid a small amount of money and was thereby present rather than absent. But this was actual cash and multiplied out over tens of thousands of tenancies and for future periods measured in decades, it aggregated to a substantial sum effectively secured on a phenomenal capital value of real estate, and payable only by those whose credit scores were good enough to get them a mortgage on a flat. No tenant wanted to jeopardise its lease by not paying ground rent.

An aggregation of ground rent wasn't quite gilt-edged, but it was not far off. Ground rents on new leases started rising, perhaps to £250 per year. For a homebuyer looking for a flat in a new development recently, this may have seemed like a minor detail compared to the purchase price needed to buy the flat at the outset. In reality, the price of a flat was a combination of the up-front premium plus the agreement to pay the ground rent. £250 per year over 125 years of a typical new flat lease is £31,250 - so even once discounted to reflect present value it would be a substantial sum, but not one that buyers noticed nearly as much as the purchase price: £250 a year was a problem for later. That was the angle that benefited the developer, which could sell off the right to the income stream and add significant profitability to its investment, up front.

The most famous ground rent problems arose with "doublers" where the £250 would contractually turn into £500 after ten years, then £1,000, and so on. The effect of this on the capital value of this income stream is obvious, and for flat buyers, this has sometimes been a disaster, with flats they cannot sell because no bank will lend against it, given the future liability. One way of escaping would be for a tenant to take a statutory lease extension, because the new lease would then be at a peppercorn ground rent: but the flat owner would have to compensate the landlord accordingly, as a capital sum, for its loss of future income.

The committee jumped on this as a reason why the future should be commonhold, and they are right that, prospectively for new developments, it would solve the ground rent issue. But surely if there is a positive number missing from a development appraisal where the ground rent would usually be, then there needs to be a positive number somewhere else, presumably being added to the sale price? (this was not touched upon). Other proposals, so far as leasehold was concerned, showed the committee at its most radical. Why not ban existing ground rents, now, retrospectively? The Law Society sagely pointed out that attempting to change the terms of an existing contract would be an affront to the rule of law and amount to confiscation of property.

The committee then came up with some ideas to cut the same point up so it looked less offensive: how about changing the calculation of the premium payable by tenants on enfranchisement? The committee concluded that compensation would need to be payable to the landlord, "but not necessarily at full value." (paragraph 116). For landlords, this may seem like the same issue of confiscation but marginalised only as to the amount.

The committee’s final thoughts on the subject of retrospective abolition were where they really let rip: “Our view is that, within any retrospective legislation, existing ground rents should be limited to 0.1% of the present value of a property, up to a maximum of £250 per year. They should not increase above £250 over time, by RPI or any other mechanism” (paragraph 117, with no talk of compensation to landlords), and then "Alternatively, the Government should establish a compensation scheme for the mis-sale of onerous ground rents, funded by the relevant developers and the purchasers’ solicitors." (paragraph 118): interesting, although there is an assumption in that sentence as to mis-selling and presumably mis-advising by...
developers and solicitors respectively, where evidence of this is not apparent. If mis-selling was the culprit, there are existing legal claims that can be made in misrepresentation and the tort of negligence, respectively, against the seller or advisor.

**What to make of it all?**

I conclude that there are some legitimate questions raised, from the consumer flat-buyer's perspective, that warrant all the consideration that the committee has now given to them. It is hardly surprising that the committee has jumped upon commonhold, because this has no back story of problems in practice – in fact it has no back story to speak of, at all. Ground rent issues would necessarily be solved for new schemes if commonhold were made compulsory, and so would incidences of "bad landlord" behaviour. Commonhold does not, however, go out in the morning and undertake ongoing maintenance or in due course major works to a block, and then recover it from residents – that would be for the unit holders to arrange, either successfully or not.

For the existing leasehold structure, there were no convincing practical explanations as to how a transition to nil ground rent leasehold, or conversion to commonhold, might ever take place. More positively, the committee has alighted upon years of hard work by the Law Commission, for example in their 2006 recommendations for replacement of the law of forfeiture, which deserve revisiting. These are early days for Parliament in taking matters forward. The report gives all stakeholders now an opportunity to comment and influence, before matters move further along, and that opportunity is worth seizing.

**Contacts**

Matthew Bonye, Partner and head of real estate dispute resolution, London
T +44 20 7466 2162
matthew.bonye@hsf.com

If you would like to receive more copies of this briefing, or would like to receive Herbert Smith Freehills briefings from other practice areas, or would like to be taken off the distribution lists for such briefings, please email subscribe@hsf.com.

© Herbert Smith Freehills LLP 2019
The contents of this publication, current at the date of publication set out above, are for reference purposes only. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on the information provided herein.