

# Sportelli: The Aftermath

*“Where there is no marriage, hope remains”*

## Introduction to the discussion

1. On 10 December 2008 the House of Lords gave judgment in both ***Cadogan v Sportelli*** and ***Cadogan v Pitts*** [2008] UKHL 71. By a majority, the appeals were allowed to the extent that hope value may be claimed in respect of non-participating tenants in collective enfranchisement. Otherwise, the appeals were dismissed.
2. There had been no appeal against the decision of the Court of Appeal in the case of ***Cadogan v Sportelli and other appeals*** [2008] 1 WLR 2142, [2007] EWCA Civ 1042 in which appeals on the issues of deferment rate and ‘status of decision’ were dismissed. On these issues, the decision of the Lands Tribunal [2007] 1 EGLR 151 stands.
3. Now that the appeal saga is at an end, the intent of this seminar is to take stock, to consider where landlords and tenants stand on the issues of hope value and deferment rate and to take account of the developing post ***Sportelli*** case law on the ‘unfinished business’ left undecided by the appeals.

## Statutory background

4. Since 1967 various statutes have conferred the right to enfranchise on owners of long residential leases. The legislation has permitted them (collectively with other lessees) to buy out the reversionary interests or (individually) to extend their leases for defined periods (50 years for houses and 90 years for flats). Over the years, both 1967 and 1993 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. As Carnwath LJ observed in the Court of Appeal<sup>1</sup>:

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<sup>1</sup> Judgment para [1]

*“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.”*

5. The House of Lords was critical. Lord Walker stated:

*“[32] The legislation is complicated and has been amended a good deal over the years. The legislative purpose of some of these amendments is far from obvious”.*

*[33] I think that there are two particular reasons, beyond the general intractability of this lengthy and much-amended legislation, that have led to the problems which your Lordships have to resolve.*

*[34] The first is that Parliament has, in this legislation, departed a long way from a simple statutory rule of open market value (calling for expert evidence from valuers). But at the same time it has not entirely displaced open market value by some clear (though arbitrary) statutory rule.*

*[35] In the 1993 Act, in both its original and its amended forms, Parliament has to my mind adopted a hybrid technique, combining a mandatory formula (in Schedule 6, para 2 and Schedule 13, para 2) followed by provisions which take open market value as a starting-point, but subject it to some far-reaching statutory assumptions (and the puzzling possibility of further unspecified but “appropriate” assumptions under Schedule 6, para 3(2) or Schedule 13, para 3(4)). It is not surprising that valuers and lawyers have found these provisions difficult.*

*[36] The second particular matter giving rise to difficulty is the parliamentary draftsman’s understandable inclination, in framing the detailed provisions of Schedule 6 and Schedule 13 to the 1993 Act, to follow a similar pattern...Because Schedule 6 and Schedule 13 are directed at such different operations, the superficial similarity between their provisions is a little deceptive.”*

Lord Neuberger was more brutal:

*“[111] ...The original drafting of at least parts of chapter I of part I of the 1993 Act left much to be desired, and subsequent amendments have in some cases made things worse. The pooriness of the drafting means that, in my opinion, it is safer to construe the paragraphs as they now stand, rather than seeking to identify what purpose or errors may be revealed at earlier stages. I should add that the inept drafting of the 1993 Act is unfair on landlords, who are being deprived of their property, and on residential tenants, the very people who are intended to benefit from the legislation.”*

## The Appeals

6. The ***Cadogan v Sportelli*** appeals were concerned with two preliminary issues directed by the Lands Tribunal arising from the rights given to tenants by the 1993 Act, to determine<sup>2</sup> “*the proper deferment rate to be applied to vacant possession value*”; and “*the proper valuation of any 'hope value'*”.
7. A further general issue was raised in the Court of Appeal as to the status of the Lands Tribunal’s decision in relation to future cases in the Leasehold Valuation Tribunal (“LVT”).
8. The ***Cadogan v Pitts*** appeals were concerned with a single preliminary issue directed by the Lands Tribunal, namely “*Whether the [landlord] is prevented as a matter of law from contending for hope value as an element in the value of the landlord's interest*”.
9. Appeals from the Lands Tribunal to the Court of Appeal and the House of Lords are on a point of law only.
10. Only the ‘hope value’ issues were pursued to the House of Lords. The House of Lords was concerned only with legal principle; it was not concerned with any question as to how to value hope value (although certain observations were made: see later).

## Deferment rate and the valuation

11. 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(1A) 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. This has become known generally, but not wholly accurately, as ‘the no-Act world’ (although perhaps ‘no-Act bubble’ might be more apposite).

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<sup>2</sup> Judgment para.[2]

12. 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 and Court of Appeal, 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]”*

### **Hope value**

13. The second preliminary issue in ***Sportelli*** derives from the assumption that the market value of the unencumbered freehold in any property will nearly always exceed 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’.
14. The House of Lords did not seek to redefine hope value; their Lordships proceeded on the basis of the definitions adopted by the Court of Appeal. Of the majority, only Lord Hope added any observation, calling it “*elusive*” and of a “*will o’the wisp character*” (para.37).
15. 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 in ***Sportelli*** and the only issue in ***Cadogan v Pitts***.

## **Deferment Rate – the road to Sportelli**

16. 1967-2000. As is well known, after LRA 1967 a capitalisation rate of 5% and a deferment rate of 6% became firmly established in respect of the Cadogan and Grosvenor Estates in central London. Higher rates were applied outside this area – generally increasing by reference to the decrease in the perceived quality of the residential investment. The 6% rate was endorsed by the Lands Tribunal (and after 1980 by the LVTs) over the years: see for example ***Lloyd-Jones v Church Commissioners*** [1982] 1 EGLR and ***Cadogan Estate v Hows*** [1989] 2 EGLR 216.
17. 2000-2005. However, with the sharp fall in interest rates and yields on alternative investments towards the end of the last century, a feeling developed among some landlords and valuers that the established rates were no longer sustainable and were too high.
18. This wave of sentiment broke in May 2004 in ***Cadogan v Pockney*** [2005] RVR 197 (LRA/27/2003) where the Lands 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*”.
19. After an initial ‘blip’ of settlements at 5.25%, ***Pockney*** failed to “stick” when it became clear that LVTs were very receptive to the idea that ***Pockney*** was wrong, or need not be followed, and reverted to the established 6% rate for which tenants continued to argue. The landlords for their part sought to go below 5.25%.

## **Arbib**

20. To consider the issue of deferment rates, the Lands Tribunal consolidated a number of appeals before a specially convened two member Lands Tribunal comprising HHJ Rich QC and PH Clarke FRICS. The lead case was ***Arbib v Earl Cadogan*** [2005] 3 EGLR 139. The decision set out its stall in the opening paragraph:  

*“The question of the appropriate deferment rate has constituted to produce a significant number of applications for permission to appeal to this Tribunal and is clearly a matter of wide concern. It was felt that comprehensive*

*consideration of this issue should be given by the Tribunal to reduce the number of appeals in the future.”*

21. In that aim, the Lands Tribunal failed. The decision stood for precisely one year. However, **Arbib** is not a dead letter. The **Sportelli** decision is best understood as picking up and developing the loose ends left by **Arbib**. **Arbib** itself continues to be a guideline case disposing of a number of arguments which were not revived in **Sportelli**.
22. **Arbib** considered such market evidence as there existed. In particular, there was an auction of seven freehold blocks of flats in Cadogan Place in 2004. The Tribunal rejected this evidence as being tainted because tenants bid for the freeholds contrary to the ‘tenant’s bid assumption’. Other transactions were rejected for various other reasons. The Tribunal concluded that there was no reliable market evidence of deferment rates.
23. In **Sportelli** an attempt was made to adduce much better and more comprehensive market evidence. That too failed.
24. **Arbib** rejected a number of arguments and much of the expert evidence:
  - (i) The suggestion that a deferment rate of 6% should be adopted simply because it was ‘conventional’;
  - (ii) The suggestion that the deferment rate should remain constant over time irrespective of changes in interest rates and inflation.
  - (iii) Evidence of previous decisions of LVTs as having little or no weight.
  - (iv) Evidence of settlements on the Cadogan estate as not “*useful*”.
  - (v) Evidence of returns on Close Brothers’ Freehold Income Trust – although it did suggest that evidence of returns from pension funds might be useful in future.
  - (vi) Evidence of notes from the accounts of the Howard de Walden Estate.
25. The Tribunal relied heavily on the trends shown in indices of returns on residential investments, gilts, interest rates and the RPI. It noted the trends in PCL residential capital values between 1988 and 2004 adjusted for RPI. (These apparently showed

that over the short term, 2000-2004, there had been no *real* growth in the value of flats, and only a modest growth in the values of houses). There was a pattern of security against inflation with some expectation of growth (at least in respect of houses).

26. In **Arbib**, the Lands Tribunal accepted that money market transactions (such as the rate of return on gilts) could in certain circumstances be relied on in arriving at a deferment rate.<sup>3</sup> Having found there to be no dependable market evidence, it therefore resorted to evidence from the financial markets.
27. No financial expert evidence was adduced in **Arbib**. The Tribunal was thus driven to rely solely on published data about investments. It searched for a suitable risk free investment as similar to a freehold investment as was possible and selected index-linked nominal zero coupon gilts as providing the nearest proxy.
28. The evidence showed that the yield on index-linked gilts had been stable at under 2% since 1999. The Tribunal then made a 'general adjustment' of 2.5% for the general risks associated with property investments compared to such gilts to arrive at a figure of 4.5%. However, given the additional risks and costs the Tribunal associated with management of flats, it added 0.25% for the deferment rate for flats on the Cadogan Estate to arrive at a figure of 4.75%.
29. The lack of financial expert evidence in **Arbib** was the catalyst for **Sportelli**.

### **Sportelli on deferment rate**

30. **Sportelli** was heard by a three-member panel of the Tribunal presided over by the President. On the issue of the deferment rate, the Tribunal in **Sportelli** heard evidence from "*an impressive array*" of four financial experts and four property valuers, together with extensive legal argument, over a period of 11 days. As Carnwath LJ said<sup>4</sup> "*it is difficult to envisage a better qualified panel of experts for the*

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<sup>3</sup> Explaining and re-stating the Court of Appeal decision in **Gallagher Estates v Walker** (1973) 28 P&CR 113 "*only in the absence of dependable open market transactions concerning the subject matter to be valued that resort should be made for guidance to other markets including non-property markets.*"

<sup>4</sup> Judgment para.[98]

*purpose than those called in this case, or of specialist counsel on both sides of the argument”.*

31. The Tribunal rejected the deferment rate (7%) derived from open market evidence given by one of the property valuers (Mr Beckett) in favour of a deferment rate derived by reference to a formula (derived from CAPM 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 arrived at the following:
- (i) risk free rate: 2.25%; less
  - (ii) real growth rate: 2%; plus
  - (iii) risk premium: (for houses) 4.5%; (for flats) 4.75%; resulting in
  - (iv) 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*”).
32. The risk free rate RFR was once again derived from the yield on index linked gilts, but use of a spot rate was rejected.

*[70] ... (b) It is however necessary to choose a period sufficient to avoid, or to be capable of allowing for, distortions such as the so-called “pension panic” which three of the experts agree is presently distorting the bond market ...*  
*(d) The choice of period for assessing the risk-free rate should be as long as is necessary for identifying from self-consistent information a steady long-run rate... We therefore agree with Professor Lizieri that the apparent decline in yields from long-term gilts should be compared with the more consistent rates for 10-year gilts, before drawing conclusions as to the risk-free rate. We regard his conclusion that: “the average index linked yields on a five year rolling basis over the last decade suggests a more stable market based risk-free rate would be in the range 2.0% - 2.5%” to be...helpful...The improved evidence available to us as compared with that produced in Arbib leads us to the conclusion that the risk-free rate should be taken as 2.25% rather than the 2% assumed in Arbib.”*

33. It may be a matter of some controversy as to how closely pegged the 2.25% RFR is to the five-year rolling average. It is also not so very clear that this is the long term trend. Regardless of how closely the RFR is pegged to the five year rolling average, it must be subject to change. What the LT did not say was that the long-term trend was steadily falling.

34. As to long term Real Growth, the 2% RGR is probably the least controversial aspect of the decision. Since 1953 the average RGR has been 2.9% - but there is general agreement that this is unsustainable. The LT made (at para.72), the valid point that too aggressive a growth assumption might have to be balanced by a higher assessment of risk and so higher RP. The short term growth rate is a matter of some controversy.
35. The generic risk premium is dealt with at paras [74] to [79] of the LT decision. The LT plumped for 4.5%. This is probably the least satisfactory part of the decision:
- (i) it is the most important, yet is the least well reasoned;
  - (ii) there is little by way of specific reasoning, just a melange of factors mentioned and then a figure plucked from the air;
  - (iii) the RP of 4.5% is well above the 2.5% in **Arbib** yet there is not much more evidence on this issue (save for Prof. Lizieri, who argued for 4.5%) and the LT does not justify the difference between the two decisions;
  - (iv) the LT arrived at its result by rejecting “pure” CAPM and the application of a “beta” (adjustment) to the equity market risk premium as being inappropriate for a reversion. However, the result is a RP which is the same as the EMRP of 4.5%;
  - (v) “[78]...*Equities are a different sort of investment, but, provided the differences are borne in mind, we accept the views of three of the financial experts that they form a useful guide to the risk premium that we have to establish*”;
  - (vi) The LT cannot wish the EMRP away; the effect is that (leaving growth prospects aside) the LT regards freehold reversions as precisely as risky as equities.

### **The Appeal to the Court of Appeal**

36. The parameters of the deferment rate issue before the Court of Appeal were quite narrow. Maybury Court Freehold sought to challenge the rejection of Peter Beckett’s market evidence, and if that challenge succeeded, to have the case remitted back to the Tribunal. The landlords resisted that. There was no alternative challenge by MCF or anyone else to the precise, financial evidence-based method adopted or as to the rate which emerged.

37. An appeal could only lie on a point of law. It was not open to MCF simply to argue that the Lands Tribunal came to the wrong conclusion. The appeal had to be put on the basis that the Tribunal had erred in law by irrationally rejecting the market evidence which suggested a higher rate. 'Irrationality' is a high hurdle, particularly when, as the CA observed, not all the tenants' valuers adopted Mr Beckett's approach.
38. The Court of Appeal accepted a key finding by the Lands Tribunal 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. It followed from that that 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.
39. However, it must be noted that although detailed criticism of the methodology adopted did not form part of the appeal, Carnwath LJ prefaced this section of his judgment with a fairly detailed summary of the financial evidence which the LT considered and of the method of arriving at a deferment rate which they did adopt. There is no hint of criticism in this exposition and the effect of the decision as to the status of the decision is more firmly to entrench this methodology and the rate which emerges.
40. No attempt was made to pursue the appeal on the deferment rate issue further. MCF and their respondent landlord, Howard de Walden, were not party to the further appeal to the House of Lords. The Lords' judgment therefore does not affect the rulings of the Court of Appeal and Lands Tribunal on the issue.

**Decision as to the status of the Lands Tribunal decision as to deferment rate**

41. MCF also attempted to dislodge that part of the Lands Tribunal's decision which attempted to entrench the decision as a 'guideline rate'. The Court of Appeal commented on the Tribunal's guidance on the future effect of its decision as a precedent for LVTs. What the Lands Tribunal did was to invite LVTs to adopt the deferment rates determined by them as the generic rates for PCL and 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.”*

42. The Tribunal held 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 LVTs 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.
43. The Court of Appeal 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 LVTs generally to follow it. In a significant departure from the pre-existing position, the Court of Appeal<sup>5</sup> went much further than the Lands Tribunal and imported into the valuation field the concept of a “factual precedent” which has emerged in the Immigration Appeal Tribunal (now the AIT). The argument sometimes heard previously that ***Sportelli*** ‘does not bind the LVT’ no longer obtains.
44. However, the Court of Appeal 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<sup>6</sup>:
- “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.”*

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<sup>5</sup> Judgment para.[97] and [98] relying on ***S v Home Secretary*** [2002] INLR 416

<sup>6</sup> Judgment para.[102]

45. This may appear to open – if only a little - a door that had been firmly closed by the Tribunal. However, getting through that door may not be easy because 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.
46. Again, MCF did not pursue any further appeal on the “status of decision” issue and the House of Lords' decision has nothing to say on the matter.

## **Hope Value**

### *Summary*

47. The Tribunal in *Sportelli* accepted that in principle ‘hope value’ was identifiable as a separate “element of value” and capable of valuation as such. This was a significant departure from *Arbib*, decided only one year previously, where the Tribunal had confirmed the (allegedly pre-existing) practice of reflecting hope value in the deferment rate.
48. The Tribunal went so far as to rule that a lump sum addition “*was appropriate*”. Although it was not an issue on the appeal to the House of Lords, this was endorsed by Lord Neuberger (see detailed discussion later).
49. 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).
50. By contrast, in respect of houses, the conclusion was that hope value did form part of the s.9(1A)/9(1C) valuation. However, the one ‘house’ appeal was unopposed and consequently the case against inclusion of hope value in respect of houses was not ventilated. In due course, in *Pitts v Cadogan* [2007] 42 EG 296 the President came to the opposite view and decided that hope value could not be included in s.9(1A)/9(1C) valuations either.

51. The Court of Appeal upheld the decision of the Tribunal but for different reasons. The court held 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 – lease extension*

52. 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 and (2) 50% of the marriage value. What the Court of Appeal 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. They refer 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.

*Schedule 6 1993 Act – collective enfranchisement*

53. 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.
54. 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.

55. There is a strong whiff of ‘pulling oneself up by one’s bootstraps’ about all of this: Parliament’s intention ought to be divined from the language of the statute, but in this case, Parliament’s intention seems to be been assumed (by the Lands Tribunal first of all) and the legislation construed so as to as fit the assumed intention.
56. So, as Ward LJ put it, “*where there is marriage there can be no hope*”<sup>7</sup> but even where there is no marriage (non-participants in collective claims) there was no hope anyway.
57. Although this was not part of the ***Sportelli*** appeal the Court of Appeal considered the ***Pitts*** judgment and the issue of hope value under section 9(1A) of the 1967 Act. The court effectively approved ***Pitts*** and decided that the Tribunal in ***Sportelli*** had erred by having regard only to the exclusion of the tenant’s overbid under subsection 9(1A), and ignoring the context of the section as a whole, including the specific provision for allocation of marriage value. A further confirmatory decision, in the ***Pitts*** appeal, was given by Carnwath LJ on 4/12/07 without an oral hearing – see [2007] EWCA Civ 1280.

### **The appeal to the House of Lords**

58. The House of Lords essentially agreed with the Court of Appeal's analysis. The Lords accepted that the assumption that the tenant was “not buying or seeking to buy” had to mean that they were excluded from the market not just at the valuation date but at all times thereafter.
59. The Lords also accepted that to have hope value where there was marriage value would be to double count.

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<sup>7</sup> Judgment para.[57]

60. Where the majority of the Lords parted company with the Court of Appeal was as to whether the 1996 amendment to para.3(1) of Sch.6 was intended to, or effective to, exclude all hope value. Lord Neuberger held that it was not, despite the fact that it was effective to exclude all tenants from the market for all time. This was because the majority questioned what market it was that the tenant was excluded from. It was held that the market from which the tenant was excluded was for the asset being valued i.e. the freehold, or any similar interest such as a 999 year lease. Para.3(1) of Sch.6 was held not to exclude the tenants from buying or seeking to buy a lease extension.
61. Logically, this would have applied to both participants and non-participants, because para.3(1) of Sch.6 no longer distinguishes between the two categories of tenant. However, it was held that it was a necessary implication of the provision that marriage value be payable for participants that hope value be excluded for participants. Thus, the outcome was that hope value was recoverable for non-participating tenants in collective enfranchisement but not recoverable for participants, and not recoverable in respect of any of the other valuation schedules/sections.

### **The Aftermath – issues for discussion**

#### *Sources of Guidance*

62. The first point to make is that there are now three sources of guidance on the various issues – the House of Lords decision deals only with Hope Value as a legal principle. For the valuation issues, the Lands Tribunal decision remains the source of guidance, supplemented by the Court of Appeal's judgment in respect of the exclusion of market evidence and as to the status of the Lands Tribunal's decision by way of “factual precedent”.

#### **Scope for a direct challenge**

63. On its face, ***Sportelli*** did not purport to be ‘the last word’. The guidance was to stand “*in the absence of compelling evidence to the contrary*”. However (perhaps emboldened by the concept of a ‘factual precedent’) the Tribunal has in the recent decision in ***Cadogan v Erkman, 42 Cadogan Square*** (22/12/08) rejected an attempt to challenge ***Sportelli***. The appeal concerned a lease with less than 20

years expired and Cadogan sought to introduce expert evidence that the sub-20 year rate should be 3.75%. The basis for this figure was that the rate below 20 years was the same as that for 20 years plus, but that the 20 year plus rate was too high. The Tribunal (no doubt rightly) considered this to be a direct challenge to **Sportelli** and refused to admit the evidence. It was not rejected as “*not compelling*” - it was simply not to be admitted.

64. The Tribunal went out of its way to remind LVTs of their powers to exclude evidence and encouraged them to reject such evidence if it was sought to be adduced in any future LVT.
65. The evidence which Cadogan sought to adduce did not challenge the build-up of the Deferment Rate from the 3 components of RFR, RGR and RP; it only challenged the value of those component factors. Nevertheless this was excluded. It must now be questionable as to whether it is even theoretically possible to challenge **Sportelli** directly.
66. In our view, even if the LVT is faced with a cogent argument, with which it agrees completely, that **Sportelli** is wrong the correct approach is for the LVT to record the argument in detail, to state that it is an argument with which the tribunal had a great deal of sympathy, but nevertheless follow **Sportelli**. Permission to appeal should not be granted if sought; it must be for the LT to regulate any further attempts to challenge **Sportelli**.

### **Sub-20 year leases**

67. Sub-20 year leases, i.e. leases with less than 20 years of the term unexpired at the valuation date, may be considered to be ‘unfinished business’. It is perhaps surprising that this issue has not been addressed in the 2 years since **Sportelli** was decided in the LT.
68. The Lands Tribunal in **Sportelli** excluded sub-20 year terms from the ‘guidance’ or ‘factual precedent’ effect. The expressed basis for doing so was that there was

room for a different growth assumption – an “*explicit real residential capital growth forecast*”<sup>8</sup>.

69. In the recent LVT decision in ***John Lyon’s Charity v Red Earl Ltd*** (LVT 13/10/08 unreported) the lease had only 3.38 years unexpired at valuation date (2/11/07). The LVT accepted the opinion of the tenant’s valuer that the outlook for house price growth at that date over the remaining term of the lease was well below the long term trend, and assumed a real growth rate of only 1% thus adding 1% to the Sportelli deferment rate.
70. It might also be argued that different geographical area forecasts are particularly relevant over short-time frames – over 80 years perhaps all market sectors perform in a roughly similar manner but over a (say) 12 year period they do not.
71. There might also be an argument that the capital value of flats and houses might grow at different rates over a shorter time frame. This possibility can be found in ***Sportelli*** para.[94]

*“[94] Mr Clark said that the growth differential that is currently evident in the flats and houses market in central London was likely to even out in the long term – say 20 years plus. Although for the past 13 years the Savills PCL flats and houses indices had shown house values to be growing more than flats, there had been earlier periods when demand for flats was perceived to be higher. No adjustment to the deferment rate was therefore appropriate to reflect the growth factor, he said, and Mr Cullum expressed the same view...[95] In Arbib the adjustment of 0.25% was intended to reflect both the greater management problems associated with flats and the possibility that there might be a better prospect of growth in the house as opposed to the flat market. As to the second of these factors we accept Mr Clark’s view that any disparity between growth rates for houses and flats is likely to even out over the longer term...”*

72. However, as noted earlier, the LT recognised that the RGR and the RP were linked. Too aggressive a growth assumption would increase risk that the value might not be achieved and thus increase the RP<sup>9</sup>. Logically, the converse must also be true, which is particularly relevant given the present falling market. Presumably this effect

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<sup>8</sup> Lands Tribunal decision at [82]

<sup>9</sup> Lands Tribunal decision para.[72]

prevents someone arguing that an assumed 5% fall in real values would add 7% to the deferment rate.

73. It is also unclear as to the quality of evidence which the LT would expect to see by way of an “*explicit growth assumption*”. The LT's track record is to require a very high quality of evidence which is difficult to collate and more difficult to find a party willing to pay for. The LVT in **Red Earl** was prepared to accept rather less.
74. There may also be an impact on the RFR. The longest dated index linked gilts are 30 years. For long terms, it is necessary to use the nearest proxy – the longest dates. But for sub-20 year terms it is possible to match the unexpired term more closely to gilt expiry. The LT decision does suggest ‘matched’ yields. Conceivably this affects the particular 5 year rolling average to be used.
75. Query also the potential (in unusual cases) for explicit risk assumptions where the lease is short. For example:
- (i) the s.9(1A)/9(1C) disregard of repairing obligations in respect of houses;
  - (ii) instances where the capital value may reflect the present condition / potential for improvement but query if the deferment rate needs to reflect risk of further deterioration. This may be more significant outside London.

### **Movement in the RFR**

76. The **Sportelli** saga has taken a long time to progress through the legal system. Because the final resolution of the Hope Value issue is so recent, it is easy to forget that the valuation date in **Sportelli** itself was December 2003 – more than 5 years ago.
77. The LT in **Sportelli** expressly stated that they expected the RFR to be “*stable*”:
- [70] It seems to us that, in order to arrive at a suitable long-term rate which is to be used as a valuation tool to derive the value of the reversion from the current vacant possession value:... (b) It is however necessary to choose a period sufficient to avoid, or to be capable of allowing for, distortions such as the so-called “pension panic” which three of the experts agree is presently distorting the bond market;... (d) The choice of period for assessing the risk-free rate should be as long as is necessary for identifying from self-consistent*

*information a steady long-run rate. We therefore agree with Professor Lizieri that the apparent decline in yields from long-term gilts should be compared with the more consistent rates for 10-year gilts, before drawing conclusions as to the risk-free rate. We regard his conclusion that: “the average index linked yields on a five year rolling basis over the last decade suggests a more stable market based risk-free rate would be in the range 2.0% - 2.5%” to be...helpful...The improved evidence available to us as compared with that produced in Arbib leads us to the conclusion that the risk-free rate should be taken as 2.25% rather than the 2% assumed in Arbib.*

78. “*Stable*” cannot mean ‘unchanging’ - that would revive the spectre of the ‘conventional’ 6% which never moved. The LT built in stability by using a 5-year rolling average. However, if one takes any set of gilts, the average has been on a downward track since 1999 (if not earlier).
79. At what point does it become permissible to argue that the average has moved down? Is a 0.25% movement a sufficient ‘step’?
80. **Arbib** may remain relevant on this issue:  
*(19) Changes in deferment rates will not occur until a change in the trend in risk-free yields has become established or the continuation of a trend establishes a new level of yields. In the circumstances in these appeals, no adjustments are to be made for the different dates of valuation.*
81. Again, what evidence is necessary to support a case that the RFR should be taken to be a different figure from the 2.25% **Sportelli** rate? It must be arguable that it is unnecessary to convene a coterie of financial experts. Surveyors are expected to have a degree of understanding of markets other than the land market and the raw data is all available on the Internet.

### **The risk free rate as the assumed sinking fund rate**

82. The recent **Nailrile v Cadogan** decision confirmed in passing something which many valuers had appreciated must logically be the case – that the **Sportelli** RFR is also the rate to be used as the assumed sinking fund (asf) rate in a dual rate calculation of the capitalisation of rents in valuing a leasehold interest: see para.[229(n)] of **Nailrile**.

## Very long unexpired terms

83. On this issue, **Sportelli** represented a departure from **Arbib**. The Tribunal in **Arbib** thought that a different rate might apply to very long deferred reversions. This was a matter they were not required to decide, but what they said was:

*(16) Although a uniform deferment rate, without regard to the length of the unexpired term, may be doubted, there is no evidence in these appeals to justify an adjustment for different unexpired terms on the Cadogan Estate.*

84. This refers to the fact that neither of the valuers who were dealing with the longest lease case in **Arbib** (the block at 55/57 Cadogan Square) sought a variation in the deferment rate on account of the longer terms. The term there was 72.156 years unexpired, not in actual fact particularly long.

85. The Tribunal in **Sportelli** was persuaded of the opposite conclusion, despite not having heard any evidence in respect of long deferred values.

86. There is an obvious mathematical difficulty. The present value is actually very sensitive to the deferment rate and in terms of actual £ pounds to be paid the effect is significant with lower value properties:

*Example 1: say FHVP £250,000; 60 years unexpired*

<i>Deferment rate</i>	<i>7%</i>	<i>6%</i>	<i>5%</i>
<i>Value of reversion</i>	<i>£4,313</i>	<i>£7,579</i>	<i>£13,384</i>

87. So for someone in the 'burbs who claims the reversion in his £250,000 flat held on a 60 year lease, the price payable for the reversion at 5% is more than 3 times the price payable at 7%. The effect is less pronounced at shorter terms unexpired:

*Example 2: say FHVP value £250,000; 45 years unexpired*

<i>Deferment rate</i>	<i>7%</i>	<i>6%</i>	<i>5%</i>
<i>Value of reversion</i>	<i>£11,903</i>	<i>£18,163</i>	<i>£27,824</i>

88. At 45 years unexpired, the difference resulting from a 2% reduction in the deferment rate is now less than 2.5 times. Taking things in the other direction:

- (i) At 75 years it is £1,564, £3,162 and £6,438.
- (ii) At 100 years it is £288, £737 and £1,901.
- (iii) At 125 years it is £53, £172 and £561.

So over very long deferrals, the effect is to add a zero to the PV of the reversion.

- 89. A lot of surveyors, particularly provincial valuers, will tell you that the prices paid in the market simply do not reflect such rates. Or that they did not – there is anecdotal evidence that real world values are being driven up by the assumption that the 5% **Sportelli** rate will apply when the lessees make a claim.
- 90. The Lands Tribunal may now have got itself into a pickle. In one case, **Sherwood Hall**, the reversion was sold 5 days before the s.13 notice was given. The LVT, dutifully applying **Sportelli**, arrived at a premium of £248,825 – which was two and a half times more than the price paid for the freehold on the open market shortly before the valuation date. The LT has given permission to appeal, observing that the discrepancy suggests that the “*startling difference*” may indicate the LVTs premium to be wrong (and we all thought that market evidence was inadmissible and therefore irrelevant!). The problem the LT may face is that the discrepancy may well suggest that **Sportelli** is wrong - at least in respect of very long deferred terms outside PCL.
- 91. In respect of very long terms within PCL, the LVT has recently rejected an attempt at a higher deferral rate in **10 Cheniston Gardens London W8**. This involved unexpired terms of 100-125 years. The nominee purchaser argued that no evidence had been put in front of the LT in **Sportelli** in relation to long unexpired terms and that the generic rate set by the LT did not therefore apply. A careful reading of the LT decision also indicated that it did not purport to provide guidance above 80 years. The LVT rejected these arguments and adopted the generic rate. The tenants have not appealed this decision - but the sums involved were modest.
- 92. The outcome of **Sherwood Hall** should therefore be interesting!

## Challenging the rate outside PCL

93. The non-PCL rate is one aspect of **Sportelli** which has been explored in depth since the Lands Tribunal's decision.
94. In **Sportelli** the LT was firmly of the view that the rate for the whole country was the same as for PCL, in the absence of “*compelling*” evidence to the contrary. However, the LT's decision to give PTA in **Sherwood Hall** indicates that the LT's view is that this is too high a threshold to apply to non-PCL cases in view of the Court of Appeal's subsequent observations: 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 LVTs 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.”*
95. 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.
96. Whether the LT requires “*compelling*” evidence or something less, it would appear that no party has yet put forward any evidence which the LT regards as satisfactory.

The CA may have opened the door a little wider to arguments about the applicable deferment rate outside prime Central London but those hoping for a higher rate elsewhere have been wholly disappointed so far. The first post-**Sportelli** decision, **Nicholson v Goff** [2007] 1 EGLR 83, (5% for a flat in Birmingham) set the tone (albeit the appeal was unopposed) and more recent decisions since the Court of Appeal judgment in October 2007 have gone the same way:-

97. **Hildron Finance Ltd v Greenhill Hampstead Ltd** (10/1/08, LT, unreported). The LT (HHJ Reid QC and NJ Rose FRICS) were prepared to accept that Hampstead lay outside the PCL area, but rejected all the grounds put forward for departing from the 5% **Sportelli** rate for flats.
98. **Daejan Investments Ltd v The Holt (Freehold) Ltd** (LT unreported 2/5/08). The LT (HHJ Huskinson and AJ Trott FRICS) considered a block in Morden. The LVT (post **Arbib** but pre **Sportelli**) had determined a rate of 7.5%. On a re-hearing, the LT (1) found that there was no evidence to support the assertion that Morden was subject to lower real growth than PCL (2) held that the building was not particularly prone to obsolescence, its admittedly poor condition being reflected in the VP value (3) found that there was no reliable evidence that prices of lower value flats such as those at the property were more volatile than those considered in **Sportelli**. The LT duly determined a 5% rate.
99. **Cik v Chavda** (LT unreported 7/8/08): The LT (The President and Mr Francis FRICS) considered properties in Hounslow. The LVT had determined (post **Sportelli**) the deferment rate at 6.5%, relying on the following factors as justifying a rate different from the **Sportelli** rate: (1) the continuing history of litigation between landlord and tenants about services and charges; (2) the “very poor tenants” that made up half the occupancy of the flats; (3) the poor external condition of the premises; (4) noise from the A3006 Bath Road and the overhead flight path; and (5) the flanking road to the industrial estate to the rear. The LT reversed the decision:-

*“We cannot in principle see why such adverse factors as these are not fully reflected in the freehold vacant possession value, and there is nothing in the evidence to suggest that they are not. All of them seem to us to be pre-eminently matters in respect of which a purchaser of the freehold with vacant possession, who proposed either to occupy or to let the flat and expected at some time in the future to sell it, would be concerned to make appropriate allowance in determining how much he was prepared to pay. We can see no*

*reason why the notional purchaser of the reversion, basing himself on this vacant possession value, would make an addition to the deferment rate because of these factors”.*(Para.[32])

100. I am reliably informed by someone involved with the latter two cases that the blocks involved were genuinely “*pretty grim*”.
101. A clear message is emerging: there is no point attempting to argue a high deferment rate in the LVT which in reality runs counter to the ***Sportelli*** decision because if the LVT accepts such an argument, its decision is unlikely to survive scrutiny on appeal.

### **Intermediate Leasehold Reversions**

102. ***Sportelli*** involved only freehold reversions. There was no valuable intermediate reversion. The question of the appropriate deferment rate for a valuable intermediate reversion was one of the issues addressed in the ***Nailrile v Cadogan*** appeals, (LT interim decision 22/12/08). One of the appeals (***Regency Lodge***) included lease extension claims on 5 flats where the intermediate landlord had a reversion in possession of c.54 years, deferred for c.27 years. The LVT determined a 6% rate. The Lands Tribunal determined 5.5% on appeal (para.[87]).
103. The Tribunal rejected any adjustment to reflect the terms of the head-lease, holding that those terms would be reflected in the capital value of the reversion.
104. The Lands Tribunal accepted that the only difference between a leasehold reversion and a freehold reversion is that on reversion, the intermediate landlord has less flexibility/more risk than a freehold reversioner, as the lease will waste should he wish to hang on to it. Consequently he may be forced to sell it in an unfavourable market.
105. The Tribunal recognised that this was an adjustment to the risk premium. The RGR and the RFR would remain the same. To add 1% to the deferment rate was to add 1% to the RP – a 22.25% increase. The LT felt that this was unjustified, and held that a c.10% adjustment was appropriate at this mid-term reversion in possession length (0.45% rounded to 0.5%).

106. It follows from the Tribunal's reasoning in **Nailrile** that the adjustment to the RP must vary with the length of the reversion in possession. It may be arguable that no adjustment at all is required if the reversion in possession is very long, say over 100 years. (Some may disagree on the basis that a leasehold, no matter how long, is not as good as a freehold, but presumably that could be reflected by taking a capital value at, say, 99% of freehold value).
107. If the reversion in possession is short, say 25 years, presumably a much greater adjustment is required. Just how much greater remains to be worked out.
108. It also follows from the Tribunal's rejection of any adjustment to reflect head lease terms that valuers must be careful to ensure that the capital value of the reversion does reflect those terms. The capital value of an intermediate leasehold reversion is essentially a question of relativity. Graphs of relativity assume no unusual lease terms. Valuers must ensure that valuation sensitive terms of the head-lease are reflected in a reduced relativity for the reversion in possession.

### **Other possibilities**

109. There are just a few arguments which may, or may not, have 'legs'.
- (i) Exceptional management difficulty for some flats: In **Sportelli**, the LT stated that: *"Our view is that the potential for problems to arise is inherent in all leases and that standard adjustment is therefore appropriate. We do not rule out the possibility that there could be a case for an additional allowance where exceptional difficulties are in prospect, but this would need to be the subject of compelling evidence."*
  - (ii) Marginal flats/houses: What is the rate for a property which is only technically a flat – most obviously the mews house designed with a small overlap to disqualify it from 1967 Act rights?
  - (iii) Vulnerable properties. What is the rate where the property is threatened by coastal erosion or flood risk?

## “Hangover” appeals

110. There are evidently still a few ‘hangover’ appeals from pre-**Sportelli** days becalmed in the system. In **Ulterra v Glenbarr RTE Co Ltd** [2008] 04 EG 174, the landlord sought to appeal a pre-Sportelli LVT determination and obtain the Sportelli norm rate. The LT (HHJ Reid QC) pointed out that all tribunal decisions are made on the basis of the evidence called, and determined that on an appeal by way of a review, it was not possible to show that the LVT was wrong. The appeal on that issue failed.

## Hope Value

111. Following the House of Lords' decision, we know where we are in legal terms. There is only hope value in respect of non-participating tenants in collective enfranchisement claims.
112. But before proceeding, it may be important to ask the question – “hope value of what?” Lord Neuberger had this to say:-

*“103. I agree with the Court of Appeal that the bracketed words in the opening part of para 3(1), when read together with para 3(1A), exclude all flat tenants from the market, and they exclude hope value as well as marriage value because the words “buying or seeking to buy” are, for the reasons given when considering section 9(1), apt to cover the future as well as the present. But this conclusion begs the question of what precisely it is that the flat tenants are not buying or seeking to buy. The natural meaning of the opening part of para 3(1) is that they are not buying, or seeking to buy, that which is described immediately before as being “sold on the open market”, namely the freehold of the building. At least as a matter of words, that would not extend to excluding from account the possibility of flat tenants seeking in the future to acquire new long leases of their respective flats: they would not be “buying” anything, let alone the building. On that basis, there is nothing in para 3 which excludes the hope value for which the appellants contend in these appeals.*

*104. However, I accept that, as Carnwath LJ said at [2008] 1 WLR 2142, para 50, such a literal reading of the bracketed words in the opening part of para 3(1) will not do. The words “buying” and “buy” in para 3(1) must cover seeking a 999-year lease at a peppercorn or any similar interest: otherwise they would have no real effect; for the same reasons, the bracketed words would extend to buying (or acquiring a 999-year lease at a peppercorn of) all but a small part of the building. However, those considerations by no means necessarily require one to construe the bracketed words so as to exclude the possibility of the flat tenants acquiring any interest in any part of the building, especially if there are good reasons, based on other provisions of the 1993 Act, to hold that they should not be so construed. In my opinion, when one*

*turns to provisions other than the opening part of para 3(1) and para 3(1A)(b), it is apparent that such hope value is not to be excluded.”*

113. The background to those observations was Lord Neuberger's acceptance that the assumption that the “*tenant [is] not buying or seeking to buy*” must mean “*ever*” or “*for all time*”, and is not limited to the valuation date. It followed that para.3(1A) of Schedule 6 (as amended) excluded the non-participants from the market, for all time. Hence the question – ‘a market for what?’

114. Probably it makes no difference in practice, but it should be understood that the ‘hope’ which is being valued is the hope that the non-participants will seek to buy something less than the freehold or a 999 year lease. Are they looking for a new 99 year lease perhaps? This is where the “*probably*” comes into play. Perhaps it could be argued that anything longer than a 99 year lease is little different to a 999 year lease. And by “*99 years*”, we mean “*99 years*” not “*99 years plus the residue of the existing term.*” In the pre-Act world, tenants often bought longer leases, but rarely were they granted leases longer than would be granted in the open market. Perhaps it could be argued that ‘hope value’ must be limited to the hope of marriage value released by the grant of a new 99 year lease in substitution for the existing lease.

115. Note Lord Hoffmann's impassioned dissent:

*“My noble and learned friend Lord Neuberger, in paragraph 104 of his opinion, accepts that the words “buying” and “buy” must cover “seeking a 999-year lease at a peppercorn or any similar interest” because “otherwise they would have no real effect”. I agree. But he nevertheless concludes that they do not exclude non-participating tenants from the market for some lesser (but unspecified) interest in reversion on their leases. With all respect to my noble and learned friend’s expertise in this part of the law, I cannot understand how he is able to distinguish between participating and non-participating tenants when the statutory assumption of exclusion from the market applies to tenants generally or how he is able to distinguish 999-year leases from shorter leases.” (para.[14]).*

116. This brings us to the next question: how to value hope value (if any)? This point is undecided. It was not an issue for the House of Lords:

*“It should be recorded that the questions raised in each of these appeals are whether the landlords are entitled, as a matter of law, to have hope value taken into account as an element in the valuation of their respective interests. If any of these appeals succeed, it would be for the LVT (or, on appeal, for*

*the Lands Tribunal) to decide whether, and if so to what extent, the landlord is entitled to hope value in any particular case.” (per Lord Neuberger at para.[80])*

117. In ***Blendcrown v Church Commissioners*** [2004] 1 EGLR 143, LT, PH Clarke FRICS (perhaps unhelpfully) put it this way:

*“I would emphasise that hope value is a speculative element of value that does not lend itself to objective assessment. It is essentially a matter of informed opinion. I cannot accept Mr Maunder Taylor's view that, because he found no indication that non-participating tenants might wish to extend their leases and did not wish to participate in the collective enfranchisement, this shows the absence of hope value. What we must consider is the subjective view of a hypothetical purchaser. If Mr Maunder Taylor's approach is correct, it is unlikely that hope value could ever be attributed to the flats of non-participating tenants. The fact that a tenant does not wish to participate in acquiring the freehold or extend his lease at the time of collective enfranchisement does not mean that he (or his successor in title) will not be interested in paying for a lease extension at some time in the future. Hope value is, by its nature, speculative, uncertain and incapable of precise assessment. It is the value now of the chance of a future payment.”*

118. However, it should be noted that the ‘lump sum addition’ method approved in ***Sportelli*** is now firmly entrenched, because earlier his speech, Lord Neuberger made the following observation, at para.[69]:

*“In some cases, hope value has been held to justify an increase in the investment value of the freehold by around 15% of the marriage value - see e.g. In *Shulem B Association Ltd's Appeal* [2001] 1 EGLR 105. In other cases, the same approach was taken as in *Lloyd-Jones* [1982] 1 EGLR 209, so the deferment rate was adjusted downwards to allow for hope value - see e.g. *Arbib v Earl Cadogan* [2005] 3 EGLR 139, para 188. However, in several conjoined appeals from the LVT, including three of the instant cases, *Sportelli*, *Grandeden* and *27/29 Sloane Gardens*, a three-member Lands Tribunal, presided over by the President, Mr Bartlett QC, convincingly concluded at [2007] 1 EGLR 153, para 112 that, where hope value could be included, it was the former approach which was appropriate.” (emphasis added)”*

119. The debate in any future case must therefore be as to the size of any lump sum addition – effectively what, if any, percentage of anticipated marriage value to adopt.

120. Although the method of reflecting any hope value in the valuation may have been settled by *Sportelli*, no decision was reached by the Lands Tribunal as to the quantification of hope value in respect of the two collective claims, **27/29 Sloane Gardens** and **59 Cadogan Square (Grandeden)**. In respect of **27/29 Sloane Gardens**, the quantum of any hope value had been agreed (at 10% of marriage value). It remains to be seen whether the **Grandeden** hope value is agreed or has to be the subject of a further hearing before the Lands Tribunal.
121. Hope value was determined at 20% of marriage value in respect of the house at **13 South Terrace**. However, this was an undefended appeal (and as it turns out hope value should have been excluded) so this decision in due course will presumably be of little value: see *Sportelli* LT para [107].
122. In short, there is not much to go on.
123. It may be supposed that market evidence is required. How much market evidence is required is a moot point. The sort of evidence required ideally is market evidence of sales of reversions where the hope value element is explicit. Failing that, settlement evidence, or perhaps portfolio valuations. A decision in relation to a collective enfranchisement in Maida Vale is awaited from the LVT. In that instance, evidence was led on the general popularity of enfranchisement in the area to show that the hypothetical buyer would expect early premiums from non-participating tenants.
124. In *Sportelli*, hope value was determined at 20% of marriage value in respect of the house at 13 South Terrace. This was based on the evidence of Roland Cullum. He in turn based his opinion on his involvement in the sales of the Henry Smith's Charity Kensington Estate to Wellcome Trust, and a sale at Ennismore Gardens to Wellcome Trust.
125. A number of points may be made about this evidence:
  - (i) First, it depended heavily on the fact that it was given by Roland Cullum himself, from first hand knowledge. He was unable to produce any documentary evidence of the Kensington Estate sale to support his recollection. A letter of advice from the Ennismore Gardens sale was produced, but this disclosed a range of valuations, from 15-25% hope value.

- (ii) Second, it might be argued that evidence of the sale of an entire estate simply is not comparable to the sale of a block of flats, because greater numbers of potential lease extension claims reduces volatility. Just how incomparable may depend on the size of the block and the number of non-participants.
- (iii) Third, for what it is worth, this very same evidence given by Roland Cullum was rejected by the LVT which heard **Cadogan v Atlantic Telecasters, 10 Holbein Mews**, the other house case heard with **Pitts/Sportelli** in the Lords.

126. There is, it would appear, a wide divergence of view among the valuation community as to the correct 'all other things being equal' starting point. A range of 10-25% is suggested, but it could be otherwise. In **Blendcrown v Church Commrs** 5% of MV was awarded. In **Shulem B** [2001] 1 EGLR 105 (an unopposed appeal) 15% was awarded.
127. Indeed, it does not follow that there is an provable hope value at all; as Lord Neuberger noted at para.[68] of his speech, in a number of cases, hope value has been rejected on the facts. He selected **SCMLLA v Gesso** LRA/13/2003 as an example but there are others, particularly at LVT level.
128. There is no doubt scope for evidence specific to individual blocks, provided that the information relied upon might be supposed to be available to the hypothetical purchaser. Information known to the landlord can be considered to be shared with a purchaser in order to maximise the price, but information of which the landlord was, at the valuation date, unaware may be more difficult to rely upon. **Duke of Westminster's Trustees v Regis Group (Barclays) Ltd** [2007] 38 EG 204 provides a recent example of a case where evidence was rejected because the parties who were aware of the information would have kept it secret.
129. How this works in practice remains to be seen. For example, the tenant's valuer may assert that the hope value should be low because the tenants have attempted to persuade the non-participant to join in the collective claim, but he/she has refused and said that he/she is not interested in a longer lease. But in the hypothetical valuation, there is no collective claim so the conversation relied upon

could never have come about. Can it be assumed that the hypothetical purchaser would knock on doors and ask (and if he/she did, would they get anything other than a dusty answer)? The hypothetical vendor will keep quiet about any failed discussions he may have had with the tenant, in order to keep the price as high as possible.

130. Does any of this make much difference, since the hypothetical purchaser will be inclined to assume that no deal is in the offing otherwise the vendor would have done the deal prior to selling?

### **Where a s.42 notice has been given**

131. The House of Lords decision is not entirely clear as to the effect on valuation of a s.42 notice by a non-participant. On one reading there is a divergence of view among their Lordships. Lord Walker said:

*“[42] ...there is to my mind no good reason why any hope value in respect of future deals that may possibly be negotiated between the freehold owner and non-participating tenants (other than those who have actually served section 42 notices before the valuation date) should be disregarded.”*

*[45] I would therefore, in agreement with my noble and learned friends other than Lord Hoffmann, hold that para 3 permits the inclusion of hope value, such as it is, in respect of new leases of the flats of non-participating tenants. But that is, I must stress, hope value in respect of deals which might be freely negotiated, rather than leases granted under any statutory right. Para 3(1)(b) excludes statutory rights (except where section 42 notices have already been served) but not the possibility of negotiated contracts. Para 3(1)(b), if read with an emphasis on “right”, is not therefore inconsistent with this construction.”*

132. By contrast, Lord Neuberger said, at [107]:

*“There are two reasons why, in my opinion, the bracketed words in para 3(1)(b) are significant for present purposes. First, all that the service of a section 42 notice does is to give the tenant a right to acquire a new lease: he can pull out at any time - see section 52. Accordingly, para 3(1) permits some hope value attributable to non-participating tenants’ flats to be included on any view. Secondly, the bracketed words in para 3(1)(b) require one to take into account the “notice”, not the rights and obligations which accrue pursuant to it. That suggests to me that the purpose of sub-para (b) is to entitle the landlord to argue that the section 42 notice is evidence that the tenant concerned is interested in acquiring a new lease of his flat. Where a non-participating tenant has served such a notice, the hope value attributable to his flat may well be increased because he has made it clear that he is interested in acquiring a new lease of his flat. In other words, by serving a*

*section 42 notice, a non-participating tenant has, in my view, assisted any contention that he would be in the market, because he has evinced a desire to acquire a new lease of his flat at market value, which is what Schedule 13 effectively means that he would have to pay.”*

133. Lord Mance agreed with both. Lord Hope also agreed with both, but gave his own speech, which did not address the section 42 notice issue. Lord Hoffmann dissented.
134. We see no divergence in view. On a careful reading, both Lord Walker and Lord Neuberger state that it is the fact of the notice which is taken into account, not the statutory rights under s.42. Therefore, it is a ‘no-Act hope value calculation which is carried out for non-participants, whether or not they have served a s.42 notice. The s.42 notice raises the hope, or the value of the hope. The practice hitherto adopted by many valuers of carrying out a Schedule 13 valuation and discounting it for contingencies is now to be regarded as wrong.
135. It is plain (if nothing else, because the Act permits it) that service of a s.42 notice may be taken into account. Logically, such a notice is good evidence of hope value. But it is never certain that a s.42 claim will complete, as Lord Neuberger noted at para [107] set out earlier.
136. Whether there is much difference between a s.42 valuation with a deduction for contingencies and a ‘no-Act’ hope valuation (and if so, in whose favour the difference lies) will depend on the facts. In some cases, a s.42 valuation may have yielded a far lower premium, if, for example, there are substantial tenant's improvements to deduct on the s.42 claim, or if the s.42 notice was given some time before the collective claim in a rapidly rising market.
137. What if the s.42 claim is made, but is invalid? (e.g. notice given before the tenant has owned the flat for 2 years). Presumably, assuming the basis for valuation would be ‘No-Act’ hope value, the service of an invalid s.42 notice is every bit as good evidence of hope value as would a valid s.42 notice.

### **Tenant's hope value**

138. At para.[93] of his speech in **Sportelli**, Lord Neuberger observed in passing, in the context of valuations under s.9(1A) of the Leasehold Reform Act 1967, that:

*“There is a potential complicating factor I should mention. In a case where the marriage value is shared equally, just as the landlord’s interest should be valued excluding hope value, so, I am inclined to think, should the tenant’s leasehold interest. In some cases, the valuation of the tenant’s interest may include hope value, as the President recognised in Pitts [2007] 3 EGLR 86, para 16, where he said that “hope value does not necessarily exclusively reside in the landlord’s interest”. It may well be unfair on the landlord if he is precluded from seeking hope value in circumstances where, for the purpose of assessing the marriage value, the tenant’s leasehold interest is valued including hope value. So, while, as a matter of principle, it appears to me that, under section 9(1A), the valuation of the landlord’s interest should not include hope value, if it could be shown that the valuation of the tenant’s interest included hope value and that this was illogical and unfair on the landlord, then an adjustment would have to be made.”*

139. This observation was plainly *obiter dicta* as the issue was not for decision in **Sportelli**. In so doing, Lord Neuberger echoed an observation of the President in **Cadogan v Pitts** [2007] 3 EGLR 86 at para.[16], also in the context of s.9(1A), that “...hope value does not necessarily exclusively reside in the landlord’s interest”. That observation was equally *obiter dicta*.

140. *Obiter* or not, the hare is up and running. It is now plainly a real issue in future cases as to whether tenant hope value should be excluded, and if so, how that is to be done.

141. The issue arose in **Nailrile v Cadogan** (22/12/08), in the **62 Cadogan Square** appeals. Relativity was in issue, and Cadogan contended that a 5% deduction should be made in order to exclude tenant's hope value. Further submissions have been invited in the light of **Sportelli**, so we have to be cautious as to what we may properly say. Paragraph [220] of the Interim Decision dated 22/12/08 holds:-

*220. The final adjustment that we consider was made by Mr Wilson and accepted by Mr Clark. It is a deduction of 5% made in respect of the tenant’s hope value. On the facts of the case we do not think that any such allowance should be made. Mr Wilson says that such a deduction is a new concept for him and that it is not supported by evidence. He discussed a figure with Mr Clark, but that, in our opinion, is an assertion and not evidence. The only justification that we were given was that it should be the same as any allowance for the freeholder’s hope value. We reject that argument for the reasons given by Mr Rainey.*

142. The Tribunal very briefly summarised those submissions at para [175]

*“175. Mr Beckett did not make any allowance for hope value. Mr Clark made a 5% deduction from relativity for tenant’s hope value, which he said was the same as that for the freehold reversion. This was indefensible because it was the freeholder who controlled the situation in the no Act world. Mr Rainey submitted that in the no-Act world there would be no such tenant’s hope value.”*

143. The freeholder's control of the situation includes deciding whether to grant a new lease and if so what price he will charge, and whether he will give any discount to someone who is an existing lessee rather than an incoming lessee.

144. **Sportelli** at para [111] is relevant and was cited to the Tribunal in **Nailrile**:

*“111. ... In comparing the with-Act world with the hypothetical situation with which we are currently concerned, Mr Cullum said that in the real world both the assignor and assignee were aware that there was latent value to be to be released, and the power to compel the freeholder to deal was in the tenant’s hands. The assignor would not abandon his latent value, and the assignee would be willing to pay a share of it, as he would be giving himself the option of releasing the whole of the marriage value. That was why market evidence of the value of leasehold interests had to be discounted in enfranchisement valuations to arrive at the no-Act world value – in other words, the value of the option had to be stripped out. In the no-Act world, the negotiating boot would be on the other foot, and the tenant would not be in a position to demand an extended lease or seek the freehold. With the purchaser of the freehold reversion being in control and knowing that it was most likely that the tenant would come forward at some stage, he would pay a price that was the sum of the reversionary value together with an amount that represented the value of that option to deal.”*

145. In other words, the 20% of marriage value that Mr. Cullum used to assess hope value was on the basis that, in the no-Act world, the landlord held the whip hand in granting extended leases.

146. The known historical reluctance of the Cadogan Estate to be a willing seller is recorded in **Arbib** at para [98]. That may be argued to be a relevant consideration, see **Railtrack v Guinness** at [23]-[24]. This argument was run in **Nailrile** but not addressed in the Interim Decision.

147. It is also strongly arguable that if one correctly adjusts to remove the benefit of the Act (“BOA”) from the capital value derived from comparables, then any ‘No-Act’ tenant's hope value must have been removed too. ‘No-Act world hope’ is the hope

of obtaining a longer lease by negotiation. It is a hope of that to which the Act now confers a right. The Act rights – the BOA – must by definition subsume and include any ‘No-Act hope’. The greater includes the lesser. For this purpose, it does not matter which of the approaches to the BOA adjustment is right. Whatever the scale of the BOA adjustment, by very definition such adjustment strips out any No-Act hope value which there might be. This argument too was run in *Nailrile* but not addressed in the Interim Decision.

### **Other effects of the decision**

#### *Section 18*

148. Section 18 is restored to some vigour. Deals with non-participants at the valuation date will need to be disclosed and can be reflected in hope value. The decision does not, however, correct the difficulty with the drafting of s.18(1) as amended by CLRA 2002, which requires disclosure of agreements entered into during the period “beginning with the relevant date and ending with the [date of exchange of contracts]”. Post-valuation date agreements are irrelevant to valuation, so the section appears only to bite on agreements which exist at valuation date (and even that requires a relaxed interpretation of “entered into” and “beginning with”).

#### *The Grosvenor Estate Belgravia ‘escalator clause’*

149. As is well known, the Belgravia estate is held by Grosvenor Estates Belgravia (“GEB”) on a 200 year head-lease. That head-lease contains an unusual clause – the ‘escalator clause’ – which provides that after 2026, GEB must account to the freehold trustees for an increasing percentage each year of the proceeds of the sale of any underlease on the estate. That percentage maximises at 90%, in 2043.
150. In a series of four decisions – **8 Chester Street** (18/10/06), **12 Chester Street** (28/8/07) (houses) and **2@10 Eaton Place** (4/5/07) **1-3@6 Upper Belgrave Street** (14/5/07) (flats) the LVT has decided that the effect of the “escalator clause” found in the head-lease of Belgravia held by GEB is such that the GEB interest is to be valued assuming a vacant possession value equivalent only to that percentage of

the premium on the grant of a new lease which GEB could keep as at the term date of the qualifying tenancy.

151. An important element of the LVT reasoning is that the qualifying (sub-)tenant must be assumed not to be in the market to do a deal (to enlarge his occupational lease) with the hypothetical purchaser of the GEB interest (and thus escape the “escalator clause”) at any time prior to lease expiry. Because of this, the appeals pending in all those cases were stayed pending the decision in **Sportelli**.
152. The outcome in **Sportelli** would not appear to be helpful to Grosvenor. Hope Value has been excluded from s.9(1A) and Sch.13 valuations and the Lords confirmed that the exclusion of the tenant from the market does indeed mean “excluded for all time” and not just at the valuation date – see Lord Walker at [39] & [40] and Lord Neuberger at [82], [83], [95] and [103]. This would appear to preclude any argument for the avoidance of the escalator based on the prospect of a deal with the tenant or a deal with a third party (investor/speculator).

#### **Willing purchaser/Identity of purchaser**

153. Occasionally an argument arises as to whether the hypothetical purchaser is ‘willing’ (because neither s.9(1A), Sch 6 para.3 nor Sch.13 para.3 say so). The Lords confirmed that the hypothetical purchaser is assumed to be willing: Lord Neuberger at para.[89], and Lord Hoffmann (not dissenting on this point) at [17].
154. In s.9(1A) cases, it has generally been assumed that the actual tenant is the purchaser, following **Lloyd Jones v Church Commrs** [1982] 1 EGLR 209 . This was disapproved by Lord Neuberger at paras [88] – [89].

#### **Value for marriage value**

119. There is an argument in circulation that for the purposes of the marriage value calculation in paragraph 4 of Schedule 6, a very long lease value (say 99% of freehold) should be adopted as a starting point rather than a freehold value. Whatever the intrinsic merits / demerits of this argument, it would seem to be inconsistent with **Sportelli**, as Lord Neuberger at para.[104] equated the “*lease... without restriction as to length of term*” with a freehold.

Philip Rainey  
Mark Loveday

5 February 2009