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GORDON DADDS

THE NEWSLETTER OF GORDON DADDS, MAYFAIR'S LAW FIRM

AUTUMN 2005

The Leasehold Debate – Investment or Wasting Asset?

The two-tier system of property ownership in England and Wales – freehold and leasehold – has caused property owners much consternation over the years, mainly in relation to leasehold flats.

For most leasehold owners and, indeed, the freeholders themselves, the conundrum remains, what should they do to preserve and enhance their investment?

Outlined below are a number of the more common issues encountered by residential flat owners (tenants), followed by a consideration of the current statutory framework with respect to the most pertinent issues, namely, ownership of the freehold, short leases and poor management.

The investment perspective

Freehold/Leasehold debate: It is generally accepted that, if a flat can be offered for sale with a “share of freehold”, this is more attractive to potential buyers than if it is simply sold as “leasehold”. Often this is reflected in the price as the buyer will have the benefit of an enhanced investment, together with the comfort of knowing that they will have a say in the future management of the building.

The short lease: This is the critical issue for tenants since, with each passing year, their lease term diminishes. This has two, closely related consequences - future saleability and the ability to mortgage. A lease as short as 30 years can be mortgaged, but only with short-term finance; if the tenant (or their buyer) is seeking to obtain mortgage finance over



a term of 20-25 years, then, in order to meet the requirements of the main institutional lenders, the lease must have at least 60 years unexpired at completion. Either way, the future saleability of a short lease can only be assured by means of a lease extension.

Poor management and/or expensive service charges: There have been a number of well-publicised management and service charge disputes over the years. Statute has intervened not only to regulate the landlord's ability to recover service charges, but also to give tenants the right to challenge them; suffice to say that failure to follow the statutory procedures could leave landlords unable to recover monies expended and tenants initiating steps to take over the management of the building.

The statutory perspective

These issues have been acknowledged by successive Governments and this has resulted in the introduction of extensive rights, primarily in favour of tenants. A summary of the most pertinent rights, including the tenants' right to purchase the freehold (collective enfranchisement), to extend their leases and to takeover the management of the building (right to manage), is set out below. In addition, there is a short commentary on the new commonhold tenure.

Collective Enfranchisement

This is the statutory right exercisable by qualifying long lessees (tenants with leases of more than 21 years) to acquire the freehold interest

in their building. The relevant provisions are found in the Leasehold Reform, Housing and Urban Development Act 1993 (“the 1993 Act”). Subject to certain exceptions (for example, buildings where the non-residential floor area exceeds 25% of the whole), the right can be claimed by qualifying tenants who own at least 50% of the flats in the building.

The 1993 Act lays down both a specific procedure for exercising this right and a formula for calculating the price to be paid. Tenants should always seek legal and valuation advice in this respect.

Collective enfranchisement is the most effective way of securing the future marketability and value of leasehold
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flats. Not only do the lessees own the freehold of their building (and are, therefore, able to extend their own leases without recourse to a third party) but they also have control of the management and maintenance arrangements.

Commonhold

In 2002 a revolutionary concept in land law was created in the form of commonhold. This new legal interest in land, known as a “freehold estate in commonhold land”, was introduced by the Commonhold and Leasehold Reform Act 2002 (“the 2002 Act”). The creation of this new estate in land was a direct response to, amongst other things, the perennial problem of ever-decreasing lease terms.

In complete contrast to the system of freehold and leasehold ownership, a building, which is either set up as or converted into commonhold land, will comprise commonhold units (the individual flats and common parts) and the unit owner will own the equivalent of a freehold interest.

The Act provides for the common parts to be owned by a Commonhold Association (a prescribed form of company limited by guarantee). The rights and duties of the Commonhold Association and the unit-holders are set out in a Community Statement (also in a prescribed form) and this regulates the use of the commonhold units; provides for the repair, maintenance and insurance of the common parts; and governs the financing of communal services and facilities.

It is likely that a developer of a new block of flats will take the opportunity to set up the estate as a commonhold. However, it is possible to convert an existing building into commonhold

provided that the freeholder and all long lessees (and their respective mortgagees) consent. Whilst there is no premium to be paid, there will be the costs of setting up the Commonhold Association and all associated statutory documentation.

Right to Manage

The right to manage is a new no-fault based right to take over the management of the building from the landlord, the provisions of which are contained in the 2002 Act. The right is exercisable by at least 50% of the qualifying tenants in the building (provided that the building also qualifies). There is no premium to be paid, although the tenants are required to meet the landlord’s reasonable administrative costs for dealing with their claim. The tenants are required to incorporate a Right to Manage company (again, in a prescribed form) and the landlord is entitled to be a member. Ownership of the freehold does not pass to the Right to Manage company, only the right to exercise all the landlord’s management and maintenance functions under the terms of the leases.

First Rights of Refusal

Landlords, too, face an uncertain future. If their tenants enfranchise under the 1993 Act, they are compelled to sell their freehold investment. Alternatively, rather than waiting for a claim to be made, they may trigger a sale of the freehold by means of offering the tenants the first right of refusal under the Landlord and Tenant Act 1987. Under this Act, the landlord specifies the price, which is not open to negotiation, and should the tenants decline to accept the landlord’s offer then he is able to sell the freehold elsewhere (subject to complying with the statutory

requirements).

Lease Extension

Finally, if there is little enthusiasm by the tenants to pursue their rights collectively, and an individual has a short lease, there is always the right to extend that lease for an additional term of 90 years (in addition to the remaining term of the lease). This right is contained in the 1993 Act and is subject only to the requirement to be a tenant under a long lease and have owned the flat in question for at least two years at the date the claim is made. As with the right to enfranchise, there is, of course, a premium to be paid and, similarly, the valuation principles are set out in the 1993 Act.

The Last Word

There is now a myriad of landlord and tenant-related legislation, not all of which will find favour with either a landlord or a tenant. However, until such time as there is a comprehensive review and, sensibly, consolidation of the existing provisions, then landlords and tenants must familiarise themselves with the ever-changing provisions to ensure that they can derive maximum benefit from their property investment.



Anne Marie Ellis, Property Department

Mental Capacity Act 2005

We strongly encourage all clients over the age of 18 to sign an Enduring Power of Attorney, allowing their financial and business affairs to be looked after if accident, illness or old age makes it impossible for them to deal with it themselves.

A simple form is all that is required to save the individual and their family

from the worry of bank accounts and other assets effectively being frozen in those circumstances.

Details can be obtained from Roger Peters or Michael Tussaud in the Private Client Department.

The Enduring Power is to be replaced by the Lasting Power of Attorney

when the relevant provisions of the Mental Capacity Act 2005 come into force, probably in 2007. The Act preserves Enduring Powers already in existence at that date, so there is no reason not to put an Enduring Power into place now.

Roger Peters
Private Client Department

What is the length of your marriage?

It is not so many years ago that family law practitioners could safely advise their clients that the duration of a marriage – for the purpose of determining any financial settlement – began with the date on which the marriage was celebrated. The length of the marriage was then, and remains, one of the more important factors to be considered in calculation of the quantum of any financial award. Cohabitation prior to marriage was not treated as additional time to be added directly to the years of marriage.

A Shift of Attitude

However, practitioners can no longer give this advice. During the past few years the judicial approach to this has changed significantly.

It was with a degree of disbelief that the writer first encountered this shift in front of a judge in October 2002, who in her judgment said that, as the years of premarital cohabitation had moved “seamlessly” into marriage, the wife was entitled to a settlement based on a “long marriage”.

Perhaps the leading reported case on this subject is the case of *CO v CO* decided in February 2004. The primary issues before the court were the quantum of the lump sum to be awarded to the wife and the determination of appropriate periodical payments to the children. The judge decided that one of the crucial issues to take into account was the way in which the court ought to treat the period of pre-marriage cohabitation of some eight years. The judge said that nowadays cohabitation prior to marriage was a common enough circumstance in all levels of adult society. Indeed, Government statistics show that cohabitation as a domestic arrangement has risen threefold in little over twenty years, so that now some 30% of single female adults regard themselves as cohabiters.

This view has been supported since then by a number of the judiciary commenting that society has moved on and that it would be “old fashioned, indeed senseless” for the courts to ignore the way in which couples now chose to order their lives and that the idea of premarital cohabitation amounting to “living in sin” was now an outdated view. Thus, the years of cohabitation prior to marriage, provided there has been a “seamless” transition one to the other will count in



calculating the total length of the marriage for ancillary relief purposes.

Is there any way out?

In practice, this new approach means that it is likely to be in the interests of the paying spouse on an eventual divorce to have done whatever was possible at the beginning of the premarital cohabitation to try to ensure that the period of time to calculate the longevity of the relationship does not run during the period of cohabitation.

It is becoming more common for cohabiters to wish to regulate their financial affairs by means of a cohabitation agreement. This may be particularly appropriate if one or both of the parties is older and if they have acquired substantial assets. Perhaps such cohabitation agreements should also state that the purpose of living together is as a “trial period” to see if there is any basis for a later marriage and specifically state that time is not to run until the date the actual marriage is celebrated. It

is not clear if this approach would be upheld by the Courts, but it may be an imaginative step worth taking if one or other party is anxious to provide for a marriage to be shorter rather than longer, given the move towards equality of division of assets on marriage breakdown in long marriages.

Of course, both parties need to have separate and independent legal advice before any form of cohabitation agreement is entered into.



Kathryn Peat, Family Department

Important litigation funding ruling in Court of Appeal

Gordon Dadds played a leading part in a recent Court of Appeal decision (Arkin -v- Borchard) which raised important issues of public policy surrounding the costs associated with providing access to justice.

Recent Government policy has shifted radically around access to justice through the courts. Legal aid has been almost replaced by a system of “no win, no fee” contracts where lawyers share the costs risk of going to court, a bit like doctors only being paid for those patients who recover from their complaints. Instead of going to court parties are being encouraged to use mediation which is costly and has to be paid for upfront. This, along with recent huge increases in court fees, seem to have more to do with saving Government money than affording citizens access to their own courts.

Mr Arkin owned a small shipping line which, he claimed, was forced out of business by several powerful shipping lines waging a price war. The European Commission found that there had been unfair competition against him but he had to take his case to the English courts to recover damages. It was one of the first such cases brought in the UK for a breach of EU competition law.

Mr Arkin got legal aid at first but that was later withdrawn and his lawyers then agreed to act on a “no win, no fee” basis. The courts do not like experts to act on a contingent basis and so Mr Arkin needed funds to pay the expert accountants (Ernst & Young) upfront as their evidence was needed to prove his case.

Elision Group Ltd, a professional funder, agreed to pay the expert’s fee (which eventually came to £1.3m) in

exchange for a share of Mr Arkin’s damages which were claimed at over \$100,000,000.

Mr Arkin eventually lost the case and the defendants asked the court to make Elision pay all their costs. Gordon Dadds was brought in to advise Elision. We ran the argument that Elision should be treated the same as the lawyers on “no win, no fee” retainers, as Elision was in effect performing the same function as the lawyers in affording access to justice. The need for such funders had been caused by the court’s preference for experts to be paid upfront.

The trial judge refused to make Elision pay the defendants’ costs on public policy grounds. He said that funders had an important role to play in such cases in enabling impecunious claimants to obtain access to justice and to make them pay the defendants’ costs might act as a deterrent to funders in the future.

The defendants appealed to the Court of Appeal which found that the funder had to pay part of the defendants’ costs. The Court said that a balance had to be struck between the conflicting interests of impecunious claimants being able to get to court and defendants being unable to recover the money spent defending themselves.

The court formulated a “solution” for such cases. Where a funder was enabling access to justice, and not interfering with the due administration of justice, the funder’s liability for the defendants’ costs should be capped at no more than the amount which the funder had paid towards the claimant’s costs of bringing the case to court. The court said that if necessary the claimant should be willing to share more of his damages if that was required to get the funder to support

him. In the event Elision was ordered to pay only £1.3m against the defendants’ overall costs of approximately £6m.

Some of the defendants are dissatisfied with that result and they are now asking the House of Lords to make Elision and some of the other defendants pay all their legal costs.

The Civil Justice Council advises the Government about modernising the civil justice system. In its latest report it makes 21 recommendations for improving access to justice, one of which (that third party funding can properly be used as a “last resort” means of providing access to justice) is directly as result of what happened in the Arkin case. Other recommendations aim to reduce costs further with a view to expediting settlement of cases. A Community Legal Aid Fund is also proposed which would require a successful claimant to share his winnings with the Legal Aid Board.

For now though, it seems that professional funding is here to stay. Poorer claimants should fare better with parties being encouraged to settle their disputes rather than argue in public about the merits of the case and who should pay the legal costs.



Cormac Cawley is a Partner in the Litigation Department of Gordon Dadds and acted on behalf of Elision in the Arkin case.

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The firm is not authorised under the Financial Services & Markets Act 2000 but we are able in certain circumstances to offer a limited range of investment services to clients because we are members of the Law Society. We can provide these investment services if they are an incidental part of the professional services we have been engaged to provide.

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