



LRA/114/2006
LRA/47/2007
LRA/89/2007
LRA/90/2007
LRA/106/2007

LANDS TRIBUNAL ACT 1949

***LEASEHOLD ENFRANCHISEMENT – intermediate leasehold interests – how to be valued –
Leasehold Reform, Housing and Urban Development Act 1993 Schedule 13 paras 6, 7 and 8***

**IN THE MATTER OF APPEALS AGAINST DECISIONS OF THE LEASEHOLD
VALUATION TRIBUNAL OF THE LONDON RENT ASSESSMENT PANEL**

BETWEEN **NAILRILE LIMITED** **Appellant**

and

(1) EARL CADOGAN **Respondents**
(2) WILLIAM HALLMAN AND NANCY HALLMAN

**Re: Flat 2, 12 Sloane Gardens, London SW1W 8DL
(LRA/114/2006)**

BETWEEN **DAEJAN PROPERTIES LIMITED** **Appellant**

and

(1) THE TRUSTEES OF THE EYRE ESTATE **Respondents**
(2) VARIOUS LESSEES

**Re: Regency Lodge, Adelaide Road, London NW3 5EE
(LRA/47/2007)**

BETWEEN

GULU LALVANI AND OTHERS

Appellants

and

**(1) EARL CADOGAN
(2) CADOGAN ESTATES LIMITED**

Respondents

**Re: 62 Cadogan Square, London SW1X OEA
(LRA/89/2007)**

BETWEEN

METROPOLITAN PROPERTIES CO (FGC) LIMITED

Appellant

and

**(1) TERENCE GEORGE KINGSTON
(2) CYNTHIA MARGARET HAYNES**

Respondents

**Re: Flat 8, Elms Court, Montagu Road, London SW19 1SZ
(LRA/90/2007)**

BETWEEN

UAE INVESTMENTS LIMITED

Appellant

and

**(1) ALIM INVESTMENTS LIMITED
(2) THE COMMISSIONERS OF THE EXHIBITION OF 1851**

Respondents

**Re: Flat 32, Albert Hall Mansions, Kensington Gore, London SW7 2AL
(LRA/106/2007)**

Before: The President and A J Trott FRICS

**Sitting at Procession House, 110 New Bridge Street, London EC4V 6JL
On 16-20, 23 and 25-27 June 2008**

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Philip Rainey and *James Fieldsend* instructed by Wallace LLP for Daejan Properties Limited, Metropolitan Properties Co (FGC) Limited and UAE Investments Limited; by Forsters LLP for Nailrile Limited; and by Goodman Derrick LLP for Gulu Lalvani and Others

Nicholas Dowding QC and *Mark Sefton* instructed by Pemberton Greenish for Earl Cadogan and Cadogan Estates Limited

Anthony Radevsky instructed by Pemberton Greenish for The Trustees of the Eyre Estate and by Farrer & Co LLP for The Commissioners of the Exhibition of 1851

Timothy Harry instructed by Portner and Jaskel LLP for the Regency Lodge Lessees

The following cases are referred to in this decision:

Visible Information Packaged Systems Ltd v Squarepoint (London) Ltd [2000] 2 EGLR 93
Cadogan v Sportelli [2006] RVR 382
Railtrack plc v Guinness plc [2003] 1 EGLR 124
Woozley v Woodall Smith [1950] 1 KB 325
Compton Group Ltd v Estates Gazette Ltd (1978) 26 P & CR 148
Fawke v Viscount Chelsea [1980] QB 441
R (on the application of Edison First Power) v Central Valuation Officer [2003] 4 All ER 209
Jones v Wrotham Park Settled Estates sub nom Wentworth Securities Ltd v Jones [1980] AC 74
Ghaidan v Godin-Mendoza [2004] 2 AC 557
Craven (Builders) Limited v Secretary of State [2000] 1 EGLR 128
F R Evans (Leeds) Limited v English Electric Co Limited (1977) 36 P & CR 185
Arrowdell Limited v Coniston Court (North) Hove Limited [2007] RVR 39
Arbib v Earl Cadogan [2005] 3 EGLR 139
Henry Smith's Charity Kensington Estate Trustees v Frampton [1985] 1 EGLR 239
Cadogan Holdings Limited v Pockney [2004] LRA/27/2003 unreported
Langinger v Cadogan LRA/46/2000 unreported

The following further cases were referred to in argument:

Jones v Wentworth Securities [1980] AC 74
Moseley v Hickman [1986] 1 EGLR 161
Szoma v Secretary of State for Work & Pensions [2006] 1 All ER 1
Hoare (VO) v National Trust [1999] 1 EGLR 155
James v UK (1986) 8 EHRR 123
Majorstake v Curtis [2008] 2 WLR 338
Howard de Walden v Aggio [2008] Ch 28
Wilson v First County Trust (No.2) [2004] 1 AC 816
Holy Monasteries v Greece (1994) 20 EHRR 1
Lithgow v UK (1986) 8 EHRR 329
Mellacher v Austria (1989) 12 EHRR 391
Papachelas v Greece (1999) 30 EHRR 923
Hentrich v France (1994) 18 EHRR 440
R (Gillan) v Commr of Police for the Metropolis [2006] AC 307

Vogt v Germany (1995) 21 EHRR 205
Fitzpatrick v Sterling Housing Association Ltd [1999] 4 All ER 705
Pepper v Hart [1993] AC 593
Fraser Pipestock v Gloucester City Council [1995] 2 EGLR 90
Shortlands Investments Ltd v Cargill plc [1995] 1 EGLR 51
Lloyds Bank Ltd v Lake [1961] 1 WLR 885
Dennis & Robinson Ltd v Kiossos Establishment [1987] 1 EGLR 133
Gray v IRC [1994] 2 EGLR 185
Nicholson v Goff [2007] 1 EGLR 83
Re Castlebeg Investments (Jersey) Ltd's Appeal [1985] 2 EGLR 209
Ryde International plc v LRT [2004] 2 EGLR 1
Customs and Excise Commrs v Cantor Fitzgerald International [2002] QB 546
Lloyd Jones v Church Commissioners [1982] 1 EGLR 209
Northern Electric v Addison [1997] 2 EGLR 111
Walton v Inland Revenue [1996] 1 EGLR 159
Trocette Property Co v GLC (1974) 28 P & CR 408
Wellcome Trust Ltd v Romines [1999] 3 EGLR 229
Re Westminster Property Group [1984] 1 WLR 1117
Simpson v Connolly [1953] 1 WLR 911
Robshaw Bros Ltd v Mayer [1957] 1 Ch 125
Lloyds Bank v Lake [1961] 1 WLR 885
Shortlands Investments v. Cargill [1995] 1 EGLR 51
Fitzpatrick v Sterling Housing Association [1999] 4 All ER 705
J A Pye (Oxford) v Graham [2005] 3 EGLR 1
Mason v Totalfinaelf UK Ltd [2003] 3 EGLR 93
National Westminster Bank plc v. Co-operative Wholesale Society [1995] 1 EGLR 97
Brown v Gloucester City Council [1998] 1 EGLR 95
Pitts & Wang v Earl Cadogan [2007] RVR 272
Raja Vyrcherla Narayana Gajapatiraju v Revenue Divisional Officer, Vizagapatam (The Indian Case) [1939] AC 302
A-G of Ceylon v Mackie [1952] 2 All ER 775
Carl v Grosvenor Estate Belgravia [2000] 3 EGLR 79

The following LVT decisions were referred to:

Sussex Lodge Freehold Ltd v Church Commissioners for England LON/ENF/1173/04 (17 November 2005)
SCMLLA v Gesso Properties (BVI) Ltd LON/00BK/OCE/2007/0070-71 (21 December 2007)
Weiss v Shawview International Ltd LON/NL/604/98 (4 August 1999)
Podd v Howard de Walden Estates LON/NL/1407/01 (18 May 2001)
Lee and Blackmun v The Portman Estate CAM/93/LVT/NL/013 (2004)
Norman Sinclair Properties Ltd LON/NL/1890-1909/03 (20 August 2003)
Matley v Liddell LON/NL/4573&4577/05 (4 June 2006)
Cadogan v Panagopoulos LON/NL/464/06 (18 September 2006)
Cadogan v Newman LON/NL/2275/03 (29 January 2005)
Chawdhary v HC Jones & Co (Surrey) Ltd LON/NL/3583, 3584 and 3585/04 (27 October 2005)
Grosvenor West End Properties v Harrison [2006] (LON/LVT/1807/2004)

INTERIM DECISION

Introduction

1. These appeals arise from applications made to leasehold valuation tribunals under section 48 of the Leasehold Reform, Housing and Development Act 1993 to determine the terms of acquisition of new leases to be granted under the Act. Under Chapter II of Part I of the Act (in which section 48 appears) the “qualifying tenant” of a flat held on a long lease has the right to acquire, in substitution for his existing lease, a new lease at a peppercorn rent for a term expiring 90 years after the term date of the existing lease. He does this by serving notice on the person who is the “competent landlord” and following the statutory procedures that lead to the grant of a new lease by that person on payment by the tenant of a premium determined under the Act. The “competent landlord” is the owner of an interest in the flat that fulfils two conditions: firstly that it is an interest in reversion expectant (whether immediately or not) on the termination of the tenant’s lease; and secondly that it is either a freehold interest or a leasehold interest of sufficient duration to enable the new lease to be granted.
2. There may, of course, be interests intermediate between those of the tenant and the competent landlord, ie leases that expire after the term date of the existing lease but before the term date of the new lease. The Act makes provision for these intermediate leasehold interests in terms of procedure and the payment to be made to the owners of them. An intermediate interest is not extinguished. It continues, shorn of the expectation of possession on its termination but with the obligation to pay rent continuing. Procedurally the competent landlord acts on behalf of the owner of the intermediate interest in relation to proceedings under the Act, except that the owner of the intermediate interest is entitled, on giving the requisite notice, to be separately represented in any legal proceedings, including those for the determination of the amount that is payable to him.
3. A number of particular features of intermediate interests are to be noted. The first is that an intermediate interest is frequently an interest that is not confined to the flat in issue but includes other flats in the same building. Secondly the existing value of an intermediate interest may be very small, typically where the reversion is for a short period and the rent payable to the owner of the intermediate interest is the same or little more than the rent payable by him. Thirdly, because every owner of an intermediate interest loses the expectation of possession of the flat and the owner of the intermediate interest immediately superior to the lease of the qualifying tenant loses his entitlement to rent but remains liable to pay rent to his landlord, the value of the interest after the grant of the new lease will often be negative.
4. It may be helpful if we adopt a defined vocabulary for the purposes of this decision. The “competent landlord”, ie the grantor of the new lease, may be the freeholder or he may be a leaseholder. In each of the present cases the competent landlord is the freeholder, and we will therefore refer to him as such. There may be more than one intermediate leaseholder, but in none of the present cases is there more than one. We will refer to the intermediate leaseholder

in each case as the leaseholder. The tenant we will refer to as the tenant: so that the three parties in each case are referred to as freeholder, leaseholder and tenant. The interest of the leaseholder in each case includes not only the particular flat for which a new lease is granted but other flats as well. We will use the term the intermediate lease when referring to the entirety of that interest and the term the ILI when referring to the leaseholder's interest in the subject flat.

5. The amount payable to the owner of an ILI is determined in accordance with Part III of Schedule 13 to the Act. The application of these provisions has given rise to differences of approach between valuers, and LVTs have themselves adopted varying approaches. In the sole Lands Tribunal decision, *Visible Information Packaged Systems Ltd v Squarepoint (London) Ltd* [2000] 2 EGLR 93, the approach adopted was to capitalise the gross rent lost by the intermediate leaseholder. This approach has been followed in some but not all LVT decisions. In addition the Schedule contains a formula for the valuation of such an interest if it is a "minor intermediate interest" (or "MILI"). A minor intermediate interest is defined as one that has an expectation of possession of not more than one month and a profit rent of not more than £5 pa. Different conclusions have been reached by LVTs as to the meaning of the MILI definition and hence the circumstances in which the MILI formula falls to be applied.

6. In the course of 2006 and 2007 the Tribunal received a number of appeals in which the valuation of ILIs under Chapter II of Part I of the 1993 Act was in issue, and it was thought appropriate to attempt to group these for hearing together, thus enabling a representative variety of cases to be considered with the objective of producing a decision that would have general application. In the event we were able to hear together five appeals.

7. The difficulty facing the valuers in these appeals is how they should value an ILI where the rent payable by the leaseholder to the freeholder exceeds the rent that it receives from the tenant following the abatement of the tenant's rent to a peppercorn under section 56(1) of the 1993 Act. The LVTs' approach to the problem in three of the appeals favours the capitalisation of the leaseholder's loss of rental income using a dual rate years' purchase (the *Squarepoint* approach). The leaseholders in these appeals argue that this approach is wrong. In four of the appeals they contend that the appropriate valuation method is to calculate the amount which a purchaser of the ILI would require in order to establish a fund (to include costs and the VAT on any reverse premium) sufficient to meet the leaseholder's continuing obligation to pay rent while at the same time producing an adequate return for the purchaser (referred to as the reducing fund approach). In the remaining appeal, that by Gulu Lalvani, the leaseholder's approach is to capitalise its negative income flow at the risk free rate of 2.25% adopted by the Tribunal in *Cadogan v Sportelli* [2006] RVR 382. This gives the amount of the reverse premium that it would have to pay a purchaser of its interest.

8. The question of how to value a negative income flow is the sole issue in three of the appeals. Of the remaining two appeals, that by Daejan Properties also raises the issue of the deferment rate to be applied to the value of the ILI where there is a substantial reversion before the grant of a new lease. In the case of 62 Cadogan Square (Lalvani) the freeholder also appealed. He argued, inter alia, that the ILI should have been valued as a MILI in accordance with paragraph 8(2) of Schedule 13 to the 1993 Act. He also argued that hope value should be

included in the valuation of the freehold reversion. Both parties have appealed against the LVT's determination of the relativity to be applied to the valuation of the existing tenants' leases.

9. The appeals raise a multiplicity of issues as to how ILIs are to be valued as a matter of law and valuation principle. Because of the great number of alternative valuations that would be needed if all the permutations of the possible outcomes on these issues were to be covered the parties agreed that we should produce an interim decision setting out our conclusions on the issues. The parties will then be able to provide us with their valuations on the basis of our approach and, if they wish, on any alternative basis that they contend that we should as a matter of law have adopted instead.

10. We begin by summarising the essential facts about each appeal, and we then proceed to deal in turn with the individual issues.

The appeals

LRA/114/2006: Nailrile Limited v (1) Earl Cadogan (2) William Hallman and Nancy Hallman

11. This is an appeal (which we refer to as Nailrile or 2/12 Sloane Gardens) by the leaseholder, Nailrile Ltd, of Flat 2, 12 Sloane Gardens, London SW1W 8DL against the LVT decision dated 14 May 2006 determining the premium to be paid for a new lease at £196,400, of which £5,600 was payable to the leaseholder and £190,800 to the freeholder. The freeholder, Earl Cadogan, is the first respondent. The valuation date is 28 July 2004.

12. The property, which was constructed as a terraced house, is divided into five flats, one of which is for the use of a caretaker. It is held by the leaseholder on a lease which expires on 29 September 2045. The rent at the valuation date was £1,000 pa, with rent reviews in 2007 and 2028 to 0.2% of the "leasehold value" of the whole building as defined in the lease. The underlease of Flat 2 expires on 26 September 2045 (so that the leaseholder has a 3 day reversion), and the rent reserved is £200 pa, which is to be reviewed on the same dates as for the headlease rent reviews to 20% of the rent payable under the headlease. Before any new lease claims were made the rent payable by the leaseholder was exactly matched by the rents it received from the underleases, so that its profit rent was nil. This would continue to be the case after each rent review. Following the grant of the new lease, therefore, the intermediate lease became onerous, with the headrent exceeding the underlease rents by £200 pa (and with the prospect of a greater annual deficit following the rent reviews).

13. The LVT concluded that the leaseholder's interest was a MILI following the grant of the new underlease, so that the MILI formula was to be applied to its valuation. The leaseholder contends that it was wrong to do so. On its behalf Mr Philip Rainey and Mr James Fieldsend (who also appeared for the leaseholders in the other appeals) called Miss Jennifer Ellis FRICS, a Member of Langley-Taylor LLP, Chartered Surveyors, to give expert valuation evidence. Mr

Peter Michael Sonneborn FCA of Sonneborn & Co, Chartered Accountants, adduced expert taxation evidence. All the parties accepted his report and by agreement he was not called to give oral evidence. Miss Ellis valued the ILI on the basis of the fund that she said would need to be established by a purchaser of that interest in order to meet the leaseholder's liabilities under the lease. Her estimate of the diminution in the value of the ILI was £33,840. Mr Mark Sefton appeared for the freeholder and called Mr Julian Mansfield Clark MRICS, a partner at Gerald Eve, to adduce expert valuation evidence. Mr Clark produced four valuations, reflecting different bases of valuation. His primary valuation was on the basis of a commutation of the headrent, which produced a nil estimate for the diminution in the value of the ILI. In the alternative he relied upon the LVT's valuation, which estimated the diminution in the value of the ILI at £3,509. The tenants did not appear.

LRA/47/2007: Daejan Properties Limited v (1) The Trustees of the Eyre Estate (2) Various Lessees

14. This is an appeal (which we refer to as Regency Lodge) by Daejan Properties Ltd, the leaseholder, against the LVT decision dated 23 February 2007 determining the total premiums to be paid by 22 underlessees for new leases in their flats at Regency Lodge, Adelaide Road, London NW3 5EE, at £794,234, of which £619,982 was payable to the leaseholder and £174,252 to the freeholders. Regency Lodge contains a total of 109 flats as well as 13 commercial units. The freeholders are The Trustees of the Eyre Estate. It is subject to a headlease to the leaseholder dated 11 March 1937 and varied by a deed of variation dated 28 April 1988. This lease expires on 25 December 2086 and is at a fixed annual rent of £4,500. Seventeen of the underleases were for terms of 99 years from December 1987. The remaining 5 underleases were for terms of 99 years from December 1933. The rents payable are in each case a matter of hundreds of £s, and the leases provide either for fixed increases or for review.

15. The LVT valued each ILI on the *Squarepoint* approach. The leaseholder said that it was wrong to do so and that the reducing fund approach should have been applied. When valuing the leaseholder's reversion after 27 years in respect of the 5 shorter underleases the LVT adopted a deferment rate of 6%. The leaseholder said that this was wrong and that the correct deferment rate was 5.25%. Miss Ellis gave valuation evidence for the leaseholder. Mr Anthony Radevsky appeared for the freeholder and called Mr Julian Edward Christian Briant MRICS, a Partner in Cluttons LLP, Chartered Surveyors, to give expert valuation evidence. Mr Timothy Harry represented the tenants and called Mr Simon Martin Radford MRICS, a Partner in Boston Radford, Chartered Surveyors, to give expert valuation evidence.

LRA/89/2007: Gulu Lalvani and Others v (1) Earl Cadogan (2) Cadogan Estates Limited

16. This is a consolidated appeal (which we refer to as 62 Cadogan Square) by the tenants and by the freeholders against a decision of the LVT dated 23 April 2007. The property, 62 Cadogan Square, London SW1X 0EA, contains six flats and a caretaker's flat. The headlease was granted by the freeholders, Earl Cadogan and Cadogan Estates Ltd, to the leaseholder Mallonbond Limited (a company that is owned by the tenants) on 25 March 1986 for a term of 65 years from 25 December 1984 in consideration of a premium of £120,000. The rent,

initially £2,500 pa, is subject to upwards only review at the end of the 21st, 42nd and 63rd years of the term to 0.55% of the leasehold value of the premises (on the assumption that the lease has a term of 65 years from the revision date at a peppercorn rent). The head rent on review as at 25 March 2006 is agreed at £45,500 pa. All of the underleases were granted on 25 March 1986 for terms of 65 years less 5 days from 25 December 1984 at rents that both initially and on review in total match the headlease rent. Following deeds of variation made on 26 January 1996 the underlease rents now total 97.54% of the headlease rent.

17. Each of the six tenants gave notice claiming a new lease under section 42 at almost exactly the same time (on 8, 14 and 21 November 2005). They did so on advice, with the intention of proceeding to a collective enfranchisement under Chapter I of Part I of the 1993 Act after the individual lease extensions had been agreed. The objective of this method of proceeding was to reduce the total amount payable to the freeholder. Notice of the separate representation of the leaseholder was served on the freeholder. The LVT determined the valuation issues between the parties, who had said at the hearing that they would produce, on the basis of the LVT's decision, a schedule of premiums for the LVT's approval. The tenants appealed on two grounds. Firstly, on the issue of relativity, they argued that the LVT was wrong to deduct a 4% allowance for onerous ground rents (OGR) from the relativity figure of 74.9% that was derived from the comparable data because those comparables already reflected OGRs. They argued that the correct relativity before any allowance for OGRs should be 78%. Secondly, the tenants said that the LVT was wrong to apply the *Squarepoint* approach when capitalising the leaseholder's loss in headrent rather than a single rate years' purchase at a risk free rate of interest.

18. The freeholders appealed on three grounds. Firstly, they said that the LVT was wrong to reject their contention that in valuing the ILI in each instance the headlease rent in respect of the flat concerned should be commuted. Alternatively, it was said, the LVT should have valued the ILI as a MILI, or, in the further alternative, held that compensation was payable under paragraph 5 of Schedule 13 to the 1993 Act to reflect the reduced amount that would be payable to the freeholders under the two-stage enfranchisement process. Secondly, the freeholders said that hope value should have been included in the valuation of the freehold reversion, or, alternatively, that hope value should have been excluded from the valuation of the existing leasehold interests. Thirdly, the freeholders said that the LVT's determination of a relativity of 70% was wrong and it had erred in saying that this was consistent with the freeholders' case. Mr Rainey for the tenants called Mr Richard David Kay MRICS and Mr Peter Beckett FRICS, both Partners in Beckett and Kay, Chartered Surveyors, as expert valuation witnesses. Mr Nicholas Dowding QC and Mr Mark Sefton appeared for the freeholders and called Mr Clark and Mr James Geoffrey Goddard Wilson MRICS, a Partner in W A Ellis, to give expert valuation evidence. The leaseholder did not respond to the appeal.

**LRA/90/2007: Metropolitan Properties Co (FGC) Limited v (1) Terence George Kingston
(2) Cynthia Margaret Haynes**

19. This is an appeal (which we refer to as Elms Court) by the leaseholder, Metropolitan Properties Co (FGC) Ltd, of Flat 8, Elms Court, Montagu Road, London SW19 1SZ, against the decision of the LVT dated 5 April 2007 determining the total premium payable for the

grant of a new lease at £58,066, of which £56,414 was payable to the freeholder and £1,652 to the leaseholder. The flat is one of 18 flats contained in two blocks, the freehold of which is vested in the second respondent, Cynthia Margaret Haynes. The leaseholder has a leasehold interest in the two blocks for a term of 99 years from 29 September 1938 at a fixed rent of £135 pa. The tenant, Terence George Kingston, holds the subject flat under a lease for 99 years less 3 days from 29 September 1938 at a rent of £50 pa, rising to £75 pa on 5 March 2009. Before the LVT all three parties agreed to use the fund approach in valuing the ILI, and accordingly the LVT did so too, although it said that, but for this agreement, it might well have been inclined to apply the *Squarepoint* approach. The LVT rejected Miss Ellis's method of valuing the fund, and the sole ground of appeal is that it was wrong to do so. Mr Rainey called Miss Ellis to give expert valuation evidence. Neither respondent appeared.

LRA/106/2007: UAE Investments Limited v (1) Alim Investments Limited (2) The Commissioners of the Exhibition of 1851

20. This is an appeal (which we refer to as Albert Hall Mansions) by the leaseholder, UAE Investments Ltd against the decision of the LVT dated 30 March 2007 determining the total premium payable for the grant of a new lease of 32 Albert Hall Mansions, Kensington Gore, London SW7 2AL, at £98,103, of which £81,328 was payable to the freeholder (the second respondent, The Commissioners of the Exhibition of 1851) and £16,775 was payable to the leaseholder. The leaseholder holds flats 1 to 83 Albert Hall Mansions under a lease granted by the freeholder for a term of 84 years from 29 September 1977 at an annual rent rising from £8,000 to £32,000 (£16,000 at the date of valuation). The tenant, Alim Investments Ltd, holds flat 32 under a lease for 84 years less 10 days from 29 September 1977 at an annual rent of £300, rising to £1,200 (£600 at the date of valuation). In valuing the ILI the LVT used the *Squarepoint* approach, and the sole ground of appeal is that it was wrong to do so and should instead have used the fund approach, which was favoured by all the valuers who gave evidence before it. Mr Rainey called Miss Ellis to give expert valuation evidence. Mr Anthony Radevsky appeared for the freeholder and called Mr Briant to give expert valuation evidence. The tenant withdrew from the appeal.

Valuation of ILIs under Schedule 13: overview

21. As we have noted above, the intermediate lease will usually extend to other flats besides the subject flat. This is the position in each of the appeals before us. Flat 2/12 Sloane Gardens is one of 5 flats (including a caretaker's flat). Regency Lodge contains 109 flats (as well as 13 commercial units), and 22 of these are the subject of the present appeals. There are 6 flats at 62 Cadogan Square (as well as a caretaker's flat) and all these are the subject of the present appeals. Flat 32 Albert Hall Mansions is one of a large number of flats contained in five blocks. Number 8 Elms Court is one of 18 flats.

22. In the case of 12 Sloane Gardens, the rent payable under each underlease is one-fifth of the headrent (£1000, with reviews to 0.2% of the leasehold value of the building in 2007 and 2028), so that there is no net rental income and the value of the intermediate lease (and the ILI before the new lease) is nil. The new lease removes one-fifth of the leaseholder's rental

income (£200 before the 2007 review), thus giving the leaseholder a net annual liability of this amount and making the interest negative in value. The position is the same in respect of 62 Cadogan Square, where the original rents under the underleases in total match the headrent (£2,500 pa up to the 2006 review, £45,500 pa from then until the next rent review, at 0.55% of the leasehold value of the block. The underlease rents were reduced by deeds of variation in 1996 to a little less than 100% of the headrent). By contrast each new lease in Regency Lodge will reduce the leaseholder's rental income but will not create a net liability (nor will the 22 new leases have this effect cumulatively). The same goes for 32 Albert Hall Mansions and 8 Elms Court.

23. Where the effect of the grant of the new lease is just to reduce the leaseholder's profit rent for the block as a whole, there is a simple but compelling argument for saying that the proper measure of what the leaseholder has lost is the capital value of the gross rent of the flat. In practice a leaseholder, faced with this loss of income, would retain the ILI and value what he has lost in this way (subject to our detailed comments on this valuation approach below). This was the approach of the Tribunal in *Squarepoint*. Where the effect of the grant of the new lease is to make the ground rent onerous, there is also a simple but compelling argument for saying that what would happen is that the leaseholder would agree with the freeholder to surrender his interest and pay the freeholder for this. It is said that, while the leaseholder would wish to relieve himself of the obligation to pay rent that was not covered by rent received from tenants, the freeholder would regard a leaseholder with a negative profit rent as a poor covenant and would be very ready to receive a lump sum payment in lieu. Mr Clark expressed the view that this is what could be assumed to happen, and we accept this view.

24. These approaches would, in our view, provide the truest reflection of the leaseholder's loss. For reasons that we give below, we conclude that, where the ground rent of the leasehold interest does not become onerous, the measure of what the leaseholder has lost is effectively the capitalised value of the gross rent of the flat. However, we do not think that it is open to us to conclude that, where the ground rent becomes onerous, the measure is what the leaseholder would pay the freeholder to accept a surrender of his lease. That approach, as we shall say, is excluded by the requirement to exclude the freeholder as a possible purchaser in such a sale.

Valuation of ILIs under Schedule 13: statutory provisions

25. Schedule 13 makes provision for the amount payable to the owner of an intermediate interest. Paragraph 1, as read with section 40(4)(c), defines "intermediate leasehold interest" to mean:

"the interest of any person [in whom there is vested a concurrent tenancy intermediate between the interest of the competent landlord and the tenant's lease], to the extent that it is an interest in the tenant's flat subsisting immediately before the grant of the new lease."

26. The Schedule provides:

“6 In connection with the grant of the new lease to the tenant there shall be payable by the tenant to the owner of any intermediate leasehold interest an amount which is the aggregate of –

- (a) the diminution in value of that interest as determined in accordance with paragraph 7; and
- (b) the amount of any compensation payable to him under paragraph 9.”

We deal with (b) (compensation) in a separate section of this decision.

27. Schedule 13 continues:

“7 (1) The diminution in value of any intermediate leasehold interest is the difference between –

- (a) the value of that interest prior to the grant of the new lease; and
- (b) the value of that interest once the new lease is granted.

(2) Each of those values shall be determined, as at the relevant date, in accordance with paragraph 8...

8 (1) Subject to sub-paragraph (2), paragraph 3(2) to (6) shall apply for determining the value of any intermediate leasehold interest for the purposes of any provision of this Schedule with such modifications as are appropriate to relate those provisions of paragraph 3 to a sale of the interest in question subject to the tenant’s lease for the time being and to any leases intermediate between the interest in question and that lease.

(2) The value of an intermediate leasehold interest which is the interest of the tenant under a minor intermediate lease shall be calculated by applying the formula set out in sub-paragraph (6) instead of in accordance with sub-paragraph (1)...”

We consider later sub-paragraphs (3) to (6) of paragraph 8, which deal with minor intermediate leasehold interests (MILIs).

28. Paragraph 8(1) applies paragraphs 3(2) to (6) of the Schedule (with appropriate modifications to relate them to the sale of an intermediate interest). Paragraph 3 provides for the valuation of the diminution in value of the landlord’s interest. Sub-paragraph (1) says that this is the difference between (a) the value of the landlord’s interest in the tenant’s flat prior to the grant of the new lease and (b) the value of his interest in the flat once the new lease is granted. Sub-paragraph (2) provides:

“(2) Subject to the provisions of this paragraph, the value of any such interest of the landlord as is mentioned in sub-paragraph (1)(a) or (b) is the amount which at [the relevant date] that interest might be expected to realise if sold on the open market by a willing seller (with neither the tenant nor any owner of an intermediate leasehold interest buying or seeking to buy) on the following assumptions –

- (a) on the assumption that the vendor is selling for an estate in fee simple or (as the case may be) such other interest as is held by the landlord, subject to the relevant lease and any intermediate leasehold interests;
- (b) on the assumption that Chapter I and this Chapter confer no right to acquire any interest in any premises containing the tenant's flat or to acquire any new lease;
- (c) on the assumption that any increase in the value of the flat which is attributable to an improvement carried out at his own expense by the tenant or by any predecessor in title is to be disregarded; and
- (d) on the assumption that (subject to paragraph (b)) the vendor is selling with and subject to the rights and burdens with and subject to which the relevant lease has effect or (as the case may be) is to be granted."

Valuation of ILIs under Schedule 13: issues of law

29. A number of issues on the effect in law of the provisions in Schedule 13 dealing with the valuation of ILIs were raised and we should deal with them at this point. They were as follows.

30. *Before and after valuation required.* Mr Rainey submitted that, since paragraph 7 defined the diminution in value of the ILI as the difference between its value prior to the grant of the new lease and its value after the grant of the new lease, it was necessary for two valuations to be carried out; and the *Squarepoint* approach, capitalising the loss of gross rent in a single valuation, was therefore incorrect in law. It is the case that paragraph 7 provides in terms for the determination of a before value and an after value in order to ascertain the diminution in value of the ILI. This does not, however, mean that the *Squarepoint* approach is wrong in law. If it can be shown to establish correctly the difference between the before and after values in particular circumstances there can be no objection to its application in such circumstances as a convenient device. We return to this later.

31. *ILI as part of interest that includes other flats.* Mr Rainey's submission was that the ILI has to be valued in isolation and that it was not permissible to do what the Tribunal in *Squarepoint* had done, which was to take into account the fact that the leaseholder's interest included the other flats in the block and that he would not in practice sell the ILI alone. "Intermediate leasehold interest" is defined in paragraph 1. It is the interest of the intermediate leaseholder "to the extent that it is an interest in the tenant's flat". To the extent that the intermediate lease is an interest in property other than the tenant's flat, therefore, it is said, it is not part of the "intermediate leasehold interest" for the purposes of the Schedule and is not to be taken into account under paragraph 7. The submission of Mr Radevsky for the freeholders in Albert Hall Mansions and Regency Lodge and of Mr Harry for the Regency Lodge lessees was that to assume the isolated sale of the ILI was unreal and that the Act should not be construed so as to produce such an unreal result. It was uncontroversial that in the real world the leaseholder would not sell his interest in a single flat in the block. Moreover, Mr Radevsky said, in the case of Albert Hall Mansions, clause 13(i) of the headlease imposed an absolute covenant on the leaseholder not to assign any part of the demised premises less than the whole.

Accordingly if the leaseholder's interest were the subject of a sale by itself the headlease could be subject to forfeiture and/or other claims for breach of covenant. On a proper construction of the Act there was no need to assume a severance of the leaseholder's interest and a separate and unlawful assignment of the ILI.

32. Although what has to be valued is the ILI as defined in paragraph 1 and although the value is to be ascertained on the basis of a sale by a hypothetical seller to a hypothetical buyer, it is not, in our judgment, the effect of the provisions that, if in reality the ILI would not (or indeed could not lawfully) be sold in isolation, such an isolated sale must be assumed. In such an assumed sale regard can be had to the likely attributes of the hypothetical seller. Thus in *Railtrack plc v Guinness plc* [2003] 1 EGLR 124, which concerned the assumed sale pursuant to compulsory powers of land over a railway, the Court of Appeal upheld the conclusion of this Tribunal that the hypothetical seller would be a company or authority with the function of maintaining the track. In Chapter II lease extension cases, if the hypothetical seller could be expected to have an interest not just in the subject flat but also in the other flats in the block and if it could be expected also that he would only sell his interest in the block as a whole, the proper way to value the ILI, in our judgment, would be as a component of such a sale of the intermediate interest. That these conditions apply in the case of Albert Hall Mansions and the Regency Lodge flats is not in dispute, and we think that the ILIs in each case should be valued as part of the leaseholder's interest. Similar considerations might have been expected to apply in the case of Elms Court (and the LVT made clear that its inclination would have been to value on the *Squarepoint* basis; but the parties agreed that the valuation should be on the fund basis, and the only matter in issue is whether the LVT was wrong to reject Miss Ellis's approach on this).

33. *Freeholder as purchaser.* Paragraph 8(1) of Schedule 13 provides that paragraph 3(2) to (6) is to apply for determining the value of any intermediate leasehold interest "with such modifications as are appropriate to relate those provisions of paragraph 3 to a sale of the interest in question..." Paragraph 3(2) provides for the assumed sale of the landlord's interest, before and after the grant of the new lease, "with neither the tenant nor the owner of any intermediate leasehold interest buying or seeking to buy". Where what has to be assumed is the sale of the ILI, Mr Rainey submitted, the appropriate modification is to substitute "landlord" for "owner of any intermediate leasehold interest."

34. Mr Dowding submitted that the only modification to paragraph 3(2) that was appropriate to relate it to the assumed sale of the ILI was to exclude the reference to the leaseholder. There was no warrant for writing in an exclusion of the freeholder from the market. The express exclusion from the market of the tenant and the leaseholder were necessary when valuing the freehold in order to prevent the sitting tenant's overbid. The same was true of the exclusion from the market of the tenant when valuing the intermediate lease. No such considerations applied, however, to exclude the freeholder when valuing the intermediate lease. Support for this approach was to be found, Mr Dowding said, by contrasting the provisions in Schedule 13 with the broadly corresponding provisions in Schedule 6, in which there had been expressly inserted, by amendment, a provision excluding the freeholder from the market.

35. The purpose of excluding the tenant and any owner of an ILI as potential purchasers when valuing the freehold is because their interests are involved in the grant of the new lease and they are potential special purchasers, each of whom might be prepared to pay more than others in the market in order to add to his ownership another interest in the flat. The same would clearly apply to the valuation of the ILI prior to the grant of the new lease: for this the tenant, the owner of any other intermediate leasehold interest and the freeholder would all be potential special purchasers. For this reason it seems to us inescapable that the competent landlord should be added to the tenant and the owner of any intermediate interest in the list of those excluded as possible purchasers. (It would not, however, be necessary to exclude the owner of any interest superior to that of the competent landlord, since such a person would not be involved in the grant of the new lease.)

36. We do not think that any assistance is to be derived from the exclusions in Schedule 6. It is not, we hope, necessary to set out the relevant provisions. Paragraph 3 of Schedule 6 is constructed rather differently from paragraph 3 of Schedule 13. The explanation for the provision in paragraph 7 of Schedule 6 that expressly excludes the freeholder in valuing the ILI appears to be this. An additional sub-paragraph, (1A), was included as an amendment to paragraph 3 in Schedule 6 specifying the persons excluded as possible purchasers of the freeholder's interest, and it was because of this that the further amendment in paragraph 7 was made adding to the list, for the purpose of valuing an ILI, the freehold owner. It is not in our view possible to derive from a contrast between this set of provisions and the amendments made to them on the one hand and the Schedule 13 provisions on the other an intention that paragraph 3 of Schedule 13, when applied to the valuation of an ILI, should not be treated as excluding the freeholder as a possible purchaser.

37. In the case of Albert Hall Mansions the LVT considered that it was not necessary to exclude the freeholder as a potential purchaser by assuming a modification to that effect of paragraph 3(2). It said that there was no indication that the exclusion of superior landlords or freeholders would be appropriate and that, where such an exclusion had been intended, it had been made explicit "(see paras 4A(1) and 4B(1) of Sched 13 as to marriage value)". As far as paragraphs 4A(1) and 4B(1) are concerned, these deal, for the purposes of marriage value, with the value of the tenant's interest respectively before and after the grant of the new lease. Excluded as a possible purchaser in the before valuation is the landlord, and in the after valuation the owner of any superior interest is excluded. Those exclusions are express because each of those paragraphs is making self-contained provision for the valuation of the interest to which it relates. There is, however, no such self-contained provision for the valuation of intermediate interests in view of the provisions of paragraph 8(1). The requirement to make "such modifications as are appropriate to relate those provisions of paragraph 3 to a sale of the interest in question" would clearly require the freeholder to be excluded as a potential purchaser if this was appropriate in order to give effect to the purpose of the exclusions in paragraph 3(2). The purpose of the exclusions in paragraph 3(2) is, as we have said, to exclude those who are involved in the grant of the new lease and who, by reason of their interest in the flat, could be special purchasers, prepared to pay more than the market in general. Where it is not the landlord's interest but that of an intermediate lessee that is being valued it seems to us to be inescapably necessary, in order to apply the provisions in accordance with this purpose, to exclude the landlord as a potential purchaser.

38. *Negative value.* The question was raised in argument whether the provisions of Schedule 13 were in any event apt to encompass negative values. Although the language of paragraph 3, with its reference to the amount which an interest might be expected to realise if sold on the open market by a willing seller, is only in terms applicable where the interest has a positive value, it is clear in our view that the provisions of Schedule 13 require to be operated where the interest has a negative value. Corresponding provisions in Schedule 6 unarguably extend to negative values since Part V of that Schedule expressly deals with interests with a negative value, and this clearly suggests that the provisions in Schedule 13 similarly encompass negative values. We do not in any event see how those provisions would be workable unless they did so.

MILI provisions

39. Schedule 13 makes provision for the valuation of minor intermediate interests (MILIs) in paragraph 8 as follows:

“ (3) ‘A minor intermediate lease’ means a lease complying with the following requirements, namely –

(a) it must have an expectation of possession of not more than one month, and

(b) the profit rent in respect of the lease must be not more than £5 per year.

(4) ‘Profit rent’ means an amount equal to that of the rent payable under the lease on which the minor intermediate lease is in immediate reversion, less that of the rent payable under the minor intermediate lease.

(5) Where the minor intermediate lease or that on which it is in immediate reversion comprises property other than the tenant’s flat, then in sub-paragraph (4) the reference to the rent payable under it means so much of that rent as is apportioned to that flat.

(6) The formula is –

$$P = \text{£} \frac{R}{Y} - \frac{R}{Y(1+Y)^n}$$

Where –

P = the price payable;

R = the profit rent;

Y = the yield (expressed as a decimal fraction) from 2½ per cent Consolidated Stock;

n = the period, expressed in years (taking any part of a year as a whole year), of the remainder of the term of the minor intermediate lease as at the relevant date.”

40. In three of the appeals, Regency Lodge, Albert Hall Mansions and Elms Court, the existing interest in the tenant’s flat is not a MILI. In each case the profit rent exceeds £5 per annum, and, in relation to five of the Regency Lodge flats, there is also more than a nominal

reversion. In Nailrile and 62 Cadogan Square, the present interest of the headlessee is clearly a MILI.

41. Equivalent MILI provisions appear in paragraph 7 of Schedule 6 to the 1993 Act and in paragraph 7A of Schedule 1 to the 1967 Act, where they are called minor superior tenancies. In each case the requirements with which a lease has to comply to make it a MILI are the same. The difference, however, between those provisions and the ones in Schedule 13 is that the former fall to be applied in a once-for-all valuation. In Schedule 13 by contrast they fall to be applied in the course of before and after valuations that establish the diminution in value of the ILI.

42. A number of issues arise in relation to the application of the MILI provisions. They are as follows. (a) *“Once a MILI always a MILI”*. A contention advanced by Cadogan is that paragraph 8(2), which provides that the value of an intermediate lease which “is” the interest under a MILI is to be calculated by applying the paragraph 8(6) formula, can only be referring to the period prior to the grant of the new lease. There is no reference to whether the interest “will be” a MILI after such grant. So, it is said, the statutory language contemplates that the test is to be applied once only, with the consequence that if the ILI is a MILI in the “before” valuation it must equally be a MILI in the “after” valuation. Were that not the case, the before and after valuations would be on different bases, so that the capitalisation rate in the after valuation could be quite different from the predetermined rate in the before valuation.

43. We do not think that this contention is correct. The function of the MILI provisions, it appears to us, is quite clearly to provide a convenient formula to apply where an interest is of very small value. It saves the parties the need to decide what capitalisation rate to use and it avoids time and money being spent on resolving any difference on this that there might be between them. Because the before value of the ILI is very small, and would not be significantly different if another capitalisation rate were used, it does not seem to us to matter if the MILI formula is not applied to the after valuation rather than a formula that is justified on the evidence. Nor is there anything in the use of the word “is” in paragraph 8(2) to compel the application of the MILI formula to the after valuation even if it does not meet the requirements in paragraph 8(3).

44. (b) *“An expectation of possession of not more than one month”*. The intermediate lease will necessarily have an earlier term date than the term date of the new lease, so that the owner of the ILI has no expectation of possession. Cadogan’s argument is that a person with an expectation of no time at all is someone who has an expectation of possession of not more than one month. That argument was accepted by the LVT in the case of Nailrile and was rejected by the LVT in the case of 62 Cadogan Square. In our judgment the argument is not correct. The requirement under paragraph 8(3)(a) is that the lease “must have an expectation of possession of not more than one month”. The literal meaning of these words is in our view the right one: there must be an expectation of possession but it must not be for more than one month.

45. Cadogan point out that, if this construction is correct, then the after valuation can never be on the MILI basis since the owner of the ILI will never have an expectation of possession for the purposes of the after valuation. We can see nothing at all remarkable in this. The MILI formula performs an obviously useful function in relation to existing ILIs of small value, but there is no reason to suppose that it must have been intended to have a wider role than this. As we have said, the formula was imported into Schedule 13 from Schedule 6, where its function was to assist in the single valuation that was required of an intermediate interest that was extinguished in the collective enfranchisement process. We can detect no purpose that would require the wording to be strained so as to apply it to the after valuation in the case of a lease extension.

46. (c) *“The profit rent”*. A similar issue arises in relation to the other limb of paragraph 8(3). Cadogan contend that where there is no profit rent or where there is a negative return there is, within the terms of the provision, a profit rent of not more than £5. Before the LVTs Cadogan succeeded on this issue in the case of Nailrile and failed on it in the case of 62 Cadogan Square. It does not arise if we are correct in our conclusion on issue (b). But we are in any event of the view that the requirement is only met if there is a positive profit rent. The reference to £5 can only be to a positive amount of £5, and this necessarily implies in our view that a profit rent of not more than £5 must be a positive amount. Since the rent under the new lease is a peppercorn the profit rent under the ILI in the after valuation will always be a negative amount unless the headrent is itself a peppercorn, in which case it will be nil. If it had been intended that the MILI provisions should apply to the after valuation, in which there is always a nil or negative profit rent (and there is no expectation of possession) it seems unlikely that this would not have been stated expressly – as it could have been, very shortly – rather than leaving the world to infer this from words in the MILI requirements that are not obviously apposite for this purpose.

47. The function of the MILI provisions, as we have said, is quite clearly to provide a convenient formula to apply where an interest is of very small value. Cadogan’s argument, if correct, would mean that an ILI with a very large headrent remaining after the lease extension would fall to be valued by the formula. That would not be consistent with the function of the provision. In such a case it would not be right to deny the parties the opportunity to adduce their own valuations, which could be wide apart, for decision by the tribunal.

48. (d) *Whether the MILI formula includes rent reviews*. The appellants in the two Cadogan appeals contend that, if a rent is subject to review, the reviewed rent must be taken into account in applying the MILI formula. Cadogan say that this is wrong. The MILI formula, they say, was clearly intended to be a simple and straightforward calculation by reference to a fixed capitalisation rate and a known rent, and, if it had been intended to take account of rent reviews, express provision would have been made for how that was to be done. There would have been no point in providing a formula in which all the inputs were carefully defined save one. Moreover there would be no particularly obvious or reliable way of taking account of future rent reviews, since the conventional way of doing this, by adjusting the yield, would not be permissible under the MILI formula.

49. The appellants rely on three authorities for their interpretation of “the rent payable under the lease” in paragraph 8(4). *Woozley v Woodall Smith* [1950] 1 KB 325 (a case under the Rent Restrictions Acts), *Compton Group Ltd v Estates Gazette Ltd* (1978) 26 P & CR 148 (in which the issue was whether or not the reviewed rent was to be fixed having regard to counter-inflation legislation) and *Fawke v Viscount Chelsea* [1980] QB 441 (a case concerning the court’s power under the Landlord and Tenant Act 1954 to order an interim rent).

50. In our view the questions of whether and how the MILI formula should be applied to take account of rent reviews is unlikely to arise in practice other than exceptionally. This is because of requirement (b) in paragraph 8(3). We have already said that this is not satisfied where the profit rent is nil or a negative amount. It is also the case, in our judgment, that the requirement is not satisfied where the post-review profit rent attributable to the flat is or could be in excess of £5. Clearly, when reference is made to the rent that “is” payable under the lease, this means the rent for which the lease provides. There is no reason why it should be confined to the rent that is payable on the next rent day following the valuation and should not extend to that payable on all subsequent rent days. For this reason, unless the effect of the review provisions in the lease is that the rent will never exceed £5, requirement (b) will not be satisfied.

51. Given this construction of requirement (a), it is in our view not surprising that there is no prescription for applying the MILI formula to rent review cases since the problem is very unlikely to arise. Were it to do so we rather think that the solution would be to take R as being the weighted average, or equivalent, profit rent over the term of n years. But on the facts of the present cases the problem does not arise.

Two-stage enfranchisement: background

52. In the case of the acquisition of the freehold or extended lease of a house under the 1967 Act or the acquisition of the freehold of premises containing flats on a collective enfranchisement under Part I of the 1993 Act any intermediate interest, to the extent that it is an interest in the house or premises, is also acquired in the enfranchisement process by the tenant or the nominee purchaser. In the case of a lease extension under Part II of the 1993 Act by contrast an ILI is not acquired. Under paragraph 10 of Schedule 11 the tenant’s new lease, and his rights and obligations under it, takes effect as if there had been a surrender and re-grant of the ILI. The owner of the ILI loses his reversion and, since the tenant’s rent is a peppercorn, he loses the rent receivable under the ILI.

53. In the case of 62 Cadogan Square the tenants own the ILI, and what Mr Beckett, advising them, perceived was that they would be substantially better off if each tenant secured an individual lease extension before together they effected a collective enfranchisement. The landlord, however, would be substantially worse off, and it is this consequence that Cadogan said was unfair. Mr Clark produced a notional valuation to illustrate how a two-stage approach to collective enfranchisement can diminish the amount that the freeholder receives. It assumes a 40-year headlease, with underleases of 40 years less 5 days of five flats, each with a freehold (long leasehold) vacant possession value of £1m. The rent payable by the intermediate leaseholder under the headlease is the same as that receivable by him under the underleases and

is substantial. The value of the ILI before enfranchisement is thus nil, and on a one-stage collective enfranchisement the intermediate leaseholder therefore receives nothing and the freeholder receives £1.5153m. If individual lease extensions under Part II precede the collective enfranchisement, however, a substantial amount (£440,685) is payable to the intermediate leaseholder because he is left in receipt of peppercorn rents but his liability for the substantial headlease rent remains. The amount payable to the freeholder (£969,500) is diminished because of this. At stage 2, the collective enfranchisement, the negative value of the ILI has to be offset against the smaller value of the freehold interest so that the amount payable to the freeholder is nil. Overall, therefore, the freeholder in fact receives £545,800 less under this two-stage enfranchisement. The owner of the ILI, by contrast, the value of whose interest before the enfranchisement process was nil, receives £440,685 simply as the result of the collective enfranchisement having been effected in two stages rather than one.

54. Mr Clark's example values the leaseholder's interest after the grant of new leases as though it is a MILI. We have rejected this approach for the reasons given in paragraph 46 above. Mr Beckett values the 'after' interest in 62 Cadogan Square by capitalising the negative profit rent at a single rate years' purchase at 2.25%. The effect of using Mr Beckett's approach in the current example (keeping everything else constant) is to increase the adverse effect upon the freeholder by proceeding under a two-stage enfranchisement. The negative value of the leaseholder's interest increases from £440,685 to £605,070 and the amount payable to the freeholder reduces from £969,500 to £896,730, making the freeholder £618,570 (41%) worse off by comparison with a single stage enfranchisement.

55. Cadogan contended that the Act should be so construed that the unfairness arising from such a two-stage enfranchisement process was avoided. The unfairness would be avoided, they said, if the Act were construed so as to reduce the rent payable under the ILI to a peppercorn, or, as it was put, commuted. They urged such a construction on the basis of conventional principles of construction or alternatively in reliance on the Human Rights Act. The unfairness could alternatively be mitigated, they said, if the ILI was valued as a MILI in the after valuation or if the landlord were held to be entitled, under paragraph 5 of Schedule 13, to compensation that reflected his potential loss as a result of the collective enfranchisement being effected in this way. We have already concluded that an ILI is not to be valued as a MILI in the after valuation. Our conclusion is that compensation under paragraph 5 of Schedule 13 is payable for such diminution in value of the landlord's interest as results from his prospective loss on the second-stage collective enfranchisement. Since compensation is provided for in this way there is no justification in our view in seeking to construe other provisions in the Act so as to provide for commutation; but in any event we do not think that it is possible on any basis to construe any of the provisions to this effect.

56. We will deal first with paragraph 5 of Schedule 13 and then with the commutation issue. We should say that we have no difficulty in accepting Cadogan's submission that in a case such as that illustrated by Mr Clark's example the Act, construed as it is expressed (and leaving out of account the possibility of compensation under paragraph 5), would operate unfairly in enabling the two stage process to be followed to the substantial prejudice of the landlord. Of course, it is the combination of a minimal reversion under the ILI, a substantial headrent and a nil profit rent that produces this effect, and these elements will only sometimes be present together. But we have no reason to believe that they are exceptional. It is also the case, as

Mr Rainey pointed out, that it is the tenants' ownership of the ILI that makes it worth their while to follow the two-stage process. In Mr Clark's example the overall cost of the two-stage process is rather higher than that of a single-stage collective enfranchisement. It may be that such an ILI owned by the tenants is not a frequent occurrence. But, where they do not own the ILI, the prospect of their purchasing it from the owner, who would stand to receive nothing in a one-stage collective enfranchisement, is manifest. We do not think, therefore, that the consequences of which Cadogan complain are to be dismissed as being a very rare exception in the operation of the statutory provisions.

Two-stage enfranchisement: compensation under paragraph 5 of Schedule 13

57. Paragraph 5 of Schedule 13 provides:

- "5. (1) Where the landlord will suffer any loss or damage to which this paragraph applies, there shall be payable to him such amount as is reasonable to compensate him for that loss or damage.
- (2) This paragraph applies to –
- (a) any diminution in value of any interest of the landlord in any property other than the tenant's flat which results from the grant to the tenant of the new lease; and
 - (b) any other loss or damage which results therefrom to the extent that it is referable to the landlord's ownership of any such interest.
- (3) Without prejudice to the generality of paragraph (b) of sub-paragraph (2), the kinds of loss falling within that paragraph include loss of development value in relation to the tenant's flat to the extent that it is referable as mentioned in that paragraph..."

58. It is this provision on which, in an alternative argument, *Cadogan* relied. They said that, since the effect of the grant of the new lease of a flat, with the head rent remaining the same, was to create a negative value in the intermediate interest in relation to the flat, the prospect of a collective enfranchisement, in which the negative value was deducted from the price, would damage the value of the reversion. If the landlord were to seek to sell the reversion the purchaser would realise that there was the prospect of a collective claim at the reduced price, and he would pay less for it. The loss was a proper subject for compensation under paragraph 5.

59. Mr Rainey submitted that paragraph 5(2) only applies where the diminution in value or the loss or damage relates to "any interest of the landlord in any property other than the tenant's flat"; and that the suggested disadvantage to the competent landlord related to his interest in the flat and not to his interest in any other part of the building. Accordingly, he said, the landlord could have no claim to compensation under paragraph 5. Even if the landlord did have a theoretical claim, any assessment of compensation would have to assume that there was a certainty of collective enfranchisement taking place immediately following the valuation

date. But the collective enfranchisement might never happen, in which case the landlord would have received compensation for a loss that he had not suffered.

60. This submission seems to us to be erroneous. The basis of the claim for compensation is that, on a collective enfranchisement after the grant of the new lease, the price payable to the landlord would be less, by a greater amount than the price payable for the lease extension, than it would be if the new lease had not been granted. To the extent that the prospect of such reduced price is reflected by a diminution in the present value of his interest in the flats (after the grant of the new lease) this would in our judgment constitute a loss for which compensation is payable under paragraph 5. Insofar as that diminution in value is a diminution in value of his interest in the other flats, it would constitute a loss under paragraph 5(2)(a); and, insofar as the diminution in value is a diminution in value of his interest in the subject flat, it would in our judgment fall under paragraph 5(2)(b).

61. As read with paragraph 5(2)(a), paragraph 5(2)(b) applies paragraph 5 to:

“any... loss or damage [other than a diminution in value of the landlord’s interest in any property other than the tenant’s flat] which results [from the grant to the tenant of the new lease] to the extent that it is referable to the landlord’s ownership of any [interest in any property other than the tenant’s flat].”

62. To the extent that the diminution in value of the landlord’s interest is a diminution in value of his interest in the subject flat it constitutes a loss within paragraph 5(2)(b) because:

- i. it is not a diminution in value of the landlord’s interest in any property other than the tenant’s flat;
- ii. it results from the grant to the tenant of the new lease; and
- iii. it is referable to the landlord’s ownership of his interest in the other flats.

Only (iii) requires explanation. The loss is referable to the landlord’s ownership of his interest in the other flats because it is by reason of such ownership that he can be compelled on a collective enfranchisement of those flats and the subject flat to transfer his interest to a nominee purchaser at a price determined under the provisions of Schedule 6. Such a loss is analogous to the loss of development value, for which express provision is made in subparagraph (3). If the amount received by the landlord on a collective enfranchisement would be less by reason of the earlier grant of the new lease, there is a prospective loss to him; and to the extent that that prospective loss is reflected in a diminution in the value of his interest in the flat on the grant of the new lease it is a loss that falls within paragraph 5(2)(b).

63. The loss that is suffered (and for which paragraph 5 provides compensation) consists of a diminution in value of the landlord’s interest in the tenant’s flat. It does not fall within paragraph 2(a) and paragraph 3, however, because of the assumption in paragraph 3(2)(b) that Chapter I confers no right to acquire any interest in premises containing the tenant’s flat. We can see no reason why a loss consisting in a diminution in value of the landlord’s interest in the tenant’s flat, although excluded as an element of the premium payable under paragraph 2(a), should not be included as an element of the premium payable under paragraph 2(c) where it

satisfies the requirements of paragraph 5(2)(b). Indeed in circumstances such as those in the case of 62 Cadogan Square it is this provision that constitutes the corrective for the unfairness that would result from the two-stage enfranchisement process.

64. Because the diminution in value of the landlord's interest falls either within paragraph 5(2)(a) (to the extent that it is a diminution in value of the other flats) or within paragraph 5(2)(b) (to the extent that it is a diminution in value of the subject flats) there is no need to determine the extent to which it falls within either of these provisions: but we rather think that the diminution in value is one that falls wholly within paragraph 5(2)(b).

65. It is no objection to the claim for compensation that collective enfranchisement may never occur. The present value of an interest in land may well depend on the view that the market takes of the possibility of future events occurring. The assessment of the loss for which paragraph 5 provides compensation will, of course, depend on the degree of likelihood that the tenants of the premises will proceed to a collective enfranchisement. If the probability of this is perceived to be low, the diminution in value of the landlord's interest by reason of the prospect of such collective enfranchisement will no doubt be small. In the case of 62 Cadogan Square, however, the evidence is that there is a firm proposal on the part of the tenants to proceed to a collective enfranchisement (indeed Mr Beckett said that this was the intention of the tenants), and each of the tenants has given notice seeking a lease extension. The valuation of the ILI in relation to each individual flat must accordingly be made with this in mind. In other cases there may be no such stated intention, and the probability of collective enfranchisement occurring would then have to be assessed in the light of the surrounding circumstances.

Two-stage enfranchisement: commutation

66. As we have said, because of our conclusions on compensation under paragraph 5 of Schedule 13, there is not in our judgment any justification for seeking to construe the provisions of the Act as providing for the commutation of the headrent. We will nevertheless address Cadogan's arguments on this. It is to be noted that they were also supported by them in the other Cadogan appeal, 2 at 12 Sloane Gardens, and by the freeholders in the Regency Lodge and Albert Hall Mansions appeals. Those freeholders, the Trustees of the Eyre Estate and The Commissioners of the Exhibition of 1851, represented by Mr Radevsky, did not seek to add anything to Cadogan's arguments, but they noted that commutation of rent is in practice adopted in the market as a practical solution because it produces a fair result.

67. Cadogan focussed on paragraph 10(1) of Schedule 11 as the provision that ought to be construed so as to provide for commutation of the headrent. So far as relevant paragraph 10(1) provides:

“Where a lease is executed under section 56.... then (subject to sub-paragraph (3)) that instrument shall have effect for the creation of the tenant's new lease of his flat, and for the operation of the rights and obligations conferred and imposed by it, as if there had been a surrender and re-grant of any subsisting lease intermediate between the

interest of the competent landlord and the existing lease; and the covenants and other provisions of that instrument shall take effect accordingly.”

68. Mr Rainey said that the purpose of this provision for a notional surrender and re-grant of the intermediate lease was as a mechanism that enabled the new lease to take effect in possession. Mr Dowding accepted this but said that there was no need to limit its operation in this way; it did not say in terms that the re-grant was in identical terms (indeed in at least one respect the terms were different in that the rent was reduced to a peppercorn), and on conventional canons of statutory construction it was appropriate to construe the provision as providing for commutation of the headrent.

69. Mr Dowding relied on the principle stated by Lord Millett in *R (on the application of Edison First Power) v Central Valuation Officer* [2003] 4 All ER 209 at paragraph 116:

“The Courts will presume that Parliament did not intend a statute to have consequences which are objectionable or undesirable; or absurd; or unworkable or impracticable; or merely inconvenient; or anomalous or illogical; or futile or pointless. But the strength of these presumptions depends on the degree to which a particular construction produces an unreasonable result. The more unreasonable a result, the less likely it is that Parliament intended it...”

70. In appropriate circumstances, therefore, Mr Dowding said, it was proper to find an implication within the express words of a statute to avoid the consequences referred to in this passage. The question whether an implication was to be found depended on whether it was proper, having regard to the accepted guide to legislative intention, and not on whether it was “necessary” or “obvious”. Paragraph 10(1) was therefore to be read purposively as follows (with italics added to show the insertions):

“Where a lease is executed under section 56.... then (subject to sub-paragraph (3)) that instrument *and any intermediate lease* shall have effect for the creation of the tenant’s new lease of his flat, and for the operation of the rights and obligations conferred and imposed by it *and any intermediate lease*, as if there had been a surrender and re-grant of any subsisting lease intermediate between the interest of the competent landlord and the existing lease *on terms which provide for the rent payable under any intermediate lease to be abated to the same extent as the rent abatement under section 56*; and the covenants and other provisions of that instrument *and of such intermediate lease* shall take effect accordingly.”

71. There is clear and high authority, closely related in subject-matter, on the question of reading words into a statute in order to reflect a purposive instruction. In *Jones v Wrotham Park Settled Estates sub nom Wentworth Securities Ltd v Jones* [1980] AC 74, a case relating to the enfranchisement of the freehold of a house under the 1967 Act, very shortly before the leaseholder’s notice was served the freeholder had granted to a property company a concurrent lease of the house (and all other houses on the freeholder’s estate) for 300 years at a peppercorn rent until the expiry of the tenant’s lease. The lease provided that, if the company should grant a sublease to the tenant, the rent payable should become a rack rent. If this provision fell to be

taken into account the price payable under the enfranchisement to the freeholder was £4,000 and to the company £nil. If the provision were left out of account the freeholder's entitlement was £50 and the company's £250. The tenant contended that the provision should be left out of account under section 23(1) of the 1967 Act as "an agreement relating to a tenancy" that purported "to modify any right to acquire the freehold" and/or provided for "the imposition of any penalty or disability on the tenant" in the event of his making application to enfranchise under the Act. The question was whether this provision should be construed as applying to an agreement to which the tenant was not a party.

72. The House of Lords, reversing the Court of Appeal and restoring the decision of the Lands Tribunal (V G Wellings QC), concluded in favour of the freeholder. Lord Russell of Killowen, with whom the other law lords agreed, said (at 113D) that the provision in the lease, while its effect was to modify the terms on which the tenant might acquire the freehold, did not modify the right itself and (at 114C) that it did not provide for the imposition of any penalty or disability on the tenant. He said (at 114B) that there was "ample scope for the operation of section 23(1) without embracing this case".

73. At 106H to 107B Lord Salmon said:

"In my opinion, it was clearly the policy of the legislature under the Act of 1967 that the tenant should obtain the freehold of his home at the ordinary market price and not at a price which had been inflated by a transaction such as the present. I have no doubt that if it had ever occurred to the legislature that a transaction such as the present might have been devised and put into operation, clear words would have been introduced into the Act, which would preclude such a transaction from affecting the market price which the tenant would have to pay for the freehold of his home. As it is, no such words appear in the Act; and accordingly it contains a gap. It is well settled, however, that the courts have no power to fill in any gap in an Act, even if satisfied that, had the legislature been aware of the gap, it would have filled it in: *Johnson v Moreton* [1980] AC 37; *Gladstone v Bower* [1960] 2 QB 384 and *Brandling v Barrington* (1827) 6 B & C 467, 475 per Lord Tenterden CJ. Accordingly, there is nothing to be done by this House, sitting in its judicial capacity, other than to allow the appeal. It may, however, perhaps be worth consideration in other quarters whether the Act should be amended."

In the event the Act was amended shortly afterwards by the Leasehold Reform Act 1979.

74. Lord Diplock at 105E to 106A said this:

"My Lords, I am not reluctant to adopt a purposive construction where to apply the literal meaning of the legislative language used would lead to results which would clearly defeat the purposes of the Act. But in doing so the task on which a court of justice is engaged remains one of construction; even where this involves reading into the Act words which are not expressly included in it. *Kammins Ballrooms Co Ltd v Zenith Investments (Torquay) Ltd* [1971] AC 850 provides an instance of this; but in that case the three conditions that must be fulfilled in order to justify this course were satisfied. First, it was possible to determine from a consideration of the provisions of

the Act read as a whole precisely what the mischief was that it was the purpose of the Act to remedy; secondly, it was apparent that the draftsman and Parliament had by inadvertence overlooked, and so omitted to deal with, an eventuality that required to be dealt with if the purpose of the Act was to be achieved; and thirdly, it was possible to state with certainty what were the additional words that would have been inserted by the draftsman and approved by Parliament had their attention been drawn to the omission before the Bill passed into law. Unless this third condition is fulfilled any attempt by a court of justice to repair the omission in the Act cannot be justified as an exercise of its jurisdiction to determine what is the meaning of a written law which Parliament has passed. Such an attempt crosses the boundary between construction and legislation. It becomes a usurpation of a function which under the constitution of this country is vested in the legislature to the exclusion of the courts.”

75. In the present case we are concerned with provisions in the 1993 Act which, in the vast majority of cases, do not cause the injustice of which complaint is made. There is, to apply Lord Russell’s words, ample scope for the operation of the provisions without the production of an unfair result other than in particular circumstances. The construction for which Cadogan extend would, however, change the wording of the provision so as to affect its operation in all cases.

76. Cadogan said that there is a “statutory ellipsis” in that paragraph 10(1) provides for the deemed surrender and re-grant of the ILI without stating on what terms it is re-granted. It is, in our judgment, necessarily implicit, however, since what is being re-granted is the lease, that the terms of the lease continue. There is no failure, therefore, to make a provision that is needed if the statutory machinery is to operate, and accordingly there is no need to imply a specific term relating to the rent. The rent is that payable under the lease.

77. The unfairness that we find to be capable of arising in a two-stage enfranchisement is not caused by some inherent unfairness in the first stage, the individual lease extensions. It arises because at the second stage, the collective enfranchisement, the valuations are carried out without reference to the valuations carried out and the amount paid at the first stage. Correction of the unfairness is thus not obviously to be sought in giving one of the provisions relating to individual lease extensions a meaning that it does not naturally bear through the insertion of the words which Cadogan suggested should be added. Paragraph 10(1) is a deeming provision. It provides, through a statutory fiction, the mechanism by which the new lease may take effect in possession. The intermediate lease is deemed to be surrendered and re-granted, and the covenants in it “take effect accordingly”. It is by no means certain, indeed it seems to us improbable, that, in order to avoid the consequences of which complaint is made, Parliament would have chosen to insert in this deeming provision an actual alteration to the terms of the lease. Commutation of the headrent would not necessarily be the only possible solution to the two-stage enfranchisement problem. The price-determination provisions of Schedule 6 on the second, collective enfranchisement, stage would be an alternative possibility. It follows, applying *Jones v Wrotham Park*, that commutation of headrent cannot be achieved under principles of conventional construction by re-writing paragraph 10(1) as suggested.

78. The alternative basis for Cadogan's commutation case was section 3 of the Human Rights Act 1998 and Article 1 to the First Protocol. Section 3(1) provides:

"So far as it is possible to do so, primary legislation and subordinate legislation must be read and given effect in a way which is compatible with the Convention rights."

Article 1 to the First Protocol, under the heading "Protection of Property", provides:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

79. Relying on *Ghaidan v Godin-Mendoza* [2004] 2 AC 557 Cadogan submitted that there are two relevant questions: whether the provisions of the 1993 Act are convention-compliant; and, if they are not, whether the interpretation of paragraph 10(1) for which they contend is "possible" for the purposes of section 3 or whether it is contrary to the underlying thrust of the 1993 Act. Mr Rainey accepted that the role of the court under section 3, if it is of the view that a conventional construction would be incompatible with convention rights, is to give effect to the provision in a way that would be compatible, provided that it is possible to do so. But, he said, any such construction must "go with the grain of the legislation"; and the "grain" of the valuation provisions of Schedule 13 is to compare like with like, before and after. The construction urged by Cadogan would cut across that grain by seeking to alter the terms of the intermediate leasehold interest. In any event it was not at all obvious that it was paragraph 10(1) of Schedule 11 that was at fault rather than some other provision in the interacting Schedules 6, 11 and 13.

80. The difficulty that faces Cadogan is that paragraph 10(1) is not itself productive of unfairness. It is the combined effects of Schedules 6, 11 and 13 that produce the consequences of which they complain where a two-stage enfranchisement is affected. They fasten on paragraph 10(1) as offering a means, if it is given a particular effect, contrary to its conventional meaning, of avoiding the unfairness that they would suffer on a two-stage enfranchisement. But as we have said, paragraph 10(1) is there purely to provide the mechanism for the new lease to take effect and not for the purpose of prescribing the terms of the existing intermediate lease that is deemed to be re-granted. The scheme of the Act is that the intermediate lease continues, but subject to the new lease. To make paragraph 10(1) operate so as to alter the terms of the intermediate lease would thus be contrary to the scheme of the Act. Moreover the effect which Cadogan say should be given to the provision in order to meet the unfair situation in which they find themselves would not be confined to their particular situation. It would apply generally, even though in the great majority of cases the re-writing that they seek would not be needed to avoid unfairness.

81. In *Ghaidan* Lord Nicholls of Birkenhead, in considering the operation of section 3, said this at 33A-C:

“33. Parliament, however, cannot have intended that in the discharge of this extended interpretative function the courts should adopt a meaning inconsistent with a fundamental feature of legislation. That would be to cross the constitutional boundary section 3 seeks to demarcate and preserve. Parliament has retained the right to enact legislation in terms which are not Convention-compliant. The meaning imported by application of section 3 must be compatible with the underlying thrust of the legislation being construed. Words implied must, in the phrase of my noble and learned friend, Lord Rodger of Earlsferry, ‘go with the grain of the legislation’. Nor can Parliament have intended that section 3 should require courts to make decisions for which they are not equipped. There may be several ways of making a provision Convention-compliant, and the choice may involve issues calling for legislative deliberation.”

82. In our judgment section 3 cannot here be invoked to change the effect of paragraph 10(1) in the way Cadogan seek. The scheme of the provisions of the Act relating to lease extensions, so far as intermediate leases are concerned, is that the relevant ILI is not acquired but continues in existence with no provision being made in relation to the terms on which it continues. To import the words that Mr Dowding suggested should be imported into paragraph 10 would constitute a substantial amendment inconsistent with the scheme of the provisions.

Deferment rate

83. A particular issue arises in relation to five of the flats in Regency Lodge, namely flats 27, 30, 46, 57 and 79. Daejan Properties Ltd’s intermediate lease, which had 81 years unexpired at the valuation date, was subject to underleases of each of these flats with about 27 years unexpired. In each case, therefore, after the expiry of the underlease, Daejan will have a reversion in possession 54 years in length. The issue is as to the deferment rate that should be applied to the vacant possession value of Daejan’s intermediate leasehold interest in each flat in order to reflect the fact that vacant possession will not be enjoyed until 27 years have elapsed. In *Sportelli* this Tribunal determined generic deferment rates of 4.75% for houses and 5% for flats. Those deferment rates, however, were applicable to freehold interests, and the parties to the appeals on the five Regency Lodge flats agree that a higher deferment rate than the 5% applicable to flats is appropriate in the case of a 54-year leasehold reversion. They disagree as to what the rate should be. Miss Ellis, giving evidence for the leaseholder, says that the rate should be 5.25%; and Mr Briant for the freeholder (the Eyre Estate) and Mr Radford for the tenants says that it should be 6%.

84. The LVT determined a rate of 6%. In its decision (at paragraph 18) it said:

“We consider Miss Ellis’ 0.25% addition to be inadequate having regard to the very significant differences between the reversion to the freehold and the reversion to a 54-year leasehold interest. Miss Ellis acknowledged the difficulties which might be faced by a purchaser at the point in the property cycle when the reversions fall due but in our

