Collective Enfranchisement: Nuts & Bolts – November 2015

The Participants

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Landmark Chambers

Who are "the participating tenants" in a collective claim?

1. Subject to exceptions, a person is a "qualifying tenant" of a flat if he is a tenant of the flat under a long lease. Although the right to collective enfranchisement is conferred on qualifying tenants generally, there is no requirement that the right be exercised by *all* qualifying tenants. Those who choose to join in the exercise of the right are referred to as "participating tenants".

2. The "participating tenants" are defined in section 14[1] as follows:

> "14.— The participating tenants.
>
> (1) In relation to any claim to exercise the right to collective enfranchisement, the participating tenants are … the following persons, namely—
>
> (a) in relation to the relevant date, the qualifying tenants by whom the initial notice is given; and
>
> (b) in relation to any time falling after that date, such of those qualifying tenants as for the time being remain qualifying tenants of flats contained in the specified premises."

3. The "relevant date" is the date on which the initial notice is given: section 1(8). The "initial notice" is the notice to the landlord claiming the right of the participating tenants to acquire the freehold and any intermediate leasehold interests: section 13.

Who's eligible?

4. To be eligible as a participating tenant, aside from being a "qualifying tenant", the lessee must be registered at HM Land Registry as proprietor of the lease at the relevant date: see *Hague on Leasehold Enfranchisement* (6th Edn.), para. 24-01.

[1] All references to sections, Schedules, paragraphs etc. are to sections etc. of the Leasehold Reform, Housing and Urban Development Act 1993.

5. There are a number of situations in which a qualifying tenant cannot be a participating tenant (Schedule 3, paras. 1-4):

   (1) The tenant has already given notice terminating the lease of the flat;

   (2) The tenant has entered into an agreement made before the expiry of their long lease for a future tenancy not at a low rent;

   (3) The landlord, at least four months before the initial notice, gave notice terminating the lease, whether or not the notice had effect to terminate the lease (if the notice to terminate was given less than four months before the initial notice, then the notice to terminate ceases to have effect);

   (4) The tenant is, or will be on a specified date, obliged by court order to give up possession;

   (5) The tenant has been served with a notice to treat pursuant to compulsory purchase, or the tenant has entered into a contract for the purchase of his interest in the flat, and the notice to treat remains in force (if the notice to treat is served on a participating tenant after the initial notice, that tenant ceases to be entitled to participate).

6. If proceedings are pending to enforce a right of re-entry or forfeiture terminating the lease of the flat, a qualifying tenant may only be a participating tenant with the leave of the court: Schedule 3, para. 3. Leave cannot be granted retrospectively if the lease has been forfeited by the time the initial notice is served. Leave will only be granted if the court is satisfied that the tenant does not wish to participate in the giving of such a notice solely or mainly for the purpose of avoiding the consequences of the breach of the terms of his lease in respect of which proceedings are pending.

How do you become one?

7. The participating tenants are self-selecting.

8. To claim the right to collective enfranchisement, the number of participating tenants must be at least half of the total number of flats contained in the premises: section 13(2)(b). This is determined once and for all at the "relevant date". Consequently, any change in the participating tenants thereafter does

not affect the validity of the claim (it may, however, affect the value of the premium to be paid: see below).

What if your neighbours want to exclude you?

9. Provided they have a sufficient majority to make the collective claim, the participating tenants can exclude whoever they want. The qualifying tenant who is excluded has no right of redress in the short term. However, once the collective enfranchisement claim is over, the excluded tenant can either claim an extended lease, or start a campaign to persuade a sufficient majority of qualifying tenants to make a further claim for the freehold, in a *coup d'état* against those who initially excluded him.

The nominee purchaser

10. The participating tenants appoint a "nominee purchaser" (section 15(2)), who conducts all proceedings arising out of the initial notice on behalf of the participating tenants (section 15(1)). The 1993 Act does not say how a nominee purchaser should be chosen or what type of legal person it should be. It might be an individual, a group of individuals, or a limited company (the latter being the most common).

Withdrawal of the notice

11. The participating tenants have the right to withdraw the initial notice (section 28(1)). They are joint and severally liable for the costs of the reversioner and any other relevant landlord in the event that the initial notice is withdrawn or deemed to be withdrawn (sections 28(4) and 29(4)).

Dealing with changes to the participants

Assignment after initial notice given

12. A participating tenant who assigns the lease after the initial notice has been given ceases to be a qualifying tenant and can therefore no longer be a participating tenant: section 14(1)(b).

13. Where a participating tenant assigns the lease by virtue of which he is a qualifying tenant of his flat, the status of participating tenant does not pass automatically to the assignee. Instead the assignee is given a right of election,

and is required by section 14(2) to notify the nominee purchaser both of the assignment and "as to whether or not the assignee is electing to participate in the proposed acquisition." There is no prescribed form of notice. Unlike in the situation considered next, the right of the assignee to elect to participate is not dependent on the approval of any other person. You are deemed to be a participating tenant from the date of assignment, not election: section 14(4).

Latecomers

14. What happens if you are a qualifying tenant who did not join in giving the initial notice, and who did not acquire your interest by assignment from one who did, but you now want to participate? Unless you fall foul of the restrictions on eligibility set out above, section 14(3) provides that you "may elect to participate in the proposed acquisition, but only with the agreement of all the persons who are for the time being participating tenants". If you do so elect, you must "notify the nominee purchaser forthwith" of your election. You are a participating tenant from the date of the agreement: section 14(4). The nominee purchaser must then notify the freeholder of the agreement, because it will affect the premium to be paid by the participating tenants: see below.

15. The Upper Tribunal in *82 Portland Place (Freehold) Limited v Howard de Walden Estates Limited* [2014] UKUT 0133(LC), stated at [76]:

> "… section 14(3) requires no particular formalities to be observed for a third party to become a participating tenant. Only two matters must be established: first, an election by a qualifying tenant of a flat contained in the specified premises "to participate in the proposed acquisition"; and, secondly, agreement on the part of all of the persons who are for the time being participating tenants. Where a qualifying tenant notifies the nominee purchaser of his election to participate, the effect of section 14(4) is that the tenant "shall be regarded as a participating tenant for the purposes of this Chapter" from the date of the agreement of all of the participating tenants for the time being."

16. Does the "agreement of all the persons who are for the time being participating tenants" require individual approval by each of those tenants. In *82 Portland Place*, no such individual approval had been obtained. However, in a Participation Agreement between the tenants and their nominee purchaser, the tenants had conferred on the latter substantial powers to act on their behalf, including a power to enter into "such agreement as may be necessary or

appropriate to ensure that there is funding available to cover the proportion of the Price attributable to any non-participating flat". It was held by the tribunal that this conferred sufficient authority on the nominee purchaser to agree to the new participant's election on each tenant's behalf: see [80] and [81].

Death, representatives, bankruptcy and mortgagees

17. Section 14 also makes provision for the death of a participating tenant and for circumstances where a lease may become vested in a personal representative, a trustee in bankruptcy or a mortgagee.

Notice of changes

18. Within 28 days of the death, assignment or agreement, the nominee purchaser must give notice of the change in writing to the landlord and any intermediate leaseholders. The notice must give details of the change, and be signed by the new participating tenant: section 14(9).

Too late to change?

19. It is too late to alter the participating tenants once a binding contract has been entered into pursuant to the initial notice: section 14(11).

Valuation issues

20. On a collective enfranchisement, "marriage value" is payable only in respect of the flats of participating tenants. The marriage value recognizes the increase in value of the flat when the freehold and leasehold are merged into one, rather than being separate entities held by different persons. The marriage value is split 50/50 between the tenant and the landlord, so the landlord will get 50% of the marriage value for each flat of the participating tenants. The more participating tenants, the more the landlord gets paid in marriage value. The participating tenants only have to pay "hope value" in respect of non-participating flats, typically only 10% of the marriage value.

21. If all or most of the tenants in a block of flats wish to participate, they sometimes seek to minimise the premium by arranging that only the minimum number participate in the claim. If some who wish to participate are left out, the price will be lower, but they have no right to an extended lease or a share of the freehold. Sometimes there is an unwritten understanding that they will

share in the costs and benefits, but sometimes those who are left out want a side arrangement. Section 18 is designed to prevent this sort of avoidance. It requires the participating tenants, via the nominee purchaser, to disclose such an arrangement to the landlord and pay a price which reflects it:

> 18(1) If at any time during the period beginning with the relevant date and ending with the time when a binding contract is entered into in pursuance of the initial notice—
>
> (a) there subsists between the nominee purchaser and a person other than a participating tenant any agreement (of whatever nature) providing for the disposal of a relevant interest, or
>
> (b) if the nominee purchaser is a company, any person other than a participating tenant holds any share in that company by virtue of which a relevant interest may be acquired,
>
> the existence of that agreement or shareholding shall be notified to the reversioner by the nominee purchaser as soon as possible after the agreement or shareholding is made or established or, if in existence on the relevant date, as soon as possible after that date.

22. There is another way in which the marriage value can be reduced, because it is only payable for those "persons who are participating tenants immediately before a binding contract is entered into in pursuance of the initial notice": Schedule 6 para. 4(2). This reflects the fact that a participating tenant can assign his flat to an assignee who chooses not to remain a participant.

23. This gives rise to a loophole which was exploited by Ms Erkman in relation to a building in Cadogan Square. She was initially a participating tenant but, after the initial notice, she hatched a cunning plan. She assigned her lease to a company apparently under the control of her family, and the assignee did not elect to participate. As a result no marriage value was payable. The landlord, Cadogan, argued that the tenants should nonetheless pay hope value, but that argument failed as well. Hope value was only payable for those flats which are non-participating at the date of the section 13 Notice, and at that stage Ms Erkman was a participant: *Earl Cadogan v Cadogan Square Ltd* [2011] UKUT 154 (LC); [2011] 3 E.G.L.R. 127.

24. The cunning plan succeeded, albeit with "reluctance", and caused quite a conundrum for the tribunal.

Participation Agreements ("PA")

Why have one?

25. Preparing a PA costs money, and some tenants may question why it is necessary. If it is a small block with only two or three lessees, it may be possible to proceed without one and rely on the general law to resolve disputes. But in all but the simplest of cases, a PA should be put in place at an early stage to prevent disputes and ensure that the claim can proceed to completion.

What you need before a PA can be drafted?

26. You need to know

    (1) Who is going to participate

    (2) How the acquisition of any property other than the reversion to the participating tenants flats ("Other Property") is going to be funded;

    (3) An initial valuation;

    (4) An estimate of costs;

    (5) An understanding of the tax issues, and tax advice if necessary.

Who are the parties?

27. The nominee purchaser and the participating tenants are always parties. The nominee purchaser can be one or more individuals, or a company. A company is normally used save where

    a. There are only a few flats or

    b. Where the average premium payable per flat exceeds £500,000 and the price payable would attract SDLT at 15% if the nominee purchaser were a company. See Finance Act 2003 s74.

28. If the Other Property is being funded by an SPV or a white knight, they will need to be parties.

Standard terms of the PA

29. There is a sample PA available on the Lease Advice website at http://www.lease-advice.org/publications/documents/document.asp?item=5. It contains some

of the basic terms required.

Role of the Nominee Purchaser

30. The PA should authorise the NP to, and it should covenant to

(1) Instruct solicitors and valuers

(2) Prepare and serve the s13 Notice

(3) Protect it by registration

(4) Conduct negotiations

(5) Take proceedings if necessary

(6) Enter a contract and complete the acquisition

(7) Where desired, agree to admit non-participants as participants

(8) Disclose s18 agreements

(9) Grant new leases following completion

Warranties

31. The Participants should warrant to each other and the NP that they are qualifying tenants. If they are not, and the claim fails, they will be liable for wasted costs and any damages suffered.

Participating tenants' covenants

32. The Participating tenants should covenant:

(1) To pay their share of the price payable;

(2) To pay their share of the costs of the NP and the Landlord, whether or not the claim is completed;

(3) To pay their share of SDLT and land registry fees;

(4) to pay, prior to completion, all arrears of rent and service charge.

(5) To surrender their lease and accept a new 999 year lease in its place

(6) Not to make enquiries of or seek advice from the NP's advisers.

Apportionment

33. The PA should provide for how the premium and costs are to be apportioned. In a simple case where the flats are similar in value and lease length it is possible to agree a fixed apportionment in advance. It is more common for the PA to provide that the apportionment is to be carried out and certified by the appointed valuer. This can only be carried out once the terms of acquisition, and in particular the premium are agreed. This apportionment is likely to be binding, even if it is subsequently discovered that it was mistaken: *Falmouth House Limited v Rahmizadeh* [2008] EWHC 214.

Default

34. The PA can of course make provision for what is to happen if a participating tenant fails to pay his share of the price before completion. No such provision was made in Etzin v Reece, HC010466, unreported 2002. One of the participants, Mr Etzin, did not pay his share on time, in spite of repeated demands. He had negotiated to sell his flat and was hoping to get the purchaser to pay his share. The others treated him as in repudiatory breach of contract, paid his share, and accepted his breach. He tendered his share one day late, but the others declined. By that time prices had risen and there was a substantial profit for whoever acquired the reversion to his flat. Mr Etzin claimed that he was entitled to specific performance of the agreement to grant him a 999 year lease, and if necessary relief from forfeiture, alternatively damages for breach of contract. His claim failed. It was held that

    (1) He was in breach of the PA;

    (2) Time was not automatically of the essence, but could be, and was made of the essence. Once it was made of the essence, failure to pay on time was a repudiatory breach;

    (3) The repudiatory breach was accepted;

    (4) Relief from forfeiture was not available.

35. He also claimed that the NP acquired the freehold as trustees to hold it in accordance with the PA, and accordingly they held on trust for him in relation to his flat. That argument was also rejected on the ground that the PA was

purely contractual, and did not create a trust. Any trust could only give effect o the contractual entitlements and any entitlement Mr Etzin had disappeared with his contractual rights. Alternatively the trust only arose on the acquisition of the freehold in favour of those who contributed to the price, so that a trust never arose in his favour.

36. It should be noted that the default also caused difficulties for Bircham, the solicitors instructed. Once Mr Etzin defaulted they continued to act for the NP in the dispute with him until he instructed separate solicitors who complained, whereupon Bircham stopped acting for all parties.

Changes in parties

37. Provision should be made for changes in the parties

(1) admitting assignees of participating tenants, if they elect to participate;

(2) admitting non-participating tenants. If no express provision is made to allow for the possibility that a non-participating qualifying tenant be permitted to participate once the initial notice has been served, it would be necessary to obtain the agreement of all the participating tenants to the variation of the participation agreement to add such a new participant, and agreement to the consequent variations in the proportions payable. This may be the preferred route if the participants want to profit from acquisition of the non participating shares. If they prefer to allow all tenants to join in, it may be preferred to remove the ability of each individual participating tenant to refuse the addition of such a new participant by inserting into the participation agreement a covenant by every participating tenant to agree to the inclusion in the claim of any such non-participating tenant who subsequently wishes to participate (together with a specification of how the proportions will be altered in that event), unless all the participating tenants agree at that time to the contrary.

(3) death of a participant.

Withdrawal

2. Thought needs to be given to whether and in what circumstances individuals or a majority can withdraw. The Agreement may provide for no withdrawal

once the process has begun. Alternatively it could provide for withdrawal in some circumstances, for example:

a. Withdrawal of the whole claim if 75% of the participants give notice to that effect, in which case the claim is withdrawn and the withdrawing participants are liable for all the costs; or

b. By an individual if the price payable by him exceeds 150% of the estimated price, in which case he can withdraw but remains liable for his share of the costs up to that time.

The Other Property

38. Provision needs to be made for funding the acquisition of Other Property, such as non participating flats, a caretaker's flat, and areas with development value such as roofspace. It is possible for the price for these elements to be funding by all the participants in proportion to their shares. This is feasible if the cost of such areas is small. If more significant funding is required, it is usually necessary for the cost of the Other Parts to be funded separately by any combination of individual participants and white knight investors. The funding for this needs to be worked out before the claim is made, to avoid the claim failing. Methods I have seen include

(1) A loan of the price payable by particular participants, documented by loan notes secured by a debenture over the assets of the NP Company. The NP company will have two classes of shares, only one of which, the A shares, attract dividends. Contributors to the cost of the Other Parts are entitled to A shares. As and when the Other Parts are exploited and the proceeds of sale received, they are applied to pay off the loans, costs and then used to pay dividends;

(2) A separate company (the SPV) is a party to the PA, and pays the price for the Other Parts, in return for which it is entitled to the grant of a 999 year lease of those Other Parts. Shares in the SPV can be offered to Participants or third parties.

(3) An unconnected third party agreeing to pay the premium relating to a particular non-participating flat, in return for the grant of a 999 year lease.

39. Agreements between the NP and anyone other than the participating tenants for the disposal of a relevant interest are disclosable under section 18. Shareholdings of anyone other than participants in the NP are also disclosable.

Tax

40. It is important to structure the agreement and funding with tax consequences in mind.

41. SDLT is now dealt with by s74 of the Finance Act 2003 which provides (with effect from 12.2.2015) as follows:

> "74 Exercise of collective rights by tenants of flats
>
> (1) This section applies where a chargeable transaction is entered into by a person or persons nominated or appointed by qualifying tenants of flats contained in premises in exercise of—
>
> (a) a right under Part 1 of the Landlord and Tenant Act 1987 (right of first refusal), or
>
> (b) a right under Chapter 1 of Part 1 of the Leasehold Reform, Housing and Urban Development Act 1993 (right to collective enfranchisement).
>
> (1A) The amount of tax is determined as follows.
>
> *Step 1*
>
> Determine the fraction of the relevant consideration produced by dividing the total amount of that consideration by the number of qualifying flats contained in the premises.
>
> *Step 2*
>
> If the amount produced by step 1 is £500,000 or less, determine the amount of tax chargeable in accordance with subsection (1B) .
>
> *Step 3*
>
> If the amount produced by step 1 is more than £500,000 and the condition in paragraph 3(3) of Schedule 4A is not met with respect to the transaction, determine the amount of tax chargeable in accordance with [subsection (1B)] [9] .
>
> *Step 4*
>
> If the amount produced by step 1 is more than £500,000 and the condition in paragraph 3(3) of Schedule 4A is met with respect to the transaction, subsection (1B) does not apply, and the amount of tax chargeable in respect of the transaction is 15% of the chargeable consideration for the transaction.
>
> (1B) Where step 2 or 3 of subsection (1A) requires the amount of tax

chargeable to be determined in accordance with this subsection, it is determined as follows.

Step 1
Determine the amount of tax chargeable under section 55 as if the relevant consideration for the chargeable transaction were the fraction of the relevant consideration calculated under step 1 of subsection (1A).
Step 2
Multiply the amount determined at step 1 by the number of qualifying flats contained in the premises.

...

Schedule 4A paragraph 3(3)

(3) The condition is that—

(a) the purchaser is a company,

(b) the acquisition is made by or on behalf of the members of a partnership one or more of whose members is a company, or

(c) the acquisition is made for the purposes of a collective investment scheme."

42. Think also about CGT and Corporation Tax on chargeable gains. The surrender of a lease and grant of a new lease are both chargeable disposals. There is an extra statutory concession, as follows:

"ESC/D39

In practice, the surrender of an existing lease and the grant of a new lease should not be treated as a disposal for Capital Gains Tax purposes if the taxpayer so wishes and all of the following conditions are satisfied:

the transaction, whether made between connected or unconnected parties, is made on terms equivalent to those that would have been made between unconnected parties bargaining at arms length;

the transaction is not part of or connected with a larger scheme or series of transactions;

a capital sum is not received by the tenant;

the extent of the property under the new lease is the same as that under the old lease;

the terms of the new lease (other than its duration and the amount of rent payable) do not differ from those of the old lease. Trivial differences should be ignored."

43. Note the difficulties which may apply:

(1) New leases are frequently granted on different terms, either to correct a

defect, widen the service charge recovery, or bring them all into line in a standard form. The concession is lost;

(2) What if prices have gone up since the valuation date. The new 999 year lease may well be worth more than the combined value of the short lease being surrendered and the premium paid by the lessee. If that is the case, the transaction is no longer on terms which would have been made between unconnected parties.

44. It has been suggested that some of these problems can be solved by making the NP company a bare trustee or nominee for the participants from the outset, and this structure is often used. However, whether this works would require detailed tax and trust advice, especially in the light of the Etzin decision referred to above.