OFFICES TO FLATS DEVELOPMENT

LEASEHOLD ENFRANCHISEMENT ISSUES

Tom Jefferies

1. Leasehold enfranchisement issues arise on any conversion to flats because the tenants of flats under long leases have the right under the Leasehold Reform, Housing and Urban Development Act 1993 to a 90 year lease extension or, in appropriate cases, to acquire the freehold.

2. A freehold owner converting the building will need to bear in mind the possibility that these rights will be exercised, and may seek advice on avoidance devices.

3. He will also need to bear in mind the requirements of the Landlord and Tenant Act 1987 to give qualifying tenants the right of first refusal before making relevant disposals.

4. An owner of a long lease of the offices may well want to extend the lease of the flats or acquire the freehold to enhance the value and marketability of the flats.

5. I will begin by giving and overview of the statutory schemes, and then focus on issues which have arisen in recent cases.

The criteria for a collective enfranchisement.

6. Part 1 of the Leasehold Reform, Housing and Urban Development Act 1993 ("the Act") gives a right to qualifying tenants of premises to which the Act applies to acquire the freehold. The Act applies to buildings containing two or more flats held by qualifying tenants. The number for flats held by qualifying tenants must be not less than 2/3rds of the total.

7. "Flat" and "dwelling" are defined by s.101 as follows:

"flat" means a separate set of premises (whether or not on the same floor)—
(a) which forms part of a building, and
(b) which is constructed or adapted for use for the purposes of a dwelling, and
(c) either the whole or a material part of which lies above or below some other part of the building

"dwelling" means any building or part of a building occupied or intended to be occupied as a separate dwelling

8. A person is a qualifying tenant of a flat if he is tenant of it under a long lease, that is one granted for more than 21 years. The tenant under a headlease of a whole building is the qualifying tenant of any flats in the building which are not sub-demised on long leases.

9. Under s.5(5), where a person would be regarded as a qualifying tenant of one flat, and would also be regarded as a qualifying tenant or 2 or more additional flats (i.e. three or more in total) then there shall be taken to be a qualifying tenant of none of those flats. Thus a person can be qualifying tenant of 2 flats, but not of 3 or more, and if he owns 3 or more he is a qualifying tenant of none of them. The Act builds in another qualification, intended to prevent a group of companies from avoiding the consequences of s.5(5) by simply putting one or more flats in hands of wholly-owned subsidiaries. Its effect is that where a flat is let to a company, a flat let to an "associated company" shall be treated as if it were let to that first company.

10. The expression "associated company" is defined using s.1159 of the Companies Act 2006 , which itself defines "subsidiary" and "holding company". The effect of the definition is that a holding company and its subsidiaries (as defined in the 2006 Act) are each the associates of the other. Section 1159 contains a definition based on voting control. A company is a "subsidiary" of a "holding company" if the latter holds a majority of voting rights, is a member with a right to appoint or remove a majority of the board, or is a member and controls voting rights pursuant to an agreement with others. The definition therefore depends on control. Schedule 6 of the 2006 Act contains further elaborative provisions (see s.1159(3)).

11. Section 4 operates to prevent enfranchisement where more than 25% of the building (excluding common parts, which are left out of the count for these purposes) is occupied for purposes other than residential purposes. It provides

> "This Chapter does not apply to premises falling within section 3(1) if—
>
> (a) any part or parts of the premises is or are neither—
>
> (i) occupied, or intended to be occupied, for residential purposes, nor
>
> (ii) comprised in any common parts of the premises; and
>
> (b) the internal floor area of that part or of those parts (taken together) exceeds 25 per cent. of the internal floor area of the premises (taken as a whole).
>
> (2) Where in the case of any such premises any part of the premises (such as, for example, a garage, parking space or storage area) is used, or intended for use, in conjunction with a particular dwelling contained in the premises (and accordingly is not comprised in any common parts of the premises), it shall be taken to be occupied, or intended to be occupied, for residential purposes.

The Criteria for a lease extension.

12. Chapter 2 of the 1993 Act confers the right to a 90 year lease extension to the tenant of a flat who has been the qualifying tenant of it for at least 2 years.

13. In contrast to the right to collective enfranchisement

    a. There is no limit on the number of flats in the building the same tenant can own;
    b. The tenant must have owned the lease for 2 years.

Rights of first refusal.

14. The Landlord and Tenant Act 1987 ("the 1987 Act") gives qualifying tenants of flats in buildings to which the Act applies the right of first refusal before the landlord makes a "relevant disposal".

15. Broadly speaking, by s1(2), the 1987 Act will apply to premises if they consist of the whole or part of a building, contain two or more flats held by qualifying tenants and the number of flats held by such tenants exceeds 50% of the flats contained in the premises.

16. The definitions of "flat" and "dwelling" are very similar to the 1993 Act definition.

17. The definition of "qualifying tenant" in s4 is broader. A person is a qualifying tenant if he is a tenant under a tenancy other than an assured tenancy, a 1954 Act protected tenancy, or a protected shorthold tenancy. The definition thus includes a tenancy at will, and leases or tenancies of any length which are not ASTs. As under the 1993 Act, a person is not a qualifying tenant of any flat if he would otherwise be qualifying tenant of three or more flats. Where there is more than one qualifying tenancy of any particular flat, only the highest in the chain is treated as the qualifying tenant: s3(4).

18. The 1987 Act applies to a "relevant disposal" which is defined by section 4(1) as

> "the disposal by the landlord of any estate or interest (whether legal or equitable) in any such premises, including the disposal of any such estate or interest in any common parts of any such premises but excluding—
> (a) the grant of any tenancy under which the demised premises consist of a single flat (whether with or without any appurtenant premises); and
> (b) any of the disposals falling within subsection (2)."

19. The grant of a lease is a disposal because section 4(3) defines "disposal" as including the creation or transfer of an estate. Where there is a contract for a disposal, it is the contract which is treated as the relevant disposal. A subsequent disposal pursuant to that contract is exempt: s4(2)(i).

20. There are a number of other exempt disposals, including
    a. a disposal by a body corporate to a company which has been an associated company of that body for at least two years: s4(2)(l); and
    b. The grant of a tenancy under which the demised premises consist of a single flat: s4(1)(a).

21. The "landlord" is generally the immediate landlord of the qualifying tenants of the flats: s2.

General considerations for freeholders converting offices to flats.

Collective enfranchisement

22. If all or most of the flats are sold on long leases, there is clearly a risk of a collective enfranchisement claim by the lessees.

23. It could come before completion of the development, for three reasons.

24. First, as explained above, there is no minimum period of ownership required for a collective claim. As soon as at least 2/3rds of the flats are let on qualifying tenancies, there is potential for a claim.

25. Second, a lease is defined as including an agreement for lease (s101(2)), so if flats are sold off plan on agreements for lease, there will be a qualifying tenant.

26. Third, on the basis of a recent decision, there will be a flat before it is habitable or fitted out.

Aldford House Freehold Ltd v (1) Grosvenor (Mayfair) Estate (2) K Group Holding Inc [2018] EWHC 3430

27. The case concerned a high value block of flats fronting Park Lane in Mayfair. A group of tenants sought to exercise the right to collective enfranchisement. The owner of the headlease, K Group Inc, and the freeholder, Grosvenor Estate, resisted the claim on various grounds, including (a) some of the tenants had not authorised their solicitor as a matter of foreign law (b) three were disqualified because they held their flat under two leases with different landlords (c) premises on the sixth and seventh floors were "flats" held by four qualifying tenants, with the effect that the claim failed because they had not been specified in the s13 notice and in any event there were not sufficient participating tenants to form a majority.

28. The crucial issue was whether the premises were flats. There had been two flats on each of the sixth and seventh floors, but they have been gutted and extended to double their size, and then divided into two units. They had been constructed to shell finishes, but

had no services and were uninhabitable. They had been demised on separate long leases to different companies, and the only permitted use was as flats both under the terms of the leases and the relevant planning permission. The tenants argued that they were not "flats" because they had not yet been constructed or adapted so they could be used as flats. Fancourt J rejected that argument. He held that they had reached the stage of being separate sets of premises, and their intended purpose was as flats. That was sufficient. This is a significant decision for the purposes of the Leasehold Reform, Housing and Urban Development Act 1993, as although there are numerous decisions on what amounts to a "house", there is very little authority on what amounts to a "flat". Permission to appeal has been granted on this issue, so a decision of the Court of Appeal will be required to settle the matter.

29. If the *Aldford House* decision is correct, a "flat" could come into being as soon as a separate set of premises comes into being which is intended to be occupied as a flat.

30. A developer selling flats off plan could face a collective enfranchisement claim once 2/3rds of the flats had been sold, and they had reached the stage of being separate sets of premises. This may well be long before completion.

31. The freeholder may wish to consider avoidance measures. Possibilities include

    a. Ensure that more than 25% is not occupied or intended to be occupied for residential purposes, taking advantage of the exemption in s4;
    b. Do not grant long leases of all the flats. Retain at least one third for letting on ASTs or serviced apartments.

32. More sophisticated avoidance schemes are available on request.

The 1987 Act

33. The freeholder will usually want to sell long leases reserving a ground rent, and then sell the reversion. He will not want to offer a right of first refusal to the lessees unless he has to.

34. Typical avoidance techniques include

    a. Set up and retain associated companies to which disposals can be made after 2 years. The shares in those companies can be sold if desired;
    b. Granting a headlease of the whole building to an associated company. The freehold can then be sold to a third party without offering it to the qualifying tenants, as the owner of the freehold is not the immediate landlord of the qualifying tenants.

35. Note that the need to comply with the 1987 Act arises once more than 50% of the flats are let to qualifying tenants. Again, a lease includes an agreement for lease: s59(2). The 1987 Act differs from the 1993 Act in that
    a. The threshold is 50%, not 2/3rds; and
    b. qualifying tenancies are more broadly defined.

<u>General considerations for leaseholders converting offices to flats.</u>

Collective enfranchisement

36. As discussed above, 75% or more of the building needs to be converted for residential purposes. This could include parking spaces or storage areas demised with or reserved for use by the owners of the flats.

37. The leasehold owner will only have a single lease of the building. He will want to know if matters can be arranged to allow a collective enfranchisement claim.

38. The owner of a lease of a whole building can also be the qualifying tenant of flats within it. There does not have to be a separate lease of each flat. See *Howard de Walden Estates Ltd v Aggio* [2009] 1 A.C. 39.

39. The difficulty which remains is that under s.5(5), a person can be qualifying tenant of 2 flats, but not of 3 or more, and if he owns 3 or more he is a qualifying tenant of none of them. Where a flat is let to a company, a flat let to an "associated company" is be treated as if it were let to that first company.

40. This limitation can be circumvented by use of a suitable corporate scheme under which underleases are granted to SPVs to hold the qualifying leases without them being associated companies. A successful scheme was created in relation to Dolphin Square, details of which are to be found in the decision of Mann J in *Westbrook Dolphin Square Limited v Friends Life Limited* [2014] EWHC 2433.

41. An important consideration is likely to be to ensure that the conversion to flats is carried out in accordance with the terms of the lease. It was held in *Henley v Cohen* [2013] EWCA Civ 446 that a tenant was barred from exercising its rights under the Leasehold Reform Act 1967 where the residential part of the building had been converted from commercial use in breach of covenant. This gives rise to issues which Myriam Stacey will discuss.

42. As discussed above, a claim could be made as soon as separate sets of premises are created, if *Aldford House* is correct. This would reduce the costs which need be incurred before a claim is made.

Lease extensions

43. No Dolphin Square type corporate scheme would be required to seek lease extensions. The lessee of the whole building could seek 90 year lease extensions for each flat. For the purposes of Chapter 2 the tenant would be a qualifying tenant even if he owned 100 flats in a building.

44. The question arises when a lease extension could be claimed. By section 39(2)(a) it can only be claimed if "the tenant has for the last two years been a qualifying tenant of the flat". Is it enough that the lessee has owned the lease of the building for 2 years, or does time only starts to run once the premises became a "flat"? There is no authority on this question.

Disregard of improvements.

45. The price payable for the freehold or a lease extension includes the market value of the landlord's reversion. In both cases, there is a disregard for improvements. In collective claims, it applies only to participating tenants' flats, but in lease extension claims to applies to the subject flats. The disregard for collective claims is in these terms, in Schedule 6 paragraph 3 (c):

> " on the assumption that any increase in value of any flat held by a participating tenant which is attributable to an improvement carried out at his own expense by the tenant or any predecessor in title is to be disregarded"

46. A disregard in similar terms was considered by the Upper Tribunal in *Portman Estate Nominees v Jamieson* [2018] UKUT 0027. This was a dispute regarding the price payable for the freehold of a house in Marylebone under the Leasehold Reform Act 1967. When the lease was granted in 1957, the demised premises consisted of an old mews building which had been connected to the main house at the rear. It was mainly demolished and replaced with a new house. The lessee contended that the construction of the new house should be disregarded. The Landlords contended that the work should not be disregarded for a number of reasons, including that the work of improvement had to be to "a house" within the meaning of the 1967 Act, that the old mews was not a house, and that the demolition was so extensive that it was not an improvement to an existing building. They relied on the Court of Appeal decision in *Rosen v Trustees of Camden Charities*, which held that the construction of a house on a bare site was not an improvement. The Upper Tribunal rejected all these arguments, holding that the overriding principle was that the tenant should not have to pay the value of work he or his predecessors had carried out. It held that the works of demolishing the old building and constructing the new house could be disregarded whether or not the previous mews building satisfied the 1967 Act definition of a house.

47. This decision would enable a developer to contend that the work undertaken in converting the offices to flats should be disregarded as improvements.

©Thomas Jefferies
10.6. 2019
Landmark Chambers
tjefferies@landmarkchambers.co.uk;
02074211327