UPPER TRIBUNAL (LANDS CHAMBER)

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TRIBUNALS, COURTS AND ENFORCEMENT ACT 2007

LEASEHOLD ENFRANCHISEMENT – Leasehold Reform Act 1967 section 9(1A), (1D) and Schedule 1 – enfranchisement by underlessee – unusual terms of head lease – calculation of marriage value – assessment of capitalisation and deferment rates.

IN THE MATTER OF AN APPEAL FROM A DECISION OF THE LEASEHOLD VALUATION TRIBUNAL FOR THE LONDON RENT ASSESSMENT PANEL

BETWEEN **GROSVENOR ESTATE BELGRAVIA** **Appellant**

and

CRAIG WAYNE KLAASMEYER
ASHLEY DIERKER KLAASMEYER **Respondents**

Re: 8 Chester Street
London SW1X 7BB

Before: His Honour Judge Huskinson and Mr N J Rose FRICS

Sitting at 43-45 Bedford Square, London WC1B 3AS
On 15, 16, 17 and 18 February 2010

Johnathan Gaunt QC and Anthony Radevsky, instructed by Boodle Hatfield, on behalf of the Appellant
Phillip Rainey, instructed by Bircham Dyson Bell LLP, on behalf of the Respondents

The following cases are referred to in this decision:

Cadogan v Sportelli [2009] 2 WLR 12
Lynall v Inland Revenue Commissioners [1972] AC 680
Inland Revenue Commissioners v Crossman [1937] AC 26
R*e Strand and Savoy Properties* [1960] Ch 582
International Drilling Fluids [1986] 1 ch 513
Olympia & York Canary Wharf Limited v Oil Property Investments Limited [1994] 2 EGLR 48
Ashworth Frazer Ltd v Gloucester City Council [1997] 1 EGLR 104
Nailrile Limited v Earl Cadogan [2009] 2 EGLR 151
Raja Vyricherla Narayana Gajapatiraju v Revenue Divisional Officer Vizagapatam [1939] AC 303
F R Evans (Leeds) Limited v English Electric Co (1978) 36 P & CR 185
A-G Belize v Belize Telecom [2009] 1 WLLR 1988
Mediterranean Salvage & Towage Limited v Seamar Trading & Commerce Inc [2010] 1 All ER (Comm) 1
Pimms v Tallow Chandlers [1964] 2 QB 547
Lady Fox's Executors v Commissioners of Inland Revenue [1994] 2 EGLR 185
Hoare v National Trust [1999] 1 EGLR 155
Arbib v The Earl Cadogan [2005] 3 EGLR l39
Olympia & York Canary Wharf Limited v Oil Property Investments Limited [1994] 2 EGLR 48
Rayburn v Woolf [1985] 2 EGLR 235
Re Strand and Savoy Properties [1960] Ch 582
Wentworth Securities v Jones [1980] AC 74
Arrowdell v Coniston Court (North) Hove Ltd [2007] RVR 39

DECISION

Introduction

1. This is an appeal by Grosvenor Estate Belgravia, the head leaseholder, with permission of the President, from the decision of the Leasehold Valuation Tribunal for the London Rent Assessment Panel ("the LVT") whereby the LVT decided that the price to be paid by the Respondents upon the enfranchisement under the Leasehold Reform Act 1967 as amended in respect of 8 Chester Street, London SW1X 7BB ("the Property"), was £1,269,249. Of this figure £100,799 was payable to the freeholder and £1,168,450 to the head leaseholder. The appeal comes before the Tribunal by way of a rehearing. Before us the Appellant contended for a total enfranchisement price of £1,413,200 and the Respondents' figure was £1,076,314.

2. There are certain points of contention between the parties regarding the appropriate capitalisation rate and deferment rate to be adopted at certain stages of the calculation of the price to be paid. However the most important point of disagreement between the parties results from the question of how to deal in the statutory valuation exercise with the fact that the Property is held by the Respondents upon an underlease from the Appellant as head leaseholder. Superior to the Appellant there are the freeholders, who are the trustees of the will of the second Duke of Westminster ("the Freeholder"). The terms of the headlease are unusual and it is these terms which give rise to the disagreement between the parties as to how to carry out the statutory valuation exercise under section 9(1A) of the Act when considering separately (and it is agreed that separate valuations are required) the value at the valuation date of the freehold and of the head leasehold interest in the Property. While the terms of the headlease are possibly unique this does not mean to say that the dispute of principle arising in the present case is one which can only affect the present parties to this appeal. This is because the head lease between the Freeholder and the Appellant is of a truly immense estate of property, being effectively the entirety of the Grosvenor Belgravia Estate. Despite the vast value of the property demised there is only reserved a rent of £1,000 per annum (which is in effect purely nominal) together with the prospect of receiving additional payments of rent and of capital after 25 March 2026. The lease is for a term of 200 years from 25 March 1984. The terms of the lease are referred to in more detail below. Bearing in mind the extent of the property demised by this head lease and the possibility of other properties contained within that estate becoming the subject of an enfranchisement claim under the Leasehold Reform Act 1967 as amended, the question of the proper valuation approach to the unusual terms of this head lease is one of potentially wide application.

3. The parties have helpfully prepared an agreed statement of facts in the following terms:

> "The following facts and issues are agreed between the parties:
>
> | | | |
> |---|---|---|
> | 1. | Valuation date: | 3rd August 2005 |
> | 2. | Underlease expiry: | 24th December 2040 |
> | 3. | Unexpired term of the underlease at the valuation date: | 35.39 years |
> | 4. | Head lease expiry | 24th March 2184 |
> | 5. | Unexpired term of the head lease at expiry of | |

	the underlease:	143.25 years
6.	Present underlease rent for unimproved Property:	£13,500 pa
7.	Unimproved rental value of the Property at the valuation date:	£13,500 pa
8.	Unimproved freehold vacant possession value of the Property at the valuation date and on the agreed terms of the Transfer:	£4,500,000
9.	Value of the unimproved Property on its existing underlease:	£2,663,000
10.	Relativity for a lease at a peppercorn rent with a term unexpired of 143.25 yrs:	99.00%
11.	Capitalisation rate for the underlease rent up to review (assuming the Property were being valued as a single freehold interest):	4.75%
12.	Freeholder's deferment rate:	4.75%
13.	Period to freeholder's reversion:	178.64 years"

4. The LVT's decision included, as it had to, an analysis of the total marriage value to be shared between the Respondents (as the enfranchising tenants) on the one hand and the superior interests on the other hand. The LVT concluded that the total marriage value was £1,135,501, such that the total price for the freehold as fixed by the LVT included one half of this sum, namely £567,751 of marriage value. It may be noted that the principal point involved in the present appeal is how the unusual terms of the head lease are to be dealt with in the valuation exercises which it is necessary to perform in order to identify what may be called the investment value or core value of the Freeholder's interest and of the Appellant's interest (100% of which the Freeholder and the Appellant respectively are entitled to retain as part of the purchase price) and how much should be attributed to marriage value (50% of which they are entitled to receive between them).

5. The terms of the head lease between the Freeholder and the Appellant have been briefly noted above and in more detail, so far as is necessary to record them for the purposes of this case, are as follows.

(1) The lease was for 200 years from 25 March 1984 at a rent (for the first 42 years of the term) of £1,000 per annum. No premium was payable. The property demised was effectively the whole of the Grosvenor Belgravia Estate. It is appropriate to note that the reddendum clause was in the following terms:

> "PAYING therefor yearly and every year during the said term hereby granted the rents specified in the Second Schedule hereto …"

(2) The lease contained an absolute covenant against assigning part of the demised premises and a qualified covenant against assignment of the whole or under letting or parting with possession of the demised premises or any part thereof – ie qualified in the sense that this was not to be done without the previous consent in writing of the Freeholder such consent not to be unreasonably withheld.

(3) The covenant against alienation, which is contained in Clause 2 (IX), then provided in subparagraph (d) as follows:

> "(i) if the Lessee shall stipulate for a fine or premium as the consideration or part of the consideration for the grant of any underlease or on any other parting with the possession of the whole or any part of the demised premises permitted by this Lease (otherwise than a parting with possession by virtue of any assignment of the whole of the demised premises) then the Lessee shall forthwith account to the Landlords on the date of receipt of such fine or premium for the Appropriate Proportion of such fine or premium which shall belong to the Landlords accordingly (which Appropriate Proportion shall be determined in accordance with sub-paragraph (ii) of this paragraph (d))
>
> (ii) the Appropriate Proportion of any such fine or premium as is mentioned in sub-paragraph (i) of this paragraph (d) shall be determined by reference to the year of the term demised by this Lease during which the grant of the underlease or the other parting with possession in question mentioned in the said sub-paragraph (i) occurs or (if earlier) the date of any agreement relating to such grant or other parting with possession (or if such agreement shall be conditional the date on which such condition or conditions shall be fulfilled) and shall be the proportion specified in the Third Schedule hereto."

(4) The Third Schedule is in the following terms:

> "The Third Schedule
>
> The Appropriate Proportion
>
> The Appropriate Proportion both for the purposes of Clause 2 (IX) (d) of this Lease and for the purposes of paragraph 1(a)(vi) of Part II of the Second Schedule to this Lease shall be as follows:-

Year of the term granted by this Lease	Appropriate Proportion
Any of the first 42 years of such term (not relevant for the purposes of Part II of the Second Schedule to this Lease)	Nil
43rd year of such term	5 per cent
44th year of such term	10 per cent
45th year of such term	15 per cent
46th year of such term	20 per cent
47th year of such term	25 per cent
48th year of such term	30 per cent
49th year of such term	35 per cent
50th year of such term	40 per cent
51st year of such term	45 per cent
52nd year of such term	50 per cent
53rd year of such term	55 per cent
54th year of such term	60 per cent

55th year of such term	65 per cent
56th year of such term	70 per cent
57th year of such term	75 per cent
58th year of such term	80 per cent
59th year of such term	85 per cent
Any year of such term after the 59th year thereof	90 per cent"

(5) The Second Schedule made provision for the rent to be paid. As already noted this was only £1,000 per annum for the first 42 years of the term. Paragraph 1 of the Second Schedule provided for the rent during the remainder of the term in the following way:

> "During the remainder of the term granted by this Lease (after the expiration of the first forty-two years thereof) the yearly rent shall be calculated in the accordance with the provisions contained in Part II of this Schedule".

(6) Part II of the Second Schedule made detailed provision the broad effect of which is that after the first forty-two years of the term, ie for each year of the term commencing on the 26 March 2026 and on each anniversary of that date, there is to be an accounting period, being the 12 months ending on the previous 31 December. During this accounting period the "Lessee's Gross Income" and the "Lessee's Outgoings" and the "Lessee's Net Income", as defined in the lease, are to be calculated. Also there is to be found for the relevant year in question the "Appropriate Proportion", which is the appropriate proportion as set forth in the Third Schedule set out above. Paragraph 2 of Part II of the Second Schedule provides that the rent payable is to be an amount equal to the Appropriate Proportion of the Lessee's Net Income during the relevant base accounting period (ie the previous calendar year expiring on the immediately past 31 December). The lease contained machinery provisions for the producing of audited accounts and for any disputes upon relevant matters to be determined by an independent chartered accountant acting as an independent expert.

6. The provision in the lease whereby, after 25 March 2026, the Freeholder becomes entitled to a proportion (increasing every year) of the head leaseholder's net income and of the premiums paid to the head lessee (eg upon the grant of some new underlease) has been referred to by the parties as "the escalator clause" and we hereafter adopt that expression. It will be seen that the broad effect of the escalator clause is that prior to 25 March 2026 the Appellant is entitled, subject to obtaining the Freeholder's consent, to deal by way of subletting of properties on the estate in such manner as it wishes including obtaining premiums, the whole of which the Appellant is entitled to keep. However as from 25 March 2026 any such dealings which generate premiums must be accounted for to the Freeholder by the payment to the Freeholder of a certain percentage, which starts at 5% in 2026 and increases each year in a regular pattern climbing five percentage points each year until eventually it becomes 90% in 2043. Similarly the Appellant is entitled to retain the entirety of the income from the estate until 25 March 2026, but thereafter has to account to the Freeholder for a percentage of the net income, the percentage being the same as that applicable to premiums. The Respondents have

asked the Appellant what was the purpose of this lease, which clearly is not a lease which the Freeholder would have agreed to grant to a stranger in the market because, the Appellant enjoys the immense extent of the property thereby demised for the first 42 years in return for no premium and a nominal rent of £1,000 pa. The Appellant by its solicitor's letter of 11 February 2010 stated as follows:

> "(1) The Lease dated 27 March 1984 was part of an inheritance tax planning arrangement;
>
> (2) the intended effect of the Lease was to cause the progressive migration of the value of the residue of the Belgravia Estate (ie those elements which had not previously been disposed of) from the Appellant to the freeholders with effect from March 2026 onwards. "

Some Statutory Provisions

7. Section 9(1A) of the Leasehold Reform Act 1967 as amended provides as follows so far as presently relevant.

> "(1A) … the price payable for a house and premises … [which falls within the rateable value limits presently applicable] … shall be the amount which at the relevant time the house and premises, if sold in the open market by a willing seller, might be expected to realise on the following assumptions:-
>
> (a) on the assumption that the vendor was selling for an estate in fee simple, subject to the tenancy, but on the assumption that this Part of this Act conferred no right to acquire the freehold or an extended lease;
>
> (b) …
>
> (c) …
>
> (d) on the assumption that the price be diminished by the extent to which the value of the house and premises has been increased by any improvement carried out by the tenant or his predecessors in title at their own expense;
>
> (e) …
>
> (f) on the assumption that (subject to paragraphs (a) and (b) above) the vendor was selling with and subject to the rights and burdens with and subject to which the conveyance to the tenant is to be made, and in particular with and subject to such permanent or extended rights and burdens as are to be created in order to give effect to section 10 below."

8. Section 9 (1D) is in the following terms:

> "Where, in determining the price payable for a house and premises in accordance with this section, there falls to be taken into account any marriage value arising by virtue of the coalescence of the freehold and leasehold interests, the share of the marriage value to which the tenant is to be regarded as being entitled shall be one-half of it."

9. The expression "house and premises" is defined in section 2(3) of the Act. This provides that the reference to the house is a reference to the house let to the tenant and the reference to premises is to be taken as referring to any garage, outhouse, garden, yard and appurtenances which at the relevant time are let to him with the house.

10. Schedule 1 to the Act makes provision in relation to the situation where the enfranchisement is being claimed not by an immediate tenant of the freeholder but by a subtenant. Paragraphs 1(1) and (2) of Schedule 1 provide as follows:-

> "(1) (1) Where a person (in this Schedule referred to as "the claimant") gives notice of his desire to have the freehold or an extended lease of a house and premises under Part I of this Act, and does so in respect of a sub-tenancy (in this Schedule referred to as "the tenancy in possession"), then except as otherwise provided by this Schedule –
>
> (a) the rights and obligations of the landlord under Part I of this Act shall, so far as their interests are affected, be rights and obligations respectively of the estate owner in respect of the fee simple and of each of the persons in whom is vested a concurrent tenancy superior to the tenancy in possession (and references to the landlord shall apply accordingly); and
>
> (b) the proceedings arising out of the notice, whether for resisting or giving effect to the claim to acquire the freehold or extended lease, shall be conducted, on behalf of all the persons referred to in (a) above, by and through that one of them who is identified by this Schedule as "the reversioner".
>
> (2) Where there is a tenancy reversionary on a tenancy in respect of which a person gives notice as aforesaid, then (except in so far as special provision is made for such a reversionary tenancy) this Schedule shall apply as if the reversionary tenancy were a concurrent tenancy intermediate between the tenancy in possession and any interest superior to it."

Paragraph 7 of Schedule 1 provides that where a conveyance is executed to give effect to section 8 of the Act (ie to give effect to the obligation to enfranchise) then by paragraph 7(1)(b) so far as at present relevant

> (b) … a separate price shall be payable in accordance with section 9 for each of the interests superior to the tenancy in possession and … section 9 shall apply to the computation of that price with such modifications as are appropriate to relate it to a sale of the interest in question subject to any tenancies intermediate between that interest and the tenancy in possession, together with the tenant's incumbrances relative to those tenancies."

11. The Leasehold Reform Act 1979 provides:

> "As against a tenant in possession claiming under section 8 of the Leasehold Reform Act 1967, the price payable on a conveyance for giving effect to that section cannot be made less favourable by reference to a transaction since 15 February 1979 involving the creation or transfer of an interest superior to (whether or not preceding his own) or an alteration since that date of the terms on which such an interest is held."

Expert evidence

12. We received evidence from Mr Julian Clark BSc MRICS on behalf of the Appellant and from Mr Timothy Martin BSc(Hons) MRICS on behalf of the Respondents.

13. The general approach of the valuers was as follows. They recognised that the assessment of the price to be paid for the superior interests is a two-stage process. First there must be assessed a core value or investment value (hereafter referred to as the core value) for, separately, the head leasehold interest and the freehold interest. It was agreed that in assessing this core value it is necessary to ignore "any marriage value arising by virtue of the coalescence of the freehold and leasehold interests" within the wording of section 9(1D) because such marriage value falls to be taken into account at a later stage. The experts were also agreed that the marriage value fell to be assessed in the traditional way, which can be summarised as follows:

(1) There is calculated the core value of the freehold (ie excluding marriage value): £a

(2) There is calculated the core value of the head leasehold interest (again excluding marriage value): £b.

(3) There is calculated the value of the enfranchising tenant's present interest (ignoring the right to claim the freehold): £c

(4) These sums are then added together and the total is then deducted from the freehold vacant possession value of the Property (which is taken as £d) in order to obtain the marriage value. Thus having regard to the figures mentioned above

Marriage value = £d–£(a+b+c)

(5) This marriage value is then shared equally between the enfranchising tenant on the one hand and the superior interests on the other hand, such that the price payable for enfranchisement is:

£a + £b + ½ marriage value

(5) As regards £c and £d these are agreed (see the agreed statement of facts) in the sums of, respectively, £2,663,000, and £4,500,000.

14. Accordingly the disagreement between the parties centres upon the assessment of £a and £b. The disagreement arises in particular from the question of the proper treatment of the escalator clause, especially in respect of the valuation of the head leasehold interest.

Valuation effects of the escalator: evidence

15. In summary Mr Clark on behalf of the Appellant says that a hypothetical purchaser (we will call that person X) would decide upon how much to bid for it by conducting the following analysis. Firstly he will calculate what benefits X, having purchased the head leasehold

interest, would be certain of being able to enjoy and then he will calculate the additional value which he might be able to enjoy. Finally he will place a risk discount to cover the chance that he would not be able to enjoy this additional value. It will be seen that X, having purchased the head leasehold interest, would face the following prospect at the termination of the Respondents' underlease on 25 December 2040. X would then have the power to grant a new occupational underlease at a premium for a term expiring on 23 March 2184 (ie for a term of 143.25 years). Upon doing so X would have to account to the Freeholder under the escalator clause for 75% of the premium received, which would climb to 80% of the premium received if the underletting did not take place until after 25 March 2041. The valuers agreed that this benefit which the head leaseholder was certain to be entitled to enjoy should be assessed, not at 25% of the value of such underlease (which would be applicable if the underlease was granted quickly, ie within 3 months of the expiry of the Respondents' underlease), nor at 20% (which would be the applicable figure if the new underlease was granted after three months but before 15 months from the expiry of the Respondents' underlease) but instead at the compromise figure of 22.5% of the value of such a new underlease. Also X would be certain to be entitled to enjoy the rents payable by the Respondents, or their successors, under the existing underlease until Christmas 2040, the entitlement being to enjoy the whole of these rents until the escalator clause began to operate on 25 March 2026 and the entitlement decreasing in five percentage point steps each year thereafter. Mr Clark's approach therefore, in considering how much X would pay for the head leasehold interest, involved the following steps:

(1) Mr Clark valued the above mentioned matters which X would be certain of being entitled to enjoy, namely rents to Christmas 2040 and 22.5% at that date of a premium for the grant of a new 143.25 year lease. Mr Clark assessed that at £404,139, which he calculated as a present value using what he contended were appropriate capitalisation and deferment rates.

(2) Mr Clark then noted the additional value to X if X, having purchased the head leasehold interest, could avoid the escalator clause in one of several possible ways. The additional value to X of avoiding the escalator clause, calculated as a present value on the basis of the adopted deferment rate, was £687,111.

(3) Mr Clark then assessed the risk which X would perceive of not being able successfully to avoid the escalator clause and enjoy this extra £687,111. Mr Clark considered X would place a 20% risk on failing to obtain this extra value. In other words he would assess the potential value of avoiding the escalator clause at 80% of £687,111 namely £549,689.

(4) Mr Clark concluded therefore that X would decide that the value at the valuation date of the head leasehold interest was £953,828 (£404,139 plus £549,689) and would duly bid that sum for it.

16. The possible ways of avoiding the escalator clause referred to by Mr Clark can be summarised as follows:

(1) Option 1: The head lessee could agree with the occupying tenant to grant a new underlease at a premium to the occupying tenant to expire in 2184. If this transaction was entered into before 2026 it would avoid the escalator clause.

(2) Option 2: The head lessee could wait in the expectation that there was a good prospect that prior to 2026 the occupying tenant would wish to sell his interest. In that case the head lessee could purchase that interest and, having done so, could grant a new underlease at a premium prior to 2026, thereby once again avoiding the escalator clause.

(3) Option 3: The head lessee could, once again prior to 2026, grant an overriding underlease until 2184 to a purchaser for a premium (ie a lease commencing immediately with the result that the lessee thereunder would become the immediate landlord of the occupying tenant until 2040). Alternatively the headlessee could grant a reversionary underlease to commence from the expiration on 25 December 2040 of the occupying tenant's underlease.

(4) Option 4: The Freeholder could buy out the head leasehold interest so as to protect the value of its own freehold reversion and/or to prevent fragmentation of the estate. On such a sale the head leaseholder could expect payment to reflect the lost ability to avoid the escalator clause and grant a sublease at a premium, being a premium the whole of which would have been retained by the head lessee.

(5) Option 5: The head lessee could sell to a purchaser which wished actually to enjoy the head leasehold interest in the Property, by enjoying the income until the expiry of the occupying tenant's underlease in 2040 and then enjoying the right to occupy until 2184. (It should be noted that this was a possibility which Mr Clark and Mr Martin had not considered prior to the commencement of the hearing before us and was a possibility which we raised with them for their views as to what if any significance it might have). In order to avoid the escalator provisions it would be necessary for such a purchase to be taken by a company (no doubt specially formed as a special purpose vehicle) so that if eventually the original shareholders of the purchaser no longer wished to live in the Property there could be a sale of the shares (but with the company remaining the head lessee and with there being no assignment or disposal so as to trigger the escalator clause).

17. Mr Clark then considered how much a hypothetical purchaser of the freehold interest (call that person Y) would decide to pay for the freehold. Mr Clark considered that Y would perform the following analysis:

(1) First Y would calculate the present value of obtaining the freehold with vacant possession at the end of the head lease. This is of course a very small sum because the large value is deferred for such a very long time. Mr Clark calculates this value at £1,125.

(2) Y would then calculate the additional value to him if the escalator clause was not avoided by the head leaseholder such that Y enjoyed the appropriate proportions through the escalator clause of the rent until the end of the underlease at Christmas 2040 and also then became entitled to 77.5% of the premium obtainable on the grant of a new long underlease. The present value (using an appropriate deferment rate) of this extra value is £687,135. Mr Clark

considered that Y would then recognise that there was only a very small chance that he would in fact ever get to enjoy this additional value, because the great likelihood would be that the head leaseholder would grant a fresh lease (eg by reaching some agreement with the Respondents or their successors) prior to the escalator clause coming into operation. Mr Clark therefore concluded that Y would assess the chance of enjoying this extra £687,135 at only 5% and would therefore value the chance at £34,357.

(3) Mr Clark therefore concluded that Y would at the valuation date bid the total of these two values of £1,125 and £34,357, namely £35,482 for the freehold.

18. Mr Clark then calculated the price to be paid by inserting his figures into the equation at paragraph 13 above, such that £a is £35,482 and £b is £953,828. The result gives rise to a marriage value of £847,690 which is to be shared equally between the Respondents and the superior interests, with the result that the price to be paid becomes £1,413,200. His calculation is set out in his exhibit JMC1.

19. Mr Martin, on behalf of the Respondents, adopted a broadly similar general approach, but he took a very different view of the facts. Mr Martin adopted different capitalisation rates (when assessing the present value of the prospective rent streams) and a different deferment rate (when working out the present value of the head leasehold reversion at the end of the occupational lease). As regards the effect of the escalator clause and the question of how much X and Y would be prepared to bid (respectively) for the head leasehold interest and the freehold in the Property, Mr Martin's analysis was in summary as follows. He noted the importance of keeping separate the core value on the one hand and marriage value on the other hand. He noted the legal advice he had received that the core value cannot include any value arising from an immediate bid by the occupying tenants (as this is classical marriage value) or arising from the prospect of an eventual bid by such tenants (because this is hope value which equally falls to be excluded at this stage). On this basis Mr Martin was of the opinion that X would conclude, when deciding how much to bid for the head leasehold interest, that the only thing he could be certain of was an income stream to Christmas 2040 and of receiving 22.5% of the value of a fresh 143.25 year underlease granted in 2040. Mr Martin concluded that there was no significant prospect of X bidding more for the head leasehold interest than that, because there was no prospective transaction (ie a transaction which generated value) open to X which was not a transaction which must be disregarded at this stage because it involved marriage value or hope value. Returning therefore to his figures Mr Martin concluded, as regards the head lease, that the total value of the income stream was £141,640 + £20,277 + £25,133 and that the value of the prospect of enjoying 22.5% of the premium on the grant of the new occupational underlease in 2040 was £127,447, making a total of £314,498 as being the value of the head leasehold interest.

20. So far as concerns how much Y would pay for the freehold, Mr Martin concluded that Y would decide that there was an effective certainty that before 2026 the head leaseholder would dispose of an interest which would avoid the escalator clause, such that there was no value to be attributed to the prospect that the escalator clause would not be avoided, see paragraph 7.11 of his proof of evidence. If that were wrong and some value were to be attached to the chance that the escalator clause would not be avoided then such value was very small and was

assessed by Mr Martin in TJMO6. However his principal point was that the freeholder would proceed on the assumption that the escalator would be avoided. Accordingly Mr Martin valued the freehold at £1,130. Thus, so far as concerns the equation in paragraph 13 above Mr Martin considered that £a is £1,130 and £b is £314,498, with the result that the marriage value is £1,521,373 (which of course must be shared equally between the Respondents and the superior interests). In the result Mr Martin concluded that the price payable for the freehold was £1,076,314.

21. We consider that we have sufficiently summarised above the evidence presented by the experts regarding the valuation of the freehold. We now describe in more detail their evidence as to the value of the head leasehold interest.

22. In his expert report Mr Clark expressed the view that, with the exception of the Freeholder, any purchaser of the head lease would take account of the potential methods of avoiding the escalator provisions before they took effect. The most likely method (option 1) would be through the grant of an extended lease to the tenant until 2184. Since there were only 35 years left on the current lease, an application by the tenant to negotiate an extended lease would become increasingly likely, since the cost of such an extension would rise year by year. In Mr Clark's view it was almost certain that the tenant would seek an extended lease within 20 years, that is before 2026.

23. Alternatively there was likely to be an opportunity for the head lessee to buy in the sublease before 2026 (option 2). Statistics suggested that the lease would be offered in the market at least once over the next 20 years. The head lessee would have reason to outbid others for the underlease, including the Freeholder. He would then be free to sell a new long underlease with vacant possession.

24. A further alternative (option 3) was for the head lessee to sell an overriding underlease expiring in 2184 or a reversionary underlease (or a contract for one). Although there would be strong competition for such an interest, Mr Clark recognised certain risks attaching to option 3. The main risk was that, notwithstanding the legal advice that he had received to the effect that the Freeholder would be acting unreasonably if it refused consent for such an underletting, the consent might nevertheless still be withheld. The head lessee would then be forced to litigate or seek a declaration from the courts to resolve the matter. A second risk was that the head lessee might not secure the grant of the reversionary lease before 2026. Since, however, the head lessee had over 20 years to secure the contract, Mr Clark did not consider that the pressure of time was significant. The third risk was that the head lessee would be put to additional cost in taking this course of action.

25. Option 4 was a sale of the head lease to the Freeholder. Mr Clark considered that the Freeholder, or an associated company, would be interested in acquiring the head lease in order to protect its interest. There would otherwise be a risk that a non-Grosvenor entity would purchase the head lease and extract the maximum return from the property by means of options 1, 2 or 3. This would remove the Freeholder's chance to secure a share of the sale price for a new long lease of the property. The Freeholder would also wish to prevent ownership of the

head lease passing into non-Grosvenor hands, since if it did the Freeholder's control over the Belgravia Estate would be reduced.

26. Mr Clark considered that, apart from the occupational tenant, the most likely purchaser of the head lease would be the Freeholder. The Freeholder's bid would be underpinned by the price which a third party investor would pay, having regard to options 1 to 4. If the Freeholder were excluded from the market, the price would be based on options 1 to 3.

27. In the course of cross-examination Mr Clark said that, if only option 3 were available, a purchaser would increase his adjustment for risk from 20% to between 25% and 30%. That assessment was given on the assumption that there was no legal impediment to the grant of an overriding (or reversionary) lease. If the prospective purchaser obtained advice to the effect that the legal position was less clear-cut, the risk allowance would increase further. Mr Clark also accepted that, if the head lessee could only escape the escalator by means of a deal with the underlessee, the latter would use his resultant bargaining position in any negotiations.

28. Mr Clark was asked by the Tribunal whether his valuation of the head lease would change if the escalator could be avoided by a purchaser who intended to hold the head lease until the underlease expired, with a view to occupying (together with his successors) the property for the balance of the head lease (option 5). He replied that there would be no change in the capitalisation of the rental income, but the agreed value of a new 143 year lease would be deferred in full for 35 years at the *Sportelli* freehold rate. This would increase the total value of the head lease from £953,828 in his principal valuation to £1,091,243, as shown in his valuation entitled Appendix B (of which £229,200 reflected the capitalised rental income).

29. In subsequent cross-examination Mr Clark said that he would reduce the reversionary value of the house, assuming only option 5 were available to avoid the escalator, by 15%, to reflect the impossibility of avoiding the application of the escalator to any income received from sub-letting.

30. Mr Martin's principal valuation (TJM1) was £1,076,314. It was prepared on the basis that avoidance value could not be included in the value of the head lessee's interest, nor could hope value be included in the value of the freeholder's interest. Mr Martin prepared four alternative valuations (TJM02, 03, 04 and 05) on the assumption that the head leaseholder could lawfully avoid the escalator and extract additional capital from the interest. He considered that a much greater risk attached to this element, because its realisation depended on a number of factors outside the head lessee's control. The alternative valuations were £1,085,288, £1,076,314, £1,119,616 and £1,162,919 respectively.

31. Mr Martin made a number of observations on Mr Clark's assessment of avoidance value. Firstly, he said it was based on the assumption that, on reversion, the head lessee would be entitled to the whole of the vacant possession value. That assumption did not conform to the provisions of the escalator clause because, by the time the occupational underlease expired, 75% of the vacant possession value would not actually belong to the head leaseholder. Secondly, Mr Martin noted that, since Mr Clark had also allocated a quarter of his 20% risk

discount to the freeholder's interest, he had in effect only deducted 15% for the risk that the escalator would not be avoided. The remaining 85% of the overage would be attributed to either the head leaseholder or the freeholder. In any event, the head lessee's avoidance value and the freeholder's hope value were simultaneous claims to the same sum of money. To make a separate allowance for each in the same valuation amounted to double counting.

32. Thirdly, the 20% deduction for a risk of this nature was inadequate. Since the vendor was assigning 100% of the risk to the purchaser, the purchaser would not be satisfied with only 20% of the potential profit. In the real world it was more likely that a purchase agreement would provide for the net profit from avoiding the escalator to take the form of a deferred payment, which would only become due when a new occupational lease had been completed. Since the Act required the valuer to assume an unconditional sale, Mr Martin considered it likely that a purchaser would seek to reverse Mr Clark's 80:20 split in his own favour.

33. Mr Martin considered that Mr Clark was in fact seeking an unsustainable 160% of the additional value, since he had taken no account of the role of the occupational tenant in releasing it. Finally, he said that Mr Clark had not followed the guidance, given by the Tribunal in *Arbib v Cadogan* [2005] 3 EGLR 139 and reaffirmed in *Cadogan v Sportelli* [2009] 2 WLR 12 and *Nailrile Limited v Cadogan* [2009] 2 EGLR 151, that risk should be accounted for in the deferment rate. He calculated that, if Mr Clark were to leave his capitalisation rate undisturbed, he could have come to the same mathematical result for the value of the overage by deferring the leasehold reversion at 7.72%.

34. Mr Martin's valuations TJM02 and 03 reflected his view that avoidance value was most accurately demonstrated by valuing on the basis of what would happen in reality, namely the grant of a new peppercorn lease to the occupational tenant by means of a surrender and regrant. TJM2 assumed such a regrant would take place just before the escalator took effect in December 2024. TJM3 assumed a regrant on the valuation date. Mr Martin thought it probable that the occupational tenant would be a willing party to such a deal. He would, however, appreciate the value of his co-operation to the head lessee, and would use it as a bargaining tool to obtain the best possible price. For this reason Mr Martin adopted the principle that, if avoidance value were added to the value of the head lease, hope value should also be added to the occupational tenant's interest. The result would be to produce enfranchisement prices which were either identical or very close to his principal valuation.

35. Valuations TJM04 and 05 assumed that option 3 was available to avoid the escalator. They incorporated a calculation of the maximum an investor would pay for the head lease, in the hope of being able to grant an overriding lease to a second investor (who had himself assumed no hope value for the prospect of an early deal with the occupational tenant). These uplift calculations represented the maximum amount which a purchaser could pay, not what he would actually pay. In the absence of the deferred payment option, the most likely position in the real world, the purchaser would have to be certain that the freeholder would not object to the grant of the overriding lease. Since there was no such certainty, the purchaser would reduce the amount of avoidance value he was prepared to pay. Furthermore, the investor-purchaser would seek to reflect in the negotiations the fact that the vendor stood to gain the considerable advantage of being released from the problems associated with the escalator.

TJM5 and 4 assumed that the purchaser would pay 50% and 25% of the avoidance value respectively. Mr Martin considered that TJM4 was more representative of the likely outcome of the negotiations. He concluded that, even if the 1967 Act permitted the inclusion of avoidance value in the head leaseholder's interest, there was either insufficient difference or not enough certainty in the overall enfranchisement price to justify adopting an approach that was not as straightforward as TJM01.

36. In cross-examination Mr Martin was asked about the possibility of the head-lease being purchased by a company, with a view to occupying the house at the expiry of the existing occupational lease. He did not disagree with Mr Clark's approach in his valuation at Appendix B, nor with Mr Clark's suggested deduction of 15% for the inability to sub-let without attracting the escalator. In answer to a question from the Tribunal he said that, if the market was poor, the restriction of any sale to a company might make a difference to the price achieved, but he did not suggest that such considerations applied at the valuation date. In re-examination he said that if the only way to dispose of the property throughout the 143 year lease term was by a sale of the company, purchasers would be concerned at the risk of future adverse changes in the tax treatment of such property ownership vehicles.

Capitalisation rate: evidence

37. The experts agreed that, if the passing ground rent of £13,500 per annum was received by the freeholder, it would be capitalised at 4.75% for the period until the next review in the occupational lease on 25 March 2021. Mr Clark adopted this rate to capitalise the ground rent receivable by the head lessee for the entire period until the expiry of the occupational lease in December 2040. It was agreed that no increase in the ground rent payable from March 2021 would have been identified on the valuation date. Mr Clark therefore capitalised an annual income of £13,500 at 4.75% until 25 March 2026, after which the escalator would take effect. He reduced the net income receivable by the head lessee in each year between 2026 and 2040 in accordance with the escalator. He applied the same capitalisation rate, 4.75%, to the capitalisation and deferment of this net income.

38. Mr Clark explained his choice of capitalisation rate as follows. He said that the rent was "dynamic". Since it was based on 10% of the full market rental value of the house, it was also secure. He considered that an investor would accept a lower initial return the shorter the period for which the rent was fixed, and the earlier the prospect of a reversion or rent review. That principle had been applied consistently in the negotiation of enfranchisement prices for houses and premiums for new leases of flats on the Grosvenor and Cadogan Estates. Mr Clark considered that the rate of 4.75% allowed for the potential growth in rental value over the remaining period to the next rent review. Although no rental growth had been identified as at the valuation date, he thought it would have been anticipated at that time that there would be growth over the remaining period until the review. He saw no reason to distinguish the quality of the income stream for the remaining term of the lease after the review.

39. Mr Clark did not consider it appropriate to increase the capitalisation rate above 4.75% to reflect the fact that the rent was received by the head lessee and not the freeholder. He pointed out that, apart from the provisions as to rent and premium apportionment, the head lease

contained few restrictions that differed significantly from the management scheme that applied to freeholds on the Grosvenor Belgravia Estate. Moreover, the costs of management incurred by the head lessee were deductible in full before the rent sharing arrangements were to be applied. Accordingly, the share of the proceeds for which the head lessee had to account to the freeholder was net of costs. The fact that management costs were deducted from gross rental income before the balance was shared between the freeholder and head lessee after 2026 was one reason why Mr Clark retained the capitalisation rate of 4.75% for valuing the rental income received by the head lessee after 2026. He had not previously encountered the suggestion that an interest in a property producing a fixed rental income of, say, £500 per annum should be capitalised at a higher rate than a similar interest producing a higher fixed rental income, merely because the costs of collecting the rents were proportionately higher for the lower income.

40. Moreover, it was not uncommon for high value residential properties in Central London to have been let at relatively low fixed ground rents in the region of £100 to £500 per annum. In the case of the appeal property, the initial rent under the occupational lease was £2,000 per annum. This had been increased to £13,500 in March 2001 and there would be a further review to a proportion of market value in 2021. Against that background, he did not think that an investor would make a further adjustment to reflect the costs of collection.

41. Moreover, Mr Clark did not consider that a purchaser of the head lease in the appeal property would anticipate incurring significant management costs which were not recoverable from the occupational tenant. The sublease was granted on full repairing terms and the tenant was required to reimburse the landlord for the costs of insurance. The tenant was responsible for the payment of all rates and taxes and there was an absolute bar against alterations. The landlord could recover its costs of repairs to party walls and shared services. The tenant was required to reimburse the landlord for the costs of any enforcement action taken under section 146 of the Law of Property Act 1925. Although section 9(1A) of the 1967 Act required the valuer to assume that the tenant had no liability to repair, he did not consider there was much risk that the tenant of such a high value property would not keep the building in repair. Failure to do so would jeopardise the value of the underlease to the financial disadvantage of the tenant.

42. For these reasons, Mr Clark did not consider that the costs of management would have an impact on the capitalisation rate applied to the head leasehold interest. Furthermore, to the extent that the escalator provisions would depress the value of that interest, he considered that the matter had been adequately reflected through the pre-determined percentage adjustments to the income receivable after March 2026, which produced the net income which would remain in the hands of the head lessee.

43. Mr Clark’s valuation of the rental income to the head leaseholder was £210,179. This comprised a capital value of £175,169 for the period of 20.64 years before the commencement of the escalator and a further £35,010, being the capital value of the balance of the income retained by the leaseholder from March 2026 until December 2040.

44. Mr Martin capitalised the ground rent payable until the commencement of the escalator provisions at 5.25%. (In fact, his detailed calculation assumed that the freeholder would receive 5% of the rent from 1 January 2025, whereas in fact the head lessee is entitled to keep all the rent until 25 March 2026). Although he accepted that the security of the income was probably the same as if it had been received by the freeholder, he believed that a purchaser of the head lease would make some adjustment for the fact that he was not only required to enforce the terms of the occupational underlease (as would a freeholder), but he was also required to comply with the terms of his own lease. In Mr Martin's experience of acting for intermediate landlords, the conduct of parallel dealings with the tenant and freeholder, such as the collection and payment of rent, enforcement of covenants and negotiating tripartite permissions, was very time consuming, and the effort was often disproportionate to the sums involved when compared to the relative simplicity of bipartite dealings. The problems of greater difficulty of management and fewer options for dealing with the property (on which weight was placed by Mr Martin) were common to all intermediate leasehold interests, both during the term of the occupational underlease and at or after the reversion, although the degree of complexity would depend on the terms of the leases that governed the interest.

45. Mr Martin said that common valuation practice, where an intermediate leaseholder had no substantial reversion, was to uplift the capitalisation rate by at least 1% and apply a sinking fund. This was because of, firstly, the differing nature of the intermediate landlord's tenure and, secondly, the need to build up a reserve of capital to buy another similar investment once the head lease had expired. Since the length of the head leaseholder's reversion in the appeal property was so long, so that further value could be derived from it, he did not think there was any need to make an allowance for a sinking fund. Nevertheless, he was in no doubt that the management of a leasehold reversionary interest was more complicated than the management of a simple freehold reversion, and warranted some adjustment to the value.

46. Mr Martin allowed for this difference by applying an uplift of 0.5% to the capitalisation rate, and arrived at 5.25%. This resulted in a modest reduction of £10,144 over the whole term of the occupational underlease below the amount a freeholder would pay. Put another way, it amounted to a discount of 5.14% from the amount an investor would pay for the interest if it had been a freehold reversion. He considered that such an adjustment was not excessive, bearing in mind that it was intended to reflect added management complications over a lengthy period.

47. In Mr Martin's opinion, the capitalisation rate should be increased further when valuing the rental income reduced by the escalator. The escalator would not by itself affect the amount of rent paid by the tenant or the security of the income, only the way it was distributed. Similarly, the diminishing figure that the head leaseholder would receive would be factored into the valuation mathematically. What would not be so factored, however, was the diminution in the head leaseholder's financial return, once it had been adjusted to reflect the time, cost and effort involved in managing the property.

48. As an illustration, Mr Martin assumed that the lessee's gross income was £1,000 and his outgoings were £100. Prior to the escalator clause, the lessee's net income would have been £900, or nine times his costs. In the final 9 months of the underlease term, beginning 25 March

2040, in respect of which the appropriate proportion payable to the freeholder would be 75%, the £1,000 gross income and the £100 outgoings would not change but, after accounting for the freeholder's share, the head leaseholder's income would fall to £225, or 2.25 times his costs. Thus the return on his efforts would have fallen by 75%. Had the appropriate proportion been applicable to the lessee's outgoings (meaning that the lessor shared in the costs in the same proportion as the income) the lessee's net income would have remained at nine times the costs. Mr Martin had little doubt that a purchaser of the head leasehold interest would conclude that the value of the investment would diminish rapidly.

49. Although by no means an exact proxy, Mr Martin thought that costs incurred in managing the investment should reflect the effort involved. That being the case, a further effect of the escalator was to act as a disincentive to active management. As an illustration, he assumed that the lessee's outgoings doubled to £200, for example to reflect additional management work in one particular year. The effect of an increase in costs without a corresponding increase in income would be reduce the head leaseholder's return to the same as his efforts (£1,000 - £200 = £800 x 25% = £200). Thus, in return for doubling his effort, the head lessee would receive a 55.5% reduction in his return (2.25 down to 1). It was not an adequate answer that the costs were recoverable under the rent provisions. What would interest an investor would be the return on his investment. In any event, the quantum of costs would have an effect on the return, as the greater the costs the lower the return. This would therefore act as a disincentive to active management.

50. Mr Martin accepted that, where an occupational lease contained full repairing and insuring covenants, no landlord, whether leaseholder or freeholder, would be liable for significant costs when managing his investment. What distinguished the present case was the additional costs and effort incurred by the head lessee in complying with the obligation to account for his costs and receipts within four months of the end of the accounting year. (paragraph 3(i) of Part II of the Second Schedule). Apart from this additional obligation, the unique effect of the escalator was substantially to reduce the potential, in a normal freehold or leasehold reversion, to obtain a positive return on the investment.

51. Mr Martin thought it would be very difficult for an investor to make a judgment today about what to pay for an uncertain return which would certainly decline by 75% over the term, but which would not begin to flow for nearly 20 years. If he could not quantify the risk, a prudent investor would attach a risk premium to his bid, sufficient to ensure that he would not make a loss on his investment over its life. As a minimum, he would expect an investor to require a return greater than the 5% annual rate at which the rent diminished through the escalator.

52. In fact, the reality was that the rate of decline in the return would increase progressively each year. Using the previous example, in the last year before the escalator took effect, the head lessee's return would be nine times his costs. The following year, when the lessee would lose 5% of his income, his return would fall to 8.55 times his costs. At the other end of the escalator, in the calendar 2038 his return will have fallen to 2.7 times his costs, and in 2039 it would be down to 2.25 times costs; a fall of 16.7% compared with the previous year. The average decline in the return, year on year, over the life of the escalator was 9.03% but this was

based on the assumption that the costs would stay constant throughout. Since the investor would not be able to identify his costs, however, he would not be able to predict his net income. Mr Martin said that there was no empirical evidence to help him come to a firm conclusion on what rate to use, but his instinct told him that an investor would certainly be cautious. If he applied a risk premium to his capitalisation rate that amounted to twice the average rate of decline in his return over the period, this would give him a reasonable margin for error. Thus, if the capitalisation rate of 5.25% were increased by 18.06%, one arrived at a capitalisation rate of approximately 6.2%. As a check, he calculated that this risk premium would produce a net present value of rental stream of £25,138 during this period, compared to £31,790 using a capitalisation rate of 5.25%, a difference of £6,652. This equated to a discount of 20.93% from the price an investor would pay by using a rate of 5.25%. In Mr Martin's judgment, a discount to the net present value of just over 20%, that was intended to take account of a decline of up to 75% in the potential return on the investment over the period in question, was not unreasonable. It produced a capitalisation rate of 6.2%, which Mr Martin used to capitalise and defer the rental income throughout the escalator.

Deferment rate: evidence

53. The head leaseholder has the benefit of a reversion of some 143 years from December 2040 until March 2184. He therefore has the ability to grant a further leasehold interest in the appeal property for that period. It is agreed that the value of such a leasehold interest at a peppercorn rent equates to 99% of the vacant possession value of the corresponding freehold interest. The agreed value of the latter is £4,500,000 and so the value of the 143.25 lease is £4,455,000.

54. Mr Clark deferred the reversion to the leasehold interest in December 2040 at 4.75%, the agreed rate for the deferment of a freehold reversion. Setting aside the particular issues surrounding the escalator provisions in the head lease, in Mr Clark's opinion there was no good reason to distinguish between the deferment rate applied to the head leasehold and the freehold interests in the appeal property, assuming they were subject to the same occupational lease. When comparing the two investments Mr Clark considered that, for the reasons given in relation to the capitalisation rate, it was not appropriate to adopt a higher deferment rate than 4.75% simply because the rent was received by the Appellant in its capacity as head leaseholder. Moreover, the head lease, with 178 years unexpired, was for such a long term that its potential for capital appreciation differed little if at all from that of a freehold reversion. On reversion, the head lease would have an unexpired term of 143 years. This would give the head lessee virtually the same flexibility as a freeholder in dealing with the property. In contrast, if the reversion were of some 50 years or less, the leasehold reversioner would be constrained by time if market conditions were unfavourable when the reversion fell in.

55. In Mr Clark's view, the agreement reached that the head lease was worth 99% of the corresponding freehold value was sufficient to account adequately for the difference between the two interests. The appropriate rate at which to defer a leasehold reversion had been considered by the Lands Tribunal in *Nailrile*, and in particular in relation to the intermediate leasehold interests in five flats which were subject to section 42 claims for extended leases at Regency Lodge, Adelaide Road, London, NW3. In that case the underleases subject to the

claims for extensions had about 27 years unexpired. After the expiry of the underleases, the intermediate leases each had a reversion of a further 54 years. The Tribunal decided that the *Sportelli* generic rate for flats of 5% should be increased to 5.5%. In paragraph 87, the Tribunal said:

> "We accept, as all the witnesses agreed, that an addition to the generic deferment rate is appropriate in the case of a leasehold reversion. We do not accept Mr Briant's view, which the LVT appears to have shared, that such an addition is in part needed to reflect restrictions contained in the headlease. These are matters that would be reflected in the capital value of the reversion, and we see no justification for assuming, as Mr Briant contended, that such values were likely to be inflated by an ill informed market. We agree with Miss Ellis that an adjustment is needed simply to reflect the fact that, because his leasehold is a declining asset, the risk of receiving the reversion at a downturn in the market is greater for the leaseholder than the freeholder. As an additional adjustment for risk this is properly to be related to the risk-free rate (4.5%) that was adopted as a component of the *Sportelli* generic deferment rate. Miss Ellis's adjustment, so related, is 5.56%; that of Mr Briant and Mr Radford 22.22%. We think that the former is rather too low and the latter substantially too high and that an adjustment in the region of 10% is appropriate. We therefore add 0.5% to the generic deferment rate for flats to reach a rate of 5.5%."

56. Comparing the circumstances of Regency Lodge with those of the current appeal, Mr Clark considered that the restrictions in the head lease of the appeal property, other than those relating to the escalator, were properly reflected in the adjustment to the capital value of the reversion which had been agreed at 99% of freehold value. He also thought that there was a clear distinction between the length of the reversion in the appeal property (143 years) and the reversions of 54 years at Regency Lodge. He agreed that, compared to a freehold reversion, a reversion of 54 years exposed the leaseholder to the risk of a downturn in the market on his reversion. That risk was that, once the downturn had passed, the leaseholder would have an interest of reduced length (and thus of relatively lower value) to sell, whereas a freeholder would still have his full freehold interest. In the case of the appeal property, should the headlessee's reversion fall in when there was a downturn in the market, the head lessee would still have a reversion of very significant length by the time values increased again, even if the period of depressed values were to last for five years. It was generally accepted that a 49 year lease was worth less than a 54 year lease, but there was little or no difference between the values of leases with 138 and 143 years unexpired. Mr Clark understood it to be common ground that a lease with an unexpired term of 130 years would be ascribed the same value as one for 143 years, that is 99% of the freehold value. Accordingly, the head lessee of the appeal property was exposed to no greater risk than a freeholder of a downturn in the market on his reversion, were the two interests to fall in on the same date. He therefore drew a distinction between the current case and the Regency Lodge appeal. In this case an adjustment to the generic rate for houses to account for the length of the head leasehold reversion was not warranted.

57. The experts' agreement in the Regency Lodge appeal that an addition to the generic deferment rate was appropriate in the case of a leasehold reversion might appear to be a point of general principle. On an analysis of the evidence, however, it was clear that the factors for which adjustments were required were confined to two points, namely the restrictions in the

lease and the period of the reversion. The first factor was dealt with in the Regency Lodge appeal by an adjustment to the capital value and the latter factor by an adjustment to the deferment rate. In reality, therefore, the only factor for which it was said that the deferment rate should be adjusted was the period of the reversion. In the current appeal, he agreed that there should be an adjustment to the capital value of the leasehold reversion to take account of the restrictions in the head lease, and had therefore valued the 143 year reversion at 99% of the freehold value. Having regard, however, to the similarity between the terms of the head lease and the Belgravia Management Scheme which applied to freehold interests in Belgravia, he did not consider that an adjustment in the deferment was justified for the period of the head lease reversion.

58. For these reasons, and subject to his further comments concerning the escalator provisions, to which we refer later, Mr Clark considered that the deferment rate of 4.75% should be applied to the value of the head leasehold reversion in the appeal property.

59. Like Mr Clark, Mr Martin assumed that, on reversion, the head lessee would be entitled to 22.5% of the premium receivable on the grant of a new underlease for a maximum term of 143 years. If a new under lease is granted (or an unconditional agreement for a new lease is entered into) not later than 25 March 2041 (which is 3 months after the termination date of the underlease) the head lessee would keep 25% of the premium under the escalator provisions. If this dead-line is not met, the head lessee's share would reduce to 20%. The agreed percentage of 22.5% reflected the risk, but not the certainty, that terms will not be agreed and all necessary legal formalities completed by March 2041.

60. Mr Martin considered that the *Sportelli* generic deferment rate of 4.75% should be increased when deferring the leasehold reversion in the appeal property. In his view, the agreement that a 143 year lease was worth 99% of freehold value did not fully reflect the fact that the head lease contained obligations to the freeholder. Whilst these might be passed to an underlessee or assignee, ultimate responsibility for their performance for the duration of the lease would remain with the head lessee. Moreover, the risks attaching to a leasehold reversion were different from those applying to a freehold, because the options available to the freeholder at the point of reversion were wider. The freeholder could sell a lease of any length, grant a lease at a rack rent, dispose of the freehold, or occupy the property himself, permanently or temporarily depending on his personal circumstances and market conditions. The leaseholder did not enjoy quite the same flexibility. He could let, sell or occupy the property. Where the reversion was relatively short, however, he would not have the luxury of being able to wait, if necessary, for market conditions to improve before exercising his preferred option. Clearly, this problem would be less severe with longer reversions.

61. In the case of the appeal property the head lessee would face a further problem. Whatever the prevailing market conditions at the time, and notwithstanding the length of his own reversion, he would be forced to sell a lease for the maximum length as quickly as possible after December 2040 in order to protect the value of his interest. If he did not grant the new underlease until after March 2043, his share of the proceeds under the escalator would fall to 10%. The agreed reduction of the lessee's share from 25% to 22.5% did not fully deal

with the problem, because it took no account of the further risk that the head lessee's share of any proceeds would halve in the two years from March 2041.

62. Mr Martin agreed with the conclusion of the Lands Tribunal, recorded in paragraph 87 of *Nailrile*, that the deferment rate should be increased because of the risk of adverse market conditions prevailing at the point of reversion. He did not agree, however, with the Tribunal's view that restrictions in the head lease were fully reflected in the vacant possession value. This was because the head lessee had a contingent liability in case of default by the underlessee or assignee. Moreover, his analysis suggested that the relationship between the values agreed for the five leasehold reversions in Regency Lodge all equalled 77.7% of freehold value, compared to the relativity of 77.2% for 54 year lease shown in the Gerald Eve graph of relativities. Had the lease restrictions been taken into account in the vacant possession values, he would have expected the agreed relativities to have been lower.

63. In order to arrive at the appropriate adjustment to reflect these terms, Mr Martin had regard to a number of settlements and LVT decisions, augmented by his own analysis of the terms of the intermediate lease and underlease in each case. He accepted that such evidence was not ideal, but he felt he had little choice in the absence of more robust evidence. He noted that, where the freehold rate had been increased by an absolute amount to reflect the leasehold nature of the reversion, the proportion of the uplift fell as the freehold deferment rate increased. In his view, the evidence did not suggest that the proximity of the reversion affected the deferment rate. If, however, proximity were to be considered in combination with the potential to general additional revenue by active management, he would expect an investor to pay somewhat more if there were a possibility of making the asset work while he waited for the reversion to arrive than if the proximity were close and the reversion short. If the reversion were long, however, the effect of its proximity would be limited, since the reversioner would have greater flexibility in dealing with the interest.

64. Mr Martin said that the principal factor which generally governed what an investor could do in terms of active management would be the terms of the underlease and intermediate lease, and in particular the covenants controlling alterations, alienation and use. Having carried out his own comparative assessment of the lease terms in the case of each of his comparables, he noted that, although there was little evidence to suggest that the valuers concerned had paid much regard to the lease terms, the percentage differential to the deferment rate appeared to increase broadly in line with the difficulty of management and generating soft income.

65. The comparables supported the proposition that deferment rates for leasehold interests increased as the length of the reversion reduced. Although the head lease of the appeal property was very long, the effect of the escalator was that the head lessee could not afford the luxury of waiting for the best time to sell. For example, if the head lessee did not sell a lease of the reversion until after March 2043, the delay of 27 months would cause it to lose 60% of its value since December 2040, when the underlease expired. The risk arising in the first 3 of the 27 months had been dealt with by reducing the lessee's share from 25% to 22.5%. The additional loss of value over the remaining 24 months would amount to a reduction in value of 50%.

66. According to the Gerald Eve relativity table, in order to simulate a reduction of 50% in value over 24 months, one would need to start with a lease of 4 years duration. It was this characteristic that made the Appellant's head lease very similar to a short reversion. Despite its length, there was a considerable risk that the head lessee would be forced to sell at an unfavourable time. In Mr Martin's view, this justified an adjustment to the deferment rate based on an analysis of shorter reversions.

67. In order to remove any distortions to the comparable evidence resulting from the presence of a number of longer reversions, Mr Martin restricted his analysis to reversions of 13.5 years or less. The analysis showed that the average uplift attributable to the short reversions was 16.67%. If the *Sportelli* risk premium of 4.5% were increased in the same proportion, it would reach 5.25%. Even within the narrow band of 13.5 years and less, Mr Martin said he would have expected the uplift to continue to increase as the length of the reversion declined, but such evidence as was available showed no consistent pattern to that effect. Accordingly, he had added 0.75% to the risk premium to reflect the head lessee's urgent need on reversion to grant a new underlease as soon as possible.

68. Mr Martin considered that one further adjustment should be made to the value of the reversion secured on the appeal property. The primary method by which a reversioner could obtain a satisfactory return from an otherwise barren investment was by means of what he termed soft income and capital. He provided details of a number of transactions with which his firm had been involved. In each case a capital sum was paid by a tenant in return for a consent, licence or lease variation. In his opinion, the potential for the head lessee to generate such soft income or capital from the appeal property was good.

69. The most likely method was by granting consent for alterations. A future owner might wish to extend the house into the rear garden at the existing lower ground floor level and, possibly, create a roof terrace and conservatory above. He might also wish to enclose the small existing rear roof terrace at first level to extend the drawing room. An ambitious owner might even want to create an entire new sub-basement floor. Consent would be required to use the new roof terrace, which could well attract a licence rent. All reconstruction work would require payment of a premium in return for consent. There was therefore a significant prospect of soft income and capital being generated from the property during the term of the head lease.

70. In this connection, the impact of the escalator was twofold. Firstly, although there was little legal impediment to the potential to generate additional income and capital, the escalator would remove 90% of this benefit for over 98% of the duration of the head leaseholder's reversion. Thus, not only was the prospect of the reversion unattractive by comparison to more normal reversions but there was a substantially increased risk that the cost of holding and managing the 143 year reversion would exceed any income that the head leaseholder was allowed to retain during the term. As a minimum, the head leaseholder would have to enforce regular redecoration of the property and other necessary maintenance and repairs; deal with applications for licences to alter, assign or sub-let; collect any licence rents (including dealing with reviews) and insurance charges; enforce breaches of covenant, any of which might necessitate instructing solicitors and/or surveyors. Furthermore, he would have to account to the freeholder for all his costs and receipts.

71. In the absence of any guarantee that soft income and capital would fund his ongoing management costs, probably the best option open to the leaseholder would be to dispose of his interest. Even that would be difficult, because of the prohibition against assigning part only, and because it was unlikely that the freeholder would be interested in taking a surrender since he was already benefiting from the escalator. Mr Martin reflected the lack of potential for soft income and capital and the risk that the management costs would not be covered by rental income by increasing the risk premium by a further 0.5%. He therefore adopted a deferment rate of 6%, calculated as follows:

Risk free rate		2.25%
Real growth rate		-2.00%
Sportelli risk premium	+4.50%	
Leasehold reversion	+0.75%	
Lost soft income and poor prospects for a return on capital	+0.50%	
		+5.75%
		6.00%

Appellant's submissions

72. On behalf of the Appellant Mr Gaunt QC invited the Tribunal to find persuasive the analysis and valuation contained in Mr Clark's Appendix JMC1. Mr Gaunt advanced the following submissions in support of this invitation.

73. By way of introduction Mr Gaunt pointed out that, viewing the situation as at the valuation date in 2005, it was virtually certain that the escalator clause would never operate in respect of the Property. This is because both valuers accepted it was very probable that if the head leasehold interest were sold to X, then prior to the commencement of the escalator clause in 2026 a transaction would be entered into at a premium, most probably between X and the occupying tenants, which would be at a premium the whole of which X could retain. The critical question therefore is whether the value released for the holder of the head leasehold interest by avoiding the escalator clause is to be taken into account when assessing the core value of the head leasehold interest (as the Appellant says) or whether it is to be left out at that stage and only brought in when calculating the marriage value (as the Respondents say). Mr Gaunt submitted it is surprising that the Respondents' valuer Mr Martin puts forward a core value to represent the investment value of the head leasehold interest based on the proposition that the underlease will run to term in 2040 (and thereby involve the escalator clause, depriving the head lessee of 77.5% of any further premium on the grant of a new underlease) when in fact everyone agrees that the underlease will not run to term but that some earlier transaction will be entered into which will avoid the escalator clause. Mr Gaunt submitted that in the real world an investor would not be able to buy the head leasehold interest at Mr Martin's core value because the investor would factor in the very real prospect of receiving 100% (rather than merely 22.5%) of the value of a 143.25 year term in the Property commencing in 2040.

74. Mr Gaunt submitted that the prospect of avoiding the escalator clause does not give rise to marriage value or hope value – he preferred to call it avoidance value. He submitted that this avoidance value had nothing to do with the sitting tenant's overbid because the escalator clause was none of the tenant's business. Mr Gaunt submitted that the House of Lords decision in *Sportelli* was concerned with ensuring a sitting tenant's overbid was dealt with in marriage value and that the hope value of the prospect of a sitting tenant's overbid was similarly dealt with. However the present case concerns the value to the head lessee of the prospect of avoiding the escalator clause during the 20 years following the valuation date. The critical question is where this avoidance value is to be placed, namely is it part of a core value of the head leasehold interest which could be achieved even disregarding any bid from the sitting tenant, or must this avoidance value be treated as part of the sitting tenant's overbid and hence part of the marriage value? Mr Gaunt pointed out that it was important to discover what someone else would pay for the head leasehold interest, ie someone other than the tenant, so as to exclude the tenant's overbid.

75. Mr Gaunt drew attention to the statutory provisions in section 9(1A) and to paragraph 7 of Schedule 1 and to the need to carry out a separate valuation for the freehold and the head leasehold interest. Each valuation was directed towards a sale of "the house and premises" upon the assumptions in section 9(1A).

76. So far as concerns the hypothetical sale of the head leasehold interest, Mr Gaunt submitted that section 9(1A) cannot be applied precisely in accordance with its terms. It is necessary to give effect to paragraph 7(1)(b) of Schedule 1 and to allow section 9 to apply to the computation of the price for the head leasehold interest by applying section 9 "with such modifications as are appropriate to relate it to a sale of the interest in question". He pointed out that section 9 is primarily directed towards dealing with the simple case where there are only two levels of interest, namely the Freehold and the long leasehold held by the enfranchising tenant. Also section 9, without recourse to paragraph 7 of Schedule 1, does not deal with the situation where there exists not merely a head lease but a headlease which extends to substantially more property than the house and premises which are to be enfranchised and which is a head lease containing an absolute covenant against assignment of parts. If applied literally the valuation exercise in section 9(1A) would involve seeking to value a head leasehold interest which in fact if sold would immediately work a forfeiture of itself and thus could be said to be potentially valueless for that reason. Mr Gaunt drew attention to the case of *Lynall v Inland Revenue Commissioners* [1972] AC 680 which upheld the decision in *Inland Revenue Commissioners v Crossman* [1937] AC 26, namely that if a sale price for an asset is to be assessed on the basis of a hypothetical sale of the asset in the open market, then a sale in the open market must be assumed to be possible and therefore there must be assumed the satisfaction of such conditions as would have to be satisfied to enable such a sale to take place. In the present case therefore it is necessary to assume that, despite the absolute covenant against assignment of part contained in the head lease, the Freeholder would grant at least a one-off permission to enable the hypothetical sale of the head leasehold interest in the Property, being an interest obtained by severing the head lessee's interest by assigning part of the property demised by the head lease. This head leasehold interest in the Property which must hypothetically be deemed to be offered for sale would contain the same terms as those contained in the head lease (because it would be a severed part of the head lease). This raised the question of whether thereafter there would be an absolute covenant against assignment even of the whole (on the basis that the whole of the house and premises

enfranchised, namely No.8 Chester Street, was merely a part of the originally demised premises and should therefore continue to be caught by the absolute covenant against assignment of part), or whether the head leasehold interest should be taken to be subject merely to a qualified covenant against assignment of whole (ie not to assign the whole without the Freeholder's consent which was not to be unreasonably withheld). Mr Gaunt submitted that it did not matter which was correct, because he accepted that once the statutorily assumed hypothetical sale of the severed reversion in No.8 Chester Street to the hypothetical purchaser X had occurred, then any further disposal, eg an assignment of the whole for a premium, would trigger the escalator clause if such a dealing occurred after the commencement of the escalator clause in 2026.

77. Mr Gaunt relied upon the existence of the five options for avoiding the escalator clause as being of importance, because he submitted that they individually and (especially) together indicated a way in which the head leaseholder could escape the escalator clause and could thereby release substantial additional value without reliance upon the occupying tenant's overbid. The crucial question for the purpose of considering the core value of the head leasehold interest (ie ignoring the occupying tenant's overbid) was to decide what the amount of the underbid would be. These options, he submitted, showed that the underbid would be much more than the core value as spoken to by Mr Martin.

78. As regards options 1 and 2 Mr Gaunt recognised that these involved a dealing with the tenant, either by the tenant purchasing the head leasehold interest (option 1) or by the head leaseholder purchasing the tenant's underlease (option 2). These would involve the coalescence of interests. However Mr Gaunt submitted that these were not transactions which had to be ignored at the stage of assessing the core value of the head leasehold interest, because of the distinction which he drew between on the one hand a bid representing the value of the occupying tenant's overbid and on the other hand a bid representing the value of escaping from the escalator clause.

79. Even if the foregoing were wrong, such that options 1 and 2 had to be ignored at the stage of calculating the core value of the head leasehold interest, Mr Gaunt submitted that options 3, 4 and 5 were unaffected by the principle that the occupying tenant's overbid must be disregarded (whether a direct bid in the nature of marriage value or an indirect bid in the nature of hope value) because the transactions contemplated in options 3, 4 and 5 had nothing to do with any transaction with the occupying tenant. Mr Gaunt developed his argument on these options as follows.

80. As regards option 3 a preliminary objection had been raised by Mr Rainey to the effect that the Leasehold Reform Act 1979 required this to be disregarded. Mr Gaunt responded as follows:

(1) First there has been no such transaction as contemplated in the 1979 Act. Mr Gaunt pointed out that option 3 merely takes account of the fact that the grant of an overriding underlease in the future would avoid the operation of the escalator and that the potential for avoiding the operation of the escalator in this way is something which would be reflected in the value of the head leasehold

interest. No transaction has actually occurred which falls to be disregarded under the 1979 Act.

(2) In any event even if the prospective grant of an overriding lease would be caught by the 1979 Act, the grant of a reversionary lease (ie for a term commencing on, say, 26 December 2040) would not be caught and would be equally effective.

(3) Paragraph 1(2) of Schedule 1 to the 1967 Act provides that Schedule 1 is to apply in relation to a reversionary tenancy "as if the reversionary tenancy were a concurrent tenancy intermediate between the tenancy in possession and any interest superior to it". However this deeming provision shows that (a) the deeming provision is necessary (ie without it a reversionary tenancy cannot be treated in this manner) and also shows (b) that the deeming provision operates solely for the purpose of Schedule 1 and therefore the deeming provision does not operate for the purposes of the 1979 Act.

(4) Any problem under Section 149 of the Law of Property Act 1925 is a problem that could easily be overcome, by waiting until within 21 years of Christmas 2040 (which will still leave over 6 years, ie from Christmas 2019 until March 2026) for the grant of the reversionary lease, or if this time constraint was troublesome a contract to enter into a reversionary lease could be made at any time between the valuation date in 2005 and Christmas 2019, see *Re Strand and Savoy Properties* [1960] Ch 582.

81. Mr Rainey had advanced an argument that a term should be implied into the head lease that an overriding lease or a reversionary lease as contemplated in option 3 cannot lawfully be granted (ie cannot be granted at all, such that the question of whether consent to it can reasonably be withheld does not even arise). Mr Gaunt rejected the suggestion of any such implication on the grounds that the head lease contained a detailed alienation clause such that no such implication was necessary because there already existed a covenant against such alienation without consent, such consent not to be unreasonably withheld.

82. As regards Mr Rainey's argument that consent could and would reasonably be withheld by the Freeholder to a proposed reversionary lease to be granted by the head lessee, Mr Gaunt advanced the following arguments:

(1) The head lease is a most peculiar and unusual transaction and the alienation clause must be construed in the light of this head lease as a whole.

(2) The head lease envisaged expressly that the head lessee (ie the Appellant) could and would exploit its asset as it chose by granting either long leases at premiums or leases at rack rents; that they were free to grant long leases of any length less than their own term, that if they did so before 2026 they could keep the whole premium; that by doing so they could deprive the Freeholder of any benefit in relation to any flat or house on the estate until 2184; and that the Freeholder could not reasonably object to such a transaction on that ground.

(3) It must be accepted that the Freeholder could not reasonably object to

(a) the grant of a new long lease to a tenant whose lease had expired;

(b) the grant of a new long lease to an existing tenant;

(c) the grant of a long lease to a new tenant after the termination of the existing tenancy; or

(d) the grant of a reversionary lease to an existing tenant.

There is no difference in principle between those transactions and the grant of a reversionary or overriding lease to someone other than the existing tenant.

(4) As regards the suggestion that the grant of a reversionary or overriding lease would not be "in the usual course of business" Mr Gaunt pointed out that the head lease was not an ordinary commercial transaction. The head lease allowed the head lessee to decide how much of the estate was let on long leases and for what terms and the head lease was designed to enable the head lessee to exploit the estate wholly for its benefit until 2026 – it being provided that whatever value remained at 2026 was to migrate back to the Freeholder between 2026 and 2043.

(5) The qualified covenant against alienation must be construed and applied against this background, where the head lessee (ie Appellant) was supposed to be able to effect transactions so as to realise capital. The Freeholder was not supposed to be able to object on the grounds that a particular transaction would deprive it of the property until 2184.

(6) The correct legal starting point is to enquire what the parties to the head lease contemplated or envisaged happening and whether they contemplated that consent to the proposed underlease could be refused on the grounds in question. Mr Gaunt submitted that *Rayburn v Woolf* [1985] 2 EGLR 235 was an instructive example of this approach. He submitted that as the head lease envisaged that the head lessee could grant underleases of individual properties for premiums and that each time it did so prior to 2026 it could keep the whole premium, it could not be a ground for refusing consent that the head lessee proposed to do precisely what the head lease envisaged it doing.

(7) The purpose of a qualified alienation covenant is to protect the landlord from having his premises used or occupied in an undesirable way or by an undesirable tenant, see *International Drilling Fluids* [1986] 1 ch 513 at page 519H. There is no question of that here.

(8) There was no good reason for restricting the right to sublet to a subletting to an existing tenant. The alienation clause does not so limit the head lessee's entitlement – the head lessee can keep the whole premium from any pre-2026 transaction and is intended to be entitled to do so. Were it otherwise the Freeholder could object to any transaction at any time on the grounds that in the future it would be deprived of its "contractual rights", viz the right to receive a growing share of premiums on grants post-2026.

(9) As regards *Olympia & York Canary Wharf Limited v Oil Property Investments Limited* [1994] 2 EGLR 48 the text at p49L was instructive. It confirmed that as

> a general rule it would be unreasonable for a lessor to refuse consent to an assignment by taking objection to some consequential happening when the lease itself envisaged that happening as unobjectionable.

83. Accordingly Mr Gaunt submitted that X (the hypothetical bidder for the head leasehold interest at the valuation date) if properly advised would conclude that there should be no or no significant difficulty in obtaining the Freeholder's consent to the grant of an overriding or reversionary lease before 2026 which would release a premium, the whole of which could be enjoyed by X because the escalator clause would not be triggered.

84. As regards option 4 Mr Gaunt submitted it was wrong to assume that the Freeholder was excluded from the potential bidders for the head leasehold interest at the valuation date. This is because Schedule 1 paragraph 7 requires separate valuations of the freehold and the head leasehold. When valuing the head leasehold it is not necessary to assume that the holder of the freehold is also selling its interest on the same date and is in consequence uninterested in purchasing the head lease. Even if the foregoing were correct, that would still leave it open for Y (the notional purchaser at the valuation date of the freehold) to be interested in also bidding at the same notional auction for the head leasehold interest. Thus the potential of a bid from the holder of the freehold must be taken into account when valuing the head leasehold interest. The holder of the freehold would be prepared to bid more than what Mr Martin perceived to be the core value for the head leasehold interest, because if successful such a bidder would know that it would definitely enjoy the full rights to any premium on a further lease without any question of having to share such premium through the escalator clause. Mr Gaunt pointed out that option 4 is a hypothetical transaction which is "tenant free" in that it does not involve factoring in value from a bid or prospective bid from the occupying tenant. He recognised that it does contemplate a coalescence of a freehold and leasehold interest but this coalescence, so far as it involves escaping from the escalator clause, is not a coalescence which is contemplated by section 9(1D) and the value of such coalescence does not fall to be shared with the Respondents.

85. As regards option 5 Mr Gaunt accepted that a purchaser (ie X) of the head leasehold interest in the Property would become bound by the alienation provisions and the escalator clause such that if after 2026 X alienated the Property in return for a premium or a market rent, then the escalator clause would operate. However X would also realise that the head leasehold interest conferred the right to enjoy the Property until 2184 and that such enjoyment could be had by way of actual occupation of the Property. Provided such occupation could be enjoyed throughout the term without involving an alienation (such as to trigger the escalator clause) such right of occupation would be exceedingly valuable. He submitted that such a result could easily be achieved by the purchase of the head leasehold interest in the name of a special purpose vehicle, ie a company especially incorporated for the purpose of holding the head leasehold interest. The shareholders could occupy the Property in right of their share ownership and if ever they wished to part with the Property they could sell the shares in the company. Mr Gaunt pointed out it was by no means unusual for a company to purchase prime Central London dwellings such as the Property – indeed Mr Martin had recognised as much.

86. Mr Gaunt accepted that both valuers recognised there would be a disadvantage to such a purchasing company in that if the shareholders did not wish themselves to occupy they would not be able to sublet (eg for a few years while the shareholders were working away from London) because any subletting would trigger the escalator clause and, anyhow after 2043, would trigger 90% of any net income having to be paid over to the Freeholder. However both valuers had considered how to quantify this disadvantage. Mr Clark had suggested a 15% discount on the value and Mr Martin had not sought to disagree with such a figure.

87. As regards the suggestion by Mr Rainey that a company purchaser would fear that the escalator clause would be triggered even by beneficial occupation through shareholders of the company, ie on the basis that a notional rent should be deemed to be "receivable" so as to trigger the provisions of the Second Schedule whereby lessee's net income fell to be shared in accordance with the escalator provisions with the freeholder, Mr Gaunt advanced the following argument. He pointed out that the case relied upon by Mr Rainey, namely *Ashworth Frazer Ltd v Gloucester City Council* [1997] 1 EGLR 104 involved a lease which made it entirely clear that there was to be a rent review to "the fair market rent", which the majority of the Court of Appeal concluded showed an intention that there must indeed be such a review and the review should not become unworkable merely because there was beneficial occupation of a unit such that no market rent from an occupying sub-lessee was actually being received. In the present case there is no provision for a fair market rent – there is merely the reservation of rent in the reddendum to be paid in accordance with the Second Schedule. Also the relevant clause in the *Ashworth Frazer* case made reference to the reviewed rent being 8% "of the rack rents receivable" – the Court attached substantial significance to the presence of the word "rack" as meaning a reference to the full annual value of the holding. In *Ashworth* the construction contended for would have meant there would have been no review even though the lease clearly intended there would be a review. The case was therefore distinguishable. There must also be noted in the present case the reference to the expression "becoming receivable" – in the hypothetical case of a purchase by the company with beneficial occupation by the shareholders, nothing would "become" receivable.

88. As regards Mr Rainey's argument that what fell to be valued was not a severed portion of the head leasehold interest but was instead the entirety of the head leasehold interest (ie of the whole of the Grosvenor Belgravia Estate as demised by the head lease, but with the calculation being only concerned with the element of such value attributable to the Property), Mr Gaunt responded as follows:

(1) Such a valuation approach would involve not following the statutory words in section 9(1A) and paragraph 7 of Schedule 1, which require the relevant interest in "the house and premises" to be valued;

(2) The decision of this Tribunal in *Nailrile* at paragraph 32 did not require any such approach because, in contrast to *Nailrile* where it could be expected that the hypothetical seller would sell its interest in a block only as a whole, in the present case there was nothing unusual in the sale of an individual house.

89. Accordingly option 5 provided a category of potential purchasers for the Property who would perceive a value in the head leasehold interest far in excess of the core value as spoken

to by Mr Martin. Such value was wholly independent of any immediate or prospective overbid from an occupying tenant and therefore did not involve any marriage or hope value, so no part of the value of this bid fell to be treated under the marriage value heading. The core value of the head leasehold interest must therefore be calculated to reflect the prospect of such a purchase by a company.

90. Having regard to all the foregoing Mr Gaunt submitted that there were five separate ways, alternatively three separate ways (supposing that options 1 and 2 involved taking account of an occupying tenant's overbid), whereby the escalator clause could be avoided. The existence of these options added substantial value to the head leasehold interest over and above the value mentioned in paragraph 15(1) above. Mr Gaunt submitted that the existence of these options all supported Mr Clark's primary valuation approach as shown in JMC1, where Mr Clark had assumed that X (ie the hypothetical purchaser of the head leasehold interest) would frame his bid on the basis that he perceived a 20% risk of failing to avoid the escalator clause.

91. Finally Mr Gaunt submitted that if, contrary to his submissions, it was necessary to value the head leasehold interest on the assumption that there was no prospect of escaping the escalator clause, such that a core value assessed on the principles in paragraphs 15(1) above had to be adopted, then the only logical consequence of that was as follows, namely that when one turned to value the freehold interest it was necessary to make the same assumption and to assume that the escalator clause would not be avoided. In these circumstances the freeholder would receive 77.5% of any premium in 2040. Mr Clark submitted an alternative valuation, reflecting this prospect, in JMC2.

92. As regards the question of capitalisation rates and deferment rate Mr Gaunt commended to the Tribunal the approach of Mr Clark for the reasons given by Mr Clark. It would not be helpful to rehearse those reasons again here.

Respondents' submissions

93. On behalf of the Respondents Mr Rainey commenced by pointing out the following, namely that a lease which includes a very onerous covenant is worth a great deal less than a lease without such a covenant. He submitted that the present appeal was an attempt by the Appellant to escape from that simple proposition. The escalator clause is undoubtedly onerous and accordingly any valuation which produces a price the same as or close to the price that would result if there were no escalator clause in the headlease is prima facie wrong. Mr Rainey developed those arguments in the following way.

94. He drew attention to the House of Lords decision in *Sportelli*, especially the speeches of Lord Hoffman and Lord Neuberger. Lord Hoffman at paragraph 2 made clear that any additional value derived from the prospect of later selling at an enhanced price to the occupying tenant (thereby releasing the occupying tenant's overbid), being a value which may properly be called "hope value" because it is based upon the hope of a further advantageous transaction, is a value which is entirely dependent upon the existence of the additional value to the special purchaser. This hope value is just as much to be excluded when assessing the core

value of the head leasehold interest as is any additional value which might be derived from a direct bid from the special purchaser, namely the occupying subtenant. Accordingly, when assessing the core value both hope value and marriage value must be excluded. What the valuer is seeking to establish is how much the relevant interest might fetch in the open market if offered by a willing seller but ignoring any additional value which might be released by means of an immediate or eventual transaction with the special purchaser, namely the occupying subtenant. Having established this core value it is next necessary to assess what the relevant interest is worth to the occupying subtenant. This value, ie the value to the special purchaser, can be expressed as equal to the core value plus marriage value (ie the extra value to the occupying tenant). It is this marriage value which is to be shared. Mr Rainey referred to *Raja Vyricherla Narayana Gajapatiraju v Revenue Divisional Officer Vizagapatam* [1939] AC 303 at pp 314-5.

95. The marriage value so calculated is value arising by reason of the coalescence of interests and is to be shared equally between the enfranchising tenant on the one hand and the superior interests on the other hand having regard to section 9(1D). Any value released from the coalescing of interests falls within section 9(1D). If a course of action designed to escape the escalator clause involves the coalescence of interests then the additional value thereby derived constitutes marriage value within section 9(1D). In summary options 1, 2 and 4, relied upon by the Appellant for escaping the escalator clause, all relied upon coalescence of interests. The additional value thereby released forms part of the marriage value which must be shared. While not conceding the point, Mr Rainey did not feel able to advance any argument to dispute the fact that if (which he did not accept) either option 3 or option 5 could properly proceed and could release additional value, then the additional value thereby released would not constitute marriage value because such value did not derive from any coalescence of interests or any overbid by the occupying tenant. Mr Rainey then dealt in greater detail with each of the options in turn after first noting the following point.

96. Mr Rainey submitted section 9(1A) can be satisfactorily operated, consistently with his submissions, without there being any need to rely upon the wording in paragraph 7(1)(b) of Schedule 1 and therefore without making "… such modifications as are appropriate to relate it to a sale of the interest in question…" However if it is necessary to make any such modifications in order to deal with the fact that in the present case there is a head leasehold interest between the freeholder and the occupying tenant, then section 9(1D) merely needs to be read as follows:

> "…any marriage value arising by virtue of the coalescence of the reversionary and leasehold interests …"

In other words the word "reversionary" is substituted for the word "freehold".

97. As regards option 1 this effectively by definition brings in the special value to the occupying tenant and hence marriage value within section 9(1D). Option 1 relies upon entering into a transaction with the occupying tenant. There is no distinction as alleged by the Appellant between avoidance value (ie the value of avoiding the escalator clause) on the one hand and hope value or marriage value on the other hand. If there were no other options available then the only way of escaping the escalator clause would be through option 1, which

specifically relies upon a bid from the occupying tenant, and in order to calculate marriage value it would be necessary first to establish the core value which would ignore this bid by the tenant. If this bid by the tenant is ignored then there is, on this hypothesis, no way at all of avoiding the escalator clause such that the core value when assessing the value of the head leasehold interest should be assessed in the manner adopted by Mr Martin.

98. Quite apart from the foregoing there is a further difficulty for the Appellant under option 1. Any suggestion that the occupying tenant wants to buy now but the head leaseholder can wait for 20 years is wrong. Both the hypothetical willing seller and the hypothetical willing buyer can walk away from the transaction if a proper price is not being agreed, see *F R Evans (Leeds) Limited v English Electric Co* (1978) 36 P & CR 185. Accordingly even if the additional bid by the occupying tenant under option 1 (being a bid to reflect the value of avoiding the escalator clause) did not almost by definition involve marriage value which was to be shared, the Appellant faced the following difficulty. In these hypothetical circumstances there is a very substantial additional value to be unlocked as between the head leaseholder and the occupying tenant. In the hypothetical negotiations the tenant, being of equal bargaining strength with the head leaseholder, could draw attention to the fact that the only way the head leaseholder could escape from the escalator clause was to do a deal with the tenant – and in these circumstances the tenant would through strength of negotiating position demand one half of the avoidance value as the price of entering into the deal.

99. By reason of the foregoing either the avoidance value constitutes part of the marriage value and must be shared by force of statute under section 9(1D), or alternatively the avoidance value would as a result of negotiating in the market be shared in any event between the enfranchising tenant and the head leaseholder such that the enfranchising tenant would obtain one half of the avoidance value through strength of negotiating position rather than through operation of section 9(1D). In other words whichever route of analysis is followed the enfranchising tenant is entitled to half of the avoidance value.

100. As regards option 2 there are the following objections:

(1) This option also relies upon a deal with the occupying tenant involving a coalescence of the head leasehold and under leasehold interests and accordingly any additional value derived therefrom falls to be shared under section 9(1D).

(2) In any event option 2 is, in effect, exactly the same in principle as option 1 in that it relies on a transaction between the head leaseholder and the occupying tenant.

(3) Quite apart from the foregoing the head leaseholder is by force of statute assumed to be a seller and therefore a hypothetical transaction involving the head leaseholder buying the underlease is contrary to the relevant statutory assumptions.

101. Turning next to option 4 Mr Rainey drew attention to the fact that in an ordinary case, as confirmed by Mr Clark, the potential existence in the hypothetical market for ahead leasehold interest of the freeholder as a potential purchaser would have no effect on the price to be paid.

The only reason why an additional price might be paid by the Freeholder in the present case would be for the purpose of coalescing the freehold and the head leasehold interests so as to enable the Freeholder to prevent a new underlease being granted in circumstances where no share of the premium became payable to the freeholder. This argument, however, could not help the Appellant. The argument did not result in any increase in the core value of the head leasehold interest for the following reasons:-

(1) First, the Freeholder is also selling its interest, namely the freehold interest. Bearing in mind the Freeholder by force of statute is a seller it would be contrary to the scheme of the Act to treat the Freeholder as simultaneously being a buyer, ie a potential bidder for the head leasehold interest in the hypothetical market.

(2) Even if the hypothetical bidder for the head leasehold interest is not the Freeholder itself but is instead some hypothetical purchaser Y who has just bought or is just about to buy the freehold interest and who is also bidding for the head leasehold interest, Y would only increase its bid (ie beyond Mr Martin's core value for the head leasehold interest) in order to release marriage value by coalescing the freehold and the head leasehold interests. Accordingly this increase in the bid forms part of the marriage value having regard to section 9(1D).

(3) Further, to approach the case on the basis of there being such a bid for the head leasehold interest and of there being an actual or prospective coalescence of the freehold and head leasehold interests is to ignore the fact that under the statute there must be a separate valuation of (i) the freehold interest and (ii) the head leasehold interest. Any option which involves coalescing these two interests and treating the relevant assessment of marriage value as though these two interests had been unified was to fall into the heresy identified in *Wentworth Securities v Jones* [1980] AC 74.

102. Having regard to the foregoing Mr Rainey submitted that options 1, 2 and 4 could be of no relevance to assessing the core value of the head leasehold interest. They could not justify any assessment of such core value on a basis more favourable than that adopted by Mr Martin in paragraph 19 above and Mr Clark in paragraph 15(1) above.

103. Mr Rainey next turned to options 3 and 5 which, if permissible and if generating of value, he felt unable to argue were options which had to be disregarded when assessing the core value of the head leasehold interest. He recognised that options 3 and 5 neither involved any coalescence of interests nor did they rely upon any overbid from the occupying tenant as special purchaser.

104. As regards option 3 Mr Rainey advanced the following arguments:

(1) This envisaged that the head leaseholder will grant an overriding or reversionary lease at a premium prior to December 2026 to some person other than the occupying tenant and will thereby escape the escalator clause and enjoy the

entirety of the premium paid. Any such transaction could only properly be taken into account provided it was not contrary to the Leasehold Reform Act 1979. Further such a transaction could only release value if the proposed grant of the overriding or reversionary lease could be effected without infringing any implied term in the head lease and could be effected with the Freeholder's consent (which could not be unreasonably withheld).

(2) The Leasehold Reform Act 1979 was intended to reverse the decision of the House of Lords in *Wentworth Securities v Jones*. Mr Rainey submitted that if the suggested overriding lease had actually been granted before the valuation date then it could not increase the price to be paid by the Respondents. By like token he submitted that the prospect of an overriding lease being granted in the future was something which could not be relied upon in the valuation exercise in order to increase the price to be paid. As regards a reversionary lease, as opposed to an overriding lease, Mr Rainey accepted that this was less obviously within the 1979 Act, but he submitted that the reversionary lease would fall within the wording "an interest superior to (whether or not preceding)" the interest of the occupying tenant. Accordingly a reversionary lease was also caught by the 1979 Act and fell to be disregarded. If this were wrong Mr Rainey accepted that section 149 of the Law of Property Act 1925 would not prevent the following through of option 3, because either the proposed reversionary lease could be executed sometime between 2019 and 2026 or, prior to 2019, a contract to enter into such a reversionary lease could be made.

(3) Quite apart from the foregoing, there should be implied into the headlease a covenant that the proposed option 3 overriding lease or reversionary lease cannot be granted. Mr Rainey developed the argument in support of his implied term in paragraphs 28 to 38 of his skeleton argument. He drew attention to the genesis of the head lease and its purpose, being mitigation of inheritance tax, and to the manner in which the parties had decided to structure the escalator clause. He pointed out that the escalator clause was central to the bargain. If it was not there in the lease, or if the clause was ineffective because it could be sidestepped, then the Grosvenor Belgravia Estate was all but given away by the Freeholder to the Appellant by the head lease. Mr Rainey pointed out that any payment under the escalator clause due to the Freeholder actually belonged to the Freeholder and that the Appellant was in effect collecting such monies as an agent with a duty to account to the Freeholder. Like all agents the Appellant was therefore a fiduciary in respect of the escalator payments. There must be an implied term that the Appellant would not act in breach of its fiduciary duty by acting in a manner specifically for the purpose of avoiding the escalator clause, because such an action would not be taken in good faith. Alternatively it must be an implied term that the Appellant would not act so as to deprive the Freeholder of the escalator payments by a "dirty trick" or that the Appellant would not grant a lease which in effect alienated the reversion on the estate, or that the Appellant would not grant a lease other than in the ordinary course of business of the Grosvenor Belgravia Estate. Mr Rainey submitted that an implied term, preventing the following of option 3, would be properly implied having regard to *A-G Belize v Belize Telecom* [2009] 1 WLLR 1988, and *Mediterranean Salvage & Towage Limited v Seamar Trading & Commerce Inc* [2010] 1 All ER (Comm) 1.

(4) Accordingly and in summary, there must be an implied term in the head lease that the head lessee, or any purchaser from the head lessee, cannot deliberately contrive circumstances where there never occurs the contingency which would bring into operation the escalator clause.

(5) Furthermore, even if there were not an implied term as contended, for the situation would remain that any purchaser of the head leasehold interest would be bound by a covenant in the lease which prevented the granting of any contemplated reversionary or overriding lease unless the consent of the Freeholder (be that the Freeholder or same successor) was first obtained. It is true that such consent could not be unreasonably withheld, but Mr Rainey submitted that it was clear the Freeholder could reasonably withhold such consent and that X, when considering how much to pay in the market for the head leasehold interest, would realise that no or no significant value should be attributed to the prospect of escaping the escalator through option 3, because there was no or no significant prospect either of obtaining the Freeholder's consent to the proposed reversionary or overriding underlease or of establishing that the freeholder was unreasonably withholding its consent to such a transaction.

(6) Mr Rainey drew attention to Woodfall's Law of Landlord and Tenant at paragraph 11.140 and he particularly relied upon subparagraphs (5), (7) and (8) which are in the following terms:

> "(5) It may be reasonable for the landlord to refuse his consent to an assignment on the ground of the purpose to which the proposed assignee intends to use the premises, even though that purpose is not forbidden by the lease;
>
> (7) Subject to the propositions set out above, it is, in each case, a question of fact, depending on all the circumstances, whether the landlord's consent to an assignment is being unreasonably withheld.
>
> (8) It will normally be reasonable for a landlord to refuse consent or impose a condition if this is necessary to prevent his contractual rights under the lease from being prejudiced by the proposed assignment or sublease."

Mr Rainey particularly relied upon (8).

(7) He referred to *Pimms v Tallow Chandlers* [1964] 2 QB 547 at 572 in which the court observed that "the proposed assignment is not a normal assignment and is pregnant with future probabilities" So here, he submitted.

(8) The granting of an occupational sublease to existing tenants would be an entirely normal transaction as contemplated by the head lease and the freeholder could not reasonably withhold its consent to such a transaction. But a reversionary or overriding lease was not the same. Such a transaction was not a normal transaction but was designed to prevent the Freeholder ever enjoying any premium value from the property so underlet.

(9) Mr Rainey pointed out that the test is whether the landlord is acting reasonably. Providing the landlord is acting reasonably in withholding consent it does not matter as to whether the court considers the landlord was right to withhold consent.

(10) Mr Rainey recognised that the decided cases, so far as their facts were concerned, merely acted as examples. However he referred to *Olympia & York Canary Wharf Limited v Oil Property Investments Limited* [1994] 2 EGLR 48. In that case a break clause, was exercisable but only by the original tenant. It was held that a proposed assignment back from a subsequent assignee to the original tenant, so as to allow the original tenant, having regained the lease, to exercise the break clause was an assignment to which a landlord could reasonably withhold consent. In that case there could, of course, have been no objection to the identity of the proposed assignee because this was the self-same original tenant to whom the landlords had chosen to let the property. It was the purpose of the assignment, namely to work a disadvantage against the landlord under the terms of the lease, which entitled the landlord reasonably to withhold consent. So here, Mr Rainey submitted.

105. The question arose as to what if any value X (as hypothetical purchaser of the head leasehold interest) would attach to the possibility of being able to avoid the escalator clause through option 3. Mr Rainey submitted that the hypothetical purchaser would obtain legal advice. This advice would be that if you try this device you will fail, either on the basis of an implied term or because the Freeholder will reasonably withhold consent. Even if the advice were not so firmly negative as this, any advice would be heavily qualified. Clear positive advice would not be forthcoming and, even it were forthcoming, X would be reluctant to place over much weight upon it because X might be unable to enter into the proposed reversionary or overriding lease for a substantial period, by which time any limitation period for the purpose of suing for negligence the lawyer who had given firm positive advice might have expired.

106. As regards the valuation evidence upon this topic, Mr Rainey drew attention to Mr Clark's acceptance that his allowance of 20% for the risks of not being able to avoid the escalator clause was assessed as a 20% risk of failing on all of options 1 to 4 inclusive (Mr Clark had not considered option 5 at the time of identifying his 20% risk factor). However option 1 was by far the most likely event as a matter of fact. Mr Clark had said that he would still only assess the risk at 30% if the only way of avoiding the escalator clause was option 3, this being on the basis of firm positive advice that the freeholder could not reasonably withhold consent. Accordingly, there being a 30% risk, Mr Clark would allocate 70% of the avoidance value to be included within the core value of the head leasehold interest. On the basis that the advice was uncertain as to the reasonableness of the landlord's withholding of consent, Mr Clark said he would allocate 40% of the avoidance value into the core value. Mr Rainey submitted that, even if the legal advice received by X did not rule out any additional bid from X to reflect value in option 3, the highest that X would go would be to detect a 40% chance of escaping the escalator clause and enjoying the avoidance value. However even this full 40% of value would not be something which X would bid when deciding how much to pay for the head leasehold interest, because X would realise that (i) he might have difficulty in obtaining full value from the prospective grantee of the overriding or reversionary lease having regard to potential legal difficulties and (ii) that the head lessee was reliant upon X's bid in order to

release this 40% of avoidance value, because without such a bid the head lessee would enjoy nothing at all in respect of this avoidance value and would be confined to enjoying merely the core value. Accordingly after identifying the value attributable to a 40% chance of avoiding the escalator, X would negotiate to split this 40% 50:50 with the vendor of the head leaseholder interest, such that the head leasehold would only enjoy 20% of the avoidance value as part of the core value of the head lease.

107. In summary therefore, the highest amount which option 3 could release into the core value of the head leasehold interest would be a mere 20% of the avoidance value. However, for reasons set out above, Mr Rainey submitted that in fact no extra value at all would be placed by X upon option 3 when deciding how much to bid for the head leasehold interest.

108. As regards option 5, this involves the hypothetical purchaser of the head leasehold interest deciding to enjoy the occupational rights conferred by such interest rather than seeking to trade on the head leasehold interest by obtaining some premium for the grant of an underlease carved out of it. This raised the question of what in fact should be deemed to be being sold in the hypothetical sale of the head leasehold interest in the house and premises.

109. Mr Rainey submitted that *Lynall* required it to be assumed that the statute contemplated a sale of the head leasehold interest could lawfully occur but that, having made such an assumption, the hypothetical transaction should not depart from the real world any more than this assumption demanded. He referred to *Lady Fox's Executors v Commissioners of Inland Revenue* [1994] 2 EGLR 185 especially at 186D to F and to *Hoare v National Trust* [1999] 1 EGLR 155 especially at 160 and 162. These showed that the statutory hypothesis is merely a mechanism for enabling one to arrive at a value for a particular interest and the hypothesis does not entitle a valuer to depart from the real world further than the statutory hypothesis compels.

110. Mr Rainey submitted that it was consistent with the foregoing, and with the analysis in *Arbid* at 160 and 161 (where a sale of a flying freehold was not assumed) and with *Nailrile* at paragraph 32 (where a sale of an interest in only one flat in a block was not assumed) that what should be assumed regarding the hypothetical sale of the head leasehold interest in the Property was as follows. It should be noted that there was in the head lease the absolute covenant against assignment of part. It should in consequence be assumed that there would not be offered in the market an assignment by way of a severed part of the head leasehold interest. What instead should be assumed is a sale of the whole of the head lease, with the relevant valuation exercise being directed towards establishing how much of the value of the head lease would be contributed to by the value of the head leasehold interest in the Property. He submitted there was no warrant for assuming a fictional severed head lease and no need assume this. This is because the head leasehold interest in the Property is saleable in accordance with the terms of the head lease, but only on the basis that the entirety of the Grosvenor Belgravia Estate is assigned, ie the entire head lease is assigned. This transaction being a permissible transaction in accordance with the terms of the head lease, it is this transaction which should be valued – although of course it is not necessary to value the entirety of the remainder of the Grosvenor Belgravia Estate, but only the contribution made to it by the head leasehold interest in the Property. Once it was understood that this was the proper valuation exercise, Mr Rainey submitted that the hypothetical purchaser would not attribute any value to the prospect of being

able to occupy the Property, as opposed to being able to enter into some underlease in respect thereof thereby releasing a premium.

111. If the foregoing were wrong, then *Lynall* made clear that it must merely be assumed that the hypothetical sale of a severed part of the headlease (ie relating to the Property) could be sold in the market, but that no further assumption should be made. Accordingly what would be offered would be a severed part of the head lease, with the Freeholder being deemed to consent to this sale of the severed part despite the absolute covenant against assignment as to part, but with the purchaser taking the Property on all the terms of the head lease including the alienation clause and the escalator clause.

112. The hypothetical purchaser of this head leasehold interest in the property would note the terms of the escalator clause and would realise that there existed the following problems so far as concerns option 5. First the head lease contains a provision, coming into operation in 2026, for the payment of a rent based upon the head lessee's net income, which in turn is based upon rents "receivable". Even if the purchase of the head leasehold interest was taken in the name of a specially formed company, with a view to the shareholders residing in the property, the fact would remain that a full market rent would be potentially receivable even though not in fact paid. Thus the company would have in effect to pay the appropriate proportion under the escalator clause of the potentially receivable market rent, which would make the purchase by the company pointless. In support of this submission Mr Rainey referred to *Ashworth Frazer Limited v Gloucester City Council.* In that case the rent was to be reviewed to 8% of "the rack rents receivable by the Lessees in respect of the demised premises on the relevant date". It was held that the fact that the site was not in fact sublet at a rack rent but was occupied by the lessees and assignees from the lessees, such that no rack rent was in fact receivable, did not prevent the operation of the rent review. It was held that the word "receivable" was used in the sense of capable of being received if sublet and that the fact that the property was not sublet was irrelevant. Thus going into occupation, through its shareholders, would trigger the escalator clause and the prospect of this occurring would prevent any company purchasing the head leasehold interest.

113. Even if the foregoing were wrong, a company purchaser would have the following disadvantages which would cause it to diminish the bid it might otherwise make for the head leasehold interest.

(1) The company could not beneficially sublet the premises. This was because any such subletting would trigger the escalator clause and, after 2043, this would involve 90% of the net income being paid over to the freeholder. Accordingly purchasers would realise that even though they personally, as shareholders of the purchasing company, could occupy the property they would be unable to obtain a commercial rent for the property if they wished, for instance, to work abroad for a few years. This inability to sublet was quantified by Mr Clark as diminishing the value of the head leasehold interest by 15%. Mr Rainey recognised that Mr Martin did not disagree with this 15%. However Mr Rainey pointed out that this 15% was only to reflect the inability to sublet, and that there were further disadvantages identified by Mr Martin, namely as follows.

(2) The fact that Option 5 involves a sale to a company and that any sale on of the Property could take place only by sale of the shares in the company rather than by way of the normal sale of a long leasehold in a house, could have a depressing effect on the price obtained in that it could limit the number of purchasers interested in purchasing. While Mr Martin recognised that in a buoyant market this would make little difference, it could have a significant effect if the company wanted in due course to sell and at the date of sale there was a less than buoyant market.

(3) Further Mr Martin had pointed out that a purchase of real property in the name of a company with a view to such real property being transferred through the sale of shares in the company rather than through a conveyance or transfer, was a device to avoid stamp duty and, as such, was exactly the sort of transaction which in due course might attract the attention of amending legislation. A prospective company purchaser, who realised that the status as a company purchaser had to continue until 2184 in order to avoid the escalator clause, would be concerned that in due course the law might change adversely to such a company purchaser.

114. In summary as regards option 5, either (i) no value should be attached to it for the reasons mentioned in paragraph 110 above, or (ii) no value should be attached to it for the reasons mentioned in paragraph 112 above, or (iii) limited value should be attached to it by reason of the matters mentioned in paragraph 113 above.

115. So far as concerns the core value of the freehold interest Mr Rainey submitted that the hypothetical purchaser of the freehold would recognise the fact that it was exceedingly likely that prior to 2026 the head leaseholder would grant at a premium some further underlease until 2184, with the result that no payment would be paid under the escalator clause to the freeholder. Accordingly the hypothetical purchaser of the freehold would bid either no more alternatively very little more than merely the value of the freehold with vacant possession deferred until 2184, which came to little more than £1,000.

116. As regards capitalisation rates and deferment rate Mr Rainey commended to the Tribunal the approach adopted by Mr Martin for the reasons given by Mr Martin. It would not be helpful to set those reasons out again here.

Conclusions

117. We accept that there must be two separate valuations under section 9(1A) and Schedule 1 of the 1967 Act, namely a valuation of the freehold and a valuation of the head leasehold interest.

118. It is necessary to establish what has been referred to as the core value of the freehold and of the head leasehold interest. Having done so it is then possible to introduce these two values,

namely respectively £a and £b, into the equation in paragraph 13 above for the purpose of calculating the marriage value and, hence, the price to be paid.

119. We consider first the value of the head leasehold interest.

120. The head lease contains an absolute covenant against assignment of part. However the statutory valuation under section 9(1A) and Schedule 1 paragraph 7 requires the assessment of the price to be paid for the relevant interest in the house and premises, ie in the Property. The House of Lords decision in *Lynall v Inland Revenue Commissioners* makes clear that the hypothetical sale in the open market of the interest contemplated by these statutory provisions must be assumed to be a transaction which can in fact take place rather than a transaction which is wholly barred by the absolute covenant against alienation. We accept Mr Gaunt's argument that it is necessary to assume that, despite the absolute covenant against assignment of part contained in the head lease, the Freeholder would grant at least a one-off permission to enable the hypothetical sale of the head leasehold interest in the Property to take place, being an interest obtained by severing the head lessee's interest by the assignment of part of the property demised by the head lease.

121. We accept that if the head leasehold interest in the Property was in fact offered for sale at the valuation date then the highest bidder would be the occupying tenant, because of the value to the occupying tenant as special purchaser. The amount which the occupying tenant would bid would include the occupying tenant's overbid. This would be justified because of the extra value to the occupying tenant flowing from the coalescence of all interests in the Property, such that the occupying tenant would end up with the freehold with vacant possession. However what it is necessary to seek for the purpose of assessing the core value of the head leasehold interest is the price which would be paid by the under bidder, ie the hypothetical X who was assessing how much to bid without taking into consideration any potential deal to be struck (either immediately or eventually) which would unlock special value by virtue of the coalescence of the freehold and leasehold interests.

122. When X is deciding how much to bid for the head leasehold interest the prospect of escaping from the escalator clause is a point of importance. It is therefore relevant to consider Mr Clark's five options. However in order to be a relevant option, that is an option which it is proper to consider when assessing the core value of the head leasehold interest, the escape from the escalator clause must arise from a transaction which does not bring in marriage value or hope value from the actual or prospective coalescence of the freehold and leasehold interests. We take the options in turn.

123. Option 1. We accept Mr Rainey's argument that this in effect by definition involves bringing in marriage value at the stage of assessing core value. Option 1 specifically envisages a purchase by the occupying tenant. We reject Mr Gaunt's argument that there is a distinction for the purpose of option 1 between marriage value and hope value on the one hand and "avoidance value" on the other hand. The matter can be tested in this way. If option 1 was the only way in which the escalator clause could be escaped, then the core value of the head leasehold interest would need to be assessed on the basis as summarised in paragraph 15(1) and 19 above, unless it was permissible to take into account the additional value which the

occupying tenant would pay. However this is plainly bringing in the occupying tenant's overbid as special purchaser into the assessment of core value and would thereby be bringing into the assessment of core value the value arising from the coalescence of interests. We also separately see force in Mr Rainey's argument that, quite apart from the foregoing, if the only escape for the hypothetical willing seller of the head leasehold interest was to do a deal with the occupying tenant, then the occupying tenant would, through force of his bargaining position, be able to negotiate a transaction which would involve an equal division of the avoidance value. Accordingly option 1 does not assist the Appellant.

124. As regards option 2 we consider that this in substance is the same as option 1, in that it relies specifically upon a prospective transaction whereby there will be a coalescence of the head leasehold interest with the under leasehold interest. Option 2 does not assist the Appellant.

125. We next take option 4. This does not rely upon any transaction, either immediate or eventual, with the occupying tenant. It does however expressly rely upon a coalescence of the freehold and the head leasehold interests. In effect it would result in the marriage value being calculated as though there was a coalescence of the freehold and the head leasehold, such that a single valuation fell to be performed as though the occupying tenant held the underlease direct from the freeholder. We accept Mr Rainey's criticism of option 4. We conclude that section 9(1D) prevents option 4 being taken into consideration when assessing the core value of the head leasehold interest, because the extra value under option 4 directly arises from the coalescence of the freehold and the head leasehold interests and because it involves a valuation approach which, as Mr Rainey submitted, would in effect be contrary to *Wentworth Securities v Jones*, which shows that the enfranchisement price cannot be assessed on a basis which disregards the existence of the head leasehold interests and in effect treats the freehold and the head leasehold interests as coalesced.

126. Option 3. We reject Mr Rainey's submission that a term is to be implied into the head lease preventing the grant of an overriding underlease or reversionary underlease. There is no justification for the implication of such a term into a detailed professionally drafted document, being a document which makes express provision regarding restrictions on alienation including the requirement of consent (not to be unreasonably withheld) to a transaction such as is being here contemplated.

127. It is not necessary for us to dwell on the prospect of the grant of an overriding underlease as opposed to the grant of a reversionary underlease commencing at Christmas 2040, because the grant of such a reversionary underlease is in our view a clear route which is open to X (as the hypothetical purchaser of the head leasehold interest) being a route:

(1) which would be without problems arising from the Leasehold Reform Act 1979, because a reversionary underlease would not be an interest superior to (whether or not preceding) the Respondents' underlease within the wording of the 1979 Act, and

(2) which would not give rise to problems regarding timing under section 149 of the Law of Property Act 1925, because

(a) there would be ample time between Christmas 2019 (ie 21 years before Christmas 2040) and March 2026 (commencement of the escalator clause) for the grant of this overriding underlease, and

(b) if the hypothetical purchaser considered this time constraint troubling, such purchaser would be advised that he could properly enter into a contract to grant such a reversionary underlease at any time between the valuation date and Christmas 2019.

128. Any prospective purchaser of the head leasehold interest who was minded to follow option 3 would note that the reversionary underlease would require the consent of the freeholder, such consent not to be unreasonably withheld. In deciding upon his bid such a hypothetical purchaser would take legal advice. There is clearly a range of legal advice which could reasonably be given. We must ignore overly pessimistic and overly optimistic advice, but even doing so there still exists a potential range of proper advice from the cautious and qualified to the firm and positive. We conclude that the range of advice which could properly be given to X would extend (without being overly optimistic) to fairly firm advice that for the reasons advanced by Mr Gaunt (and set out in paragraph 82 above) the freeholder could not reasonably withhold consent to the proposed transaction. Some lawyers advising hypothetical purchasers would give less positive advice than that, but the hypothetical purchasers receiving such advice would be outbid by the hypothetical purchaser who received the fairly firm advice which we conclude could and would be given to at least one of the hypothetical purchasers, namely fairly firm advice (but without of course being a guarantee) that consent could not be unreasonably withheld. We use the expression "fairly firm advice" rather than "firm advice" for this reason, namely the lawyer advising X, while giving the opinion that Mr Gaunt's argument was correct, would be likely to draw attention to the highly unusual terms of the headlease and to advise this would necessarily introduce a degree of uncertainty as to how the courts would ultimately decide the case.

129. The hypothetical purchaser of the head leasehold interest who received such advice would of course note that no guarantee was being given and that there was a degree of qualification upon the advice. He would take into account the risk that, having purchased the head leasehold interest, he found that ultimately he was not able to enter into the proposed transaction because he could not obtain the Freeholder's consent and could not establish that such consent was being unreasonably withheld. X would therefore reduce his bid to reflect this risk. Also it is insufficient merely to assess the risk of losing and to apply that percentage risk in the calculation of the price, because that fails to recognise that X would realise that he was in effect buying a potential lawsuit, with all the trouble and costs and delays that that could involve. If option 3 was the only method of escaping the escalator clause, then we do not consider Mr Clark's assessment of 30% risk, which was to be applied to the extra value of escaping from the escalator clause, to be sufficient. If option 3 stood alone we consider that X would assess the value of the head leasehold interest supposing that the escalator clause could definitely be avoided without risk so far as concerns the premium obtainable for the grant of the proposed reversionary lease (the escalator clause would, of course, under option 3 continue to be applicable to the rental stream from 2026 until the termination of the underlease in 2040). To the totality of this latter value we conclude that X would apply a 40% reduction and would accordingly be prepared to pay 60% of this value for the head leasehold interest.

130. Option 5. We reject Mr Rainey's argument that, on the basis of *Nailrile*, we must assume that what is being hypothetically offered for sale in the market at the valuation date is not a severed part of the head lease (severed so as to relate merely to the Property) but is instead the entirety of the head lease extending to the whole of the Grosvenor Belgravia Estate. Such an assumption is in our judgment contrary to the terms of *Nailrile* itself in paragraph 32 – in *Nailrile* it could be expected that the hypothetical seller would sell its interest in the block only as a whole, but in the present case there is nothing unusual in the sale of an individual house. There does exist the absolute covenant against assignment of part in the head lease, but *Lynall* shows, as already noted above, that there must be assumed a one-off consent from the Freeholder to this transaction. Also this argument by Mr Rainey is contrary to the statutory requirement that what is valued is the relevant interest in the house and premises.

131. We do not accept Mr Rainey's argument that X would be deterred from placing any value on option 5 by reason of the prospect that occupation by the purchasing company (through the occupation of its shareholders) would result in rent becoming receivable (although not in fact of course received) so as to trigger an obligation under the escalator clause to pay over to the freeholder a proportion of such rent. We accept the distinction drawn by Mr Gaunt between the provisions of the Second Schedule of the head lease and the provisions which were considered by the court in *Ashworth Frazer Limited v Gloucester City Council*. In the latter case it was plainly intended there should be a rent review to 8% "of the rack rents receivable", and to have concluded that nothing was receivable because the tenant was itself in occupation would have thwarted this express contemplation of the lease. There was also in that case the reference to "rack rents receivable" and the court concluded that "rack" was a reference to the full annual value of the holding. There is no such provision in the present case. Also in the present case the relevant words are "becoming receivable" – the word "becoming" is in our view inconsistent with deeming a notional rent to be receivable in circumstances where it has not become receivable.

132. The hypothetical purchaser of the head leasehold interest, when contemplating what value option 5 provided, would note that the severed part of the head lease would contain an alienation clause which either included an absolute covenant against further assignment or (if not that) which in any event contained a provision which would apply the escalator clause to any subsequent assignment or parting with possession at a premium. Also the hypothetical purchaser would note that any subletting would attract the escalator clause regarding the rents becoming receivable. Accordingly the hypothetical purchaser would approach the transaction on the basis that the purchase would have to be effected by a special purpose vehicle in the nature of a company specially formed for the purpose (such that any disposal of the Property could be effected by the sale of shares in the company so as not to attract the operation of the escalator clause) and that underletting the Property would in effect be of no or no significant value to the purchaser because of the provisions of the escalator clause.

133. Clearly these points are disadvantages. As regards the inability to underlet, Mr Clark's opinion was that this would justify a 15% reduction in the value of the head leasehold interest. Mr Martin did not seek to disagree with this appraisal. However, we do not consider that such a reduction would adequately reflect the disadvantages of option 5, despite the fact that Mr Clark did not see the need for any further reduction. Mr Martin's opinion was that if the pool

of hypothetical purchasers was limited to company purchasers then this could be a negative factor in a weak market.

134. We consider that there must be a significant disadvantage in option 5 beyond the mere inability usefully to underlet the Property. Mr Martin did not suggest that the state of the market at the valuation date was particularly difficult such as to justify a further reduction based upon those conditions to reflect the fact that under option 5 the purchaser was limited to a company purchaser. However we consider the hypothetical purchaser would recognise that, as and when it wished to dispose of the Property, it would be unable to offer the Property in the normal way in the market. It would instead have to offer for sale the shares in the company which had been formed as a special purchase vehicle. The purchaser would recognise that if at that stage the market was difficult then this limitation on its ability to dispose of the Property (ie only through the sale of shares in the company) could well depress the price to be obtained. We also accept that some adverse weight would be given by the hypothetical purchaser to Mr Martin's point regarding the possibility of changes in the law being introduced to curb purchases by special purchase vehicle companies insofar as that involved the loss of revenue through the loss of stamp duty. As regards Mr Rainey's further point, that the hypothetical purchaser would see a further disadvantage because of the potential unavailability of the capital gains tax exemption for principal private residences, we do not consider that we can give any weight to that bearing in mind (a) that there is no evidence before us that the availability or unavailability of this exemption would weigh significantly in the minds of purchasers for a house such as the Property and (b) this disadvantage must be viewed against the apparent corresponding advantage of a subsequent purchase being able to proceed without the need to pay stamp duty. We make no further adjustment for these taxation based points. However we do consider that Mr Clark's reduction of 15% is far too low. We hold this view notwithstanding that Mr Clark applied the 15% reduction not merely to the additional value attributable to avoiding the escalator clause but instead to the total value which the head leasehold interest would have if the escalator clause could definitely be wholly avoided without risk. We consider that the appropriate reduction is 30% applied to the total value which the head leasehold interest would have if the escalator clause could be avoided without risk so far as the premium value of the 143 year lease is concerned.

135. Considering the pool of hypothetical purchasers for the head leasehold interest, these would include:

(1) Those only interested in the core value of the head leasehold as assessed by Mr Clark at paragraph 15(1) above and Mr Martin at paragraph 19 above

(2) Those interested also in option 3; and

(3) Those interested also in option 5.

Hypothetical purchasers falling within category (1) would be outbid by those in categories (2) and (3). As regards hypothetical purchasers within category (2) we consider that those would be outbid by hypothetical purchasers within category (3), who would note the following:

(a) that if they purchased the head leasehold interest they would be certain of enjoying some value, namely the value identified in paragraph 15(1) above but subject to the adoption of appropriate capitalisation rates and deferment rate (we

show what we consider to be the correct assessment of this value in Appendix 5);

(b) that a 30% discount upon the entirety of the value of the head leasehold interest, assuming the escalator clause could be avoided without risk so far as the premium value of the 143 year lease is concerned, would be an appropriate level of bid (see paragraph 134 above);

(c) that they could reasonably feel encouraged to bid as much as is identified in paragraph 134 above by the fact that they would also have the ability, if they so chose, to attempt to follow option 3, with the knowledge that if that failed then they could still enjoy all the benefits available to an option 5 purchaser. We do not consider that this additional feature, ie the ability for an option 5 purchaser if it wished to do so to attempt also to follow option 3, would result in the option 5 purchaser being prepared to increase its bid above that identified in paragraph 134 above. However the potential ability for an option 5 purchaser to seek to follow option 3 is a matter which we consider the option 5 purchaser would note and might treat as giving further justification for bidding as much as we have identified in paragraph 134 above. In conclusion, therefore, we consider that the value of the head leasehold interest is properly represented by a 30% reduction from the total value which the head leasehold interest would have if it were known that the escalator clause could be avoided without risk in respect of the enjoyment of the value of the 143 year lease from 2040. (The escalator clause would of course under option 5 continue to be applicable to the rental stream from 2026 until the termination of the underlease in 2040).

136. So far as concerns the valuation of the freehold which falls to be performed under section 9(1A) and Schedule 1, we can express our conclusions on this more briefly. We consider that the hypothetical purchaser of the freehold would conclude that there was a virtual certainty that the escalator clause would be avoided by the head leaseholder entering into a transaction with the occupying tenant prior to Christmas 2026. We do not consider that the hypothetical purchaser would even place the 5% chance of the escalator clause not being avoided which Mr Clark has adopted. The only possible purchaser who might pay a substantial sum for the freehold would be the head leaseholder, but the additional value attributable to the special purchaser position of the head leaseholder is a value which arises by virtue of the coalescence of the freehold and head leasehold interests and must be disregarded at the stage of calculating the core value of the freehold. In conclusion therefore we consider the value £a to be attributed to the freehold is the figure of £1,130 suggested by Mr Martin, representing the present value of the freeholder's distant reversion at the end of the head lease.

137. We now turn to consider the question of the capitalisation rate and deferment rate.

Capitalisation rate: conclusions

138. We consider firstly the appropriate capitalisation rate to be adopted in the period before the escalator comes into operation. We accept Mr Clark's opinion that no increase above the agreed freehold capitalisation rate is justified in the circumstances of this appeal. Mr Martin

relied upon the management problems which can result from the need to deal with both freeholder and underlessee. He accepted that the nature of the head lessee's involvement with the occupational tenant was no greater than it would be if he owned the freehold interest. Bearing in mind the significant amount of ground rent payable, we are not persuaded that the need for the head lessee to deal from time to time with two parties instead of one, in circumstances where most if not all management costs are likely to be recoverable, would lead to the investor requiring an increased rate of return.

139. Different considerations apply to the rent receivable when the escalator is in operation. Paragraph 3 of Part II of the Second Schedule to the head lease requires that, from 25 March 2026 onwards

> "(i) The lessee shall produce for the inspection and approval of the Landlords and their accountants within four calendar months after the end of the Base Accounting Period for that year of the term properly audited figures certified as correct by the Lessee's accountants (who shall be a firm of chartered accountants) stating what is the Lessee's Gross Income the Lessee's Outgoings and the Lessee's Net Income during the Base Accounting Period for that year of the term and giving full details as to how such items have been calculated.
>
> (ii) the Lessee and its accountants shall also produce forthwith on request any further information which is reasonably requested by the Landlords or their accountants in considering such audited and certified figures."

140. Paragraph 3 (v) provides that, in default of agreement between the parties as to the accuracy of such figures, the matter shall be referred to expert determination by an independent chartered accountant.

141. Mr Clark did not consider that the need to account annually to the freeholder was particularly onerous. He said it was to be expected that any investor interested in such a property, who intended to manage his investments properly, would have in place a proper accounting and payment system, whether or not it was needed to provide the information to a third party. Whilst this is no doubt true, the obligation to have such information formally audited within four months of the end of each calendar year, with the potential risk of further work resulting from the appointment of an independent accountant, is in our judgment not one which would be considered as normal by the type of investor who would be interested in an investment secured on a single house such as the appeal property. We also agree with Mr Martin that the fact that net income, after deducting the freeholder's share and assuming that all management costs are recoverable from the occupational tenant, will decline from £12,825 in 2026 to £2,700 in 2040, increases the risks inherent in this particular investment. We find that such risks will be reflected in the market by increasing the capitalisation rate between 2026 and 2040 by 0.75% to 5.5%.

Deferment rate: conclusions

142. We agree with Mr Clark that the agreed valuation of the head leasehold reversion of 143 years at 99% of the freehold value is sufficient to reflect the head lessee's obligations to the freeholder. We also agree with him that, as a general point of principle, the risk to the head lessee's long reversion is not significantly greater than the risk to the freeholder. A 143 year reversion, therefore, does not of itself justify a higher deferment rate than a freehold reversion.

143. Mr Martin suggested that, in the case of the appeal property, there was an exceptional reason for the risk premium element of the deferment rate to be increased above the *Sportelli* rate of 4.5%. The reason was that, if the head leaseholder was unable to sell a new long lease between December 2040 and March 2043, the share of the proceeds payable to the freeholder would increase from 75% to 90%. Mr Clark, on the other hand, considered that a good quality house in Central London, correctly priced and marketed, would sell quickly, and certainly in less than 1.25 years. He said that the risk that the head lessee would be unable to sell before March 2041, when the freeholder's share increased to 80%, had already been reflected by increasing the amount deducted as being due to the freeholder from 75% to 77.5%. The head lessee would have until March 2042 to grant a new occupational lease before the freeholder's share increased to 85%. That was 15 months from the date of the reversion. Mr Clark would have expected a sale to take place within that period.

144. We accept Mr Clark's opinion that, in most circumstances, it should be possible to sell a long lease in a house in Chester Street within 15 months. It does not necessarily follow, however, that the price achieved on such a sale would reflect conditions in a buoyant, or even a normal market. In our judgment, the rapid decline in the percentage of the sales proceeds which would remain in the head lessee's hands in the years immediately following the expiry of the current occupational lease means that the head lessee (supposing that he was intending to sell a new long lease of the Property after Christmas 2040 rather than pursue options 3 or 5) will effectively be in a position of a forced seller of the Property in December 2040. In a poor market, this could mean that he would have to accept a substantially lower price in order to achieve a sale. In *Nailrile*, the Tribunal effectively added 11.11% to the risk free rate for a reversion to a 54 year lease (an addition of 0.5% to a risk free rate of 4.5%). In the current appeal the leasehold reversion will be very much longer than in *Nailrile*. The effect of the escalator, however, is that the rate of decline in the value of the reversion in the hands of the head lessee will be much greater than in *Nailrile*, where the head lessee would retain all the sale proceeds. Mr Martin's suggested addition of 0.75% to the risk premium (and thus to the deferment rate) has the effect of adding 16.66% to the risk free rate. We do not think that such an addition exaggerates the effect of the escalator on the risk to the reversion and we accept it as appropriate on the assumption that the purchaser was not intending to pursue options 3 or 5.

145. We are not persuaded by Mr Martin's analysis of comparable transactions and LVT decisions, suggesting that the deferment rate was influenced by the prospects of obtaining soft income or capital. He fairly acknowledged that it was unclear what attention had been paid to the terms of the respective head leases by the parties concerned with those transactions. In this respect Mr Martin's approach is contrary to the conclusion drawn by the Tribunal in paragraph 87 of *Nailrile* and we reject it as being unsupported by any reliable evidence in this case.

Accordingly we conclude a deferment rate of 5.5% (an increase of 0.75% on the *Sportelli* rate) is appropriate when valuing the basic value as described in paragraph 15(1) above which X is certain to enjoy.

146. However, a purchaser who does intend to pursue either option 3 or option 5 will have made an appropriate risk based adjustment when deciding on the value to attach to the prospective 143 year underlease. Having done so such a purchaser will not be troubled by any problems of being a forced seller as at Christmas 2040, because either he will already have sold the reversionary underlease (option 3) or he will be proposing to retain the head lease in a company (option 5). Therefore, he will be content to adopt the *Sportelli* generic deferment rate of 4.75 per cent.

Result

147. The attached Appendix 1 is a calculation, setting out our valuation incorporating the conclusions we have reached assuming option 5 is adopted. It produces an enfranchisement price of £1,292,245, which is higher than if option 3 were adopted (that is, £1,238,933, see Appendix 4). The appeal is allowed. We determine the enfranchisement price payable by the Respondents at £1,292,245, of which £1,290,291 is payable to the Appellant and £1,954 to the Freeholder.

Postscript

148. It was argued by the Respondents that the price properly payable on enfranchisement was a figure which was (a) less than that determined by the LVT and (b) less even than the figure contended for by the Respondents before the LVT. The Appellant argued that, there being no cross appeal by the Respondents, there was no jurisdiction in this Tribunal to determine a price which was lower than that determined by the LVT alternatively (if that was wrong) there was no jurisdiction to determine a price lower than that contended for by the Respondents before the LVT. This argument was developed in some depth by the parties and included an argument that the decision of the Tribunal in *Arrowdell v Coniston Court (North) Hove Ltd [2007] RVR 39* which concerns this point was (a) obiter (b) wrong. It will be seen that in the result we have concluded that the Appellant's appeal should be allowed and that the price to be paid is more than the price decided by the LVT. Accordingly this point regarding jurisdiction does not arise for our decision. We consider it would not be appropriate yet further to prolong this decision by adding a further obiter observation upon these points, especially having regard to the fact that there exist draft new rules, namely The Tribunal Procedure (Upper Tribunal) (Lands Chamber) (England and Wales) Rules 2010, which if implemented will introduce provision for a Respondent's notice in appeals to the Upper Tribunal. We would however merely add the following in case it ever becomes of relevance. The LVT's decision in the present case is dated 18 October 2006. The Respondents made it clear from an early stage in the appeal process that they wished to contend for a figure lower than that decided by the LVT and lower than that contended for by them before the LVT. The Appellant accepts (and if the Appellant had not accepted we would have so found in any event) that no prejudice of any kind has been caused to the Appellant by the fact that the Respondents have argued for a price lower than that contended for by them before the LVT. The Appellant has in no way been taken by surprise

and there is no question that other evidence would have been brought forward if there had been a formal cross appeal. The appeal has proceeded before us as a rehearing. Accordingly if the point had become relevant we would have exercised any discretion which we had in favour of the Respondents so as to allow them to contend for a price lower than that for which they contended before the LVT. Had we decided that the price properly payable was less than that decided by the LVT or less than that contended for by the Respondents before the LVT we would have determined the price in this lower sum unless compelled as a matter of jurisdiction to limit ourselves merely to dismissing the Appellant's appeal. As to whether we have such jurisdiction, that is not a point upon which it is necessary or appropriate for us to reach a decision.

Dated: 26 March 2010

His Honour Judge Huskinson

N J Rose FRICS

8 CHESTER STREET, LONDON, SW1X 7BB
Valuation by Lands Tribunal assuming adoption of Option 5

		£	£	£	£
A	**Valuation of Head Lease assuming purchased by a company proposing to enjoy income until expiry of occupational lease and then occupy the property**				
	Annual rental income	13,500			
	Years Purchase for 20.64 years @ 4.75%	12.9755	175,169		
	Capital value of net rental income between 25/3/2026 & 24/12/2040 from Appendix 2		29,017		
	On reversion to		204,186		
	Value of leasehold interest with vacant possession From 25/12/2040 Until 24/03/2184 having 143.25 years unexpired				
	Estimated value of freehold in possession	4,500,000			
	Adjust to lease of 143.25 years – 99.0%	4,455,000			
	Deferred 35.39 years @ 4.75%	0.1935			
			862,043		
			1,066,229		
	Deduct allowance for onerous nature of investment – 30.0%		319,869		
					746,360
B	**Valuation of Freehold**				
	Reversion to unimproved freehold value on Head Lease expiry		4,500,000		
	Present value of £1 deferred 178.64 years @ 4.75%		0.000251		1,130
C.	**Lessors' share of marriage value**				
	Freehold value with vacant possession		4,500,000		
	Less				
	Value of Head lease	746,360			
	Value of Freehold	1,130			
	Value of Underlease	2,663,000	3,410,490		
	Total marriage value		1,089,510		
	Lessors' share – 50%				544,755
D.	**Enfranchisement price**				**£1,292,245**
E.	**Apportionment**				
	To Head Leaseholder				
	Present interest		746,360		
	Share of marriage value 544,755 x 746,360 / 747,490 =		543,931	1,290,291	
	To Freeholder				
	Present interest		1,130		
	Share of marriage value 544,755 x 1,130 / 747,490 =		824		
				1,954	
					1,292,245

8 CHESTER STREET, LONDON SW1X 7BB
Valuation of Profit Rent from Underlease to Head Leaseholder during escalator

			£	£	£
For remainder of underlease term until –		24/12/2040			
Apportioned rent per annum receivable wef		25/03/2026		13,500	
Less apportioned rent		5%		675	
				12,825	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	20.64 years @	5.5%	0.3312		
				0.3139	
					4,025
Apportioned rent per annum receivable wef		25/03/2027		13,500	
Less apportioned rent payable per annum		10%		1,350	
				12,150	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	21.64 years @	5.5%	0.3139		
				0.2975	
					3,615
Apportioned rent per annum receivable wef		25/03/2028		13,500	
Less apportioned rent payable per annum		15%		2,025	
				11,475	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	22.64 years @	5.5%	0.2976		
				0.2821	
					3,237
Apportioned rent per annum receivable wef		25/03/2029		13,500	
Less apportioned rent payable per annum		20%		2,700	
				10,800	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	23.64 years @	5.5%	0.2820		
				0.2673	
					2,887
Apportioned rent per annum receivable wef		25/03/2030		13,500	
Less apportioned rent payable per annum		25%		3,375	
				10,125	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	24.64 years @	5.5%	0.2673		
				0.253	
					2,562
Apportioned rent per annum receivable wef		25/03/2031		13,500	
Less apportioned rent payable per annum		30%		4,050	
				9,450	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	25.64 years @	5.5%	0.2534		
				0.2402	
					2,270
Apportioned rent per annum receivable wef		25/03/2032		13,500	
Less apportioned rent payable per annum		35%		4,725	
				8,775	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	26.64 years @	5.5%	0.2402		
				0.2277	
					1,998
				c/f	20,594

			£	£	£
				b/f	20,594
Apportioned rent per annum receivable wef		25/03/2033		13,500	
Less apportioned rent payable per annum		40%		5,400	
				8,100	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	27.64 years @	5.5%	0.2277		
				0.2158	
					1,748
Apportioned rent per annum receivable wef		25/03/2034		13,500	
Less apportioned rent payable per annum		45%		6,075	
				7,425	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	28.64 years @	5.5%	0.2158		
				0.2046	
					1,519
Apportioned rent per annum receivable wef		25/03/35		13,500	
Less apportioned rent payable per annum		50%		6,750	
				6,750	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	29.64 years @	5.5%	0.2045		
				0.1938	
					1,308
Apportioned rent per annum receivable wef		25/03/2036		13,500	
Less apportioned rent payable per annum		55%		7,425	
				6,075	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	30.64 years @	5.5%	0.1939		
				0.1838	
					1,117
Apportioned rent per annum receivable wef		25/03/2037		13,500	
Less apportioned rent payable per annum		60%		8,100	
				5,400	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	31.64 years @	5.5%	0.1838		
				0.1742	
					941
Apportioned rent per annum receivable wef		25/03/2038		13,500	
Less apportioned rent payable per annum		65%		8,775	
				4,725	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	32.64 years @	5.5%	0.1742		
				0.1651	
					780
Apportioned rent per annum receivable wef		25/03/2039		13,500	
Less apportioned rent payable per annum		70%		9,450	
				4,050	
Years purchase for	1.00 years @	5.5%	0.9479		
Deferred	33.64 years @	5.5%	0.1651		
				0.1565	
					634
Apportioned rent per annum receivable wef		25/03/2040		13,500	
Less apportioned rent payable per annum		75%		10,125	
				3,375	
Years purchase for	0.75 years @	5.5%	0.7109		
Deferred	34.64 years @	5.5%	0.1565		
				0.1113	
					376
					29,017

8 Chester Street, London SW1X 7BB
Valuation of Rental Income to Freeholder from Head Lease
During escalator until Underlease Expiry

				£	£	£
For remainder of underlease term until –			24/12/2040			
Apportioned rent per annum receivable wef		25/03/2026	5% of	13,500	675	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	20.64 years @	4.75%		0.3837		
					0.3663	
						247
Apportioned rent per annum receivable wef		25/03/2027	10% of	13,500	1,350	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	21.64 years @	4.75%		0.3663		
					0.3497	
						472
Apportioned rent per annum receivable wef		25/03/2028	15% of	13,500	2,025	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	22.64 years @	4.75%		0.3497		
					0.3339	
						676
Apportioned rent per annum receivable wef		25/03/2029	20% of	13,500	2,700	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	23.64 years @	4.75%		0.3339		
					0.3188	
						861
Apportioned rent per annum receivable wef		25/03/2030	25% of	13,500	3,375	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	24.64 years @	4.75%		0.3187		
					0.3043	
						1,027
Apportioned rent per annum receivable wef		25/03/2031	30% of	13,500	4,050	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	25.64 years @	4.75%		0.3043		
					0,2905	
						1,177
Apportioned rent per annum receivable wef		25/03/2032	35% of	13,500	4,725	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	26.64 years @	4.75%		0.2905		
					0.2773	
						1,310
Apportioned rent per annum receivable wef		25/03/2033	40% of	13,500	5,400	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	27.64 years @	4.75%		0.2773		
					0.2647	
						1,429
Apportioned rent per annum receivable wef		25/03/2034	45% of	13,500	6,075	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	28.64 years @	4.75%		0.2647		
					0.2527	
						1,535
Apportioned rent per annum receivable wef		25/03/2035	50% of	13,500	6,750	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	29.64 years @	4.75%		0.2527		
					0.2413	
						1,629
					c/f	10,363

				£	£	£
					b/f	10,363
Apportioned rent per annum receivable wef		25/03/2036	55% of	13,500	7,425	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	30.64 years @	4.75%		0.2413		
					0.2304	
						1,711
Apportioned rent per annum receivable wef		25/03/2037	60% of	13,500	8,100	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	31.64 years @	4.75%		0.2303		
					0.2199	
						1,781
Apportioned rent per annum receivable wef		25/03/2038	65% of	13,500	8,775	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	32.64 years @	4.75%		0.2199		
					0.2099	
						1,842
Apportioned rent per annum receivable wef		25/03/2039	70% of	13,500	9,450	
Years purchase for	1.00 years @	4.75%		0.9547		
Deferred	33.64 years @	4.75%		0.2099		
					0.2004	
						1,894
Apportioned rent per annum receivable wef		25/03/2040	75% of	13,500	10,125	
Years purchase for	0.75 years @	4.75%		0.7229		
Deferred	34.64 years @	4.75%		0.2004		
					0.1449	
						1,467
						19,058

8 CHESTER STREET, LONDON, SW1X 7BB
Valuation by Lands Tribunal assuming adoption of Option 3

		£	£	£	£
A	**Valuation of Head Lease assuming escalator can definitely be avoided by grant of reversionary underlease**				
	Annual rental income	13,500			
	Years Purchase for 20.64 years @ 4.75%	12.9755	175,169		
	Capital value of net rental income between 25/3/2026 & 24/12/2040 from Appendix 2		29,017		
	On reversion to		204,186		
	Value of leasehold interest with vacant possession				
	From 25/12/2040				
	Until 24/03/2184				
	having 143.25 years unexpired				
	Estimated value of freehold in possession	4,500,000			
	Adjust to lease of 143.25 years – 99.0%	4,455,000			
	Deferred 35.39 years @ 4.75%	0.1935			
			862,043		
			1,066,229		
	Deduct allowance for onerous nature of investment – 40.0%		426,492		
					639,737
B	**Valuation of Freehold**				
	Reversion to unimproved freehold value on Head Lease expiry		4,500,000		
	Present value of £1 deferred 178.64 years @ 4.75%		0.000251		1,130
C.	**Lessors' share of marriage value**				
	Freehold value with vacant possession		4,500,000		
	Less				
	Value of Head lease	639,737			
	Value of Freehold	1,130			
	Value of Underlease	2,663,000	3,303,867		
	Total marriage value		1,196,133		
	Lessors' share – 50%				598,066
D.	**Enfranchisement price**				**£1,238,933**
E.	**Apportionment**				
	To Head Leaseholder				
	Present interest		639,737		
	Share of marriage value 598,066 x 636,737 = 640,867		597,011	1,236,748	
	To Freeholder				
	Present interest		1,130		
	Share of marriage value 598,066 x 1,130 = 640,867		1,055		
				2,185	
					1,238,933

8 CHESTER STREET, LONDON, SW1X 7BB
Valuation by Lands Tribunal of the value in the Head Lease which head leaseholder is certain to receive (as referred to in paragraph 135 above)

		£	£	£	£
Annual rental income			13,500		
Years Purchase for 20.64 years @	4.75%		12.9755	175,169	
Capital value of net rental income between 25/3/2026 & 25/12/2040 from Appendix 2				29,017	
On reversion to				204,186	
Value of leasehold interest with vacant possession					
From	25/12/2040				
Until	25/03/2184				
having 143.25	years unexpired				
Estimated value of freehold in possession			4,500,000		
Adjust to lease of 143.25 years		99.0%	4,455,000		
Deduct amount payable to freeholder under escalator		77.5%	3,452,625		
Minimum proceeds that headleaseholder would expect to receive			1,002,375		
Deferred	35.39 years @	5.5%	0.1503		
				150,657	
Value of head lease if head lease escalator provision cannot be avoided					354,843