UPPER TRIBUNAL (LANDS CHAMBER)

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UTLC Case Number: LRA/52/2012

TRIBUNALS, COURTS AND ENFORCEMENT ACT 2007

LEASEHOLD ENFRANCHISEMENT – flat – deferment rate – whether Zuckerman addition for management applicable to a well-run block in prime central London – held Zuckerman addition not applicable to such a building or at all

IN THE MATTER OF AN APPEAL AGAINST A DECISION OF THE LONDON LEASEHOLD VALUATION TRIBUNAL

BETWEEN **ALEXANDER VOYVODA** **Appellant**

and

(1) GROSVENOR WEST END PROPERTIES **Respondents**
(2) 32 GROSVENOR SQUARE LIMITED

Re: Flats 1, 2 and 12
33 Grosvenor Square
London W1 2HL

Before: Sir Jeremy Sullivan, Senior President and Mr N.J. Rose FRICS

Sitting at 43-45 Bedford Square, London WC1B 3AS
on 24 and 25 June 2013

Philip Rainey QC, instructed by Dorman Joseph Wachtel, solicitors for the appellant
Anthony Radevsky, instructed by Boodle Hatfield LLP, solicitors for the first respondent
Judith Jackson QC, instructed by Russell-Cooke LLP, solicitors for the second respondent

The following cases are referred to in this decision:

Cadogan v Sportelli [2007] 1 EGLR 153
Cadogan v Sportelli [2008] 1WLR 2142
Zuckerman v Calthorpe Estate [2011] L&TR12(UT)
City and Country Properties Ltd v Yeats [2012] UKUT 227 (LC)
Daejan Investments Ltd v Benson [2011] L&TR14
Daejan Investments Ltd v Benson [2013] 1 WLR 854 (SC)
Garside v RFYC Ltd and Maunder Taylor [2011] UKUT 367 (LC)
London Borough of Camden and The Leaseholders of 37 flats at 30-40 Grafton Way LRX/185/2006) LT
Phillips v Francis [2013] 13 EG76 (Ch.D)
Sportelli [2008] 1WLR 2142

The following cases were also cited:

Sportelli [2007] EWCA Civ 1042
Re Lethaby [2011] UKUT 86 (LC)
Kutchukian v John Lyon [2013] 2 P & CR 3 (CA)
Culley v Daejan Properties Ltd [2009] UKUT 168 (LC)
Kleinwort Benson v Lincoln City Council [1999] 2 AC 349

DECISION

Introduction

1. This is an appeal, by way of rehearing, against the decision of the London Leasehold Valuation Tribunal (the LVT) by which, under section 48 of the Leasehold Reform, Housing and Urban Development Act 1993 (the 1993 Act), it determined the terms of acquisition of a new lease of a flat known as Flats 1, 2 and 12, 33 Grosvenor Square, London, W1 (the appeal property). All the terms of the lease apart from the premium payable were agreed during the course of the LVT hearing. The LVT determined the premium payable as £4,641,650, of which £1,259,950 was payable to Grosvenor West End Properties, the competent landlord (GWEP) and £3,381,700 to 32 Grosvenor Square Limited, the intermediate landlord (32GSL).

2. The appeal, for which permission was granted by the former President, George Bartlett QC, is concerned with only one aspect of the LVT's decision. The appellant leaseholder, Mr Alexander Voyvoda, contends that the LVT was wrong to find that, when valuing 32GSL's reversion in what is agreed to be a well run block of flats in prime central London, the 0.25% uplift for flats to the generic deferment rate of 4.75%, made by the Lands Tribunal in *Cadogan v Sportelli* [2007] 1 EGLR 153, should not be increased by a further 0.25% to reflect management risks in addition to those considered in *Sportelli*.

3. It is agreed that the deferment rate of 5% used by the LVT to value GWEP's long leasehold interest is correct. The parties also accept the LVT's decision to add 0.5% to that rate to reflect the fact that 32GSL's reversion is to a mid-term lease rather than a freehold or very long lease. The further uplift of 0.25% for additional management risks, which is proposed by the appellant and resisted by the respondents, was referred to throughout as the *Zuckerman addition* after the decision of the Upper Tribunal in *Zuckerman v Calthorpe Estate* [2011] L & TR12 (UT). We shall do the same.

4. The appellant served the initial notice under section 42 of the 1993 Act on 30 April 2010, which is the valuation date.

5. Mr Philip Rainey QC appeared for the appellant and called expert evidence from Mr Peter Beckett FRICS of Beckett and Kay. Counsel for GWEP, Mr Anthony Radevsky, called expert evidence from Mr Julian Clark BSc, MRICS of Gerald Eve LLP and factual evidence from Mr Simon Elmer, currently operations director and the location director for Eaton Square on the Grosvenor Estate. Ms Judith Jackson QC, appearing for 32GSL, called expert evidence from Mr Robert Orr-Ewing of Knight Frank LLP.

6. It was not suggested that it would assist us to visit the appeal property and we have not done so.

The facts

7. In the light of an agreed statement and the evidence we find the following facts.

8. 33 Grosvenor Square (the building) is situated in the south west corner of Grosvenor Square. It is fronted by Grosvenor Square on the short north side, South Audley Street on the long east side, Reeves Mews on the short south side and by neighbouring properties on the long west side. It is a purpose built block of flats dating from the 1950s, with car parking on the lower ground floor, two commercial units on the ground floor and residential units from the first to seventh floors. The property has a porter, four lifts and storerooms on the sixth floor. The main pedestrian access is from South Audley Street. The garage access is from Reeves Mews.

9. The appeal property is arranged as one flat, but the entrance for each individual flat is marked with the flat number. The gross internal areas are as follows:

Flat 1	1,862 sq. ft.
Flat 2	1,208 sq. ft.
Flat 12	1,427 sq. ft.
	4,497 sq. ft.

10. The accommodation is currently arranged as four bedrooms, three bathrooms, four shower rooms, a WC, a kitchen, a kitchenette, a utility room, a staff bedroom, a staff room, two reception rooms, a dining room, a media room, a study, a gym and a library. There are three balconies (not demised) and three storerooms (Nos 11, 12 and 19) on the sixth floor.

11. The flats were originally let as individual units, but have since been combined.

12. The underlease of each flat grants the right to park one car in the basement garage.

13. At the valuation date the unexpired terms of each of the three underleases were as follows:

Flat 1, box room No 11	–	15.09 years
Flat 2, box room No 19	–	13.83 years
Flat 12, box room No 15	–	16.06 years

14. Each lease reserved a ground rent of £50 per annum.

15. GWEP holds a lease of the building, and further land closer to Grosvenor Square, with an unexpired term at the valuation date of about 173.9 years. The ground rent reserved under this lease is nil.

16. 32GSL holds a lease of the building, and further land closer to Grosvenor Square, with an unexpired term at the valuation date of about 47.15 years. The rent payable is £7,500 per annum, fixed for the duration of the term.

17. On 13 January 1977 a licence was granted permitting the three flats to be combined for the remaining terms of the underleases. Clause 3(iv) of the licence calls for the reinstatement of the original separate flats on expiry of the underlease of flat 2 unless the licensee is released from this obligation by 32GSL.

18. There is a defect in the underleases. It has been agreed that the resultant service charge deficit should be capitalised at £35,592, which figure should be deducted from the value of 32GSL's current interest.

Evidence of Mr Beckett

19. In his expert report dated 31 October 2012, Mr Beckett observed that the LVT decision was given without the benefit of the decision in *City and Country Properties Ltd v Yeats* [2012] UKUT 227 (LC), in which the Upper Tribunal gave guidance on the matters to be taken into account when choosing the deferment rate in connection with the enfranchisement of flats. *Yeats* endorsed the *Zuckerman* addition of 0.25% to reflect the more onerous service charge regime which was not considered in *Sportelli*, subject to the following qualification (para 46(3)):

> "However if there exists clear evidence showing that the purchaser of the freehold reversion would realise, upon the facts of the particular case, that it was extremely improbable that, as freeholder, it would ever become burdened with any responsibility of management, then this evidence may well be sufficient to displace this additional 0.25% (such that only the extra 0.25% as allowed in *Sportelli* should be added.)"

20. Mr Beckett concluded that the "normal" upward adjustment to the *Sportelli* generic rate in the case of flats was now 0.5%, but there would be exceptions to that uplift as indicated in para 46(3) of *Yeats*. Such exceptions would only arise if special and unusual circumstances were identified.

21. Mr Beckett said that his firm was reluctant to accept instructions to manage owner occupied blocks of flats. The reason was that in practice it was extremely difficult to comply with the multiple rules and regulations governing service charges.

22. Firstly, there was the lease, which could often be complex and ambiguous, or leave gaps in what should be a complete service charge system.

23. Secondly, there were the original provisions in the Landlord and Tenant Act 1985 relating to the reasonableness of service charges. It was not always easy to say of a given service charge item that the LVT would regard it as reasonable. The option of finding out in advance whether the LVT would find it reasonable was unattractive, in terms of cost and delay.

24. Thirdly, there were the consultation requirements of the Commonhold and Leasehold Reform Act 2002. These were highly technical, with severe penalties for understandable and, in the long run, unavoidable errors. An example was the Court of Appeal judgment in *Daejan Investments Ltd v Benson* [2011] L&TR14, the effect of which was that substantial sums expended on particular repairs became largely irrecoverable because of a breach by the landlord of the consultation rules in The Service Charges (Consultation Requirements) (England) Regulations 2003.

25. In the view of his firm (which Mr Beckett accepted was not universally shared), the risk of making errors during the consultation process was too great when set against the relatively modest fee levels that managing agents could command for such work.

26. Mr Beckett recognised that both *Zuckerman* and *Yeats* related to properties outside the Prime Central London area (PCL). But, he said, PCL was not a place where service charge disputes were unknown. He produced details of some such disputes which had resulted in hearings before the LVT. Although he had only carried out limited investigations, he considered it likely that there had been more service charge disputes in PCL in 2010 than there had been in Birmingham in 2007 (*Zuckerman* related to a block of flats in Edgbaston, valued as at 2007). Lessees of valuable flats in PCL were financially capable of, and willing to pursue, service charge disputes before the LVT. Moreover, service charge applications heard by the LVT only reflected a small proportion of the problems which managing agents had to face. Some of them were settled without an application to the tribunal; some errors were not noticed by the parties concerned; and some were listed but did not come to a hearing. The purchaser of the freehold interest in a block of flats was potentially exposed to all these problems. He would adjust for that risk by increasing the deferment rate.

27. Mr Beckett accepted that a prudent purchaser of a property investment would pay a price which reflected the assumption that he was competent to manage the risks to which he would be exposed on acquiring that investment. It was reasonable to assume that those risks could be managed, but they could not be eliminated. The more risky the situation, the higher the deferment rate. If there was a risk of special problems arising from the management of blocks of flats, it must be reflected in the higher deferment rate that the Upper Tribunal had set.

28. As for the suggestion that the investor would be able to recover any lost service charges from his managing agents, Mr Beckett made the following points. It was not certain that a court would find that a managing agent who failed to cope with an issue which arose in an area which was "ferociously complicated", was negligent; in cases of particular difficulty a managing agent would reasonably insist on obtaining his clients' instructions before proceeding with a particular course of action; in many cases service charges could not be recovered from recalcitrant tenants without applications to both the LVT and the court and landlords were often understandably reluctant to go down that route; the managing agent would insist that his contractual relationship left much risk with the landlord client.

29. Mr Beckett also suggested that managing agents adopted a conservative approach to their duties as the regulations became ever more onerous and risky. Rather than carrying out works of improvement – or even major repair works – managing agents would tend only to carry out works which they were forced to do. The long term effect would be that, in blocks in PCL where owner occupiers were inclined to carry out substantial works of improvement and modernisation to their flats, the relatively poor standard of the exterior and common parts would reduce the value of the reversion.

30. Mr Beckett said that, in contrast to GWEP's headlease, which was protected by 32GSL's very valuable lease until it expired, the latter was not protected from service charge disputes at all. So far from it being "extremely improbable" that it would encounter service charge problems, 32GSL could expect to encounter them regularly throughout the unexpired term of its lease. In the light of the Upper Tribunal's guidance in *Yeats,* it must follow that a *Zuckerman* addition to the deferment rate should be applied to this reversion. The location of the building in PCL would not protect it from such problems.

31. During the course of his examination in chief Mr Beckett was asked to comment on the significance of the Supreme Court judgment which overturned the judgment of the Court of Appeal in *Daejan* and was handed down on 6 March 2013 [2013] 1WLR 854. He replied that a particular item of risk to the landlord had been removed as a result of that judgment He had not considered that the previous position had been of vital significance, however. It was an example of the problems which resulted from the 2003 Regulations, most of which still remained. Whereas *Daejan* had improved the position, the judgment of the Chancellor in *Phillips v Francis* [2013] 13 EG 76 (Ch. D), which apparently meant that a landlord was required to consult on any item of works, however small, had made it worse. So had the Upper Tribunal decision in *Garside v RFYC Ltd and Maunder Taylor* [2011] UKUT 367 (LC), which suggested that a decision to carry out works and charge for them in a particular service charge year rather than spread the cost over several years might not be reasonable. Buyers of property investments were "nervous birds". The risks of investing in owner occupied blocks of flats were significantly greater than what they had been thought to be in *Sportelli* such as to justify an addition of a further 0.25% to the deferment rate.

Evidence of Mr Orr-Ewing

32. In his expert report dated 20 November 2012 Mr Orr-Ewing, like Mr Beckett, referred to the decisions in *Zuckerman* and *Yeats*. He said that, whenever the Upper Tribunal had differentiated between factors affecting the vacant possession value and adjustments to the generic deferment rate, there was a distinction between areas of low capital values and poor management and areas of high capital values which tended to command good and professional management. In a well-run block in PCL landlords would generally appoint competent and professional managing agents. It was in the interests of landlords and tenants to keep the blocks maintained, thereby enhancing the capital values of their respective investments.

33. Both *Zuckerman* and *Yeats* concerned blocks outside London. In paras 44 and 45 of *Yeats,* the Upper Tribunal made the point that *Daejan* had been decided in November 2009 by the Upper Tribunal (four months before the valuation date in *Yeats*) and that this decision had

raised the market's perception of the impact of the 2003 Regulations. This was the factor which in their view justified increasing the 0.25% management addition for flats in *Sportelli* (where the valuation dates were between December 2003 and July 2005) to 0.5%.

34. In *Daejan*, the property was a mixed use building in Muswell Hill and the landlord's failure to comply with the 2003 Regulations was very serious. This failure had caused the tenants substantial prejudice because they were deprived of being consulted upon the estimates obtained for major works. The effect of such failure to observe the 2003 Regulations meant that the landlord was unable to recover the service charge beyond £250 per tenant and was therefore seriously out of pocket. The management company was the landlord's own company.

35. As in *Yeats*, the valuation date in the present case was shortly after the date of the Upper Tribunal's decision in *Daejan*. Nevertheless, Mr Orr-Ewing did not agree that an investor would consider that the risks associated with managing a block in PCL were twice as great as the market had considered them to be in September 2006 when *Sportelli* was decided in the Lands Tribunal (Mr Orr-Ewing noted that the Tribunal in *Sportelli* did not consider that any fine-tuning below 0.25% was justified). On the contrary, *Daejan* would have operated to draw the investor's attention to the need to engage good managing agents who would have in mind the importance of complying with the 2003 Regulations.

36. Further, in PCL, the capital values were very high and the management costs modest in relation to those values. Mr Orr-Ewing said that he had had quite a lot of experience of investors buying reversions (both individual flats and blocks) in PCL. His experience was that they were motivated by the prospect of capital appreciation and management of the building was not an adverse consideration. In PCL there was a well-developed section of the property industry which was set up especially for the purpose of managing residential blocks. If the hypothetical purchaser were to argue for such a deduction, the response of the hypothetical vendor would be that the answer lay in the purchaser's own hands, namely to appoint competent managing agents. Mr Orr-Ewing asked rhetorically why the hypothetical vendor should agree to discount the price to reflect the future failure of the incoming purchaser to comply with the 2003 Regulations. If the purchaser employed a firm like Knight Frank he could be confident that the managing agent would know what it was doing. If, contrary to expectations, it made an error, the agent would risk being sued by its client and have to make recompense. Mr Orr-Ewing said he had made enquiries of his colleagues who were responsible for managing two large estates and many individual blocks. They had told him that they had put in place procedures to ensure that the 2003 Regulations were complied with. He had ascertained that no claims had been made against Knight Frank during the last six years in respect of a failure to comply with the 2003 Regulations. All the main managing agents carried substantial professional indemnity insurance. In PCL, therefore, in the absence of clear evidence to the contrary, he did not agree that as at April 2010 (a) the market would have had a reasonable expectation that mistakes would be made by managing agents in PCL, such that (b) the 2003 Regulations were not complied with in such a way as to result in substantial prejudice to the tenants and (c) that the landlord would be left substantially out of pocket.

37. Mr Orr-Ewing therefore considered that a deferment rate of 5.5% for 32GSL's leasehold interest was appropriate.

38. Asked in evidence in chief to comment on the Supreme Court judgment in *Daejan*, Mr Orr-Ewing said that the effect of failure to comply with the 2003 Regulations was now much less draconian than had been previously thought. This fortified his view that it was not necessary to make an allowance for management difficulties beyond the 0.25% determined in *Sportelli*.

Evidence of Mr Elmer

39. Mr Elmer said in his witness statement dated 21 November 2012 that, through its service centre, the Grosvenor Estate directly managed approximately 450 properties across the London estate that were subject to some form of service charge payment. The amount spent on the delivery of services in Eaton Square alone was approximately £3 million per annum. In Mr Elmer's opinion the 2003 Regulations had proved to be a force for good. The setting down in the Regulations of requirements as to better communication, consultation and transparent reporting had encouraged landlords to be more responsive and responsible, resulting in better relationships between landlord and tenant. This was advantageous to the landlord, because it created a property in which it was more desirable for tenants to live.

40. Mr Elmer estimated that, over the last ten years, Grosvenor had only received approximately ten accusations from its tenants of non-compliance with the 2003 Regulations. Only one of these complaints had been the subject of proceedings before an LVT and that was determined in favour of Grosvenor. To the extent that any of the remaining complaints were of any substance, the parties had been able to resolve the disputes amicably.

41. Mr Elmer said that Grosvenor had found compliance with the 2003 Regulations to be straightforward. It had, relatively easily, put in place standard documentation to enable clear communication with its tenants. It had also introduced standard procedures, such as a policy that the 24/7 service desk team dealing with the management of properties on the London estate was not permitted to authorise any payment in the discharge of services exceeding £250 without referring the matter to a more senior member of the team.

42. In the course of cross examination Mr Elmer accepted that he did not know the details of the settlements which had been reached with tenants who had alleged non-compliance with the 2003 Regulations, and that the standard documentation which Grosvenor had put in place "only scratches the surface of complying with the Regulations". Mr Elmer said that he was aware of the judgment in *Philips v Francis*. There was an outstanding application for permission to appeal to the Court of Appeal and Grosvenor would review its consultation procedures when the outcome of the appeal was known. He accepted that, if the Chancellor's judgment was upheld, the landlord's position would be more difficult.

Evidence of Mr Clark

43. In his expert report dated 19 November 2012 Mr Clark pointed out that the value of each of the flats subject to the appeals in *Zuckerman* and *Yeats* were £158,000 as at 2007 and £125,000 as at March 2010 respectively. In his opinion different considerations applied to such comparatively low value flats than to the appeal property, where it was agreed that the extended lease value at 30 April 2010 was £9,254,826. Mr Clark did not think that the perceived additional risks attributable to the additional service charge regulations introduced in 2003 would have had any measurable adverse impact on the value of 32GSL's interest, such as to result in an increase in the deferment rate.

44. Mr Clark said of the appellant's case – that the *Zuckerman* addition should apply irrespective of location – that it presupposed that the cost/value relationship was the same everywhere. That could not be right. In *Zuckerman* the vacant possession values of the flats were in the region of £198 per square foot in 2007, compared to the range of £740 to £1,100 per square foot in the *Sportelli* appeals between 2003 and 2005. The agreed freehold value of the appeal property was £2,100 per square foot. Accepting that service charge levels were likely to be higher in PCL than elsewhere because of the greater range and sophistication of services provided and the higher maintenance and construction costs in London compared to the rest of the country, Mr Clark nevertheless considered that, relatively speaking, service charges for PCL properties were likely to represent a smaller proportion of the underlying value of the property than in the case of non-PCL properties. In *Zuckerman*, PCL values were shown to be 3.75 to 5.6 times the values in Edgbaston, even before accounting for the later valuation date for the Edgbaston appeals and there might have been some capital growth in the intervening period. He doubted whether the same relationship would apply when comparing service charge levels between the two locations. The valuation date in *Yeats* (March 2010) was only a few weeks before that in the current appeal. The floor area of the flat was not given in either the LVT or the UT decisions in *Yeats*, but in the LVT decision the flat was described as having a small living room, two very small bedrooms, a tiny kitchen with dated units and a small bathroom. Assuming that the flat had a floor area of circa 400 square feet the freehold value determined (£126,250) would equate to a unit value of £315 per square foot, which was 6.67 times less than the freehold value of the subject flat.

45. In this case a 0.25% increase in the deferment rate above 5.5% would reduce the value of 32GSL's reversion by £86,541, representing 3.73% of the present value of the reversion before the adjustment for the service charge deficit (£2,317,993). That was in effect applying a risk adjustment of just under 3.75% for the possibility that at some future date, prior to the reversion in 2026, 32GSL would fail to recover an element of its service charge expenditure because of a failure to comply with the regulations. In Mr Clark's view that was a very high risk adjustment, considering that *Sportelli* had decided that the same adjustment of 0.25% covered all the general risks associated with managing flats compared to houses. For instance, 32GSL covenanted to insure the building. A failure to have insured the building in the event of a fire or other disaster would be catastrophic, but the risk of not insuring the building or failing to comply with the insurance policy provisions such as to invalidate the insurance policy was the type of risk that was subsumed into the *Sportelli* uplift to the deferment rate for flats of 0.25%.

46. Mr Clark said that investors in reversions in PCL properties, particularly large blocks of flats such as the building were generally sophisticated. Such PCL investors were well advised on the relevant regulations. They set up management systems and procedures to ensure that such matters as service charge regimes were properly resourced and managed in order to minimise the risk of non-recovery of service charge expenditure. It was likely that the class of investor who would bid for the landlord's interest in 33 Grosvenor Square would have been advised early on of the implications of the 2003 Regulations and would have had the management systems in place to accord with the regulations soon after they came into force. Certainly by the valuation date an investor would have been aware of the risks of not adhering to the regulations and would have sought to "manage out" the risks by imposing rigorous internal procedures and checks. If, unlike the Grosvenor Estate, the investor did not manage the property in-house, then it would appoint a firm of managing agents. It would be in the investor's interest to ensure that the appointed firm had the required systems in place to manage the investment in accordance with the regulations. It was also likely that the management contract would be drawn up so that the risk of a failure to adhere to the regulations would fall on the managing agent and not on the investor.

47. Mr Clark agreed with Mr Elmer's view that, although the 2003 Regulations were rigorous and failure to comply with them might result in the landlord suffering non-recoverable charges, they should not necessarily be seen as disadvantageous to the investor, since they had led to better communication between landlords and lessees and to greater transparency of service charges. Improved communication and relationships between lessees and the landlord could underpin the value of the landlord's interest.

48. In relation to the appeal property, there was already a specific adjustment built into the valuation which accounted for the intermediate leaseholder's inability to recover a significant portion of the service charge costs. The amount under this head apportioned to the appeal property was agreed at £4,100 per annum which, capitalised over the period to the reversion, was just under £35,600. That sum had been deducted from the value of 32GSL's reversion as a specific allowance. It represented 1.53% of the present value of 32GSL's reversion (£2,317,993) deferred at 5.5%.

49. Mr Clark made two further points. Firstly, as there was already a specific allowance in the valuation for the actual non-recoverability of certain service charge costs, it would be double counting to make any further allowance for risk such as by increasing the deferment rate. Applying the *Zuckerman* risk allowance would therefore be factoring in a risk of something not happening, whereas the agreed allowance already accounted for it not happening at all. Secondly, the actual costed non-recoverable items in this case, which comprised a significant part of what would normally be recoverable in a standard service charge agreement, equated to just 1.5% of the value of the intermediate leaseholder's reversion. That compared to the much greater *Zuckerman* risk allowance of 3.73%. The former allowance was for a reality, whereas the latter reflected the risk of a failure to comply with regulations, which might never occur.

50. The fact that the *Zuckerman* addition was so much greater than the costed allowance in this case demonstrated that the former was excessive and unwarranted, not only in the

circumstances of this case but for PCL flats generally, given the expectation that blocks of high class flats in PCL would be well managed.

51. Mr Clark produced a supplementary report dated 14 June 2013, in which he commented on the valuation implication of the Supreme Court's judgment in *Daejan*. In the light of that judgment he considered that the risk profile for landlords which had formed the basis of the decisions in *Zuckerman* and *Yeats* had changed considerably. Although a landlord might well have to bear the tenants' costs of challenging a landlord's application for dispensation, the risk to the landlord had reduced to that of not being able to recover the margin between the costs he believed the tenants should pay for the works proposed and a reasonable assessment of the extent and cost of those works. Provided the works proposed, or for which the tenants were being billed, were justified and properly costed by the landlord, the margin for which the landlord was at risk would be quite small, even if the tenants could substantiate some prejudice, for which the factual burden of proof would fall on them.

52. Moreover, for the purposes of the valuation under Schedule 13 paragraph 3 for competent landlords and paragraph 8 for intermediate landlords (or the corresponding paragraphs 3 and 7 of Schedule 6), the hypothetical purchaser could be assumed to be acting rationally and prudently when acquiring the landlord's interest. It would be inconsistent with such an approach if the hypothetical purchaser did not also act rationally and prudently in his management of the building. Mr Clark considered that this would include obtaining accurate specifications and cost estimates for any works that were proposed to be undertaken to the building, as well as acting prudently in the consultation process.

53. Mr Clark therefore considered that, although landlords of flats remained at risk, the level of risk was adequately covered by the existing uplift of 0.25% in the deferment rate that had been established in *Sportelli*.

Relevant case law

54. In *Sportelli* the conclusions of the Tribunal (George Bartlett QC, President, HH Judge Michael Rich QC and P R Francis FRICS) as to the adjustment to be made to the generic deferment rate of 4.75% for houses to reflect the difference between houses and flats were as follows:

> "[95] In *Arbib*, the adjustment of 0.25% was intended to reflect both the greater management problems associated with flats and the possibility that there might be a better prospect of growth in the house as opposed to the flat market. As to the second of these factors, we accept Mr Clark's view that any disparity between growth rates for houses and flats is likely to even out over the longer term. We think, however, that an adjustment needs to be made to reflect the management problems, although we do not consider it appropriate to differentiate between flats that are the subject of headleases and those that are not. Nor do we think that the management concerns are necessarily so much less for a single flat than for a block to warrant a different adjustment. Even where flats are efficiently managed, service charge and repairs problems inevitably occur, and the management exercise in itself is, we feel, sufficiently more complex to

warrant a generalised 0.25% addition for flats. We do not consider that any fine-tuning below this percentage is justified.

[96] Because what we are considering is a long-term investment, it is the prospect of management problems arising during the course of the tenancy that is the important consideration rather than the state of affairs at the time of valuation. Our view is that the potential for problems to arise is inherent in all leases and that standard adjustment is therefore appropriate. We do not rule out the possibility that there could be a case for an additional allowance where exceptional difficulties are in prospect, but this would need to be the subject of compelling evidence."

55. In the Court of Appeal judgment in *Sportelli [2008]* 1WLR 2142 Carnwath LJ said (para 102):

"The tribunal's later comments on the significance of their guidance do not distinguish in terms between the PCL area and other parts of London or the country. However, there must in my view be an implicit distinction. The issues within the PCL were fully examined in a fully contested dispute between directly interested parties. The same cannot be said in respect of other areas. The judgment that the same deferment rate should apply outside the PCL area was made, and could only be made, on the evidence then available. That must leave the way open to the possibility of further evidence being called by other parties in other cases directly concerned with different areas. The deferment rate adopted by the tribunal will no doubt be the starting point; and their conclusions on the methodology, including the limitations of market evidence, are likely to remain valid. However, it is possible to envisage other evidence being called, for example, on issues relevant to the risk premium for residential property in different areas. That will be a matter for those advising future parties, and for the tribunals, to consider as such issues arise."

56. The Lands Tribunal decision in *Sportelli* was dated 15 September 2006 and the Court of Appeal judgment was handed down on 25 October 2007. The decision of the Upper Tribunal in *Zuckerman* was dated 18 November 2009. The Tribunal (N J Rose FRICS) followed Carnwath LJ's guidance in *Sportelli* in holding (para 41) that "the starting point when considering the appropriate deferment rate to be adopted in this appeal is the 5 per cent determined in *Sportelli* for flats in PCL." Its conclusions as to the allowance to be made for flats were as follows:

"[55] Mr Rutledge relied primarily on the introduction of the provisions of the 2002 Act to support his view that the risks to landlords of flats had increased since *Sportelli*. He had in mind in particular The Service Charges (Consultation Requirements) (England) Regulations 2003 (the 2003 Regulations), which imposed strict procedural requirements, failure to comply with which could leave landlords unable to recover a large proportion of the costs of repairs. Although these regulations had come into force nearly three years before the *Sportelli* hearing, the potential seriousness of their impact had become increasingly widely known and this had reduced the relative attraction of investments secured on blocks of flats. Mr Willson replied that there had not been any changes to legislation post *Sportelli* that would have made a difference. There was no reason why the impact in Birmingham should be different from PCL.

[56] The provisions of the 2003 Regulations are potentially extremely serious for landlords (see the Lands Tribunal decision dated April 11, 2008 (George Bartlett QC, President and N J Rose FRICS) in *London Borough of Camden and The Leaseholders of 37 flats at 30-40 Grafton Way* (LRX/185/2006) Unreported June 30, 2008 Lands Tr). I accept Mr Rutledge's evidence that, although LVTs have only heard a limited number of service charge appeals relating to properties in Birmingham, there have been other examples of landlords of such properties agreeing to bear part of the cost of disputed items without the need for a tribunal hearing. The 2003 Regulations came into force on October 31, 2003. I am satisfied that by September 2007, the first date with which I am currently concerned, the market was more aware of the dangers posed by the regulations than was the case in *Sportelli*, where the properties fell to be valued between two and a quarter and three and three quarter years earlier. I conclude that, in the eleven cases with which I am currently concerned, investors would have required an addition of 0.5 per cent to reflect the greater management problems associated with flats than with houses. In reaching this conclusion, I have borne in mind that the subject flats are no longer subject to the original headlease. Had that headlease still been in existence, I would not have considered it appropriate to depart from the *Sportelli* uplift of 0.25 per cent."

57. This conclusion was the subject of detailed consideration by the Tribunal (HH Judge Huskinson and N J Rose FRICS) in *City & Country Properties Ltd v Yeats* dated 17 July 2012. The Tribunal said

"43. There is however a separate argument we must consider based upon *Zuckerman* and the finding there that by the valuation date relevant in that case (September 2007) the market was more aware of the dangers posed by the 2003 Regulations than was the case in *Sportelli*, where the properties fell to be valued substantially earlier. This led the Tribunal in *Zuckerman* to conclude that investors would have required an addition of 0.5% above the rate for houses (not merely 0.25% as applied in *Sportelli*) to reflect the greater management problems associated with flats than with houses. In summary the Tribunal was recognising in *Zuckerman* that the responsibility of ownership of a reversion on a block of flats (as compared to the ownership of a reversion upon a single dwelling house) is more burdensome than was recognised in *Sportelli*.

44. Upon this point Mr Sharp gave evidence as summarised above to the effect that the market had taken the 2003 Regulations in its stride and that now management was conducted along tramlines and that in fact management was now easier and more efficient than in 1982. However, whilst this may be Mr Sharp's personal experience, we accept the evidence of Mr Pridell that within the many applications made to leasehold valuation tribunals generally (and to this LVT in particular) there are a substantial number of cases where landlords and tenants are embroiled in service charge disputes regarding consultation under section 20 of the Landlord and Tenant Act 1985 as amended and the 2003 Regulations. Since the valuation dates in *Sportelli* the potentially draconian effect of the legislation has become more widely recognised. In paragraph 53 of its decision the LVT drew attention to the decision of the Lands Tribunal in *Daejan v Benson*, where the Tribunal made reference to:

> "… the potential effects – draconian on the one side and a windfall on the other – are an intrinsic part of the legislative scheme."

This decision (a decision of the Tribunal whose constitution included the Senior President and which was subsequently upheld in the Court of Appeal) was given in November 2009, i.e. some four months before the valuation date in the present case. (Permission has been granted for a further appeal to the Supreme Court).

45. In our judgment those investing in freehold reversions upon flats would as at the valuation date have had a raised concern about possible management problems during the course of the tenancy, i.e. raised above the level of concern recognised in *Sportelli*. This raised level of concern would have arisen from the 2003 Regulations and from their subsequent interpretation and application especially in a case such as *Daejan v Benson*. This raised concern would have led a hypothetical purchaser of a freehold reversion upon flats to adjust the 4.75% deferment rate (i.e. the *Sportelli* rate for houses) in accordance with the analysis in the following paragraph.

46. We consider that the adjustment to be made to the deferment rate (i.e. an adjustment above the 4.75% deferment rate in respect of reversions upon houses) in order to allow for the management risk attendant upon reversions upon flats is as follows:

(1) There should be an addition of 0.25% (whether or not a head lease exists) as allowed for in *Sportelli*. This 0.25% is a reflection of the fact that a purchaser of a reversion would require an uplift in the deferment rate to reflect the lack of certainty that the purchaser would not become involved with any management problems. Certainty exists where the reversion is upon a dwelling house, but it does not exist where a reversion is upon flat(s).

(2) There should be an addition of a further 0.25% to the deferment rate to reflect the potential actual burden of management (taking into consideration the 2003 Regulations) which will fall upon the purchaser or which may in the future fall on the purchaser during the course of the lease. We consider the analysis in *Zuckerman*, as summarised in para 43 above, to be correct.

(3) However if there exists clear evidence showing that the purchaser of the freehold reversion would realise, upon the facts of the particular case, that it was extremely improbable that, as freeholder, it would ever become burdened with any responsibility of management, then this evidence may well be sufficient to displace this additional 0.25% (such that only the extra 0.25% as allowed in *Sportelli* should be added)."

58. The leading judgment of the Supreme Court in *Daejan* was given by Lord Neuberger. He summarised the issues at para 38 as follows:

"(i) The proper approach to be adopted on an application under section 20ZA(i) to dispense with compliance with the requirements; (ii) Whether the decision on such an application must be binary, or whether the LVT can grant a section 20(1)(b) dispensation on terms; (iii) The approach to be adopted when prejudice is alleged by tenants owing to the landlord's failure to comply with the requirements."

Lord Neuberger analysed each of these issues in detail, but in summary he concluded that the LVT should be proportionate in its treatment of dispensation applications, that such applications can be granted by the LVT "on terms" and that, to the extent that the tenants have

suffered prejudice, the outcome should be that they should be put in the same position as if the requirements had been satisfied. At para 74 of the judgment in the section headed "Overview of the analysis so far", Lord Neuberger said:

> "74 All in all, it appears to me that the conclusions which I have reached, taken together, will result in (i) the power to dispense with the requirements being exercised in a proportionate way consistent with their purpose, and (ii) a fair balance between (a) ensuring that tenants do not receive a windfall because the power is exercised too sparingly and (b) ensuring that landlords are not cavalier, or worse, about adhering to the requirements because the power is exercised too loosely."

59. At para 73 he outlined the type of terms which the LVT would impose on the landlord in return for granting dispensation, such that the outcome would not be too favourable to the landlord:

> "I have in mind that the landlord would have (i) to pay its own costs of making and pursuing an application to the LVT for a section 20(1)(b) dispensation, (ii) to pay the tenants' reasonable costs in connection of investigating and challenging that application, (iii) to accord the tenants a reduction to compensate fully for any relevant prejudice, knowing that the LVT will adopt a sympathetic (albeit not unrealistically sympathetic) attitude to the tenants on that issue."

60. The outcome of the *Daejan* judgment was that, by a majority of three to two (Lord Clarke and Lord Sumption agreeing, Lord Hope and Lord Wilson dissenting), the Justices found in favour of the appellant landlord to the effect that it was granted dispensation, with the respondent lessees' aggregate liability to pay for the works to be reduced from just under £280,000 by the £50,000 which the landlord had offered, plus the lessees' reasonable costs insofar as they reasonably contested the claim for dispensation and reasonably canvassed any relevant prejudice which they might suffer. So far as the landlord was concerned, that was a very considerable improvement on the position without a dispensation, in which case it would have been entitled to total service charges of £1,250.

The consultation regulations

61. As originally enacted, section 20(1) of the Landlord and Tenant Act 1985 provided as follows:

> "**Limitation of service charges: estimates and consultation**
>
> 20. – (1) Where relevant costs incurred on the carrying out of works on a building exceed the limit specified in subsection (2), the excess shall not be taken into account in determining the amount of a service charge unless –
>
> (a) the requirements of subsection (3) as to estimates and consultation have been complied with, or
>
> (b) those requirements have been dispensed with by the court in accordance with subsection (5): and the amount payable shall be limited accordingly.

(2) The limit is whichever is the greater of –

(a) £25, or such other amount as may be prescribed by order of the Secretary of State, multiplied by the number of flats in the building, or

(b) £500, or such other amount as may be so prescribed.

(3) The requirements are:-

(a) At least two estimates for the works shall be obtained, one of them from a person wholly unconnected with the landlord.

(b) A notice accompanied by a copy of the estimates shall be given to each of the tenants concerned or shall be displayed in the buildings so as to be likely to come to the notice of all those tenants; and, if there is a recognised tenants' association for the building, the notice and copy of the estimates shall also be given to the secretary of the association.

(c) The notice shall describe the works to be carried out and invite observations on them and on the estimates and shall state the name and the address in the United Kingdom of the person to whom the observations may be sent and the date by which they are to be received.

(d) The date stated in the notice shall not be earlier than one month after the date on which the notice is given or displayed as required by paragraph (b).

(e) The landlord shall have regard to any observations received in pursuance of the notice; and unless the works are urgently required they shall not be begun earlier than the date specified in the notice.

(4) For the purposes of subsection (3) the tenants concerned are all the landlord's tenants of flats in the building by whom a service charge is payable to which the costs of the proposed works are relevant.

(5) In proceedings relating to a service charge the court may, if satisfied that the landlord acted reasonably, dispense with all or any of the requirements of subsection (3)…"

62. The limits in section 20(2) were doubled with effect from 1 September 1988 by The Service Charge (Estimates and Consultation) Order 1988.

63. The Commonhold and Leasehold Reform Act 2002 substituted the following new section 20 with effect from 31 October 2003 in England:

"**20 Limitation of service charges: consultation requirements**

(1) Where this section applies to any qualifying works or qualifying long term agreement, the relevant contributions of tenants are limited in accordance with subsection (6) or (7) (or both) unless the consultation requirements have been either –

(a) complied with in relation to the works or agreement, or

(b) dispensed with in relation to the works or agreement by (or on appeal from) a leasehold valuation tribunal.

(2) In this section "relevant contribution", in relation to a tenant and any works or agreement, is the amount which he may be required under the terms of his lease to contribute (by the payment of service charges) to relevant costs incurred on carrying out the works or under the agreement.

(3) This section applies to qualifying works if relevant costs incurred on carrying out the works exceed an appropriate amount.

(4) The Secretary of State may by regulations provide that this section applies to a qualifying long term agreement –

(a) if relevant costs incurred under the agreement exceed an appropriate amount, or

(b) if relevant costs incurred under the agreement during a period prescribed by the regulations exceed an appropriate amount.

(5) An appropriate amount is an amount set by regulations made by the Secretary of State; and the regulations may make provision for either or both of the following to be an appropriate amount –

(a) an amount prescribed by, or determined in accordance with, the regulations, and

(b) an amount which results in the relevant contribution of any one or more tenants being an amount prescribed by, or determined in accordance with, the regulations.

(6) Where an appropriate amount is set by virtue of paragraph (a) of subsection (5), the amount of the relevant costs incurred on carrying out the works or under the agreement which may be taken into account in determining the relevant contributions of tenants is limited to the appropriate amount.

(7) Where an appropriate amount is set by virtue of paragraph (b) of that subsection, the amount of the relevant contribution of the tenant, or each of the tenants, whose relevant contribution would otherwise exceed the amount prescribed by, or determined in accordance with, the regulations is limited to the amount so prescribed or determined.

20ZA Consultation requirements: supplementary

(1) Where an application is made to a leasehold valuation tribunal for a determination to dispense with all or any of the consultation requirements in relation to any qualifying works or qualifying long term agreement, the tribunal may make the determination if satisfied that it is reasonable to dispense with the requirements.

(2) In section 20 and this section –

"qualifying works" means works on a building or any other premises, and

"qualifying long term agreement" means (subject to sub-section (3)) an agreement entered into, by or on behalf of the landlord or a superior landlord, for a term of more than twelve months,

(3) The Secretary of State may by regulations provide that an agreement is not a qualifying long term agreement –

(a) if it is an agreement of a description prescribed by the regulations, or

(b) in any circumstances so prescribed.

(4) In section 20 and this section "the consultation requirements" means requirements prescribed by regulations made by the Secretary of State.

(5) Regulations under subsection (4) may in particular include provision requiring the landlord –

(a) to provide details of proposed works or agreements to tenants or the recognised tenants' association representing them,

(b) to obtain estimates for proposed works or agreements,

(c) to invite tenants or the recognised tenants' association to propose the names of persons from whom the landlord should try to obtain other estimates,

(d) to have regard to observations made by tenants or the recognised tenants' association in relation to proposed works or agreements and estimates, and

(e) to give reasons in prescribed circumstances for carrying out works or entering into agreements.

(6) Regulations under section 20 or this section –

(a) may make provision generally or only in relation to specific cases, and

(b) may make different provision for different purposes.

(7) Regulations under section 20 or this section shall be made by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament."

64. The Service Charge (Consultation Requirements) (England) Regulations 2003 came into force on 31 October 2003. Regulation 6 set the appropriate amount referred to in section 20(5) as a sum which results in the service charge contribution of any tenant to the cost of the relevant works being more than £250.

65. Schedule 4, Part 2 of the 2003 Regulations applies, as in the case of the current appeal, to private landlords proposing to carry out qualifying works without a qualifying long term agreement. In *Daejan* (at para 12), the Supreme Court adopted the following four stage summary of those requirements:

> "*Stage 1: Notice of intention to do the works*
>
> Notice must be given to each tenant and any tenants' association, describing the works, or saying where and when a description may be inspected, stating the reasons for the works, specifying where and when observations and nominations for possible contractors should be sent, allowing at least 30 days. The landlord must have regard to those observations.
>
> *Stage 2: Estimates*
>
> The landlord must seek estimates for the works, including from any nominee identified by any tenants or the association.
>
> *Stage 3: Notices about estimates*
>
> The landlord must issue a statement to tenants and the association, with two or more estimates, a summary of the observations, and its responses. Any nominee's estimate must be included. The statement must say where and when estimates may be inspected, and where and by whom observations can be sent, allowing at least 30 days. The landlord must have regard to such observations.
>
> *Stage 4: Notification of reasons*
>
> Unless the chosen contractor is a nominee or submitted the lowest estimate, the landlord must, within 21 days of contracting, give a statement to each tenant and the association of its reasons, or specifying where and when such a statement may be inspected."

Discussion

66. With one exception, all of the factors relied upon by Mr. Beckett in his evidence as justifying the *Zuckerman addition* were in existence and, if they had been thought to have any significance in valuation terms, would have been taken into account by the Tribunal when it decided in *Sportelli* that there was a need to make 0.25% uplift to the generic deferment rate of 4.75% for houses to reflect the more complex management problems that were associated with flats.

67. The one exception was not the existence of the 2003 Regulations, which had come into force prior to all of the relevant valuation dates (the earliest of which was 22 December 2003, and the latest of which was 7 July 2005) in the conjoined appeals that were heard by the Tribunal in *Sportelli*. It was the fact that, as the Tribunal concluded in paragraph 56 of its decision in *Zuckerman*, by September 2007 the market had become -

> "more aware of the dangers posed by the regulations than was the case in *Sportelli* where the properties fell to be valued between two and a quarter and three and three quarter years earlier."

68. The market's awareness in 2007 that the 2003 Regulations posed dangers for landlords of flats did not, in the Tribunal's view in *Zuckerman*, stem from the fact that the consultation regime under the regulations was more elaborate and prescriptive than the consultation requirements in the original section 20 of the 1985 Act. It stemmed from the fact that, on the law as it was then understood to be, a failure to comply with the strict procedural requirements imposed by the 2003 Regulations "could leave landlords unable to recover a large proportion of the costs of repairs": see paragraph 55 of *Zuckerman*. In paragraph 56 of *Zuckerman* the Tribunal illustrated the "potentially extremely serious" consequences for landlords of failure to comply with the 2003 Regulations by reference to the 2008 decision of the Lands Tribunal in the *Camden* case, in which the landlord had been unable to recover service charges amounting to some £495,000.

69. That it was the market's awareness post *Sportelli* of the potential severity of the consequences for the landlord of a failure to comply with the 2003 Regulations, rather than a perception that compliance with the regulations was unduly difficult, that was the basis for the additional 0.25% management allowance in *Zuckerman* is confirmed by the Tribunal's decision in *Yeats*. Endorsing the approach in *Zuckerman*, the Tribunal said in paragraph 44 of its decision in *Yeats*:

> "Since the valuation dates in *Sportelli* the potentially draconian effect of the legislation has become more widely recognised. In paragraph 53 of its decision the LVT drew attention to the decision of the Lands Tribunal in *Daejan v Benson*, where the Tribunal made reference to:
>
> … the potential effects – draconian on the one side and a windfall on the other – are an intrinsic part of the legislative scheme."

In paragraph 45, the Tribunal concluded that the level of concern about possible management problems during the course of a tenancy that had been recognised in *Sportelli* had been raised, not simply by the coming into force of the 2003 Regulations, but by the "subsequent interpretation and application" of the regulations, "especially in a case such as *Daejan v Benson*."

70. The Supreme Court's decision in *Daejan v Benson* has removed the basis on which the Tribunal reached the conclusion in *Zuckerman* and *Yeats* that post *Sportelli* there was a raised level of concern about possible management problems which would be reflected in the market. The potential effects of the legislation for the landlord of an efficiently managed block of flats are no longer "draconian".

71. Mr. Beckett acknowledged that his firm's reluctance to accept instructions to manage owner occupied flats meant that his experience of such management was limited. His perception that it was extremely difficult to comply with the requirements of the 2003 Regulations may well be due in large part to his own lack of experience in management. We preferred the evidence of Mr. Elmer, who has considerable experience of operating the 2003 Regulations in practice, that provided proper procedures were put in place, compliance with the 2003 Regulations was straightforward (paragraph 41 above). We also accepted his evidence that in well-managed blocks of flats the more prescriptive requirements in the

regulations had proved to be a force for good, in that they had resulted in better relationships between landlord and tenant to their mutual advantage (paragraph 39 above).

72. Mr. Elmer fairly accepted that if the Chancellor's judgment in *Phillips v Francis* is upheld on appeal it will make the landlord's position more difficult. We do not accept that the market would view the additional difficulty of complying with the consultation requirements in the regulations with anything like the degree of trepidation with which it viewed the potentially draconian effect of the legislation as it had been interpreted by the Tribunal and the Court of Appeal prior to the Supreme Court's judgment in *Daejan.*

73. It follows that we do not accept Mr. Beckett's evidence that the effect of the Supreme Court's judgment in *Daejan* was to remove a particular item of risk which had not been of "vital significance" and that most of the "general problems" which resulted from the 2003 Regulations remain (paragraph 31 above). We prefer Mr. Clark's view (paragraphs 51-53 above) that in the light of the Supreme Court's judgment in *Daejan* the risk profile which had formed the basis of the Tribunal's decisions in *Zuckerman* and *Yeats* has been changed to such an extent that although there is still an element of risk, the level of risk is adequately covered by the uplift of 0.25% in the deferment rate which was established in *Sportelli*.

74. Since we have concluded that there is no longer any basis for making a *Zuckerman addition* we do not need to reach a conclusion on the Respondents' further contention that the LVT was entitled to decide that a *Zuckerman addition* was not justified in the particular case of a well run block in PCL.

Conclusion

75. The appeal is dismissed.

Dated: 25 July 2013

Sir Jeremy Sullivan, Senior President of Tribunals

N J Rose FRICS