Neutral Citation Number: [2018] EWCA Civ 1704

Case No: C3/2017/2563

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (LANDS CHAMBER)
HHJ Hodge QC and AJ Trott FRICS
[2017] UKUT 0242 (LC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 19/07/2018

Before :

LORD JUSTICE UNDERHILL
LORD JUSTICE FLOYD
and
LORD JUSTICE SALES

- -

Between :

Whitehall Court London Limited	**Appellant**
- and -	
The Crown Estate Commissioners	**Respondents**

- -

Anthony Radevsky and **Paul Letman** (instructed by **Wallace LLP**) for the **Appellant**
Stephen Jourdan QC and **Cecily Crampin** (instructed by **Pemberton Greenish LLP**) for the **Respondents**

Hearing date: 19 June 2018

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Approved Judgment

Lord Justice Floyd:

1. This appeal raises a question about the valuation provisions in the Leasehold Reform, Housing and Urban Development Act 1993 ("the 1993 Act"), and an issue about the construction of a lease.

2. Whitehall Court is a large Victorian mansion block which fronts the Victoria Embankment in London. The freehold is owned by the Crown and managed by the respondents, the Crown Estate Commissioners ("CEC"). Whitehall Court London Limited ("Whitehall") is the lessee under a lease ("the Headlease") dated 12 May 1987 of Blocks 3 and 4 of Whitehall Court ("the Building") for a term which expires on 4 April 2086. The Building contains a large number of high value flats, some offices and a club, all of which are held on long underleases reserving a ground rent.

3. One of the underleases, that of Flat 71A ("the Flat 71A Underlease"), is held by a Ms Keely. On 21 July 2015 a notice was served under section 42 of the 1993 Act (in fact by a predecessor of Ms Keely, but nothing turns on that) claiming a new and extended lease of Flat 71A. CEC admitted the claim by notice in reply dated 24 September 2015. Although the terms of acquisition, including the total premium to be paid, were agreed with Ms Keely, Whitehall and CEC were unable to agree the valuation of their respective interests and therefore the division of the premium payable by Ms Keely between them. Ms Keely therefore made an application to the First-tier Tribunal Property Chamber ("the FTT") on 22 March 2016.

4. Ms Keely took no part in the proceedings before the FTT (or the subsequent appeal to the Upper Tribunal (Lands Chamber) ("the UT")) because the issues which arose for decision were between Whitehall and CEC. Before the FTT those parties agreed that there were six issues which needed to be determined in order to apportion the premium between the two parties. By its decision issued on 29 September 2016 the FTT (Judge Andrew and Mr I.B. Holdsworth BSc MSc FRICS) duly determined the six issues. After a revision which is immaterial, the FTT decided that the price to be paid for the new lease was £227,683 of which £220,023 was to be paid to the Crown and £7,660 to Whitehall. Both parties were granted permission to appeal to the UT on the issues on which they lost. In its decision issued on 20 July 2017 the UT (Judge Hodge QC and Mr A.J. Trott FRICS) identified seven issues requiring resolution, and duly resolved them. The UT granted Whitehall permission to appeal in relation to two central issues. These were numbered issues 1 and 3 before the UT and can be formulated as follows:

> Issue 1: what is the scope of the valuation assumption contained in paragraph 3(2)(b) of Schedule 13 of the 1993 Act? Does it apply, as Whitehall contends and as the FTT decided, solely to the flat the subject of the new lease claim? Or does it extend, as CEC contend (and as the UT decided) to the building of which the flat forms part?
>
> Issue 3: what is the true construction of "Net Receipts" in the Headlease? Does it extend to all premiums received by Whitehall as headlessee including those where the transaction is prohibited under the terms of the headlease ("Covenant Breach Transactions"), as both the FTT and UT held that it did?

5. In addition to these two central issues, the UT granted consequential permission to appeal on some other issues so that the valuation conclusions could be revisited to

reflect such success as Whitehall achieved on issues 1 and 3. The parties were agreed that, in the event of such success, those issues should be remitted to the UT (unless disposed of by agreement).

The Headlease and the Flat 71A Underlease

6. To understand how the issues which I have identified above arise, it is necessary to set out or summarise some provisions of the Headlease and the Flat 71A Underlease.

7. The rent reserved by clause 2 of the Headlease comprises:

> (1) A yearly rent of £10,760, which is payable regardless of what income the headlessee receives.
>
> (2) An additional rent of "The amount by which the Landlord's Share (as defined in the Second Schedule hereto) in any accounting year (as also so defined) exceeds £21,406".

8. The "Landlord's Share" is defined in paragraph 1(a) of the Second Schedule as "the proportion of the Net Receipts to which the Landlord is entitled as set out in paragraph 2 of this Schedule". Paragraph 2 of the Second Schedule lists a series of percentages for each year of the term rising from 60% for each of the Accounting Years 5 January 1987 to 4 January 1992 and then rising by specified increments until it reaches 85% from 5 January 2009 onwards.

9. "Net Receipts" are defined in paragraph 1(b) of the Second Schedule as follows:

> ""Net Receipts" during each year of the said term (ending on the 25th day of December (hereinafter called "the Accounting Year") means the total of the following sums received by the Tenant in respect of any underlease of any part of the demised premises granted varied extended or renewed or in respect of which the rent shall have been reviewed after the commencement hereof…".

10. There then follows a list of five different types of payment:

> "(i) All rents received by the Tenant during the Accounting Year in respect of the demised premises including (without prejudice to the generality of the foregoing) licence franchise and concession fees mesne profits interest in respects of sums in arrear and all other income in the nature of rent or otherwise arising from the demised premises but excluding any sums properly and reasonably received in respect of service charges (including management fees properly payable in respect of such service charges) insurance rents and similar sums and payments for repairs decoration maintenance and services provided
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> (ii) All capital and other sums received whether as premiums or otherwise in consideration of the grant of renewal or continuance of any underlease

> (iii) All sums in the nature of capital or income received by the Tenant during the Accounting Year in respect of the demised premises for the variation or surrender of any undertenancy except legal costs surveyors' fees and disbursements
>
> (iv) All sums received by the Tenant (or which would have been received by the Tenant but for any default or neglect) during the Accounting Year in respect of the demised premises from insurers under any insurance against loss of rents
>
> (v) All losses of rent and other sums suffered during the Accounting Year due to any failure by the Tenant to use its best endeavours to ensure the fullest underletting of the demised premises or to take timely action under the terms of any underletting to review rents or to recover any arrears of rent or other sums or to obtain the best consideration for any underletting or in respect of any breach of Clause 3(16) of this Lease and all arrears of rent and other sums written off as bad debts without the consent in writing of the Landlord
>
> after deducting reasonable legal and surveyor's costs fees and disbursements incurred by the Tenant in connection with any underletting of part of the demised premises and any rent reviews thereunder to the extent that the same are not recoverable from a third party".

11. The reference in (v) to clause 3(16) is a reference to clause 3(16)(c)(iii) which requires any underletting to be"at best premium .. or at best open market rent … reasonably obtainable…".

12. The effect of these rent provisions is that the Crown receives £10,760 regardless of what income Whitehall receives. Whitehall can retain the whole of the amount by which Net Receipts exceed £10,760 until its Net Receipts reach the point where additional rent is payable. Some arithmetic shows this point to be when Net Receipts reach £25,184[1], called the Threshold Rent. The balance of Net Receipts above the Threshold Rent in any accounting year is then divided between the Crown and Whitehall so that after 5 January 2009 the Crown receives 85% of the balance whilst Whitehall receives the remaining 15%.

13. The Flat 71A Underlease is for a term expiring on 24 March 2086, at a fixed yearly ground rent of £180, doubling to £360 on 25 March 2029, to £720 on 25 March 2050 and to £1,440 on 25 March 2071.

14. At the date of the FTT's decision a little over half the under-lessees of Whitehall Court had exercised their rights under the 1993 Act to take extended leases at a peppercorn ground rent. Thus the ground rental income payable to Whitehall under the Headlease

[1] The point at which the additional rent is zero is when the "Landlord's Share" is £21,406. As the Landlord's share is 85% of Net Receipts, Net Receipts must be "£21,406 x 100/85: £25,184.

has been steadily eroded and will continue to be eroded as other under-lessees take extended leases on these terms.

15. In addition to the income from ground rent, Whitehall has also received other income. As originally designed and constructed, pairs of flats in Whitehall Court were separated by a short lateral corridor at a right angle to the main corridors. A number of adjoining flats have come into common ownership and the owners have, with consent, created one large flat after taking a lease ("a corridor lease") of the lateral corridors from Whitehall. Until the first day of the hearing before the FTT it was common ground that income from the grant of corridor leases, and all Whitehall's other receipts, including, for example, payments for licences to make structural alterations, formed part of Net Receipts as defined in paragraph 1(b) of the Second Schedule. However, from that point on, Whitehall have argued that Net Receipts only includes income derived from transactions which were both permitted under the Headlease and for which Whitehall was entitled to recover a rent or premium. These conditions were not met in the case of corridor leases because clause 3(16)(c) restricts any letting to "any one individual residential flat or office unit". Similarly there is a prohibition on making certain structural alterations. Thus, so Whitehall submitted, premiums received for corridor leases or permission to make structural alterations would not be a Net Receipt.

The importance of the issues

16. The valuation exercise required by Schedule 13 of the 1993 Act in the present case is to calculate the diminution in value of the parties' respective interests in Flat 71A as a result of the grant of the new lease. One effect of the grant of the new lease will be the loss of the ground rent payable by the under-lessee under the Flat 71A Underlease. Many of the details of the valuation dispute do not matter, and are not the subject of this appeal. However the valuation of the loss of the ground rent depends on the probability that Whitehall's Net Receipts will exceed the Threshold Rent.

17. Issue 1 is therefore of importance to the parties because if the assumption in paragraph 3(2)(b) of Schedule 13 extends beyond the tenant's flat to other flats in the block, then the likely erosion of ground rents in those other flats (as tenants make claims under the 1993 Act) will fall to be ignored, and those ground rents will make more of a contribution to Net Receipts. If, on the other hand, the assumption is limited to the tenant's flat, the real erosion of the ground rents must be taken into account.

18. Issue 3 is of importance for similar reasons. If transactions which are not permitted under the terms of the Headlease ("Covenant Breach Transactions") can nevertheless be treated as Net Receipts, then the probability of Net Receipts exceeding the Threshold Rent in any year is increased.

The legislation

19. The 1993 Act confers two distinct rights on qualifying tenants of flats: a collective right to acquire the freehold of premises in which their flat is contained, and an individual right to acquire a new lease of the tenant's own flat. Chapter I of the 1993 Act is concerned with the first of these rights, the right to collective enfranchisement. Chapter II is concerned with the second, the right of individual tenants to a new lease.

20. Section 1 defines the right to collective enfranchisement as the right to have the freehold of certain premises acquired by a person nominated for this purpose, and at a price determined in accordance with Chapter I. Section 3 provides that Chapter I applies to any premises if (a) they consist of a self-contained building, (b) they contain two or more flats held by qualifying tenants and (c) the total number of flats held by such tenants is not less than two-thirds of the total number of flats contained in the premises. A qualifying tenant is defined by section 5 as a tenant under a "long lease", a term which is further defined by section 7. A claim to exercise the right to collective enfranchisement is made by serving a notice under section 13 which must, amongst other things, specify the premises of which the freehold is proposed to be acquired (section 13(3)(a)(i)). The Act defines the term "specified premises" as the premises specified in a section 13 notice.

21. Section 32(1) gives effect to Schedule 6 to the Act which relates to the determination of the price payable by the nominee purchaser for the freehold and any intermediate leasehold interests (which are also to be acquired). Paragraph 1 (in Part I of Schedule 6) defines "intermediate leasehold interest" as the interest of a tenant under a lease which is superior to the lease held by a qualifying tenant of a flat contained in the specified premises. Part II of Schedule 6 is concerned with the freehold valuation. Paragraph 2 provides that the price payable for the freehold is to be the aggregate of three sums:

> "(1) Subject to the provisions of this paragraph … the price payable by the nominee purchaser for the freehold of those premises shall be the aggregate of—
>
> (a) the value of the freeholder's interest in the premises as determined in accordance with paragraph 3,
>
> (b) the freeholder's share of the marriage value as determined in accordance with paragraph 4, and
>
> (c) any amount of compensation payable to the freeholder under paragraph 5."

22. Paragraph 3 provides for the valuation of the freeholder's interest under paragraph 2(1)(a) using the familiar model of a sale on the open market by a willing seller, but subject to certain adjustments:

> "(1) Subject to the provisions of this paragraph, the value of the freeholder's interest in the specified premises is the amount which at the relevant date that interest might be expected to realise if sold on the open market by a willing seller (with no person who falls within sub-paragraph (1A) buying or seeking to buy) on the following assumptions—
>
> …
>
> (b) on the assumption that this Chapter and Chapter II confer no right to acquire any interest in the specified premises or to acquire any new lease (except that this shall not preclude the

> taking into account of a notice given under section 42 with respect to a flat contained in the specified premises where it is given by a person other than a participating tenant);"

23. The persons who fall within paragraph 1A, and who are thereby excluded from the notional market being considered are the nominee purchaser and tenants of premises contained in the specified premises (as well as owners of interests in appurtenant property and common parts which the nominee purchaser is to acquire under other provisions of the Act).

24. Part III of Schedule 6, which contains paragraphs 6 to 9 of the Schedule, has corresponding provisions dealing with the price payable for any intermediate leasehold interests. Paragraph 3 (in Part II) applies with appropriate modification to the valuation of such interests.

25. Chapter II of the 1993 Act is introduced by section 39 which provides that Chapter II has effect for the purpose of conferring on a qualifying tenant of a flat the right to acquire a new lease of the flat on payment of a premium determined in accordance with Chapter II. Section 56 obliges the landlord to grant to the tenant, in substitution for the existing lease, and on payment of the premium payable under Schedule 13 in respect of the grant, a new lease of the flat at a peppercorn rent for a term expiring 90 years after the term date of the existing lease. By section 56(2) the tenant is required to pay the owners of any intermediate leasehold interests such amounts as are payable under Schedule 13.

26. Part I of Schedule 13 defines "intermediate leasehold interest" as the interest of any person falling within section 40(4)(c) "to the extent that it is an interest in the tenant's flat". A person falling within section 40(4)(c) is a person in whom there is vested a concurrent tenancy intermediate between the interest of the competent landlord and the tenant's lease. In the present case Whitehall is the holder of the intermediate leasehold interest and the Crown is the competent landlord.

27. Paragraph 2 in Part II of Schedule 13 provides that the premium payable by the tenant in respect of the grant of the new lease is to be the aggregate of—

> "(a)the diminution in value of the landlord's interest in the tenant's flat as determined in accordance with paragraph 3,
>
> (b)the landlord's share of the marriage value as determined in accordance with paragraph 4, and
>
> (c)any amount of compensation payable to the landlord under paragraph 5."

28. Paragraph 3(1) provides that the diminution in value of the landlord's interest is the difference between—

> "(a) the value of the landlord's interest in the tenant's flat prior to the grant of the new lease; and
>
> (b) the value of his interest in the flat once the new lease is granted."

29. Paragraph 3 goes on to provide, by sub-paragraph (2), how the landlord's interests in the tenant's flat, prior to and after the new lease is granted, are to be valued, again by resort to the open market model, subject to adjustments:

> "(2) Subject to the provisions of this paragraph, the value of any such interest of the landlord as is mentioned in sub-paragraph (1)(a) or (b) is the amount which at the relevant date that interest might be expected to realise if sold on the open market by a willing seller (with neither the tenant nor any owner of an intermediate leasehold interest buying or seeking to buy) on the following assumptions:
>
> …
>
> (b) on the assumption that Chapter I and this Chapter confer no right to acquire any interest in any premises containing the tenant's flat or to acquire any new lease;"

30. Part III of Schedule 13 deals with amounts payable to owners of intermediate leasehold interests and follows a similar structure to Part II. Paragraph 8 provides that paragraph 3(2) applies for determining the value of any intermediate leasehold interest subject to appropriate modification "to relate those provisions to a sale of the interest in question…".

Relevant case law

31. No case has had to address the precise point which arises in this case concerning the extent of the assumption in paragraph 3(2)(b) of Schedule 13, although there is some helpful guidance in the authorities to which we were referred.

32. Assumptions of the kind which appear in Schedule 6 and 13 are common features of compulsory purchase legislation. In *Earl Cadogan v Sportelli* [2010] AC 226 at [17], Lord Hoffmann referred to the "normal practice, in all statutes which provide for compulsory acquisition at market value, to insert an assumption that the hypothetical vendor is under no obligation to sell". He went on to say that this meant that:

> "The sale is between a hypothetical willing vendor and a hypothetical willing purchaser and takes place in a market undisturbed by the existence of compulsory powers."

33. An intermediate leasehold interest ("ILI") in an individual flat is not something which in reality is (or even sometimes lawfully can) be sold in isolation. In *Nailrile v Earl Cadogan* [2009] 2 EGLR 151 the Lands Tribunal recognised that this meant that the proper approach to the valuation of an intermediate leasehold interest under the 1993 Act is to value it as a component of the interest in the block as a whole. At [32] the Tribunal (George Bartlett QC and Andrew Trott FRICS) said:

> "Although what has to be valued is the ILI as defined in para.1 [of Schedule 13] and although the value is to be ascertained on the basis of a sale by a hypothetical seller to a hypothetical buyer, it is not, in our judgment, the effect of the provisions that, if in

> reality, the ILI would not (or indeed could not lawfully) be sold in isolation, such an isolated sale must be assumed. In such an assumed sale, regard can be had to the likely attributes of the hypothetical seller…. In Chapter II lease extension cases, if the hypothetical seller could be expected to have an interest not just in the subject flat but also in the other flats in the block and if it could be expected also that it would sell its interest in the block only as a whole, the proper way to value the ILI, in our judgment, would be as a component of such a sale of the intermediate interest."

34. *Mundy v Sloane Stanley Estate Trustees* [2018] EWCA Civ 35 concerned the valuation of marriage value under paragraph 4A(1)(b) of Schedule 13 of the 1993 Act. The lessee contended that the assumptions required by that paragraph precluded the valuer and the Tribunal from having regard to any leasehold transaction in the real world where the lease attracted rights under the Act. That contention was rejected. At [35] Lewison LJ, with whom Arden and Peter Jackson LJJ agreed, said:

> "In my judgment there is nothing in the positive requirement in para. 4A(1)(b) to assume that no rights under the Act attach to the lease or the premises in which the tenant's flat is situated that forbids a valuer from looking at transactions in the real world in order to assist in determining value on the required assumptions."

35. The court also rejected a related argument by the lessee that the market which the valuer was required to assume was one in which no one had rights under the Act. Lewison LJ pointed out that although, in some cases, judges have spoken of a "no-Act world" this was inaccurate jargon which could not replace the words of the Act. He considered "no-Act building" to be a better shorthand for the statutory hypothesis: see [44]. Having recognised that Lord Hoffmann in *Sportelli* had referred to a "*market* undisturbed by the existence of the compulsory power", he continued:

> "I do not accept this argument. First it is not the natural meaning of the words, and we should adopt the natural meaning of the words unless that produces a result which is nonsensical or inconsistent with the intention of the legislature. Second, it overlooks the fact that in paragraph 4A(1)(b) Parliament has specifically delineated the geographical extent to which the assumption applies. Third, it would conflict with the primary instruction to assume a sale on the open market. Fourth it would produce an unworkable result by eliminating all (or almost all) available evidence from consideration. Nor do I consider that the passage from Lord Hoffmann's speech (which was a dissenting speech) assists the argument. Lord Hoffmann was speaking in general terms, and the point now under discussion was not in issue."

36. That case emphasises that the open market valuation required is a real world valuation subject only to the assumptions *required* to be made by statute: see [48].

The decision of the FTT

37. On Issue 1, the FTT thought that the language of the assumption could support either interpretation of the assumption. In those circumstances it was reasonable to consider the intention of Schedule 13 and the no-Act assumption, which was made to facilitate a valuation of the landlord's interest in the tenant's flat. There was no obvious reason for applying the assumption to any other flat. Parliament was unlikely to have had the specific circumstances of the present case in mind when enacting the provision. In paragraph 50 the FTT said:

> "Paragraph 3(2)(b) requires the experts to assume, when valuing the diminution in value of the landlord's interest, that the lessee of the particular flat does not have the right to acquire a greater interest in that flat either through a collective enfranchisement under chapter 1 or by the grant of a new extended lease under chapter 2. In our view it does no more than that. Such an interpretation is consistent with the scheme of the enfranchisement legislation which is to apply the "no act" assumption to the subject property."

38. On issue 3 the FTT relied on the fact that the Headlease expressly included within "Net Receipts" income from "any licence franchise and concession" even though the Headlease did not specifically authorise the grant of any of these things. Further, in the context of valuation, one was concerned with what the hypothetical purchaser would assume. Having made enquiries he would discover that annual returns have always included the premiums now suggested by Whitehall not to be included in Net Receipts. Accordingly the FTT decided that, with one exception, the premiums and rents received needed to be taken into account. The one exception was premiums received for the grant of licences for non-structural alterations.

The decision of the UT

39. The UT decided issues 1 and 3 in favour of CEC. As to issue 1, the extent of the paragraph 3(2)(b) assumption in Schedule 13, the UT considered that the "grammar" of the assumption favoured Whitehall's case. However, in the end, the UT favoured the Crown's interpretation "for essentially two reasons". The first reason was that the only expressed physical restriction on the extent of the assumption in paragraph 3(2)(b) was "any premises containing the tenant's flat"; and the assumption extended to "any interest" in such premises. This suggested a wider physical area of application for the "no new lease" limb of the assumption than merely the applicant tenant's flat. The second reason lay in the principle underlying the assumption, namely that of fairness to the person whose interest (or interests) was (or were) being expropriated. The purpose of the assumption was to prevent the landlord's interest being valued on a less favourable basis because the 1993 Act conferred rights of collective and individual enfranchisement.

40. On issue 3 the UT agreed with the FTT that, because the definition of Net Receipts included the grant of a licence, franchise or concession, which would be breaches of the terms of the Headlease, the parties had expressly contemplated that Net Receipts could include receipts from acts which were in breach of covenant.

41. The UT also accepted the further reasons given by CEC as to why "Net Receipts" should include the Covenant Breach Transactions. These were, in essence, that it would have been obvious to reasonable parties in 1987 that over a term of nearly 100 years there would be occasions when the headlessee would enter into transactions which were strictly speaking in breach of the terms of the Headlease. In those circumstances the freeholder would have a choice to treat the transaction as unlawful, in which case he would not be entitled to treat the income as Net Receipts, or to waive it, in which case it would not be open to the headlessee to rely on his own breach to argue that the income was not Net Receipts. Although the freeholder and headlessee could agree in respect of a particular payment to treat the receipt as excluded, absent any such agreement any such sum would fall within the definition. The UT disagreed, however, with the FTT's exception in respect of non-structural alterations, for which they could see no logical justification.

The appeal

Issue 1

42. There is no doubt, as both tribunals below pointed out, that the language of paragraph 3(2)(b) is open to both sides' interpretations. Both sides advanced clarificatory wording to explain their cases. Thus Whitehall submitted that the paragraph should be read as saying that:

> "Chapter I and this Chapter confer no right to acquire any interest in any premises containing the tenant's flat or to acquire any new lease **of the tenant's flat**"

whilst CEC submitted that it should be read as:

> "Chapter I and this Chapter confer no right to acquire any interest in any premises containing the tenant's flat or to acquire any new lease **of any part of the premises containing the tenant's flat**".

43. Both constructions are possible as a matter of language. Whitehall emphasises that the diminution in value of the landlord's interest is the difference between the landlord's interest in the tenant's flat prior to the grant of the new lease and the value of the landlord's interest in the flat after the new lease is granted. The valuation is therefore focussed on the tenant's flat which is the only relevant unit of valuation, not on the building of which it forms part. Thus it followed that it is the valuation of the interest in the tenant's flat which was the subject of the assumption in paragraph 3(2)(b). It made no sense for the reference to Chapter II rights in this sub-paragraph to relate to the premises containing the tenant's flat, because Chapter II did not confer any right to a lease of the building. There was therefore no reason why the right of other tenants in the block to obtain a new lease of their flats should be disregarded.

44. I think these submissions confuse the subject matter of the valuation with the assumptions to be made for the purposes of arriving at the valuation. Paragraph 3(2)(b) requires the open market valuation to take place under certain assumptions. It does not follow from the fact that what is being valued is the diminution in value of the landlord's interest in the tenant's flat that one is not required to switch off Chapter I and Chapter

II rights which are afforded to other tenants in the same block. Thus paragraph 3(2)(b) requires an assumption that Chapter I confers no rights to acquire any interest in any premises containing the tenant's flat. Although the focus of the valuation is still the landlord's interest in the tenant's flat, the assumption must switch off for the purposes of valuation not only that tenant's collective enfranchisement rights (if he has any, which he may not if he does not have the right sort of underlease) but the rights of all other qualifying tenants in those premises. Such an assumption is necessary, because otherwise the Chapter I rights held by those other tenants would depress the value of the landlord's interest in the tenant's flat, even if the tenant himself did not have any Chapter I rights. Thus the scope of the assumption in relation to Chapter I rights plainly extends to qualifying tenants of other flats in the block.

45. In this respect the FTT was, with respect, wrong to say that "the scheme of the enfranchisement legislation was to apply the "no act" assumption to the subject property" by which they meant the tenant's flat. The assumption has to extend beyond that if it is to work, at least in the context of Chapter I rights. They were therefore also wrong to say that there was no reason to extend the assumption beyond the tenant's flat.

46. It is of course entirely possible that the drafter of the 1993 Act intended nevertheless to confine the scope of the valuation assumption in the case of Chapter II rights (and in contrast to Chapter I rights) to the tenant's flat. There are, however, a number of indications that this was not the intention. Firstly, the language of the assumption is in this respect the same as the language of the assumption to be made in respect of collective enfranchisement in Schedule 6 paragraph 3(1)(b) for the purposes of valuing the freehold interest as a whole. The expansive language "any new lease" is there intended to capture any Chapter II rights in any part of the specified premises, and therefore the Chapter II rights of tenants of other flats in the block. Whilst it is possible that the drafter thought that the context of Schedule 13 would necessarily convey a more limited meaning to the expression "any new lease", I do not think that can be so, given the general words of the assumption ("Chapter I and this Chapter confer no right"), the fact that there is one express spatial limitation of the assumption ("premises containing the tenant's flat"), the meaning of the words "any new lease" in Schedule 6, and the availability to the drafter of words such as "of the tenant's flat" to make clear that the spatial assumption was to be more limited in the case of Chapter II rights than in the case of Chapter I.

47. Further, the language of Schedule 6 defeats Whitehall's semantic point that it makes no sense for the reference to Chapter II rights in paragraph 3(2)(b) of Schedule 13 to relate to the premises containing the tenant's flat, because Chapter II does not confer any right to a lease of the building. Exactly the same point could be made in relation to Schedule 6. The solution to that conundrum is to read the reference to "any new lease" in Schedule 6 as referring to any new lease of a part of the specified premises and in Schedule 13 as referring to any new lease of a part of the premises containing the tenant's flat. The Act as a whole is simply not concerned with granting tenants collective leasehold rights of the whole building.

48. It is also material to bear in mind, as I have indicated, that what is being valued is the diminution in value of the landlord's interest in the tenant's flat as a component of the landlord's interests as a whole. Although Mr Radevsky, for Whitehall, quibbled with the suggestion that the landlord's interest could never be sold separately, he did not dispute the proposition derived from *Nailrile* that in Chapter II lease extension cases

the proper way to value the ILI would be as a component of a sale of the landlord's interest as a whole. Given that approach, it seems to me to be both artificial and unfair to conduct that valuation operation on the basis that it is only the tenant's flat to which the assumption of "no-Act" applies, rather than the flats of all the tenants in the block.

49. Whitehall submitted that support for its construction was to be found in another comparative analysis between Schedules 6 and 13. In Schedule 6 paragraph 3(1)(b) the assumption is followed by words of exception: "*(except that this shall not preclude the taking into account of a notice given under section 42 with respect to a flat contained in the specified premises where it is given by a person other than a participating tenant)"*. A section 42 notice is the notice by which a qualifying tenant claims a new lease under Chapter II. So this exception qualifies the assumption to be made and allows the actual giving of a section 42 notice by a tenant who is not exercising his Chapter I rights to be taken account of, despite the fact that Chapter II rights generally are to be ignored. Whitehall says that it would be inconsistent with this provision to construe the assumption in Schedule 13 as extending to the whole of the block containing the tenant's flat, but without the exception allowing the valuer to take account of a section 42 notice served by a non-participating tenant.

50. The effect of the bracketed words in paragraph 3(1)(b) of Schedule 6 was the subject of some discussion in the Supreme Court in *Earl Cadogan v Sportelli* (supra) which concerned whether valuations could take account of hope value (as distinct from marriage value) in a variety of enactments: see Lord Hoffmann (dissenting) at [21]-[22]; Lord Walker at [45] and Lord Neuberger at [106] to [107]. The majority concluded that in a collective enfranchisement case the landlord who could recover marriage value in relation to participating tenants' flats could also recover hope value in relation to non-participating tenants' flats. As Lord Neuberger put it, hope value could be recovered under Schedule 13 insofar as that hope value was attributable to the possibility of non-participating tenants wishing to obtain new leases in the open market rather than as of right: see [96] to [115]. In that connection the bracketed words in paragraph 3(1)(b) were significant. The same did not hold true as regards hope value under Schedule 13: see Lord Neuberger at [94] to [95]. It seems to me that Whitehall's point loses such force as it might have had once one appreciates that the bracketed words are doing work in distinguishing Schedules 6 and 13 for these purposes.

51. Whitehall further argues that there is support for its position in a comparison of the classes of person excluded from "buying or seeking to buy" in Schedule 6 paragraph 3(1A) and Schedule 13 paragraph 3(2). In the former it is the nominee purchaser and any tenant of premises contained in the specified premises, whilst in the latter it is the tenant and the owner of any intermediate leasehold interest. Whitehall submits that it is significant that the statute does not exclude from the market the tenants of other flats contained within the building of which the tenant's flat forms part.

52. In response to this point, CEC draw attention, firstly, to the fact that as originally enacted Schedule 6 only directed the exclusion from the market of the nominee purchaser and the participating tenants. The class of persons was widened by the Housing Act 1996 by amending the language of paragraph 3(1) and adding the new paragraph 3(1A), but those amendments could not affect the meaning of Schedule 13 paragraph 3(1)(b). CEC submit, secondly, that it is not surprising that it was thought necessary to exclude a wider category of persons from the market under Schedule 6 than under Schedule 13. In Schedule 6 the purpose of the exclusion is to exclude special

purchasers of the freehold, whereas in Schedule 13 the valuation context is different, and so the likely special purchasers are likely to be different as well.

53. I agree that the amendments to Schedule 6 were unlikely to have changed the meaning of Schedule 13, but this is not an answer to Whitehall's point. As far as tenants are concerned, as originally enacted, Schedule 6 excluded all participating tenants, whereas Schedule 13 excluded only the tenant of the flat. However, the assumption requiring the 1993 Act rights to be switched off and the assumption regarding the classes of special purchasers to be excluded are not the same thing, and have different purposes. The "no-Act" assumption is there to prevent the compulsory acquisition powers depressing the open market valuation, whilst the exclusion of special purchasers is designed to prevent those purchasers unduly raising the valuation by their presence in the market. I can see no *a priori* reason why the two should march in step. I am therefore not persuaded by this argument either.

54. The interaction between the exclusion of special purchasers and the no-Act assumption does give rise to another point, however. If the tenant in question is treated as excluded from the market, there does not appear to be anything that the assumption in respect of Chapter II rights could ever bite on. If, however, it extends to all the Chapter II rights in the building, then the assumption bites on the Chapter II rights of the other tenants in the premises of which the tenant's flat forms part.

55. Whitehall also relied on an analogy with the "no scheme" rule in compulsory acquisition cases: see for example *Waters v Welsh Development Agency* [2004] UKHL 19. At [63] Lord Nicholls gave six pointers as to how one determines the extent of such schemes. The sixth of these was that, when in doubt, a scheme should be identified in narrower rather than broader terms. Thus Whitehall submits that the court should opt for the narrower construction of the assumption in relation to Chapter II rights. That analogy, as it seems to me, merely begs the question of what is to be regarded as the equivalent of a "scheme" in the context of valuations under Schedule 13. The assumption with which we are concerned clearly extends to the whole building so far as Chapter I rights are concerned. The question for us is whether the "scheme" is the same for Chapter II rights, or a narrower one. For my part I did not find this analogy particularly helpful.

56. The FTT considered (paragraph 48 of its decision) that the Crown would not suffer any loss of the value of the ground rental income if the no-Act assumption did not extend beyond the tenant's flat, because the Crown would be compensated for that loss of income on the grant of each extended lease. The UT disagreed with that conclusion (paragraph 52 of its decision), and in my judgment it was right to do so. On the FTT's construction of the assumption the Crown would receive less for the diminution in its interest in the instant case, and would receive less for each subsequent flat for which an extended lease was granted.

57. A further consequence of Whitehall's construction is that there would be a significant difference between the valuation under Schedule 6 and Schedule 13. The freehold in a collective enfranchisement case under Schedule 6 would be valued on the basis that none of the tenants had any rights under Chapter I or Chapter II, and there was no risk of ground rents being eroded. If on the other hand the landlord is compelled to grant long leases, the loss of his interests would on each occasion be valued (as a component of his interests as a whole) on the basis that the tenants other than the tenant of the flat

under consideration have Chapter II rights entitling them to extended leases at no rent. Whilst not a conclusive consideration on its own (given that, as already noted, there are certain differences between Schedule 6 and Schedule 13 valuations), it is nevertheless entitled to some weight. It is true that in *Sportelli* Lord Walker warned about the dangers of reading too much into the apparent symmetry between Schedule 6 and Schedule 13 (see [45]). However I agree with CEC that it is unlikely that Parliament was intending to produce a fundamental difference in the overall approach to valuation between the two types of enfranchisement.

58. It is right to be cautious about the reference by Lord Hoffmann in his dissenting judgment in *Sportelli* to "a market undisturbed by the existence of compulsory powers". It is clearly not legitimate to take the assumption as applying beyond the confines of the premises of which the tenant's flat forms part: see *Mundy*. That is because it is only legitimate to disturb the real world to the extent one is required to by the assumption, and there is no basis in the language of Schedule 13 for extending the assumption that far.

59. It would also be wrong to place too much emphasis on Lewison LJ's use of "no-Act building" in *Mundy* as a convenient shorthand for the assumption. Just as it is clearly wrong to paraphrase the assumption as a "no-Act world", it would be wrong to adopt an alternative phrase adopted for convenience in that case when the issue which arises in the present appeal did not arise there. Nevertheless it seems to me, now that we have heard all the arguments in the present appeal, that Schedule 13 paragraph 3(2)(b) does require the assumption of a no-Act building not only for the purposes of Chapter I but also for the purposes of Chapter II rights. Whitehall's hybrid assumption is incorrect.

60. I would therefore uphold the decision of the UT on issue 1.

Issue 3

61. Whitehall submits that both tribunals were wrong as a matter of law on the interpretation of the Headlease. The UT had proceeded on the false basis that parties to the Headlease would have contemplated that the headlessee would act in breach of the terms of the lease and risk forfeiture. The only proper assumption was that the headlessee would respect the terms of the lease and seek permission. Any permission granted would give rise to a collateral agreement which would fall outside the Headlease. The fact that paragraph 1(b)(i) of the Second Schedule expressly included as Net Receipts instances of parting with possession which would be a breach of the Headlease did not mean that all Covenant Breach Transactions fell within the definition. Paragraph 1(b)(i) was in contrast with the other sub-paragraphs, none of which contained any such express provision.

62. CEC broadly supported the decision of the UT. Clause 3(16)(b) was a covenant by the headlessee "not to … part with or share possession of or grant any licence in respect of the demised premises or any part thereof" except by way of a permitted underlease. Despite that, the definition of Net Receipts includes income from granting licences, franchises and concessions, each of which would be a breach of clause 3(16)(b). It was accordingly clear that the parties did intend that money paid for Covenant Breach Transactions would be included in Net Receipts.

63. On this issue I think CEC are plainly correct. The language of paragraph 1(b) and its sub-paragraphs is perfectly general. Thus sub-paragraph (i) includes "… all other income in the nature of rent or otherwise arising from the demised premises…", sub-paragraph (ii) includes "all capital and other sums received whether as premiums or otherwise in consideration of the grant or renewal or continuance of any underlease", and sub-paragraph (iii) includes "[a]ll sums in the nature of capital or income received by the Tenant during the Accounting Year in respect of the demised premises for the variation or surrender of any undertenancy…". This is expansive language, plainly wide enough to include within its scope monies received in respect of the identified transactions when those transactions involve a breach of covenant and have not been authorised by the freeholder.

64. Whitehall's argument, although not presented as such, requires words to be read in to the definition of Net Receipts which are not there. In my judgment, this is not what a reasonable person having the background knowledge available to these parties would have understood them to be using the language to mean.

65. The consequence of Whitehall's construction is that any monies received for Covenant Breach Transactions could be retained by Whitehall. CEC could bring proceedings for forfeiture or seeking to have the transaction reversed, but if they did not do so it would have no call on the monies received under the terms of the Headlease. I think the parties are most unlikely to have intended such an uncommercial outcome. Rather they would have understood that, where a breach of covenant occurred, the freeholder could waive the breach, thereby making the transaction lawful: see *Metropolitan Properties Co. Ltd v Cordery* (1980) 39 P.&C.R. 10. Against that background it makes perfect sense for the Headlease to include within its definition of "Net Receipts" monies received from Covenant Breach Transactions.

66. There is some further support for CEC's construction in paragraph 1(b)(v) of the Second Schedule which expressly contemplates that Whitehall may be in breach of the obligation under clause 3(16)(c)(iii) that every underlease should be at the best open market rent. Paragraph 1(b)(v) brings within "Net Receipts" any losses of rent suffered as a result of such breach. It would however be absurd if the rent actually received by Whitehall from an underletting in breach of the covenant in clause 3(16)(c)(iii) did not also fall within "Net Receipts". This also suggests that Covenant Breach Transactions are within the contemplation of "Net Receipts".

67. Subject to the point about structural alterations, Whitehall accepts that if its construction argument is rejected, receipts from all the types of transaction under consideration, including the grant of corridor leases, fall to be treated as Net Receipts. I think the UT was also right in the conclusion it reached in relation to structural alterations. Clause 3(14) of the Headlease prohibits certain structural alterations. However, it permits other defined alterations without the need to obtain the consent of the landlord and some with the landlord's consent, such consent not to be unreasonably withheld. If Whitehall in fact receives payment for prohibited alterations in respect of a particular tenant, and accounts for those sums to CEC, I can see no difficulty with viewing this as a Net Receipt, for example under paragraph 1(b)(iii) of the Second Schedule, as a sum received in respect of the demised premises for a variation of the undertenancy.

68. I would therefore uphold the decisions of the FTT and the UT on this issue.

Conclusion

69. For the reasons I have given I would dismiss this appeal.

Lord Justice Sales

70. I agree.

Lord Justice Underhill

71. I also agree.