TOPIC 4

Principles of mortgage and property law

LEARNING OBJECTIVES

This topic looks at the laws underpinning mortgages and property ownership. An adviser is not expected to be a legal expert but understanding some basic principles and key issues can help you to spot pitfalls and provide a more helpful service to clients.

By the end of this topic, you should have an understanding of:

- important legislation relating to mortgages and property ownership;
- types of legal mortgage and the priority of legal charges;
- the ways in which property can be owned;
- land tenure;
- the provisions of the Commonhold and Leasehold Reform Act 2002.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about property law and mortgages.

For instance:

- What is the difference between freehold and leasehold?
- What does the term 'tenant' mean in relation to ownership of property?
- In what circumstances can the owner of a leasehold flat take over ownership of the freehold of the building?

You may have a good idea of the answers to these questions. If you do, that's great – we can build on that knowledge and introduce some of the finer detail. If not, don't despair – by the end of the topic you'll have a good grasp of the details.

TOPIC 4

4.1 Introduction

Mortgage law and practice has evolved over time, generally to the benefit of borrowers. This has arisen from changes to the law and, in recent years, as a result of social policy and improved consumer protection. For example, while borrowers were once unable to repay a mortgage loan early, they now have the right to do so at any time. Borrowers are also now far better protected if they cannot make a repayment when it is due.

KEY TERMS

CONVEYANCE

The transfer of rights in property is described as a conveyance.

MORTGAGEE AND MORTGAGOR

The borrower is described as the *mortgagor* and the lender as the *mortgagee*. It is not uncommon for people to get these two terms confused, so ensure that you memorise them correctly.

In Scotland, the borrower is the *debtor* and the lender is the *creditor*.

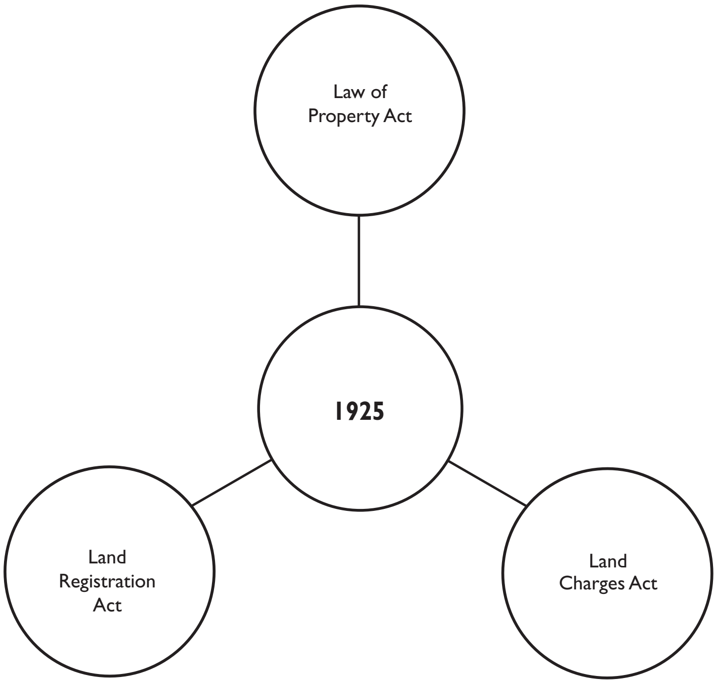
4.2 What is the basis of modern property law?

The year 1925 was a significant one for property ownership. Three pieces of legislation were passed, changing the way in which property could be owned, the registration of property and the way in which mortgages could be secured on land. We do not need to know the details of each piece of legislation, but it is important to understand the key changes the three Acts brought about.

COMMONHOLD

We will see in section 4.5.3 that a 2002 Act added a third form of ownership known as 'commonhold'. Do you know what this is?

FIGURE 4.1 WHAT ARE THE THREE SIGNIFICANT PROPERTY ACTS OF 1925?



Although the 1925 Acts have been updated by subsequent amendments and legislation, they still underpin the basis of land and mortgage law in England and Wales. They simplified the ways in which mortgages can be created, and the most common method now is through a legal charge.

One of the most significant changes was to reduce the ownership of land to two forms:

- estate in fee simple absolute in possession – more commonly known as 'freehold'; and
- estate for a term of years absolute – more commonly known as 'leasehold'.

KEY TERMS

FEE SIMPLE

The right for the property to be inherited on death.

ABSOLUTE

No limits on ownership.

KEY TERMS

IN POSSESSION

Immediate entitlement to occupation: nobody else has a prior claim.

TERM OF YEARS ABSOLUTE

Leasehold estate, which has a limited duration that must be fixed and certain.

The 1925 Acts introduced a system of land registration for all property (updated in later Acts). They also introduced legal remedies for the lender in the event of default or other breach of the terms of the mortgage by the borrower.

Other key provisions included the following:

- A minor (a person under the age of 18) cannot hold an interest in land.
- Where two or more loans are secured on a property, their priority is determined by the date of their registration.
- The borrower has a right to let the mortgaged property unless the mortgage deed states otherwise (in practice all lenders include a clause in their mortgage deed that specifically excludes this right).
- The lender is not liable for any loss made on the execution of its power of sale.
- The lender has the right to determine how the proceeds of any insurance claim relating to the mortgaged property are used.

CUIUS EST SOLUM, EIUS EST USQUE AD COELUM ET AD INFEROS

A principle of land ownership in the UK is that 'whoever owns the soil owns everything up to the heavens and down to the depths of the earth' (translated from Latin).

There are some exceptions to this principle. Court cases have established that the right to airspace above the land is limited to what is reasonable for the ordinary use and enjoyment of the land – so an individual could not take action for trespass against an aeroplane 30,000 feet above their property. The owner of land also owns the space below it and any minerals lying beneath it, apart from the rights of the Crown in relation to oil, coal, natural gas, gold and silver.

4.3 What are the types of mortgage?

Lenders will only usually lend for property purchases on the strength of a legal mortgage. Prior to the Law of Property Act 1925, there were a number of ways in which a legal mortgage could be created, but the 1925 legislation reduced these to two, and in practical terms the only option today is the mortgage by way of legal charge, known as standard security in Scotland. The property is owned by the borrower from the outset and the legal charge is a deed that states that the property has been charged with the debt (the loan) as security for the lender.

The lender acquires certain rights that leave it in a very strong position should the borrower default. The charge is cancelled when the mortgage is fully repaid.

SCOTLAND

A mortgage is created slightly differently in Scotland. See the Scottish supplement, 'Securities over heritable property'.

4.3.1 What are second and subsequent mortgages?

As we saw in Topic 3, a second mortgage (or second charge) is where a borrower already has a mortgage (first charge), and then arranges more borrowing against the same property through a different lender.

REMEMBER

A second mortgage ranks behind the first mortgage in terms of priority for repayment.

The first-charge holder usually inserts a clause in the mortgage deed allowing it to make further advances as part of the first charge, rather than on a second-charge basis. For this reason, a second charge is almost invariably with a different lender.

4.3.2 How is the priority of charges determined?

Registered land

The second charge will be registered with the relevant registry and the date order of registration generally determines which takes priority in the event of default, provided the earlier mortgagees followed proper procedures in registering their charges.

IN BRIEF

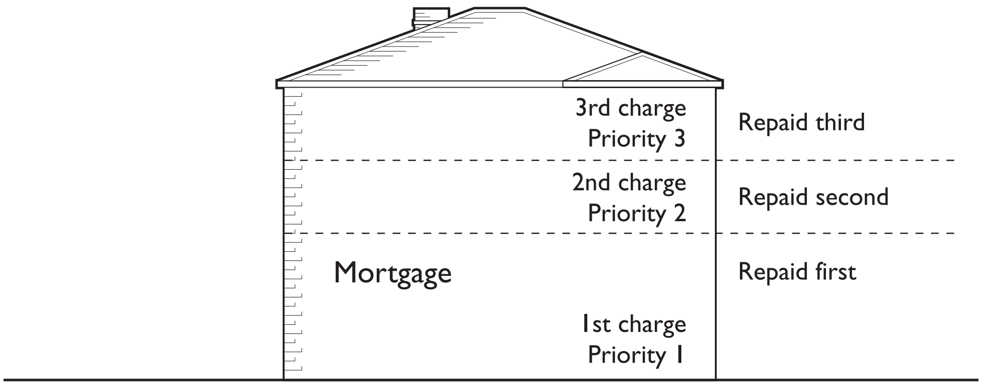
PRIORITY OF CHARGES

If the borrower defaults and the property is sold, the first mortgagee will benefit first from any sale proceeds before any surplus is available for the second, and so on; the earlier mortgage 'takes priority'. Subsequent mortgagees receive their share of any surplus in order of priority until each of their claims is satisfied, or until the sale proceeds run out. If there is anything left at the end, it must be repaid to the borrower.

Unregistered land

The lender that holds the title deeds as security will be regarded as the first-charge holder. Subsequent charges will be recorded in the Land Charges Registry, with their priority set in date order.

FIGURE 4.2 RANKING OF MORTGAGE CHARGES



If the first mortgagee fails to receive enough from the sale of the property to repay its loan, then subsequent mortgagees will get nothing. So, a lender will only accept a second or subsequent mortgage if it feels that there is sufficient 'equity' (value) in the mortgaged property to comfortably cover both earlier mortgages and its own.

Second mortgages present the lender with a higher risk and are likely to be offered at higher rates of interest or with higher tariffs of charges and fees; they are often provided by finance houses, which specialise in higher-risk secured lending.

4.4 What are the types of joint property ownership?

LEGAL AND EQUITABLE OWNERS

It is possible for up to four people to be registered as legal owners of a property. If there are more than four potential owners, four will be registered as the legal owners. Those who have a right to a share in the property but are not shown as legal owners at the Land Registry are referred to as equitable (or beneficial) owners.

TENANCY/TENANT

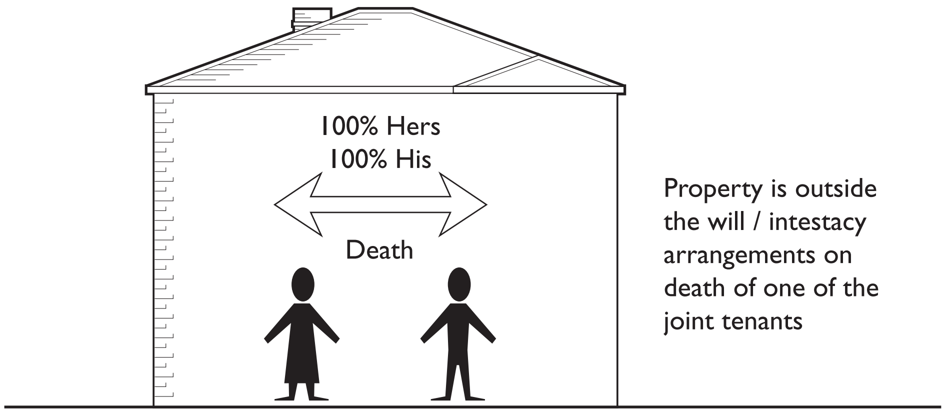
Legal terms used in the Law of Property Act 1925 to describe joint owners of property. This can be confusing, because we now tend to use these terms to describe people who *rent* a property.

When a property is owned jointly, the Trusts of Land and Appointment of Trustees Act 1996 dictates that a trust of land is created automatically, with the legal owners as trustees. The legal owners are those who are the registered proprietors of a registered property or those whose names are shown in the latest conveyance for unregistered property. They have the power to transfer legal ownership of the land or to mortgage it as they wish, as long as they all agree. The legal owners hold the property on trust for each other and the equitable owners, and jointly owned property can usually only be sold if there are at least two legal owners. In most cases the legal and equitable owners are the same, although this is not always the case. Equitable owners do not have the right to transfer legal ownership.

4.4.1 Joint tenancy

Joint tenancy is the most common type of joint ownership – it is the default type. In simple terms it means that each joint owner owns 100 per cent of the property – there is no division of the property. On the death of any joint owner, the surviving joint owner(s) will take over legal ownership of the property. The transfer is automatic and cannot be overridden by any provisions made by a joint tenant in a will or through the laws of intestacy. For example, George and Claudia own their property as joint tenants. If George died, Claudia would become the sole owner of the property, regardless of anything that George had stated in his will.

FIGURE 4.3 JOINT TENANCY

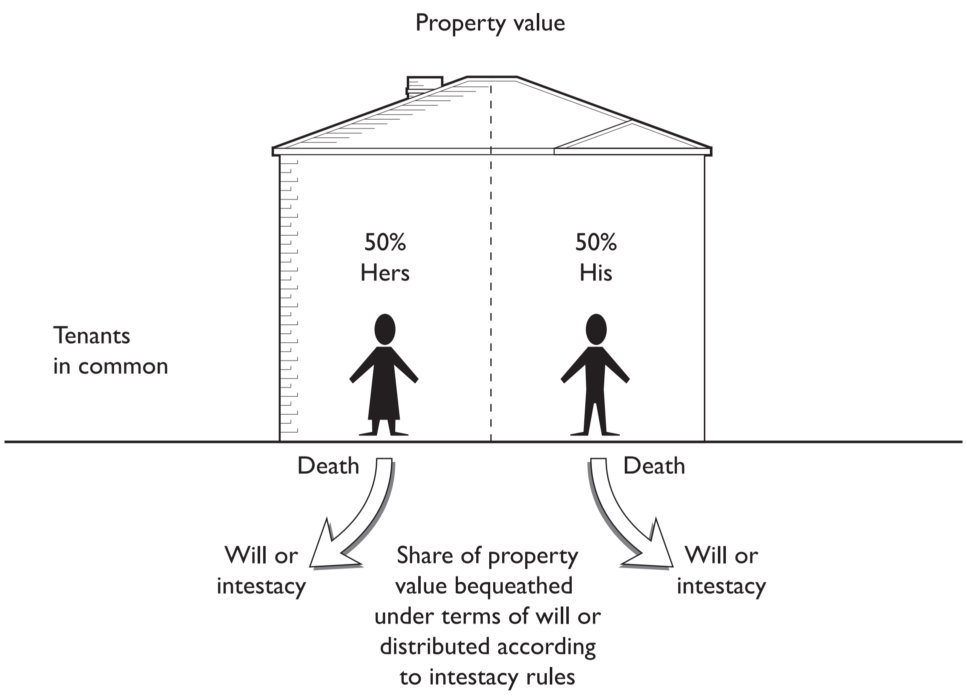


4.4.2 Tenancy in common

Tenancy in common is often described incorrectly. With tenancy in common, both legal and beneficial ownership feature.

The same basic principle applies to legal ownership – the joint legal owners are regarded as one single owner but are trustees of the land. However, each legal owner is also the beneficial (or equitable) owner of a defined interest (share) of the equity in the property, as agreed between them.

FIGURE 4.4 TENANTS IN COMMON



So, what does this all mean?

On the death of a joint tenant in common, legal title to the whole property passes to the survivor, who continues to hold it as a trustee in land. There is now one legal owner of the property. From a technical viewpoint, a property held jointly cannot be sold if there is only one surviving owner; there must be at least two legal owners for a sale to go ahead.

Each joint owner (or their heirs in the event of their death) is regarded as having a beneficial interest equal to their agreed share of the property. In simple terms this would equate to their share of the remaining equity in the property after any mortgage debts have been settled.

It is the beneficial interest (not legal ownership) that a joint tenant can leave to their chosen beneficiaries on their death.

The surviving legal owner, as trustee of the land, has a duty to look after the interests of a beneficial owner until a new joint legal owner can be appointed and the property is sold, if appropriate.

To set up a tenancy in common, a notice of severance (a written notice of the change) is served on the other owners. The original of the notice, or a certified copy, signed by all the owners, should be sent to the Land Registry together with a Form A restriction request on the property. The Form A restriction prevents either party selling the property or their share without agreement from the co-owner. The restriction will show up on conveyancing searches.

This means that the surviving legal owner cannot sell the property without following a legal process to appoint a new joint legal owner. Equally, because the beneficiaries are not the legal owners, they cannot force a sale.

The surviving owner, as a trustee, can (but is not obliged to) appoint someone to act as trustee for the deceased owner's share – usually their executor or personal representative. Once another trustee has been appointed, the property can be legally transferred into the joint names of the original owner and the new trustee as the new joint legal owner.

The new joint owners still have an obligation to look after the interests of the beneficial owners.

Once there are two legal owners again, the property can be sold and the proceeds distributed in accordance with the agreed shares.

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OWNERSHIP *V* MORTGAGE

The situation described above refers to the ownership of the property itself and not the mortgage. The mortgage would be on a joint and several basis, so the survivor would take over responsibility for the debt, regardless of their eventual share of the property.

CASE STUDY: TENANCY IN COMMON

Dave and Sheila own their property, valued at £300,000 with no mortgage, as tenants in common on a 50:50 basis. Both have made wills, leaving their share of the property to their children; Dave's brother Jim is his executor.

On Dave's death, Sheila would become the sole legal owner of the property. However, Dave's £150,000 beneficial share of the equity in the property would pass to the beneficiaries of his will for the purposes of the distribution of the estate and inheritance tax.

Although Sheila would own legal title to the property, she would have to hold Dave's share on trust for his beneficiaries. On Dave's death, the restriction placed on the property at the Land Registry would mean that Sheila could not sell the property and would continue to hold the property as a trustee of land; nor could Dave's beneficiaries force Sheila to sell the property because she would be the sole legal owner at that stage.

Sheila could appoint Jim (or anyone else) to replace Dave as a trustee. Once that was done the property could be transferred into Sheila and Jim's names as joint owners. As joint owners Sheila and Jim could sell the property if they both agreed, but they must at all times protect the interest of the equitable owners – Dave's beneficiaries and Sheila. On Sheila's death, her executors and Dave's trustee must ensure that Dave's beneficiaries receive their rightful share of the property.

Tenancy in common can be useful if someone wants to leave their share of the property value to someone else rather than the joint owner. In most cases this would be part of an inheritance tax (IHT) mitigation plan, or perhaps to protect the inheritance of children from a first marriage in the case of a second marriage.

An example might be where two parents buy a holiday home on the coast. They have reasonable assets and would like to avoid IHT if possible. In the event that either of them were to die, it would be better to leave the children a share of the property rather than cash because the survivor would need the cash in order to live. In order to achieve this, the parents can arrange ownership on a tenants in common basis, each leaving 50 per cent to the children in their wills. On death, the children will own 50 per cent of the property value and the survivor the other 50 per cent. Most importantly, the share of the property value left to the children will form part of the deceased's nil-rate band and will enable the survivor to benefit from the cash left in the estate.

CHECK YOUR UNDERSTANDING

You learned about IHT in UK Financial Regulation – refer back to your study text if you need to refresh your memory.

A HIDDEN TRAP?

We established that, if a joint tenant dies, the surviving joint owner(s) become(s) the sole owner of the whole property, so 100 per cent of the property passes automatically to the survivor. However, IHT regulations regard jointly owned assets as being owned in equal shares by each owner, which means that the deceased owner's notional share of the equity in the property is treated as a transfer for IHT.

Where the owners are married or civil partners this is a technical issue because the spouse exemption means no tax would be payable. However, if the owners are not in that situation an IHT liability could arise.

For example, Joe and Glenda have lived together for 30 years but have never married. They own their house in London, worth £800,000, outright, having paid off the mortgage some time ago.

Joe dies. Glenda will become sole legal owner of their house, but £400,000 (50 per cent) of the house value will form part of Joe's estate for IHT purposes. This seems a bit of a contradiction, because Glenda would own the whole house, and nobody else would have a claim on any of its value.

Everything Joe owned above the nil-rate band would be subject to IHT. For example, if Joe died when the nil-rate band was £325,000 and IHT was 40 per cent, IHT would be payable at 40 per cent on the value of his estate above that amount. Even if he left nothing else, his share of the house would create a bill of £30,000. How would Glenda, or the family, find the funds to pay the bill? The additional residence nil-rate band would not apply because the property did not pass to a lineal descendant.

JOINT OWNERSHIP – SCOTLAND

Joint property is similar to a joint tenancy in England and Wales.

Common property is similar to a tenancy in common in England and Wales.

4.5 How does land tenure work?

Land tenure in Scotland is different from that in England and Wales. Students sitting the examination in Scotland will need to study the Scottish Appendix in addition to this topic.

TENURE

Denotes the way in which title to the property is held; it is taken from the French *tenir*, meaning 'to hold'.

We saw in section 4.2 that the 1925 legislation reduced the number of ways in which property (legal estates in land) could be held to two: freehold and leasehold. The Commonhold and Leasehold Reform Act 2002 introduced a third type of tenure – commonhold.

4.5.1 Freehold estate

The freehold estate is the best and highest form of ownership of land in England and Wales. However, although the owner of a freehold property owns it outright and with no restrictions, they are still not able to do totally as they might wish.

IN BRIEF

WHAT FACTORS MIGHT AFFECT FREEHOLDER RIGHTS?

- There is a requirement to meet local authority conditions, for example, those relating to property use and alterations.
- The owner is subject to local and national planning legislation, which may affect both the use of the property and the extent to which it can be altered.
- There may be covenants or easements that apply to the land.
- The title itself may contain restrictions imposed by an earlier owner.
- Former public utilities (now private companies providing water, electricity, gas, etc) have certain rights over the land.
- The owner has obligations to those who enter or pass by the property – for instance, if a tile falls off the roof and injures someone, the owner can be liable.

Freehold ownership does not always mean that the property is better security than leasehold property. Freehold land can provide defective title and have specific features that make it unsuitable from a lender's point of view. In particular, many lenders are reluctant to consider mortgages on freehold flats. The reason for this is that the buildings invariably have common areas for which there is no clear accountability. For example, the ceiling of one person's flat is another person's floor, so it is unclear who is responsible for damage. If the property is leasehold, there is a freeholder who determines who has responsibility.

IN BRIEF

FLYING FREEHOLD: A PROPERTY NIGHTMARE?

Flying freehold is the term used when part of a freehold property extends above or below another person's property but is not next to or touching the ground. Common examples include:

- a passage between two terraced houses (numbers 1 and 2), where the passage is on land owned by number 1 but part of a bedroom in number 2 is over the passage;
- a 'coach house' style property, where part of the property sits above an entrance to communal parking for the development;
- a cellar that extends under the neighbouring property;
- a balcony that extends over land owned by the property next door.

A flying freehold can be a major problem, because the owner of the land may fail to maintain their property, which could result in damage to the property with the flying freehold.

Lenders are usually reluctant to lend on property with a flying freehold, unless there is an enforceable right of support, shelter and repair, and appropriate rights of entry. In other words, there must be an enforceable requirement on the landowner to maintain the property to prevent damage, and to allow access to carry out any repairs to the property with the flying freehold.

4.5.2 Leasehold estate

Leasehold estate is a less permanent form of estate than freehold. It is a form of land tenure where a person has rights over the land for a specific period only. Referred to in the Law of Property Act 1925 as 'a term of years absolute', leasehold is a legal estate in land and occurs where the freeholder (the lessor) agrees to lease the land or property to another (the lessee). A typical lease may have an original term of 99 years, but it could be as long as 999 years.

FIGURE 4.5 HOW DOES LEASEHOLD OPERATE?

Head lease

Sets out the term of lease, the amount of ground rent, and the rights and obligations of . . .

The lessee (leaseholder)

Who pays ground rent to . . .

The lessor (freeholder)

Who can create the lease for any length of time, but if the length exceeds 21 years the lessee may gain statutory rights to buy them out

Ground rent on a leasehold property is usually relatively low, typically between £50 and £200 a year.

GROUND RENT AND LEASEHOLD HOUSES

Most leasehold properties are flats, and until recent years few houses were held on that basis. However, significant numbers of leasehold new-build houses have been sold with a clause allowing ground rent to double after a specified time. Some developers also imposed unreasonable costs or obstacles on those who sought to buy the freehold (ie enfranchisement), or sold on the freehold to speculators who in turn increased the cost of enfranchisement.

Many leases contain a clause allowing a ground rent increase after perhaps ten years and then another after a further ten years, and so on. Even with an increase, the ground rent will be a relatively small amount.

It is possible for a leaseholder to create a lease to allow another person to use the property, known as a ‘sub-lease’, as long as the term is shorter than the original lease and the head lease does not prohibit it.

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IN BRIEF

LEASEHOLDERS: RESTRICTIONS AND RESPONSIBILITIES

The freeholder of the leasehold property may be bound by any of the freehold conditions described above; these affect the leaseholder as well.

Leases may carry additional constraints such as:

- specific conditions relating to maintenance and repairs;
- constraints on use of the property;
- restrictions on alterations or enlargement;
- duties in respect of common areas – for example, where there is a block of leasehold flats, contributions may be required for the upkeep of spaces for communal use, such as landings and stairs, although the responsibility for the maintenance of the common areas lies with the freeholder;
- a requirement to insure through a specified company.

!

NOTE ON LEASEHOLD

When someone buys a leasehold property, they are actually buying the right to lease the property – it is the lease that has value and that is what the purchaser is buying. At no point does the leaseholder own the land or the bricks and mortar, unless they are able to buy the freehold as well. The purchase price of the lease will depend on a number of factors, including the type of property, the value of the property, the rent and the remaining term of the lease.

The lender must understand the nature of the lease when a leasehold property is considered for mortgage. If the lease is too restrictive it will affect the resale value of the property.

The unexpired term of a lease is very important. When a lease expires, the land and building reverts totally to the freeholder and, as a result, as the lease approaches expiry date, the value of the property will fall significantly. Most lenders are very wary of short leases, usually specifying that the lease must have a certain minimum number of years to run beyond the redemption date of the mortgage. A typical requirement would be 30–40 years more than the mortgage term.

LEASE TERM

A borrower buys a leasehold property for £100,000. The property is leasehold with 30 years to expiry. The purchase is funded by a 25-year mortgage.

Eight years later, the borrower defaults on the mortgage and the lender takes possession. By this time, the lease has only 22 years to run and, at the end of that period, it will revert to the freeholder. Anyone buying the property will only have use of it for 22 years and no rights at all after that. It is likely that the lender will find it almost impossible to sell the property for anything like its normal market value if it has to take possession.

BUYING AND SELLING PROPERTY WITH A SHORT LEASE

It is quite common at auction to see leasehold properties with very low estimated sale prices compared to similar properties – they appear to be real bargains. However, this usually means that the current lease has a very short period of time to run. The buyer will be taking a big risk because, as things stand, the lease has little value and will diminish rapidly in future, leaving them with no tangible asset when it expires.

However, if the buyer can secure a lease extension (see section 4.5.4.2), and is prepared to make the investment to do so, the value could soar and turn a risky investment into a profitable one. The main problem is that the buyer does not have an automatic right to extend the lease until they have owned it for two years, which means they have to take the risk of buying the lease first.

In many cases, it is in the vendor's interest to extend the lease before putting the property on the market, rather than attempting to sell with a short lease at a low price.

Failure to comply with a lease can result in its termination. This is called forfeiture and is a serious matter for the lender. In all instances, the rights of the freeholder take precedence over those of the lender. If the borrower fails to comply with the conditions of the lease and rights are forfeited, the lender

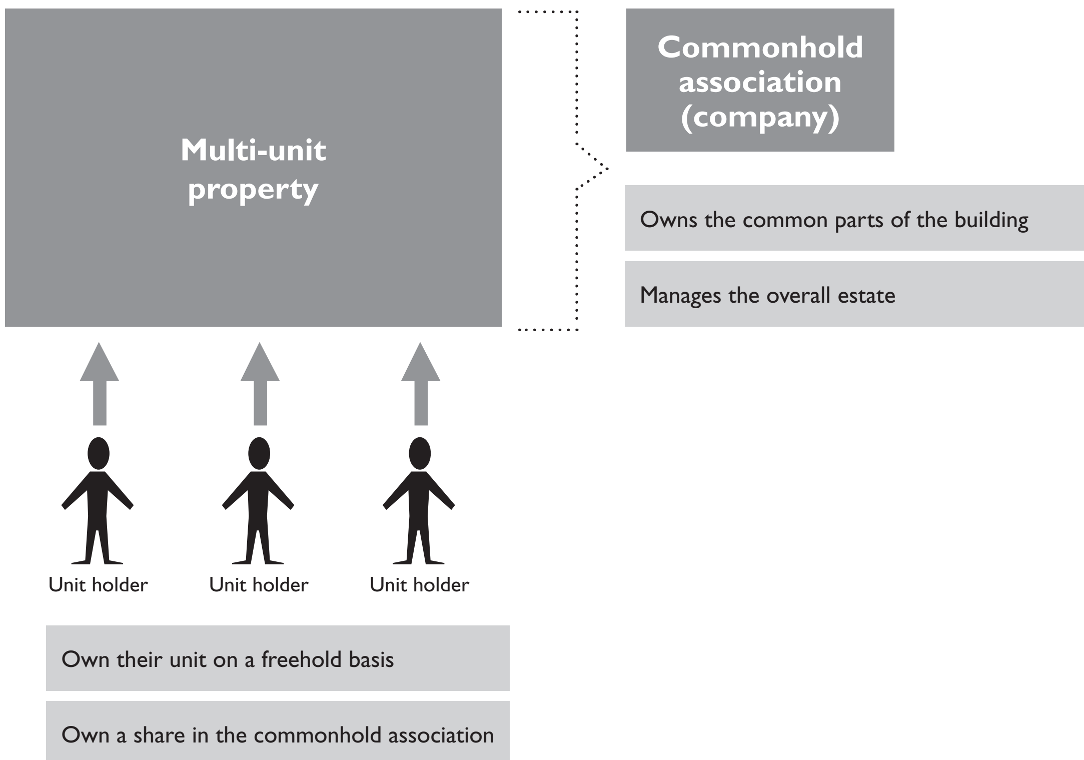
> **VENDOR**
>
> The seller of the property.

is left with no security. Consequently, all lenders include a clause in the legal charge, standard security or mortgage conditions that the conditions of the lease can be fulfilled by the lender if the borrower does not do so. In other words, the lender has the right to do the things a leaseholder should do if the leaseholder fails to comply. The lender will almost certainly add any expenses incurred to the mortgage account. As lenders will not always become aware of this happening, many have insurance policies in place to cover them against losses caused by forfeiture.

4.5.3 What is commonhold?

The Commonhold and Leasehold Reform Act 2002 brought about a change in the way in which property can be owned. Commonhold was introduced as a new type of tenure to provide flexibility for those who would previously have owned leasehold property within a larger development – a block of flats, for example. The larger development is called the multi-unit property and each individual property is called a unit.

FIGURE 4.6 HOW IS COMMONHOLD STRUCTURED?



Shares in the commonhold association may not be equal and may be based on the size of each unit. For example, the owner of a two-bedroom unit may be allocated two shares, while the owner of a one-bedroom unit may be allocated just one share and the owner of a studio flat half a share.

In practice, commonhold is similar to a leasehold arrangement, but the maintenance of the building is the responsibility of a company owned by the unit owners (the commonhold association), rather than appointed by a freeholder. Only unit holders can be shareholders, although the association can appoint up to two directors who are not shareholders. As shareholders in the commonhold association, unit holders can vote at the annual general meeting. An important point is that, unlike leasehold, where the rights of the freeholder are superior to the leaseholder, with commonhold no individual has rights in the property that are superior to those of the unit holder.

- As a company, the association is required to establish a memorandum of association, articles of association and a commonhold community statement. The community statement includes the rights and obligations of individual unit holders, voting majorities and other essential rules for the community.
- The commonhold association would normally be expected to hold an annual general meeting where shareholders can vote on management issues and the running of the building, with voting on a simple majority basis.
- The commonhold association is able to set a commonhold assessment, which is an annual charge to unit holders to cover the expenses of running the association, and can also require unit holders to contribute to a reserve fund to cover the costs of maintenance and repairs to the common areas of the building. These charges are likely to vary depending on the size of each flat.
- The land/property must be registered with the Land Registry as an estate in commonhold land. This can only be done after the commonhold association has been formed. This means that a developer intending to build a block of flats on a commonhold basis must register a commonhold association with the Land Registry before the property can be registered. Once flats are sold, shares in the association can be transferred to the new unit holders who will take over control.
- The same rights and obligations that would exist between a freeholder and a leaseholder exist between the association and each unit holder. The association will collect a commonhold assessment, which replaces the management charge on leasehold property.

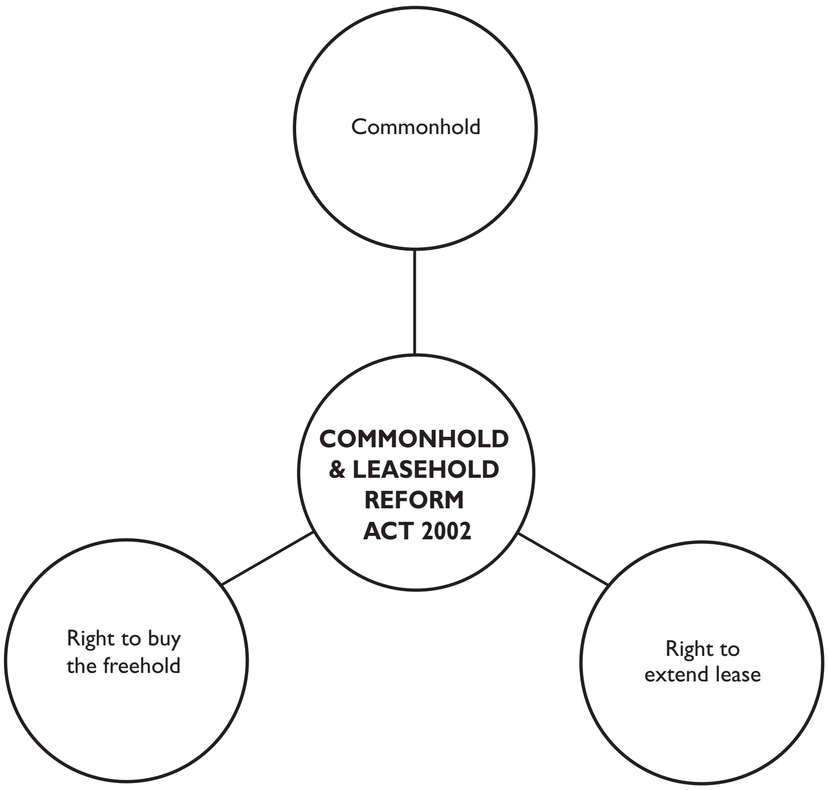
CONVERTING AN EXISTING MULTI-UNIT ESTATE TO COMMONHOLD

An existing multi-unit estate can be converted to commonhold only where all leaseholders, their lenders and the freeholder are in agreement. All leasehold obligations and agreements will terminate and be replaced by those of the commonhold association. It is not common for existing property to convert to commonhold in view of the difficulty in gaining agreement from all parties, and the costs of conversion.

This topic looks at an overview of leasehold ownership and the legislation that applies to it. The potential implications of owning leasehold property are covered in more detail in Topic 13.

4.5.4 What else is in the Commonhold and Leasehold Reform Act 2002?

FIGURE 4.7 WHAT ARE THE MAIN PROVISIONS OF THE 2002 ACT?



The Commonhold and Leasehold Reform Act 2002 is designed to make it easier for leaseholders of flats to purchase the freehold of their building on a collective basis, or for individuals to extend their lease. It was felt that the previous provisions under the Leasehold Reform, Housing and Urban Development Act 1993 were too restrictive and prevented many leaseholders from being able to exercise the right of enfranchisement.

Those with long leases on houses had certain rights under the Leasehold Reform Act of 1967 to buy the freehold or extend the lease by a further 50 years, increased to 90 years by the Leasehold Reform Housing and Urban Development Act 1993. Subsequent legislation, including the 2002 Act, has extended this right so that most long-term leaseholders now have the right to buy their freehold. For the purposes of this text, we will focus on the more common purchase of leasehold flats.

> **ENFRANCHISEMENT**
>
> The right of the owners of leasehold properties in a building (eg a block of flats) to join together to buy the freehold of the building.

4.5.4.1 Buying the freehold of a flat

In order for leaseholders to be able to buy the freehold of a flat, they must be qualifying tenants, the main requirement for qualification being that the original lease on the flat was for a period of more than 21 years. Where the lease has changed ownership, the right passes to the new leaseholder, providing the original lease was for longer than 21 years. There is no need for the leaseholder to live in a flat, which means landlords can still qualify.

A qualifying tenant can purchase the freehold where the building meets the following criteria:

- The building must contain two or more flats.
- At least two-thirds of the flats must be held on a long lease – a lease that was originally granted for a term of more than 21 years.
- No more than 25 per cent of the internal floor area of the building (excluding common areas such as stairs and hallways) can be used for non-residential purposes.
- At least 50 per cent of the leaseholders in the block must agree to participate. For example, in a block of 12 flats, at least eight must be held on a long lease and at least six leaseholders must agree to participate in the purchase.

Leaseholders cannot be qualifying tenants where:

- the landlord is a charitable housing trust and provides the flat as part of its charitable work;
- the lease is for commercial purposes;
- the leaseholder owns qualifying leases of more than two flats in the building.

A leaseholder does not have to participate in the purchase of the leasehold. If they choose not to do so, they will lease their property from the new freeholders.

A further major restriction on leaseholders purchasing the freehold of their building is a situation where it is a converted property with four or fewer flats and the same person has held the freehold since before the conversion, and they (or an adult family member) have lived in one of the flats as their main residence during the previous 12 months. For ease of understanding we can call them a 'resident landlord'.

4.5.4.2 Extending the lease

As an alternative to buying the freehold, qualifying tenants who have held a long lease for more than two years have the right to buy a new lease, which will extend the existing lease by 90 years. This provision was included in the 1993 Act but improved by the 2002 legislation. For example, on a flat bought three years ago with 40 years left on the lease, exercising the right to extend the lease would result in a new lease of 130 years.

As long as the applicant meets the qualifying criteria, the landlord cannot normally refuse the application. The payment made by the leaseholder to the landlord, known as the premium, must be a 'fair' value based on open market values. The value is based on the landlord's financial loss as a result of the extension, and generally includes:

- the reduction in the freeholder's financial interest caused by the extended lease;
- an element of the increase in value of the property as a result of the extension;
- compensation for the loss of ground rent.

The ground rent payable on the lease is cancelled and replaced by a 'peppercorn rent' from the point at which the lease is extended. The effect is to reduce the ongoing ground rent to zero.

In some cases, a leaseholder may qualify to extend their lease but may wish to sell the property before they have done so. If the property is on a short lease, this could significantly affect the sale price or even make a sale almost impossible. The vendor has two choices:

- **To extend the lease before sale.** This will take some time, which could delay any potential sale and may be an expense the vendor cannot afford.
- **To exercise their right to extend the lease and begin the process, but then assign the rights to the new purchaser.** The purchaser will be assured that they can extend the lease, even though they have not owned the lease for the minimum two years. The premium payable for extending the lease and any further costs will be the new owner's responsibility. This buyer

will factor the cost of the lease extension into their offer, but the fact that the lease can be extended soon after purchase will result in a significantly higher price than selling with a short lease.

Where the leaseholder does not qualify to extend the lease under the legislation, they can negotiate a voluntary extension with the landlord, although the ground rent on the remainder of the original lease would not automatically be cancelled. The premium would be set by the landlord, who has the right to refuse an extension.

4.5.4.3 The Right to Manage (RTM)

One further change to leasehold law in the 2002 Act gave qualifying leaseholders the right to take over management of the building from the freeholder by setting up a Right to Manage (RTM) company.

The qualifying criteria for the leasehold property owners are as follows:

- The building or part of the building must contain at least two flats.
- At least two-thirds of the flats in the building must be owned by long leaseholders.
- Non-residential areas of the building cannot exceed 25 per cent of the building's total floor area.
- As with buying the freehold of a flat, if there are four or fewer flats and there is a resident landlord, the building will not qualify.
- At least 50 per cent of the qualifying leaseholders must agree to participate.

There is a set procedure to take over management of the building, as follows:

- Participating leaseholders must set up an RTM company with directors and standard articles of association.
- All those leaseholders who are not members of the company, or have not agreed to become members, must be served with a notice inviting them to participate.
- The freeholder must be sent a notice of claim within two weeks of the notice to non-members.
- The freeholder can respond with a counter-notice (challenge) within one month.
- If the freeholder does not challenge then the RTM company acquires the right to manage four months from the notice of claim. The freeholder can apply to be a member of the RTM.

- If the freeholder issues a counter notice, the RTM company can apply to the first-tier tribunal (England), or leasehold valuation tribunal (Wales) for a ruling about it.
- The RTM takes on all management functions for the building, although the freeholder must be consulted about any alterations or other matters relating to the building other than maintenance.
- The RTM has the right to enforce obligations under the lease, but cannot use the forfeiture procedures.

4.5.5 Leasehold Reform (Ground Rent) Act 2022

The Act came into force on 30 June 2022 as the first part of the government's aim to make leasehold ownership fairer and more affordable for leaseholders. The Act states that the ground rent on a long residential lease (21 years or more) created from 30 June 2022 and subject to the payment of a premium cannot exceed "one peppercorn per year". This peppercorn rent means that no money can be legally charged or paid as ground rent on leases regulated by the Act – effectively the ground rent is zero. The term peppercorn rent has an historical basis, because for a lease to be legally binding there had to be a consideration from both sides. Historically, ground rents were very low, and many were subject to the payment of a single peppercorn as the ground rent, or in some cases other odd items, just to show that a consideration had been paid. As a result, the term peppercorn rent was used to signify a ground rent of minimal value, and as today a single peppercorn has virtually no practical value, the 2022 Act effectively bans the payment of ground rent.

The Act does not apply to statutory lease extensions under the Leasehold Reform, Housing and Urban Development Act 1993, as these leases are already subject to a peppercorn rent. But if a lease is extended on a voluntary basis, ground rent will still be payable until the start of the extended lease, which will be the date when the original lease was due to end.

4.5.6 The Leasehold and Freehold Reform Bill

Introduced to parliament in November 2023, the Bill is intended to provide further reforms to leasehold property ownership through an Act of parliament to take effect in 2024. The key elements of the Bill are as follows.

- To increase the standard lease extension term for houses and flats to 990 years (an increase from 90 years in flats, and 50 years in houses), with ground rent reduced to a peppercorn rent (ie zero financial value) once a premium has been paid.
- To remove the 'marriage value' (see section 13.5.1), which makes it more expensive to extend leases that are close to expiry.
- To remove the requirement for a leaseholder to own their property for two years before they can exercise their right to extend the lease.

- To increase the 'non-residential' limit in mixed-use property from 25 to 50 per cent. This will mean leaseholders in buildings with a mixture of residential and commercial areas will be able to buy their freehold or exercise their right to manage in buildings where up to 50 per cent of the floorspace is non-residential.
- To strengthen recent legislation that ensures freeholders and developers cannot escape their liabilities to fund building remediation.
- To ban the sale of new leasehold houses (not flats) in England and Wales, other than in exceptional circumstances. This part of the legislation was not included in the original Bill due to time constraints, but will be covered by an amendment as it works its way through Parliament.

GOV.UK (2023)

4.6 What should an adviser know when advising on property law?

A mortgage adviser is not expected to be an expert on matters of land law: it is a complex and specialised area, and one in which the solicitor will advise the borrower.

It is useful, however, for the adviser to be able to:

- understand factors applicable to tenure that affect the saleability of the property, especially those of which the owner might not be aware;
- outline the rights and obligations of the lender under the mortgage deed;
- (in England and Wales) distinguish between freehold, leasehold and commonhold, particularly to answer basic questions by the borrower;
- (in Scotland) understand the basis of land ownership and its implications for borrowers;
- understand the problems associated with lending on leasehold properties and freehold flats;
- understand the principles of leasehold reform and other recent legislation.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the key provisions of the 1925 property acts?
- explain the basics of a mortgage by way of legal charge?
- explain the difference between joint tenancy and tenancy in common?
- outline the types of restriction that might be placed on the rights of a freeholder?
- describe the main aspects of commonhold?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

GOV.UK (2017) *Fixing our broken housing market* [online]. Available at: www.gov.uk/government/publications/fixing-our-broken-housing-market

GOV.UK (2023) *Guide to the Leasehold and Freehold Reform Bill* [online]. Available at: www.gov.uk/guidance/guide-to-the-leasehold-and-freehold-reform-bill

Test your knowledge

?

Use these questions to assess your learning for Topic 4. Review the text if necessary.

Answers can be found at the end of this book.

1) The borrower is known as the 'mortgagor'. True or false?
2) Which of the following is the technical definition of 'freehold' land tenure?
   a) Estate in fee simple absolute in possession.
   b) Estate in fee simple for a term of years absolute.
   c) Estate in possession for fee simple absolute.
   d) Absolute term in possession for fee simple.
3) A legal charge is known in Scotland as a mortgage by demise. True or false?
4) A 'second mortgage' is a further loan from the original lender. True or false?
5) Where more than one charge is held over registered land, the order of priority for repayment in the event of default is determined by:
   a) which lender is owed the most money.
   b) the magistrates' court.
   c) the date order in which the charges were registered.
   d) the Financial Ombudsman Service.
6) Gary had a property subject to a legal charge with the Pleasant Building Society, registered 15 years ago on 1 May, securing a loan of £140,000, and a legal charge with the Consolidated Loans company, registered 10 years ago on 11 July, securing a loan of £30,000. Gary defaulted on his loans and the house was taken into possession and sold for £160,000 on 10 May this year. Who would get what from the proceeds of the sale?
   a) Consolidated Loans would receive £30,000 and Pleasant Building Society would receive £130,000.
   b) Pleasant Building Society would receive £140,000 and Consolidated Loans would receive £20,000.

c) Pleasant Building Society would receive £140,000, Gary would receive £20,000 and Consolidated Loans would receive nothing.

d) Pleasant Building Society and Consolidated Loans would require the court to decide how the proceeds should be divided between them.

7) 'Tenancy in common' means that when one joint owner dies their beneficiaries automatically become joint legal owners of the property. True or false?

8) Keith and Linda have just married. They have both been married before and each has two adult children. Each has a house of their own, but they have now decided to sell them and buy a home together. Which ownership arrangement would enable them each to leave their share of the property value to their children on their death?

   a) Joint tenancy.

   b) Joint and several tenancy.

   c) Tenancy in common.

   d) Ownership in one name with the partner as a beneficial owner.

9) Why might it be inadvisable for a leaseholder with 20 years remaining on their lease to put their flat on the market?

10) Iliana owns one of two flats in a converted house on a leasehold basis. She and her fellow leaseholder cannot buy the freehold of the property because it is too small to qualify under the commonhold legislation. True or false?