Law Commission
Reforming the law

# Reinvigorating commonhold: the alternative to leasehold ownership

HC586

Law Com No 394

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# The Law Commission

The Law Commission was set up by the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

The Law Commissioners are:

The Right Honourable Lord Justice Green, Chairman

Professor Sarah Green

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The text of this Report is available on the Law Commission's website at http://www.lawcom.gov.uk.

All website footnotes in this Report were last visited on 10 July 2020.

# Table of contents

# Glossary and abbreviations

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| **2002 Act** | Commonhold and Leasehold Reform Act 2002 |
| **Commonhold Regulations** | Commonhold Regulations 2004 |
| **Commonhold Amendment Regulations** | Commonhold (Amendment) Regulations 2009 |
| **Commonhold (Land Registration) Rules** | Commonhold (Land Registration) Rules 2004 |
| **Articles of association** | The rules which govern how the **commonhold association** operates, for example, how directors of the association are appointed. |
| **Call for Evidence** | In this document, the Law Commission invited consultees' views on problems with the current law of **commonhold** which may have been preventing commonhold's uptake. Reponses received formed the basis of the **Commonhold Consultation Paper**. |
| **Charge** | A type of security interest. When a lender loans an amount of money, it will often seek a security interest over the borrower's property, such as a charge or a mortgage. While charges and mortgages are technically different, in relation to land, most mortgages take the form of a charge. When the borrower sells the property, lenders with the benefit of a charge will be repaid first out of the proceeds of sale, in priority to other lenders who do not have a charge. Property can be subject to multiple charges granted to different lenders. |
| **Charging order** | A charge imposed by the court on property. The court can impose a charging order if the owner of the property has been ordered in legal proceedings to pay a sum of money to another and has failed to do so. The person to whom the money should have been paid is said to have "the benefit of the charging order". He or she may ask the court to order the sale of the property, in order to recover the money that is due to him or her. |
| **Collective enfranchisement/collective freehold acquisition** | The statutory right of certain residential leaseholders, acting with the other leaseholders in their building (or buildings), to purchase the freehold of their building (or buildings).This right is currently referred to as "collective enfranchisement". In the **Enfranchisement Report**, we refer to this right as the right of "collective freehold |

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| | acquisition" ("CFA") and we adopt this new terminology in this Report. |
| **Common parts** | Any areas of the **commonhold** which do not form part of a **unit**. Common parts will generally include communal areas shared between unit owners (such as gardens and grounds, entrance halls, landings and staircases) and structural parts of the building, such as the external walls and the roof. Additionally, the common parts will include any pipes, cables and other installations, except for those situated within a unit and which serve only that unit. |
| **Commonhold** | A form of **freehold** property ownership created by the **2002 Act**. It enables individual properties within a building or larger development to be owned on a freehold basis. It provides a structure to manage the relationship between these separate freehold properties (such as flats within a block of flats or houses on an estate) and to manage any common parts shared between them (the **common parts**). |
| **Commonhold association** | A private **company limited by guarantee** which owns the **common parts** and manages the **commonhold**. |
| **Commonhold Consultation Paper** | The Law Commission's Consultation Paper on proposed reforms to the law of commonhold ("CP" in footnotes). Our recommended reforms in light of consultees' views are outlined in this Report. |
| **Commonhold community statement ("CCS")** | The CCS is a document which sets out the rights and obligations of **unit owners** and the **commonhold association**. The CCS is also the document which defines the physical boundaries of the **commonhold units** (and therefore the **common parts**). |
| **Commonhold contributions** | The **contribution to shared costs** and the **contribution to the reserve fund** are referred to collectively as the commonhold contributions. |
| **Commonhold unit** | A separate, individually owned property (such as a flat) or area of land within a larger development. For instance, a unit may be a flat within a block of flats, or an office within an office block. A unit could also be an individual house on an estate with shared gardens, or an individual shop within a retail park. An area of land not connected to a building could also be a unit, such as a car parking space. |
| **Company limited by guarantee** | A type of private company, made up of members (in the case of a **commonhold association**, the members are the **unit owners**) and registered at Companies House. Its members do not hold shares in the company, but rather are liable to contribute towards the company's debts up to |

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| | a certain limit. In the case of commonhold associations, this limit is £1. Unit owners are liable for this sum only in the event that the company becomes insolvent. |
| **Contribution to the reserve fund** | Sums that **unit owners** are required to pay into the commonhold's **reserve fund**. The contribution is referred to in the **2002 Act** as the "reserve fund levy", but for clarity we have adopted the terms "contribution to the reserve fund" or "reserve fund contribution". This contribution is separate from the **contribution to shared costs**. |
| **Contribution to shared costs** | Sums that **unit owners** are required to pay towards the day-to-day running costs of the commonhold, for instance paying for services provided and any ad hoc repairs required throughout the year. This contribution is referred to in the **2002 Act** as the "commonhold assessment", but for clarity we have adopted the terms "contribution to shared costs" or "shared cost contribution". This contribution is separate from the **contribution to the reserve fund**. |
| **Conversion** | The process by which **leaseholders** adopt the commonhold structure to replace their existing **leasehold** structure. |
| **Conveyancer** | A lawyer (including a solicitor or licensed conveyancer) acting on the sale, purchase or mortgage of a **freehold** or **leasehold** property. |
| **Creditor** | A person or institution to whom a debt is due. A creditor who has obtained a court or **Tribunal** order that the sums are due is referred to as a "judgment creditor". |
| **Enfranchisement** | Enfranchisement is the process by which certain residential leaseholders who own a long lease can extend their lease or buy the freehold or their building (either individually or collectively with the other leaseholders in the building. See **collective freehold acquisition**). |
| **Enfranchisement Report** | The Law Commission's report on recommended reforms to the law of enfranchisement, published alongside this Report: Leasehold home ownership: buying your freehold or extending your lease (2020) Law Com No 392. |
| **Equity (in a unit)** | A **unit owner's** "equity" in his or her **unit** is the "net value" of the unit to him or to her. The net value is the market value of the unit minus the value of any **charges** secured on the property, including those secured by **charging orders**. |

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| **Flying freehold** | A **freehold** property which in part or in whole does not touch the ground, and consequently is situated above another **freehold**, or **leasehold**. For instance, a first-floor flat is situated above the ground-floor flat, and so would be a flying freehold if sold on a freehold rather than leasehold basis. A **flying freehold** may be distinguished from a **commonhold** unit by the absence of a **commonhold association** to manage the building. |
| **Freehold management company ("FMC")** | An FMC is a **residents' management company** which also owns the **freehold** of a block of flats (or other development). The FMC will therefore be the **landlord** of the **leaseholders** in that block or development. |
| **Freehold** | A form of property ownership that lasts forever, and which generally gives fairly extensive control of the property. |
| **Freeholder** | The owner of the freehold interest in the property. The freeholder has a superior interest to any person with a leasehold interest in the same property. |
| **Ground rent** | A sum payable at regular intervals under the terms of a **lease** (usually every year) over and above the initial purchase price. |
| **Heads of cost** | We refer to the **commonhold contributions** having heads of cost when the expenditure has to be allocated in such a way that certain items have to be borne by some, but not all, of the **units**. For instance, flats which do not have the benefit of a parking space would not contribute to the cost of marking out or resurfacing the parking area. This principle can be applied even when a commonhold is not divided into **sections**. The Royal Institution of Chartered surveyors in its Guides relating to leasehold service charges refers to this as a service charge being calculated by reference to "schedules of expenditure". |
| **Home purchase plan** | A financial arrangement offered by a bank or other financial institution whereby an individual is permitted to purchase their home in a manner which conforms with religious norms governing the prohibition of interest payments. |
| **Injunction** | An order of a court which requires a person or body to either perform or refrain from performing an act or series of acts. |
| **Indemnity** | A promise given by one person to another to compensate that person for losses incurred as a result of a particular transaction. |

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| **Insolvent** | A company, including a **commonhold association**, is said to be insolvent if it has insufficient assets (such as money or other property) with which to meet its debts and financial liabilities. |
| **Landlord** | A person (either an individual or a company) who holds an interest in property out of which a lease has been granted. A landlord may be the **freeholder** of the property, in which case the leasehold interest will be granted directly out of the freehold interest. Alternatively, a landlord may be a **leaseholder**, in which case the landlord will grant a sub-lease out of his or her leasehold interest. |
| **Leasehold** | A form of property ownership which is time-limited (for example, ownership of a 99-year lease), where control of the property is shared with, and limited by, the **landlord**. |
| **Leaseholder** | A person who holds a **leasehold** interest in a property, granted by a **landlord**. |
| **Leaseholder-controlled company** | A collective term which includes **residents' management companies**, **freehold management companies** and **right to manage companies**. |
| **Limited use area** | An area within the **common parts** which has been designated for the exclusive use of one or more **unit owners**. Limited use areas will be specified in the **CCS**.[1] |
| **Local rule** | A provision in the **CCS** which is specific to that particular **commonhold**, rather than one which is required by law to apply to all commonholds. |
| **Long lease** | A lease that is granted for a term of more than 21 years. |
| **Mortgage** | A loan advanced by a financial institution that is registered as a **charge** against land or other property |
| **Negative equity** | A **unit owner** (or a **unit**) will be in negative equity when the total value of the **charges** which are secured on the property exceed its market value. See also **equity**, above. |
| **Non-consenting leaseholder** | A leaseholder who, despite being eligible to participate in the conversion process, does not actively agree to the conversion. |

[1] The meaning of the term 'limited use area' is wider under the current law. A limited use area also describes an area within the common parts that may only be used in a specified way. See Commonhold Regulations 2004, sch 3, para 1.4.5.

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| **Ordinary resolution** | A collective decision of the **commonhold association's** members, where:<br>• if the decision is made in a meeting, over 50% of the votes cast by those present and voting are in favour of the decision; or<br>• if the decision is made by the **written procedure**, over 50% of all the votes in the commonhold are cast in favour.<br>Compare with a **special resolution** and **unanimous resolution**. |
| **Participating leaseholder** | A leaseholder who is eligible to participate in the conversion process and who actively agrees to the conversion. |
| **Premium** | A lump sum payable to the **freeholder** in addition to any sums due under the lease. A premium will be payable to purchase the leasehold interest, to obtain a lease extension and to acquire the **freehold** of the property. |
| **Positive covenant** | An obligation that requires a property owner to do something, such as carry out repairs or spend money for the benefit of another property. |
| **Reserve fund** | A pool of money which is set aside to cover the costs of future, one-off or major works needed in the **commonhold**, such as replacement of the lift or roof. |
| **Residents' management company ("RMC")** | An RMC is a company which is owned and controlled by the **leaseholders** in a block of flats or other development. The RMC is responsible for the repair and maintenance of the structure and **common parts** of the development (as defined in the particular **lease**). |
| **Resolution** | A collective decision of the **commonhold association's** members. |
| **Right to Manage** | The statutory right for leaseholders of flats, acting with the other leaseholders in their building, to take over their landlord's management functions, without also buying the **freehold** of the building. |
| **Right to manage company ("RTMCo")** | A RTMCo is a specific type of **residents' management company**, set up by the **leaseholders** exercising their statutory right to manage in the **2002 Act**. |
| **RTM Report** | The Law Commission's report on recommended reforms to the right to manage, published alongside this Report: Leasehold home ownership: exercising the right to manage (2020) Law Com No 393. |

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| **Section** | A **section** is a mechanism allowing the management of different types of property interests within the commonhold to be separated out (for example, commercial and residential interests). Sections offer a way of ensuring that only those who will be affected by a particular decision are entitled to participate in the making of that decision, and that only those who benefit from a particular service or facility will be responsible for paying towards the associated costs. |
| **Service charge** | A charge payable by the **leaseholders** under the terms of the **lease** to cover the cost of services provided by the **landlord** or a management company. Typically, these include matters such as the repair and maintenance of the common parts, the insurance of the buildings and the upkeep of any garden and parking areas. |
| **Shared ownership leaseholder/Shared owner** | A **leaseholder** who holds a property under a **shared ownership lease**. |
| **Shared ownership lease** | An arrangement under which a **leaseholder** invests in a "share" of a house or flat (usually between 25% and 75%) and pays rent to the **landlord** on the remaining share. The **lease** permits the leaseholder to acquire additional shares in the property over time (a process known as 'staircasing'), usually up to 100%, thereby allowing the leaseholder to own the property. An allowance is made to the rent payable on the "unpurchased share" as the stake in the "purchased share" increases. |
| **Special resolution** | A collective decision of the **commonhold association's** members, where:<br>• if the decision is made in a meeting, at least 75% of the votes cast by those present and voting are in favour of the decision; or<br>• if the decision is made by the **written procedure**, at least 75% of all the votes in the commonhold are cast in favour.<br>Compare with an **ordinary resolution** and **unanimous resolution.** |
| **Staircasing** | See **shared ownership lease** |
| **Tenant** | Although the terms **tenant** and **leaseholder** are often used interchangeably, we use the term **tenant** in this Report to refer to individuals who have been granted tenancy agreements of 21 years or less. |
| **Transitional period** | If land is registered as **commonhold** land at a time when the identities of the individual **unit owners** are not yet |

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|---|---|
| | known (for instance, when a new commonhold development is being built and the prospective purchasers are not yet known), a transitional period begins. During this period, the **CCS** is not in force, and the **commonhold association** does not own the **common parts**. The **freeholder** of the commonhold land (usually the developer) will remain the owner of all the units and the common parts. Once one or more (but not all) of the **units** have been sold to another person, the transitional period comes to an end. |
| **Tribunal** | The First-tier Tribunal (Property Chamber) in England and the Leasehold Valuation Tribunal in Wales. Each has jurisdiction over a number of aspects of residential leasehold law, and housing law more generally. |
| **Unanimous resolution** | A **collective decision** of the **commonhold association's** members, where:<br>• if the decision is made in a meeting, 100% of the votes cast by those present and voting are in favour of the decision; or<br>• if the decision is made by the **written procedure**, 100% of all the votes in the commonhold are cast in favour.<br>See also **ordinary resolution** and **special resolution**. |
| **Unit** | See **commonhold unit** above. |
| **Unit owner** | The **freehold** owner of a particular commonhold **unit**. Unit owners are referred to in the **2002 Act** as "unit holders", but for clarity we adopt the term "unit owner". |
| **Written procedure** | The written procedure can be used to pass a **resolution** of the **commonhold association** without requiring a meeting of the members. The procedure requires the members to sign a document containing the wording of the **resolution**. |

# Reinvigorating commonhold: the alternative to leasehold ownership

*To the Right Honourable Robert Buckland QC MP, Lord Chancellor and Secretary of State for Justice*

## Chapter 1: The future of home ownership

### INTRODUCTION

1.1 Our homes are hugely important. It is no surprise, therefore, that housing policy is high up the political agenda. Problems that we experience with our homes can become particularly pronounced. Many leaseholders of flats would point to issues with cladding that were brought into focus following the Grenfell Tower fire tragedy as an illustration of this impact. A recent report from the UK Cladding Action Group found that 9 out of 10 leaseholders surveyed said their mental health had deteriorated as a direct result of the situation in their building.[1] For all of us, the COVID-19 pandemic, and consequential requirement to "stay at home", has emphasised how much we depend on our homes.

1.2 Broadly speaking, we occupy our homes either as owners or as renters.

(1) Owners: Many people own, or aspire to own, a home.[2] The focus of our projects, and of Government's work on leasehold and commonhold reform, is on owners.

(2) Renters: There have been significant reforms to the way in which homes are rented in Wales,[3] and Government intends to provide tenants with greater security in their homes in England.[4] Renters are not the focus of this Report.

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1 UK Cladding Action Group, *Cladding and internal fire safety: mental health report 2020* (May 2020), p 6, at https://drive.google.com/file/d/1ezKSaJqO3bVyG9-eH58SoiT2bH4D8PjW/view.

2 In the 2010 British Social Attitudes survey, 86% of respondents expressed a preference for buying a home and 14% preferred to rent: Department for Communities and Local Government, *Public attitudes to housing in England: Report based on the results from the British Social Attitudes survey* (July 2011), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/6362/1936769.pdf.

3 Renting Homes (Wales) Act 2016. The 2016 Act was enacted following recommendations made by the Law Commission in its reports, Renting Homes (2003) Law Com No 284 and Renting Homes in Wales (2013) Law Com No 337.

4 See proposal for a Renters Reform Bill, which would remove the current right of landlords in the private rented sector to evict their tenants by giving two months' notice to leave: *The Queen's Speech, December 2019*, pp 46-47, at

1.3 Reforms concerning home ownership have been discussed for some time, and the future of home ownership is set to change.

1.4 In this Report, we recommend reform of the law of commonhold. Alongside this Report, we are publishing reports with our recommended reforms to the right to manage ("RTM") and to leasehold enfranchisement. We have already published our report setting out the options for reducing the price that leaseholders must pay to make an enfranchisement claim.[5]

> Enfranchisement is the right for people who own property on a long lease ("leaseholders") to buy their freehold or extend their lease.
>
> The right to manage ("RTM") is a right for leaseholders to take over the management of their building without buying the freehold.
>
> Commonhold allows for the freehold ownership of flats, offering an alternative way of owning property which avoids the shortcomings of leasehold ownership.

1.5 Before we explain our recommendations for reform, it is important to consider the overall purpose of reform, to explain how our three reports fit together, and to explain their relationship with Government's work on leasehold and commonhold reform.

1.6 In this chapter, we start by looking to the future and explaining what the future of home ownership could look like after reform. We then discuss the route to get there.

(1) In Part A, we summarise how home ownership currently works and its problems.

(2) In Part B, we discuss our recommended reforms and Government's reforms.

(3) In Part C, we explain how all the proposed reforms fit together.

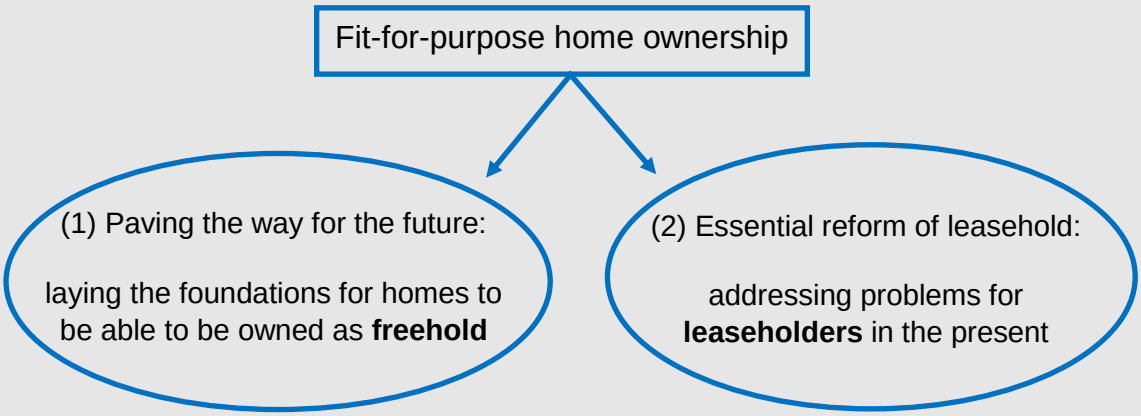
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/853886/Queen_s_Speech_December_2019_-_background_briefing_notes.pdf. See also temporary measures whereby landlords will have to give all renters 3 months' notice if they intend to seek possession of a property in the Coronavirus Act 2020, s 81 and sch 29.

[5] Leasehold home ownership: buying your freehold or extending your lease – Report on options to reduce the price payable (2020) Law Com No 387 ("the Valuation Report").

## HOME OWNERSHIP AFTER REFORM: A SUMMARY

1.7 The reforms proposed by the Law Commission and by Government are intended to create fit-for-purpose home ownership. They are about making our homes ours, rather than someone else's asset.

1.8 The reforms fall into two categories.




### (1) Owners of future homes

1.9 For owners of future homes:

(1) houses will always be sold on a freehold basis – because Government intends to ban the sale of houses on a leasehold basis.[6]

(2) flats will:

(a) be sold *solely* on a freehold (that is, "commonhold") basis – if Government requires commonhold to be used and bans leasehold; or

(b) sometimes be sold on a commonhold basis and sometimes on a leasehold basis – if Government actively incentivises commonhold, but does not go as far as to ban leasehold; or

(c) continue (as is presently the case) to be sold on a leasehold basis – if Government takes no action to require or incentivise the use of commonhold and/or does not ban leasehold.

(3) commonhold will be a viable alternative to leasehold – because our recommendations will make commonhold workable.

(4) insofar as any homes are sold on a leasehold basis, they will not contain any ground rent obligations – because Government intends to restrict ground rents to zero.[7]

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6 Subject to exceptions.

7 Subject to exceptions.

1.10 As a consequence, for owners of future homes:

(1) the right for leaseholders to buy the freehold of their house will be largely redundant – because houses in the future will already have been sold freehold;

(2) if flats are *only* sold on a commonhold basis, the right for leaseholders (i) to extend their lease, (ii) to buy their freehold, or (iii) to take over the management of their block of flats (the RTM), will be redundant – because the flats will already have been sold freehold;

(3) if flats continue to be sold on a leasehold basis:

(a) it will be significantly cheaper for leaseholders to extend the lease of their flat – because (i) restricting ground rents to zero, and (ii) our options for reducing enfranchisement prices, will limit the amount that leaseholders have to pay;

(b) it will be significantly cheaper for leaseholders (with their neighbours) to buy the freehold of their block – because (i) restricting ground rents to zero, and (ii) our options for reducing enfranchisement prices, will limit the amount that leaseholders have to pay.

(i) Those leaseholders would then be able to convert to commonhold, if they wanted to do so.

(ii) Those leaseholders are less likely to want or need to exercise the RTM (which involves taking over the management of a block but not buying the freehold) – because the cost of purchasing the freehold will be significantly cheaper than it is now.

### (2) Leasehold owners of existing homes[8]

1.11 While there can be an ambition for freehold to be the basis of home ownership in the future, it is crucial to recognise that leasehold will continue to exist for some time. Many people already own a leasehold home. And some homes may be granted on a leasehold basis in the future – namely (i) any flats granted on a leasehold basis (if commonhold is not required, or sufficiently promoted), and (ii) any houses which are exempt from the leasehold house ban. For those leaseholders:

(1) it is necessary for various problems with leasehold ownership to be resolved; and

(2) they will need to have the improved rights that we recommend:

(a) to extend their lease or to purchase their freehold, and – in the case of flats – to convert to commonhold; and

(b) to take over the management of their block.

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8 Including leasehold owners of future homes, to the extent that leases are still granted of future homes.

1.12 The recommendations that we make in our reports on enfranchisement and the right to manage will considerably improve the position of existing leaseholders, and any future leaseholders, in a number of respects. In particular:

(1) a lease extension will result in a lease being extended by 990 years at a peppercorn rent, so that the need to extend a lease only arises once and no ground rent is payable;

(2) more leaseholders will be able collectively to purchase the freehold of their block or take over the management of the block: leaseholders cannot currently do so if more than 25% of the block is commercial property, and we recommend raising the threshold to 50%;

(3) it will be possible to purchase the freehold or take over the management of multiple buildings (for example, in an estate);

(4) the process for making an enfranchisement or RTM claim will be easier, quicker, and cheaper, with procedural traps removed;

(5) leaseholders making an enfranchisement or RTM claim will no longer have to pay their landlord's costs (in the case of enfranchisement, if Government sets premiums at market value); and

(6) leaseholders making an enfranchisement claim will be better able to convert from leasehold to commonhold, if they wish to do so.

1.13 In addition, the options for reducing enfranchisement prices in our earlier report would reduce the amount that leaseholders have to pay to extend their lease or purchase their freehold.

| Home ownership after reform | Existing homes | Future homes |
|---|---|---|
| Houses | Improved rights for leaseholders<br><br>Existing leaseholders can buy the freehold – and it will be cheaper to do so | New houses are freehold |
| Flats | Improved rights for leaseholders<br><br>Existing leaseholders can buy the freehold and convert to commonhold – and it will be cheaper to do so | Government to decide whether commonhold is compulsory, incentivised, or optional<br><br>Even if leasehold continues, the right to buy the freehold (including converting to commonhold) will be significantly cheaper |

## PART A: HOW HOME OWNERSHIP CURRENTLY WORKS AND ITS PROBLEMS

### Freehold and leasehold ownership

1.14 What does "ownership" mean? When an estate agent markets a house or flat as being "for sale", what is the asset on offer? In England and Wales, property is almost always owned on either a freehold or a leasehold basis.

(1) Freehold is ownership that lasts forever, and generally gives fairly extensive control of the property.

(2) Leasehold provides time-limited ownership (for example, a 99-year lease), and control of the property is shared with, and limited by, the freehold owner (that is, the landlord).

1.15 So we refer to "buying" or "owning" a house or a flat. But when we buy on a leasehold basis, we are in fact buying a lease of a house or flat for a certain number of years (after which the assumption is that the property reverts to the landlord). A leasehold interest is therefore often referred to as a wasting asset: while it may increase in value in line with property prices, its value also tends to fall over time as its length (the "unexpired term") reduces. There comes a point when the remaining length of the lease makes it difficult to sell, because purchasers cannot obtain a mortgage since lenders will not provide a mortgage for the purchase of a short lease.[9]

1.16 In addition, leasehold owners often do not have the same control over their home as a freehold owner. For example, they may not be able to make alterations to their home, or choose which type of flooring to have, without obtaining the permission of their landlord. The balance of power between leasehold owners and their landlord is governed by the terms of the lease and by legislation. Recently, concerns have been raised that the lack of control historically associated with leasehold ownership has – in some cases – become a feature of freehold ownership. We return to that issue below.

1.17 As well as a division of control, landlords may have different interests from leaseholders. For instance, the landlord may see a leasehold property solely as an investment opportunity or a way of generating income, while for leaseholders the property may be their home as well as a capital investment.

| Different types of ownership | Freehold | Leasehold |
|---|---|---|
| **Duration of ownership** | Lasts forever | Time-limited |
| **Control** | Generally extensive | Shared with landlord |

[9] If a lease is unmortgageable, and if the leaseholder cannot afford to extend the lease, the leaseholder might be able to sell the lease to a cash-buyer who can afford to pay the landlord to extend the lease. The purchase price would be reduced by (at least) the cost of a lease extension.

1.18 In summary, therefore, leasehold does not provide outright ownership. The experience of leasehold owners has been described as being that of "owners yet tenants".[10] On the one hand, they are homeowners, with some of the benefits that ownership brings, such as a financial stake in the home. On the other hand, they have a landlord who maintains some control over their use of their home, who has a financial interest in their home, and who will ultimately take back the home on the expiry of the lease.

> The inherent features of leasehold "provided the impetus for the development of commonhold, and remain at the heart of many criticisms of leasehold. They do not simply suggest the need for tighter regulation of developers and landlords in the interests of their leaseholders. Instead, they call into question the ability of the landlord-tenant relationship to deliver home-ownership, and provide an imperative for a radical increase in the control held by individuals over their homes. This change, which is reflected in the Law Commission's three residential leasehold and commonhold projects, arguably marks a renewed focus on the home as a vital element in people's financial and personal autonomy".[11]

### Leasehold as a valuable asset for landlords

1.19 As we go on to explain below, these inherent features of leasehold ownership are the root cause of many criticisms that have been levelled at it as a mechanism to deliver home ownership. Conversely, these features of leasehold ownership are the very reason that it is an attractive investment opportunity, and a valuable asset, for landlords.

(1) Since a lease is a *time-limited interest*, there will come a point when the leaseholder needs to extend the lease or buy the freehold in order to retain the property. The leaseholder has to pay the landlord in order to do so. In addition, throughout the term of the lease, the leaseholder will usually have to pay ground rent to the landlord, which provides a source of income for landlords.

(2) The landlord's *control* over the property provides a further source of income. For example:

(a) landlords can charge leaseholders a fee for certain actions, such as giving consent to alterations to a flat, or for registering a change of ownership when a leaseholder sells his or her flat; and

(b) landlords can receive income indirectly through the service charge that leaseholders are required to pay for the costs of maintaining their block or estate. For example, the premium for insuring a block will be paid by the leaseholders, but when arranging the insurance policy the landlord might receive a commission from the insurance company. Similarly, the landlord might arrange for the services at a block (such as for

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10 I Cole and D Robinson, "Owners yet tenants: the position of leaseholders in flats in England and Wales" (2000) 15 *Housing Studies* 595.

11 N Hopkins and J Mellor, ""A Change is Gonna Come": Reforming Residential Leasehold and Commonhold" (2019) 83(4) *Conveyancer and Property Lawyer* 321, 331-322 ("*A Change is Gonna Come (2019)*").

management, for cleaning, or for repair work) to be undertaken by an associated company.

## Why are homes owned on a leasehold basis?

### Flats

1.20 Flats are almost universally owned on a leasehold, as opposed to freehold, basis. There is a good legal reason for that: certain obligations to pay money or perform an action in relation to a property (such as to repair a wall or a roof) cannot legally be passed to future owners of freehold property. These obligations are especially important for the effective management of blocks of flats. For instance, it is necessary that all flat owners can be required to pay towards the costs of maintaining the block, which is important since flats are structurally interdependent. There are therefore good reasons, under the current law, why flats are sold on a leasehold basis.

### Houses

1.21 But leasehold ownership is not limited to flats. Sometimes houses are sold on a leasehold basis. That has been the case for some years.[12] More recently there has been an increase in new-build houses being sold on a leasehold basis. That allows developers to sell the property subject to an ongoing obligation to pay a ground rent.

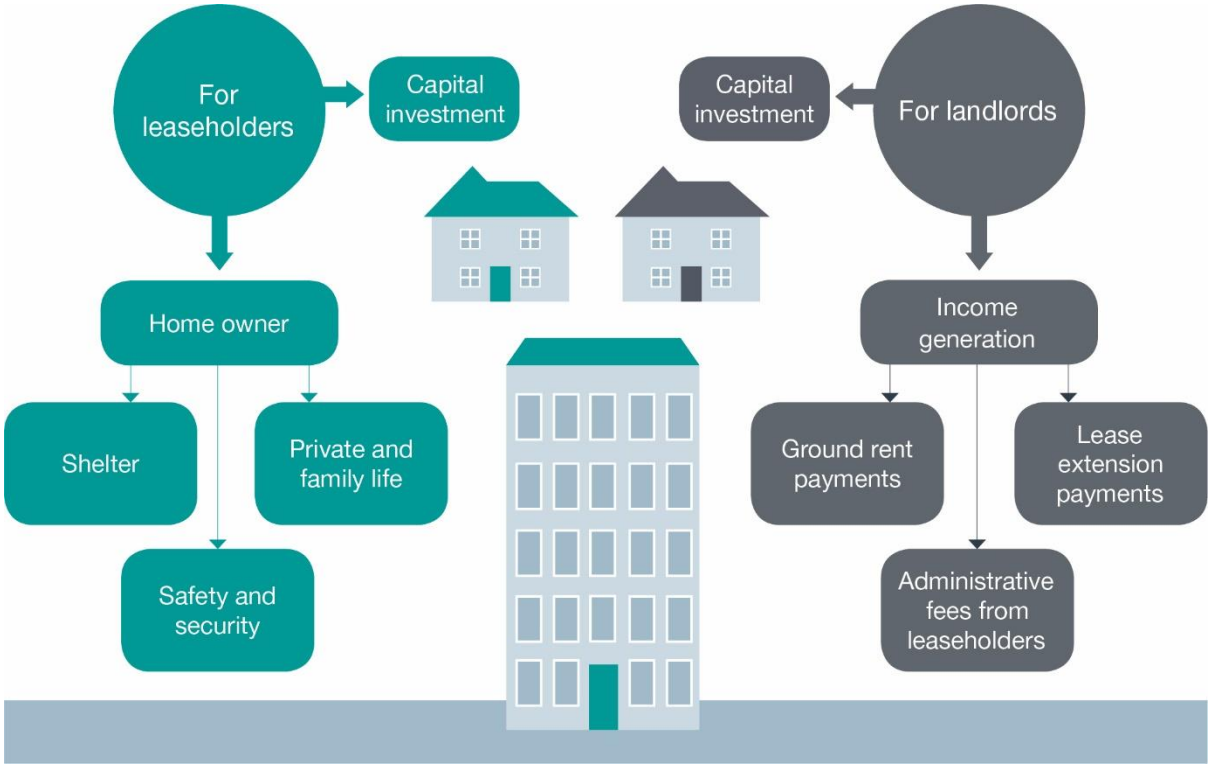
1.22 The legal reasons for selling houses on a leasehold basis are less apparent than those for leasehold flats. One reason might be the need to impose positive obligations on house owners in relation to the upkeep (management) of an estate, but that does not apply in all cases.

### A source of income

1.23 We have explained that there can be good legal reasons why homes are sold on a leasehold basis. The reasons why, for legal purposes, houses and flats may be sold on a long lease do not, however, require the lease to provide income streams to the landlord (see paragraph 1.19 above), beyond those needed to maintain the property, the block, or the estate.

[12] Historically, the sale of houses on a leasehold basis became widespread practice in particular areas of the country.

**Figure 1: The purpose of a leasehold home**




### Leasehold and feudalism

1.24 Leasehold is often referred to as "feudal". In fact, leasehold developed outside of the main feudal tenures and later in time. Leases began as contracts, not interests in land. But while "feudal" is a misdescription of the landlord-tenant relationship, it is not necessarily a mischaracterisation. The language of "feudalism" reflects the power imbalance experienced by leaseholders, and concerns that the tenure has too readily facilitated the extraction of excessive monetary payments from those leaseholders.[13]

## What is wrong with leasehold home ownership?

1.25 Residential leasehold has, for some time, been hitting the headlines and is the subject of an increasingly prominent policy debate. There is a growing political consensus that leasehold tenure is not a satisfactory way of owning residential property.

> "too often leaseholders, particularly in new-build properties, have been treated by developers, freeholders and managing agents, not as homeowners or customers, but as a source of steady profit. The balance of power in existing leases, legislation and public policy is too heavily weighted against leaseholders, and this must change".[14] Housing, Communities and Local Government Select Committee

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13 *A Change is Gonna Come (2019).*

14 Housing, Communities and Local Government Committee, Leasehold Reform (2017-19) HC 1468, para 25, at https://publications.parliament.uk/pa/cm201719/cmselect/cmcomloc/1468/1468.pdf.

### Criticisms based on leasehold ownership being inherently unfair

1.26 Many people have a fundamental objection to leasehold being used as a mechanism for delivering home ownership. They argue that the fact that external investors have a financial stake in a person's home – which arises from the time-limited nature of the leaseholder's interest and the control enjoyed by the landlord – creates an inappropriate, unbalanced and inherently unfair starting point for home ownership. Leasehold, it is argued, is fundamentally flawed as a mechanism to deliver the type of home ownership that people want and expect. The solution is said to be for home ownership – of both houses and flats – to be delivered through freehold (including commonhold) ownership.

1.27 Arguments about inherent unfairness are compounded by the inequality of arms that exists, broadly speaking, between leaseholders and landlords in the current leasehold regime. It is a systemic inequality between leaseholders (as a whole) and landlords (as a whole), as opposed to an individual inequality as between particular people within those groups. We discussed the inequality of arms, the opposing views on whether leasehold ownership is inherently unfair, and competing arguments about reform in our earlier report on valuation in enfranchisement.[15]

### Criticisms of ways in which the leasehold market operates

1.28 While there is a strong voice that leasehold is inherently unfair and should be replaced with freehold (including commonhold), there are also criticisms of specific aspects of how the leasehold market operates.[16] To those who have a fundamental objection to leasehold, they are all symptoms of what they consider to be an inherently unfair system. But these criticisms are not made solely by those who have a fundamental objection to leasehold; many who do not object to the use of leasehold nevertheless have concerns about aspects of the way that it operates. For example, concerns have been raised about:

(1) legal, practical and financial obstacles for leaseholders seeking to exercise their statutory rights, including:

(a) their right to extend their lease or buy their freehold (that is, their enfranchisement rights);

(b) their right to take over management of their block (that is, the RTM);

(c) their right to challenge the reasonableness of service charges that have been levied by landlords;

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15 Valuation Report, para 1.71 and 3.45 onwards (on the inequality of arms), para 3.4 onwards (on inherent unfairness), and Ch 3 generally on competing views about reform.

16 We summarise the wider policy debate in Ch 1 of our Enfranchisement, Commonhold and Right to Manage Consultation Papers, where we refer to media coverage, the activities of campaign groups, Government announcements, the work of the All-Party Parliamentary Group on Leasehold and Commonhold, and various Parliamentary debates about leasehold.

(d) the "right of first refusal", which is intended to allow leaseholders whose landlord proposes to sell the freehold of their block of flats to step in to the purchaser's shoes and themselves purchase the freehold instead;

(e) the right to apply to the Tribunal[17] for a manager to be appointed to manage the block instead of the landlord;

(f) the right to form a recognised tenants' association, and acquire the contact details of the leaseholders in a block in order to do so;

(2) high and escalating onerous ground rents, with a particular concern about the imposition of ground rents which double at periodic intervals (generally ten years) during the term of a lease; such obligations can make properties unmortgageable and unsaleable, trapping the owners in their homes;

(3) houses being sold on a leasehold, as opposed to freehold, basis, for no apparent reason other than for developers to extract a profit from owning the freehold;

(4) the absence of any compulsory regulation of managing agents, either in terms of their qualifications or the quality of their work;

(5) excessive service charges levied by landlords;

(6) the ability of landlords to require leaseholders to pay all or some of the landlord's legal costs when there has been a dispute between the parties, including in cases where the leaseholder has "won" a legal challenge against their landlord;

(7) the legal entitlement of landlords to "forfeit" (that is, terminate) a lease if the leaseholder breaches a term of the lease;

(8) the charging by landlords of unreasonable permission fees for leaseholders to carry out alterations to their property; and

(9) close relationships between property developers and particular conveyancers which may threaten the latter's independence in advising clients seeking to buy leasehold properties from the referring developers.

1.29 The concerns set out above lie against a background, generally speaking, of leasehold purchasers not understanding what leasehold ownership involves.

> "For most consumers, buying a house or flat will be their largest purchase and investment. Because it is a relatively infrequent purchase consumers are unlikely to accumulate significant knowledge of the process or of the salient characteristics of different forms of property ownership. Further, while the value of the purchase may make the consumer cautious, the sheer magnitude of the purchase price will typically

[17] The First-tier Tribunal (Property Chamber) in England and the Leasehold Valuation Tribunal in Wales.

make other amounts of money involved seem insignificant by comparison". Competition and Markets Authority[18]

1.30 Further, even when purchasers do understand what leasehold ownership involves, there is often no choice over the form of ownership. As we explained above, flats are almost invariably owned on a leasehold basis.

1.31 Some criticisms outlined above can fairly be described as abusive practices by landlords or developers. The Competition and Markets Authority ("CMA") launched an investigation into leasehold home ownership in 2019 and published an interim report in 2020.[19] The CMA expressed concerns about ground rents in leases, about mis-selling of leasehold houses, about service charges and permission fees, and about a failure of "checks and balances" in the leasehold system. The CMA stated that it intended to take enforcement action in relation to the mis-selling of leasehold property, and in relation to leases containing high and escalating ground rents.

1.32 While there have been abusive practices in leasehold, we would emphasise that there are other landlords who operate fairly and transparently. But however fairly the system is operated, inherent limitations of leasehold remain.

1.33 All of the criticisms summarised above derive, at least to some extent, from those inherent limitations – namely that the asset is time-limited, and that control is shared with the landlord. Those limitations are compounded by the fact that the landlord and leaseholder have opposing financial interests – generally speaking, any financial gain for the landlord will be at the expense of the leaseholder, and vice versa. Accordingly, the leasehold system has been reformed over the years in an attempt to create an appropriate balance between those competing interests. Given their opposing interests, it is very unlikely that leaseholders and landlords will agree that the balance that has been struck between their respective interests is fair. Their interests are diametrically opposed, and consensus will be impossible to achieve.

"For landlords, property is fundamentally about money: both the capital value in the freehold and the income that is generated from ground rent payments, commissions, enfranchisement premiums and other fees. That is not to say that the profit generated cannot be used for good ends, and landlords come in many guises. … But the fact remains that the primary value of property to many landlords is financial. And whether a particular landlord has observed better or worse practices does not alter the fact that, systematically, leaseholders still lack autonomy and control over their homes.

For homeowners, the home is also about money, but in a very different sense. It is about having a financial stake in the property in which we live; a stake we are increasingly being asked to draw upon to support us financially into retirement, as well as to support the next generation. But the more a person's home is used as a financial asset to benefit their landlord, the less it is an investment for the individual. The more a leaseholder's money is providing an investment for their landlord, the less their

[18] Competition and Markets Authority, *Leasehold housing: update report* (February 2020) para 33, at https://www.gov.uk/cma-cases/leasehold.

[19] Competition and Markets Authority, *Leasehold housing: update report* (February 2020).

money is providing an investment for their own future, their family and their next generation.

For homeowners, however, the home is about more than money. Britain has famously been described as a nation of homeowners. Fulfilling the dream of home-ownership has long been many people's ambition. Much of this ambition can be attributed to the non-financial, "x-factor" values that home-ownership encompasses, and which have become embedded in an ideology of home ownership. Our home is the focal point of our private and family lives; it is integral to our identity, reflecting who we are and the community we belong to. Bad law and bad practice that affect people's experience in their home therefore have a particular impact on them. The current programme of law reform marks an opportunity to reform the law so that it can better deliver both the financial and non-financial benefits of home ownership".[20]

### Freehold ownership of flats: commonhold

1.34 In many countries, leasehold ownership does not exist. Instead, forms of "strata" or "condominium" title are used so that flats can be owned on a freehold basis.

1.35 In England and Wales, commonhold was introduced as an alternative to leasehold in 2002, to enable the freehold ownership of flats.[21] Commonhold allows the residents of a building to own the freehold of their individual flat (called a "unit") and to manage (or appoint someone to manage) the shared areas through a company. For many blocks, the homeowners would not themselves carry out the day-to-day management but would instead appoint agents to manage the block. Crucially, however, the homeowners (rather than an external landlord) would control the appointment of those agents.

1.36 For homeowners, commonhold offers a number of advantages over leasehold ownership. In particular:

(1) it allows a person to own a flat forever, with a freehold title – unlike a leasehold interest, which will expire at some point in the future;

(2) no ground rent is payable;

(3) it gives the homeowner greater control of their property than leasehold; and

(4) it is designed to regulate the relationship between a group of people whose interests are broadly aligned. That is in stark contrast to the leasehold regime, which has to attempt to balance and regulate the competing interests of landlord and leaseholder.

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20 *A Change is Gonna Come (2019),* 330-331.

21 Commonhold was created by the Commonhold and Leasehold Reform Act 2002. While primarily designed to enable the freehold ownership of flats, commonhold is equally capable of applying in a commercial context. It can, for example, regulate the relationship between individually owned offices within an office block.

1.37 Despite these apparent advantages, however, commonhold has not taken off – fewer than 20 commonholds have been created since the commonhold legislation came into force.[22]

### Why has commonhold failed?

1.38 Various suggestions have been made as to why commonhold has not taken off.

(1) Some have suggested that shortcomings in the law governing commonhold can make it unworkable in practice and have led to a lack of confidence in commonhold as a form of ownership.

(2) Some ascribe commonhold's low uptake to an unwillingness of mortgage lenders to lend on commonhold units.

(3) Some think that there may be a lack of consumer and sector-wide awareness of what is a relatively unfamiliar form of ownership.

(4) Others point out that commonhold remains less attractive to developers than leasehold because of the opportunities that leasehold offers to secure ongoing income-streams on top of the initial purchase price paid by the leaseholders.

(5) Others point out that Government provided no incentives for developers to use commonhold – and no disincentives to them continuing to use leasehold (for example, by removing the financial advantages for developers of selling leasehold flats).

(6) Others suggest that the low uptake is more the result of inertia among professionals and developers. Moreover, we have been told that there is insufficient incentive (financial or otherwise) for developers of homes and commercial property to change their practices and adopt a whole new system while the existing one (from their perspective at least) does the job.

### Stewardship and culture change[23]

1.39 A common thread that runs through all three of our projects is moving management and control from a third-party landlord to homeowners. But it is in relation to commonhold that the management of land has come under the greatest scrutiny, because of the removal of the relationship of landlord and tenant. This shift from leasehold to freehold tenure has raised questions as to the stewardship of land and the utility of the landlord-tenant relationship in the residential context. Stewardship is not always defined, but in this context, we use the term to mean the management of land over time and for the next generation of owners. It has been suggested that landlords are necessary to provide stewardship over residential property. Institutional landlords are said to act as custodians who take a long-term view of the investments needed in a building or estate.[24] Such landlords are also said to have superior

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22 L Xu, "Commonhold Developments in Practice" in W Barr (ed), *Modern Studies in Property Law: Volume 8* (2015) p 332.

23 Taken from *A Change is Gonna Come (2019)*, 328-329.

24 Housing, Communities and Local Government Committee, Leasehold Reform (2017-19) HC 1468, para 81.

expertise in overseeing insurance, maintenance, health and safety, fire risks, planning obligations, building regulations and anti-social behaviour.[25]

1.40 But this argument must address the following challenge: if owners of houses are trusted to be the stewards of their house, why can owners of flats not be similarly trusted? While leaseholders have a shorter-term interest than their landlords, it is the term of the lease granted by the landlord that so constrains them. There is no reason to assume that leaseholders would not have the same incentives as landlords presently do if they had the same enduring financial stake.[26] The management of a block is undoubtedly more complex than that of an individual house. It is not suggested that commonhold unit owners themselves will personally take charge. In all but small blocks, where self-management is a realistic choice, the expectation is that professional managers will be appointed.

1.41 This insistence on the necessity of landlord freeholders to provide inter-generational stewardship of a building or estate is symptomatic of a broader issue. The reform of leasehold, and particularly the reinvigoration of commonhold, bring about a need for cultural change, and for all participants in the housing market to re-think fundamental assumptions on which the market currently operates.

1.42 It has been suggested, for example, that developers will not build unless there is a professional landlord in place to manage the development. This ignores the fact that commonhold structures are used around the world and that large, mixed-use developments are built in those jurisdictions. It is also argued that commonhold owners will not take an active interest in the management of their block. Such arguments operate on the assumption that flat owners are ultimately apathetic about how their buildings or estates are run.[27] While commonhold is about empowering and giving responsibility to owners of flats, it is also about owners of flats being ready to accept responsibility and therefore being ready to take on that cultural change. Law reform must be matched by changes in people's expectations of what home-ownership will involve. It should not be assumed that apathy generated in a leasehold system – where the long-term financial investment and control of a building lie with an external third party – will carry over into a system in which, from the outset, investment and control lie with the unit owners.

1.43 In summary, therefore, commonhold should not be looked at through the lens of leasehold. Commonhold involves a culture change. It moves away from an "us and them" mindset, towards "us and ourselves".

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25 See, for example, https://wslaw.co.uk/wp-content/uploads/2019/07/LR-December-Bulletin-2018.pdf, p 3.

26 S Bright, "Do freeholders provide a unique and valuable service?" (2019) at https://www.law.ox.ac.uk/housing-after-grenfell/blog/2019/04/do-freeholders-provide-unique-and-valuable-service.

27 Housing, Communities and Local Government Committee, Leasehold Reform (2017-19) HC 1468, para 17.

## PART B: LAW COMMISSION AND GOVERNMENT RECOMMENDATIONS FOR REFORM

### The impact of COVID-19

1.44 The final stage of the preparation of our reports has been undertaken against the backdrop of the COVID-19 pandemic. In common with many people in England and Wales, Law Commission staff and Commissioners found themselves working from, as well as living in, their homes, as everybody limited contact with others to benefit the health of their communities. It is a reminder of the huge importance that a home plays in a person's life, and that individuals must work together to build and get the most out of a community. A significant part of our current work reforming leasehold and commonhold has been aimed at making sure that there exist the right tools to ensure homeowners have the comfort and certainty that they need to enjoy their homes into the future, and, where homes form part of bigger developments, the right people are involved in the decisions that enable their communities to flourish.

### Law Commission recommendations for leasehold and commonhold reform

1.45 We have published a suite of final reports on our three projects:

(1) leasehold enfranchisement;

(2) the right to manage; and

(3) commonhold.

1.46 Our three projects fall into two categories.

(1) Improving leasehold: our recommendations about leasehold enfranchisement and the right to manage are aimed at improving the existing system of leasehold ownership, to make it easier, quicker and cheaper to exercise leasehold rights.

Our starting point in these projects is the fact that leasehold ownership exists. Our recommendations are aimed at improving the law governing leasehold ownership.

(2) Reinvigorating commonhold, so that leasehold is no longer needed: our recommendations about commonhold are aimed at creating a workable alternative to leasehold ownership, with a view to its widespread use in the future.

> Once we have commonhold in a way that works … we do not need long residential leases. Commonhold solves the two underlying concerns that we hear about leases. … Once commonhold is there and it is working, if you want a system of ownership that removes those underlying concerns with leasehold,

you can use commonhold". Professor Nick Hopkins, evidence to the Housing Select Committee[28]

Our starting point in this project is that it is not necessary for leasehold to be used as the mechanism for delivering home ownership. Rather, commonhold can be used instead, and we would go as far as to say that it should be used in preference to leasehold, because it overcomes the inherent limitations of leasehold ownership set out above. But commonhold can only replace leasehold if it is workable in practice.

"The right to manage and enfranchisement … mitigate the systemic difficulties with leasehold. But commonhold alone removes those difficulties, delivering freehold ownership of individual flats or units, and collective freehold ownership and management of the common parts".[29]

1.47 We summarise our three projects below.

## Our Terms of Reference

1.48 The Terms of Reference for all three of our projects include two general policy objectives identified by Government, which are:

(1) to promote transparency and fairness in the residential leasehold sector; and

(2) to provide a better deal for leaseholders as consumers.

1.49 Our Terms of Reference include specific provisions for each of our projects, which we set out in the following chapter and in Appendix 1 to this Report.

1.50 Our Terms of Reference are not neutral. They require us to make recommendations that would alter the law in favour of leaseholders. They indicate a policy conclusion reached by Government that the leasehold system in its current form is not a satisfactory way of owning homes.

1.51 We set out many criticisms of leasehold above. Some amount to abusive practices, which have often been a focus of concern (particularly in media reports). But the reform of leasehold is not intended simply to remove abuse. Those practices have served to highlight long-standing concerns with leasehold. Government's work and our recommendations for reform are therefore not confined simply to removing abuses. Our Terms of Reference refer generally to providing "a better deal for leaseholders as consumers". Our recommendations for reform are therefore intended to make the law work better for all leaseholders.

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[28] Housing, Communities and Local Government Committee, Oral evidence: Leasehold reform (2017-19) HC 1468), response to Question 456, at http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/housing-communities-and-local-government-committee/leasehold-reform/oral/95161.pdf.

[29] *A Change is Gonna Come (2019)*, 328.

### Improving leasehold: reform of leasehold enfranchisement

1.52 Leasehold enfranchisement is the process by which leaseholders may extend the lease, or buy the freehold. In order to exercise enfranchisement rights, leaseholders must pay a sum of money ("a premium") to their landlord.[30]

1.53 We make recommendations for a brand-new, reformed enfranchisement regime. We recommend that the enfranchisement rights, and the leaseholders who qualify for them, should be expanded, improved, simplified and rationalised. And we recommend that the process that leaseholders must follow to exercise enfranchisement rights should be improved and simplified, and that the costs that leaseholders incur doing so should be reduced.

1.54 We previously published our final report concerning one aspect of leasehold enfranchisement, namely the amount that leaseholders must pay to their landlords in order to make an enfranchisement claim.[31] As required by our Terms of Reference, we set out the options for Government to reduce the premiums paid by leaseholders.

### Improving leasehold: reform of the right to manage

1.55 The right to manage is a right for leaseholders to take over the management of their building without buying the freehold. They can take control of services, repairs, maintenance, improvements, and insurance.

1.56 We make recommendations which will make the RTM more accessible, less confusing, and more certain. Our recommendations would simplify and liberalise the criteria that govern which properties may be subject to an RTM claim. We have designed a new process by which information and claims are exchanged between leaseholders, landlords, and RTM companies to clear the procedural thicket which currently plagues the regime but also will facilitate better communication between all parties. We also recommend that RTM companies should not be required to cover any non-litigation costs incurred by the landlord as a result of an RTM claim.

### The alternative to leasehold: reinvigorating commonhold

1.57 We explain above that commonhold allows for the freehold ownership of flats (and other interdependent properties), offering an alternative way of owning property which avoids the shortcomings of leasehold ownership.

1.58 We also summarised some of the reasons why commonhold is said to have failed in paragraph 1.38 above.

1.59 Our project seeks to address the first suggested barrier to the uptake of commonhold in paragraph 1.38 above: perceived shortcomings in the legal design of the commonhold scheme. Our project analyses which aspects of the law of commonhold have so far impeded commonhold's success, for example by affecting market confidence, or making it unworkable. In accordance with our Terms of Reference, we

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30 There is an exception: leaseholders of houses can extend their lease without paying a premium but instead paying a higher annual rent. See para 2.8(2) of the Enfranchisement Report.

31 Valuation Report.

recommend reforms to reinvigorate commonhold as a workable alternative to leasehold, for both existing and new homes.

1.60 Other barriers to the uptake of commonhold, including those identified in paragraph 1.38 above, are not problems with the law and do not fall within our Terms of Reference.[32] They are issues which Government is considering – and Government therefore has a crucial role in seeking to reinvigorate commonhold as a mechanism for delivering home ownership.

## Government proposals for leasehold and commonhold reform

1.61 Improving and facilitating home ownership is a priority for Government, and – as part of that – reform of residential leasehold and commonhold law has become an increasing priority. The UK Government and Welsh Government have announced various proposals for reform. Our recommendations for reform will be considered by both Governments as part of their overall programmes of reform.

1.62 We summarise Government's current proposals for reform below. We do not comment on those proposals. They are all matters which fall outside the scope of our projects. Nevertheless, it is important to explain those proposals in order to explain how all proposed reforms (including those that we recommend) fit together.

### Ministry of Housing, Communities and Local Government

1.63 The Ministry of Housing, Communities and Local Government ("MHCLG") has announced its intention to bring forward the following measures.[33]

(1) For the future, banning the sale of houses on a leasehold basis, other than in exceptional circumstances.[34] As we explain further below, the only good legal reason for selling houses on a leasehold basis – namely ensuring that owners on an estate will contribute to (reasonable) shared costs – would be provided by the creation of "land obligations": see paragraph 1.63(11) below.

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32 Our project did, however, provide an opportunity to gather evidence on these wider measures to reinvigorate commonhold, and we report on them in this Report.

33 See: (1) Department for Communities and Local Government ("DCLG"), *Tackling unfair practices in the leasehold market: A consultation paper* (July 2017) ("*Tackling unfair practices consultation, July 2017*");
(2) DCLG, *Tackling unfair practices in the leasehold market: Summary of consultation responses and Government response* (December 2017) (*Tackling unfair practices response, December 2017*");
(3) MHCLG, *Implementing reforms to the leasehold system in England: A consultation* (October 2018) ("*Implementing reforms consultation, October 2018*");
(4) MHCLG, *Implementing reforms to the leasehold system in England: Summary of consultation responses and Government response* (June 2019) ("*Implementing reforms response, June 2019*"); and
(5) MHCLG, Government response to the Housing, Communities and Local Government Select Committee report on leasehold reform (July 2019) ("Response to Select Committee, July 2019").

(1) and (2) are at https://www.gov.uk/government/consultations/tackling-unfair-practices-in-the-leasehold-market; (3) and (4) are at https://www.gov.uk/government/consultations/implementing-reforms-to-the-leasehold-system; (5) is at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/814334/CCS0519270992-001_Gov_Response_on_Leasehold_Reform_Web_Accessible.pdf.

34 *Implementing reforms response, June 2019*, Ch 2. The ban would apply, predominantly, to houses that are built in the future. The ban on the grant of leases of houses would, however, also prevent the grant of a *new* lease over an *existing* house. The ban would not apply to existing leases of houses.

(2) For the future, when homes are sold on a leasehold basis (which, following the leasehold house ban, will predominantly be flats), restricting ground rents to zero in those leases.[35]

(3) Regulation of the property agent sector, including letting, managing and estate agents through mandatory licensing, mandatory codes of practice, new qualifications provisions and a new regulator with a range of enforcement options.[36]

(4) Consideration of reform of the regulation of the service charges that leaseholders must pay, including the requirements to consult with leaseholders before incurring expenditure on major works or on long-term contracts.[37]

(5) Reviewing the ability of landlords to charge leaseholders permission fees under long leases, such as fees for permission to make alterations to the property.[38]

(6) Reviewing the circumstances in which leaseholders are required to contribute to their landlord's legal costs.[39]

(7) Requesting that the Law Commission update its previous recommendations to abolish forfeiture.[40]

(8) Protecting leaseholders from losing their homes for small sums of rent arrears.[41]

(9) Reviewing loopholes in the "right of first refusal".[42]

(10) Implementation of most of the Law Commission's recommendations on fees charged in leasehold retirement properties ("event fees"), including limiting the

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35 *Implementing reforms response, June 2019*, Ch 3.

36 The proposals included plans for a mandatory code of practice covering letting and managing agents and nationally recognised qualification requirements for letting and managing agents to practise. In addition, an independent regulator was proposed which would oversee both the code of practice and the delivery of the qualifications: DCLG, *Protecting consumers in the letting and managing agent market: call for evidence* (October 2017), and MHCLG, *Protecting consumers in the letting and managing agent market: Government response* (April 2018). A working group chaired by Lord Best was subsequently tasked with "considering the entire property agent sector to ensure any new framework, including any professional qualifications requirements, a Code of Practice, and a proposed independent regulator, is consistent across letting, managing and estate agents": see: *Regulation of property agents working group – final report* (July 2019), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/818244/Regulation_of_Property_Agents_final_report.pdf.

37 *Response to Select Committee, July 2019*, pp 25-29.

38 *Response to Select Committee, July 2019*, pp 23-24.

39 *Response to Select Committee, July 2019*, p 29.

40 *Response to Select Committee, July 2019*, pp 29-30. We have previously recommended that forfeiture be abolished and replaced with a regime to enforce the terms of leases in a proportionate way: Termination of Tenancies for Tenant Default (2006) Law Com No 303.

41 *Tackling unfair practices response, December 2017*, Ch 4.

42 *Response to Select Committee, July 2019*, p 13. We explain the right of first refusal in para 1.28(1)(d) above.

circumstances in which event fees can be charged and requiring the disclosure of information to prospective purchasers.[43]

(11) To support the leasehold house ban, relying on the implementation of the Law Commission's recommendations to reform property law, including introducing "land obligations" and reforming the way in which rights over land are created, varied, terminated and regulated.[44]

(12) Extending mandatory membership of a redress scheme to landlords who do not use managing agents.[45]

(13) Setting a cap on what leaseholders can be charged for the provision of information about the lease to potential purchasers, and a minimum time within which the information must be provided.[46]

(14) Extending rights currently enjoyed by leaseholders to freeholders of houses – in particular:

(a) extending the right to challenge charges for the maintenance of an estate where they are unreasonable, as well as allowing freeholders of houses to apply to change their managing agent;[47]

(b) protecting freeholders from losing their homes for unpaid service charges which are owed as "rentcharges";[48]

(c) reforming the "right of first refusal" by extending the right to leaseholders of houses;[49] and

(d) considering regulating the ability of developers and others to charge homeowners permission fees, such as to make alterations to their property.[50]

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43 Letter from Heather Wheeler MP, then Minister for Housing and Homelessness, to the Rt Hon Lord Justice Green, Chair of the Law Commission, 27 March 2019, at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2017/03/Letter-from-Mrs-Heather-Wheeler-MP.pdf.

44 *The Queen's Speech 2016*, p 61, at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/524040/Queen_s_Speech_2016_background_notes_.pdf; *Tackling unfair practices response, December 2017*, para 36; and Implementing reforms consultation, October 2018, para 2.21. See also Making Land Work: Easements, Covenants and Profits À Prendre (2011) Law Com No 327.

45 MHCLG, *Strengthening consumer redress in the housing market* (January 2019), para 123, at https://www.gov.uk/government/consultations/strengthening-consumer-redress-in-housing.

46 *Implementing reforms response, June 2019*, Ch 5, which sets out proposals for a cap of £200 plus VAT and a timeframe of 15 working days.

47 *Tackling unfair practices response, December 2017*, Ch 5; *Implementing reforms response, June 2019*, Ch 4.

48 *Tackling unfair practices response, December 2017*, para 81.

49 *Implementing reforms response, June 2019*, paras 2.34-2.35; *Response to Select Committee, July 2019*, p 13.

50 *Response to Select Committee, July 2019*, pp 23 to 24.

(15) Ensuring the New Homes Ombudsman is created and requiring developers of new-build homes to belong to it, which would provide new-build homebuyers with an effective route to resolve disputes, avoiding the need to go to court.[51]

(16) Considering the case for creating a Single Housing Court, to see whether it could make it easier for all users of court and tribunal services to resolve disputes, reduce delays and to secure justice in housing cases.[52]

1.64 Some measures have already been implemented.

(1) Changes have been made to the recognition of residents' associations, to require landlords to provide residents' associations with information about leaseholders.[53]

(2) A Government-backed pledge, designed to help leaseholders with onerous ground rent terms, has been agreed by many landlords, developers, conveyancers and managing agents.[54]

(3) Restrictions are to be placed on the properties that qualify for support from the Help-To-Buy scheme in England, reflecting the leasehold house ban and the restriction of ground rents to zero.[55]

(4) Government has committed that no new scheme will fund the building of leasehold houses.[56]

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51 MHCLG, *Redress for purchasers of new build homes and the New Homes Ombudsman: technical consultation* (June 2019) and *Government response* (February 2020), at https://www.gov.uk/government/consultations/redress-for-purchasers-of-new-build-homes-and-the-new-homes-ombudsman.

52 MHCLG, *Considering the case for a Housing Court – A Call for Evidence* (November 2018), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/755326/Considering_the_case_for_a_housing_court.pdf.

53 The Tenants' Associations (Provisions Relating to Recognition and Provision of Information) (England) Regulations SI 2018 No 1043. The regulations are intended to make it easier for residents' associations to contact leaseholders, increasing the likelihood of those leaseholders becoming members of the association. This affects the chances of the association being formally recognised under s 29(1) of the Landlord and Tenant Act 1985, which improve if a higher percentage of the leaseholders are members. For background, see s 130 of the Housing and Planning Act 2016; DCLG, *Recognising residents' associations, and their power to request information about tenants* (July 2017), at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/632116/s130_HPAct_consultation.pdf.

54 MHCLG, *Public pledge for leaseholders* (27 June 2019), at https://www.gov.uk/government/publications/leaseholder-pledge/public-pledge-for-leaseholders.

55 *Tackling unfair practices response, December 2017*, para 47; MHCLG, *Leasehold axed for all new houses in move to place fairness at heart of housing market* (27 June 2019), at https://www.gov.uk/government/news/leasehold-axed-for-all-new-houses-in-move-to-place-fairness-at-heart-of-housing-market; MHCLG, *Housing Secretary clamps down on shoddy housebuilders* (24 February 2020), at https://www.gov.uk/government/news/housing-secretary-clamps-down-on-shoddy-housebuilders

56 MHCLG, *Funding for new leasehold houses to end* (2 July 2018), at https://www.gov.uk/government/news/funding-for-new-leasehold-houses-to-end.

1.65 In addition, commonhold has been brought back on to the political agenda. MHCLG has stated that, in addition to pursuing leasehold reform:

> we also want to look at ways to reinvigorate commonhold. … This will help ensure that the market puts consumers' needs ahead of those of developers or investors. We will also look at what more we can and should do to support commonhold to get off the ground working across the sector, including with mortgage lenders.[57]

### Welsh Government

1.66 The Welsh Government has imposed restrictions on properties that qualify for support from the Help To Buy Wales scheme, namely that houses should generally be sold on a freehold basis and that ground rents should be restricted.[58] At the same time, a Help To Buy Wales conveyancer accreditation was introduced, and the use of an accredited conveyancer was made mandatory for sales through the scheme, to ensure a minimum level of information is given to purchasers on a range of issues, including information about leasehold. In addition, the major developers operating in Wales pledged not to use leasehold for new-build houses, whether sold through the Help To Buy scheme or otherwise.[59]

1.67 In addition, the Welsh Government established a working group on leasehold reform. The group's report, published in 2019, made a wide range of recommendations, including recommendations to:[60]

(1) legislate to ban the unjustified use of leasehold in new-build houses, with some exceptions;

(2) legislate to ban onerous ground rents and implement the reduction of future ground rents to a nominal financial value;

(3) improve education and awareness for all participants in the property market;

(4) improve transparency for consumers with respect to the obligations that burden a leasehold or freehold property at the point of sale; and

(5) introduce an updated Code of Practice in Wales for the licensing and accreditation of managing agents.

1.68 The Welsh Government has also published a Call for Evidence to better understand how private housing estates are maintained through the payment of estate service charges by homeowners and residents. The evidence base collected by this process

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57 *Tackling unfair practices response, December 2017*, p 25.

58 Developers have to present genuine reasons for a house to be marketed as leasehold. In addition, starting ground rents need to be limited to a maximum of 0.1% of the property's sale value and leasehold agreements have to have a minimum term of 125 years for flats and 250 years for houses.

59 *Written Statement: Leasehold Reform in Wales* (6 March 2018), at https://gov.wales/written-statement-leasehold-reform-wales.

60 *Residential Leasehold Reform – A Task and Finish Group Report*, pp 21-22, at https://gov.wales/independent-review-residential-leasehold-report. See also *Written Statement: Response to Report of the Task and Finish Group on Leasehold Reform* (6 February 2020), at https://gov.wales/written-statement-response-report-task-and-finish-group-leasehold-reform.

will then be used by the Minister for Housing and Local Government to consider the case for reform.[61]

## PART C: THE BIG PICTURE – HOW THE VARIOUS REFORM PROPOSALS FIT TOGETHER

### Introduction

1.69 In Part B, we have summarised the areas in which we are recommending reform, and we have summarised (without commenting on) Government's proposals for reform. We now explain how all those proposed reforms fit together.

1.70 It is important to look at existing and future home owners. Reform must cater for the needs of:

(1) Leaseholders of existing homes: reform must cater for the needs of the leaseholders of existing houses and flats, as well as the future owners of those homes.[62] It is estimated that there are at least 4.3 million leasehold homes in England alone.[63]

(2) Owners of future homes: reform must cater for the needs of the owners of houses and flats that are built in the future: 178,000 new-build properties were completed in England in 2019, of which 78% were houses and 22% were flats.[64]

> "The work of the Law Commission and of the Government brings onto the horizon an unprecedented level of reform of residential leasehold and commonhold. Lying at the heart of the work is an acknowledgement that leasehold home ownership has failed to deliver the benefits associated with being an owner, and that the systemic problems with leasehold mean that the tenure is ill-equipped to do so".[65]

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61 Welsh Government, *Estate charges on housing developments: call for evidence* (February 2020), at https://gov.wales/sites/default/files/consultations/2020-02/estate-charges-on-housing-developments.pdf.

62 In addition, it is necessary to consider leasehold owners of future homes, to the extent that leases are still granted in the future.

63 MHCLG, *Estimating the number of leasehold dwellings in England 2017-2018* (26 September 2019), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/834057/Estimating_the_number_of_leasehold_dwellings_in_England__2017-18.pdf.

64 MHCLG, *House building; new build dwellings, England: December Quarter 2019* (26 March 2020), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/875361/House_Building_Release_December_2019.pdf.

65 *A Change is Gonna Come (2019)*, 330.

## Overall aim: fit-for-purpose home ownership

1.71 The aim of all the proposed reforms can be summarised as seeking to create fit-for-purpose home ownership.

1.72 There are two strands to that work:

(1) paving the way for the future: laying the foundations for homes to be able to be owned as freehold; and

(2) essential reform of leasehold: addressing problems for leaseholders in the present.

## (1) Paving the way for the future: laying the foundations for homes to be able to be owned as freehold

### Owners of future homes

1.73 MHCLG's proposed ban on *houses* being sold on a leasehold basis (see paragraph 1.63(1) above) will ensure that, in the future, houses will be sold on a freehold basis (subject to exceptions). Accordingly, houses that are built in the future will predominantly be owned on a freehold basis.

1.74 By implementing our recommendations for the creation of land obligations, there would no longer be any reason – from a legal point of view – for selling houses on a leasehold basis. That is because land obligations would allow for freehold owners to be subject to positive obligations. Land obligations would be a rational and controlled mechanism for requiring payments to be made.

1.75 Turning to future *flats*, as recorded in our Terms of Reference, Government wishes to reinvigorate commonhold as a workable alternative to leasehold. Our recommendations to reform the law of commonhold will overcome the defects in the current legal regime so that commonhold can be used with confidence.

1.76 In the future, the sale of all flats could be on a commonhold basis, rather than as leasehold (as is invariably the case currently).[66] The Law Commission's reforms will ensure that commonhold is workable and flexible enough to cater for the wide range of modern-day developments.

> We urge the Government to ensure that commonhold becomes the primary model of ownership of flats in England and Wales, as it is in many other countries. … there is no reason why the majority of residential buildings could not be held in commonhold; free from ground rents, lease extensions, and with greater control for residents over service charges and major works. We are unconvinced that professional freeholders provide a significantly higher level of service than that which could be provided by leaseholders themselves". Housing, Communities and Local Government Committee[67]

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66 We refer to the sale of flats to cover (a) the sale, for the first time, of new-build flats, and (b) the sale of *existing* flats which are not already subject to a long lease, such as where a freehold owner splits a house into multiple flats and sells the individual flats.

67 Housing, Communities and Local Government Committee, Leasehold Reform (2017-19) HC 1468, p 3.

1.77 If commonhold is not used (or if it is used only in some cases), the 40,000 or so flats built each year (or some of them) will continue to be sold on a leasehold basis, with the inherent limitations of leasehold.

1.78 Developers and other property-owners are currently incentivised to sell flats on a leasehold basis. As we explained in paragraph 1.19 above, the freehold is a valuable asset for the developer because it provides a steady income from ground rents, income from lease extension premiums, and other income from the leaseholders. Developers can therefore sell the flats that they build twice: they sell a long lease to the homeowner, and they can sell the freehold to an investor. By contrast, commonhold flats can only be sold once – to the homeowner. Developers therefore have no incentive to adopt commonhold. The restriction of ground rents to zero will remove one significant incentive to sell flats on a leasehold basis, since a developer will not receive (or be able to sell) a steady ground rent income. However, the freehold will continue to be valuable, because enfranchisement premiums might be paid and there may be additional income to be gained from owning the freehold. Accordingly, the incentive will remain to sell flats on a leasehold basis. Moreover, given the limited consumer awareness about commonhold, there may not be sufficient consumer demand to act as a catalyst for change. Even if such demand were to exist, the fact that demand for housing outstrips supply means that prospective homeowners do not have the bargaining power to demand commonhold flats.[68]

1.79 We summarise in Appendix 3 to this Report what consultees said about the steps that would be necessary to reinvigorate commonhold.

1.80 Based on the evidence that we have gathered during our projects, we have concluded that commonhold will not be used unless (a) it is made compulsory, or (b) adequate incentives are put in place to make it more attractive to developers than leasehold (or conversely that leasehold is disincentivised sufficiently to makes it less attractive than commonhold). Commonhold will not take root on its own. There is no reason why developers will start selling commonhold flats for so long as there is more money to be made by selling leasehold flats.

1.81 Developers have had the option of using commonhold or leasehold for over 15 years, but have almost invariably used leasehold. Commonhold was not pushed by Government. Unless it is encouraged, or mandated, there is no reason to believe that the outcome will be any different from when it was first introduced. But the consequences may be even graver. For those who object to commonhold, and prefer leasehold, a second apparent "failure" of the commonhold model is likely to be claimed to be a reason that commonhold cannot and will not work. That, in our view, would be a very unfortunate outcome, and would do a great disservice to current and future homeowners. Commonhold is used around the world; it can and does work. But for so long as there is more money to be made from leasehold, and unless initial impetus can be given to overcome inherent inertia and a lack of awareness, it is not

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68 House of Commons Library Briefing Paper, *Tackling the under-supply of housing in England* (2020), http://researchbriefings.files.parliament.uk/documents/CBP-7671/CBP-7671.pdf; Welsh Government, *Delivering More Homes for Wales: Report of the Housing Supply Task Force* (2014), at https://gov.wales/sites/default/files/publications/2019-04/delivering-more-homes-for-wales-recommendations.pdf.

going to take root on its own. Without Government intervention, commonhold simply cannot compete with leasehold.

1.82 Accordingly, while implementation of our recommendations on commonhold reform is necessary for the reinvigoration of commonhold, it will not be sufficient on its own to do so.

1.83 For houses, Government has decided to ban the use of leasehold, so that freehold ownership is used.[69] That policy can be pursued because the legal mechanisms for owning houses on a freehold basis already exist (subject, to some extent, to the creation of land obligations: see paragraph 1.63(11) above). It would be a logical extension of that policy to ban the use of leasehold for flats, so that commonhold (freehold) ownership is used instead – once a workable legal mechanism exists. Our recommendations to reform commonhold would create that workable legal mechanism, and so banning the use of leasehold for flats becomes a realistic possibility.

1.84 As well as the direct loss of income that developers would suffer by selling flats on a commonhold basis, they would also have to adapt to an unfamiliar ownership model. This was one of the other barriers to the success of commonhold noted in paragraph 1.38 above, alongside inertia amongst professionals, a lack of sector-wide and consumer awareness, and caution on the part of mortgage lenders. These barriers to the uptake of commonhold all require Government intervention if they are to be overcome.

1.85 Government must therefore decide:

(1) whether there should be an equivalent of the leasehold house ban for flats, so that flats cannot be sold on a leasehold basis in the future but must instead be sold on a commonhold basis. Put another way, commonhold could be made compulsory; or

(2) whether developers and other property-owners should (as is currently the case) be left to choose between using leasehold or commonhold for the sale of flats, and if so:

(a) whether – and how – the sale of flats on a commonhold basis should be incentivised; and/or

(b) whether – and how – the sale of flats on a leasehold basis should be disincentivised; and

(3) what measures it will adopt in order to overcome the other practical barriers to commonhold, in particular a lack of awareness, and caution and inertia amongst developers, lenders and professionals.

[69] Subject to exceptions.

### Leaseholders of existing homes

1.86 For leaseholders of existing houses,[70] our recommendations to reform the enfranchisement regime will provide improved rights to acquire the freehold (an "individual freehold acquisition"), and therefore move away from leasehold ownership to freehold ownership.

1.87 For leaseholders of existing flats,[71] our recommendations to reform the enfranchisement regime will provide improved rights both to extend the lease and to acquire the freehold of the block – a "collective freehold acquisition". In addition, our recommendations to reform the law of commonhold will allow leaseholders to then convert the block to commonhold, if they wish to do so. We recommend that leaseholders should have a choice whether (1) to undertake only a collective freehold acquisition, retaining the leasehold structure, or (2) replace the leasehold structure by converting to commonhold.

1.88 As commonhold becomes more prevalent, it is likely to be more desirable for leaseholders to convert to commonhold, rather than merely purchase the freehold by making a collective freehold acquisition claim. In time, Government might decide that leaseholders should only be able to convert to commonhold, rather than carry out a collective freehold acquisition claim and retain the leasehold structure.

### Ensuring freehold ownership itself is fit-for-purpose

1.89 We have summarised above the measures that would pave the way to home ownership – of both houses and flats, and of both existing and future homes – to be freehold rather than leasehold.

1.90 That ambition does, however, rest on an assumption that freehold ownership is preferable to leasehold ownership. Generally speaking, for the reasons we set out in paragraphs 1.14 to 1.18 above, freehold ownership is preferable to leasehold ownership. Freehold ownership, however, is not without its own problems.

(1) Concerns have been expressed about some features of freehold ownership. For example, freehold house owners can be required to pay estate management charges,[72] and there have been concerns about such charges being high or about difficulties challenging the charges. When sums are due under a "rentcharge", any failure by the freeholder to pay the sums due can result in them losing the property.[73]

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70 Including leaseholders of any future houses that are sold on a leasehold basis.

71 Including leaseholders of any future flats that are sold on a leasehold basis.

72 The legal position is that positive obligations cannot bind future owners of the land (see para 1.20 above). However, freehold land can be subject to a requirement to pay an "estate rentcharge", and there are various "workarounds" which can be effective to bind future freehold owners such as a "chain of covenants" protected by a restriction at HM Land Registry.

73 See *Roberts v Lawton* [2016] UKUT 395 (TCC), [2017] 1 P & CR 3, which featured the method of enforcing rentcharges implied by s 121(4) of the Law of Property Act 1925 whereby the holder of a rentcharge that is in arrears may grant a lease of the charged land to a trustee to raise money to discharge the outstanding debt. See MHCLG's work on fees and charges (paras 1.63(14)(a) and (b) above) and the Welsh Government Call for Evidence (para 1.68 above).

(2) There has been growing concern that certain undesirable features of leasehold ownership have been replicated in freehold ownership. The term "fleecehold" has been used to describe this phenomenon. Examples include obligations imposed on freehold homeowners to pay permission fees to make alterations to their home and inappropriate charges for the upkeep of neighbouring land and facilities.[74]

(3) As home ownership moves away from leasehold, the opportunity for developers and investors to make money from leasehold will evaporate. It is quite possible that they will look for ways to make money instead through freehold ownership. There is, therefore, a risk that the problems currently seen in leasehold may appear in freehold.

1.91 Put another way, moving from leasehold to freehold ownership is not a complete solution to the problems currently faced by homeowners, and nor does it guarantee that practices decried in the context of leasehold ownership will not also emerge as part of freehold ownership.

1.92 Certain reforms to freehold ownership are therefore necessary:

(1) Government's plans to extend certain rights currently enjoyed by leaseholders to freeholders will provide protections that do not currently exist (see paragraph 1.63(14) above); and

(2) the implementation of our recommendations on property law reform – including the creation of land obligations – will improve the operation of freehold ownership, and introduce a more streamlined, proportionate and controlled mechanism for homeowners to contribute towards maintenance costs: see paragraph 1.63(11) and 1.74 above.

1.93 As well as resolving existing problems with freehold ownership, it will be necessary to continue to monitor the way in which freehold ownership is working in practice in order to address any future problems as they arise. In particular, freehold is not free from the risk of abuse, and it is necessary to ensure that bad practices in leasehold do not creep back in under the disguise of freehold ownership.

1.94 In the case of commonhold, our recommendations for reform are designed to ensure that this form of freehold ownership is fit-for-purpose. There are various problems with the current commonhold model, and they would be resolved by our recommendations for reform. We have said that it is important that the practical operation of freehold ownership is monitored, and commonhold is no different. In this Report, we conclude that the law of commonhold should be kept under review – just as it is in other countries which adopt a similar ownership model – in order to identify and resolve any problems as they emerge in the future.

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[74] See, for example, BBC News, *'Fleecehold': New homes hit by 'hidden costs'* (20 March 2019), at https://www.bbc.co.uk/news/uk-england-46279048. See also MHCLG's work on permission fees (para 1.63(14)(d) above).

**Summary: reforms that lay the foundations for home ownership to be freehold**

| Laying the foundations for home ownership to be freehold | Existing homes | Future homes |
|---|---|---|
| Houses | Improved enfranchisement rights: existing leaseholders can buy the freehold | Leasehold house ban: new houses to be sold on a freehold basis |
| Flats | Improved enfranchisement rights: existing leaseholders can buy the freehold and convert to commonhold | Commonhold is available. Government to decide whether commonhold should be compulsory, incentivised, or optional. |

### (2) Essential reform of leasehold: addressing problems for leaseholders in the present

1.95 While there can be an ambition for freehold to be the basis of home ownership in the future, it is crucial to recognise that leasehold currently exists, and will continue to exist – certainly in the short term, and probably for many years to come.

(1) There are millions of existing leaseholders of houses and flats. Even if those leaseholders transition to freehold (or commonhold) ownership, that process will be gradual.[75] Unless and until existing leaseholders become freeholders, they need suitable protection as leaseholders.

(2) Similarly, if and in so far as leasehold continues to be used in the future, there needs to be suitable protection for leaseholders.

(a) For owners of future houses, leasehold generally ought not be relevant, since Government proposes to ban leasehold houses (subject to exceptions).

(b) For owners of future flats, leasehold would not be relevant if commonhold becomes the norm, either because it is made compulsory or because it is sufficiently incentivised over leasehold (see paragraphs 1.75 to 1.85 above).

[75] Although we are recommending the expansion of enfranchisement rights, some leaseholders would remain unable to buy the freehold. For example, while we recommend increasing the threshold for commercial use from 25% to 50% (see para 1.12(2) above), leaseholders will not be able to buy the freehold to their block if more than 50% of the block is in commercial use.

1.96 It is therefore necessary for various problems with leasehold ownership to be resolved. Of the various reforms discussed in Part B above,[76] those intended to improve the position of existing leaseholders and any future leaseholders include:

(1) improving the enfranchisement regime, so that it is easier, quicker and cheaper for leaseholders to extend their lease or buy their freehold: see paragraphs 1.52 to 1.53. We recommend the creation of an improved right to a lease extension, and improved rights for leaseholders to acquire their freehold (either individually or with their neighbours). Exercising enfranchisement rights removes the ground rent in existing leases, whether the claim is for a lease extension or for the purchase of the freehold. We have already published our report on the options that are available to Government to reduce the premiums that leaseholders must pay in order to exercise enfranchisement rights;

(2) improving the right to manage, so that it is easier, quicker and cheaper for leaseholders to take over control of the management of their block. We recommend improvements to the right to manage: see paragraphs 1.55 to 1.56;

(3) (for leaseholders of future homes only) restricting ground rents to zero in future leases: see paragraph 1.63(2).[77] Having said that, houses built in the future will not generally be leasehold (as a result of the leasehold house ban) and flats built in the future would not be leasehold if commonhold is used in preference to leasehold.[78] Put another way, once the restriction on ground rents is effective, there might be very few leases to which it would apply – houses will generally be sold freehold, and flats could always be sold commonhold;

(4) regulating property agents and requiring landlords who do not use managing agents to be members of a redress scheme: see paragraphs 1.63(3) and 1.63(12);

(5) consideration of the reform of the regulation of service charges, permission fees, and legal costs: see paragraphs 1.63(4), 1.63(5) and 1.63(6);

(6) reviewing our previous recommendations to abolish forfeiture in leasehold: see paragraphs 1.63(7) and 1.63(8);

(7) reviewing loopholes in the "right of first refusal": see paragraph 1.63(9);

(8) reforming the regulation of event fees: see paragraph 1.63(10) above;

(9) regulating the provision of information by landlords to prospective purchasers of leases: see paragraph 1.63(13); and

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[76] See para 1.45 to 1.68 above.

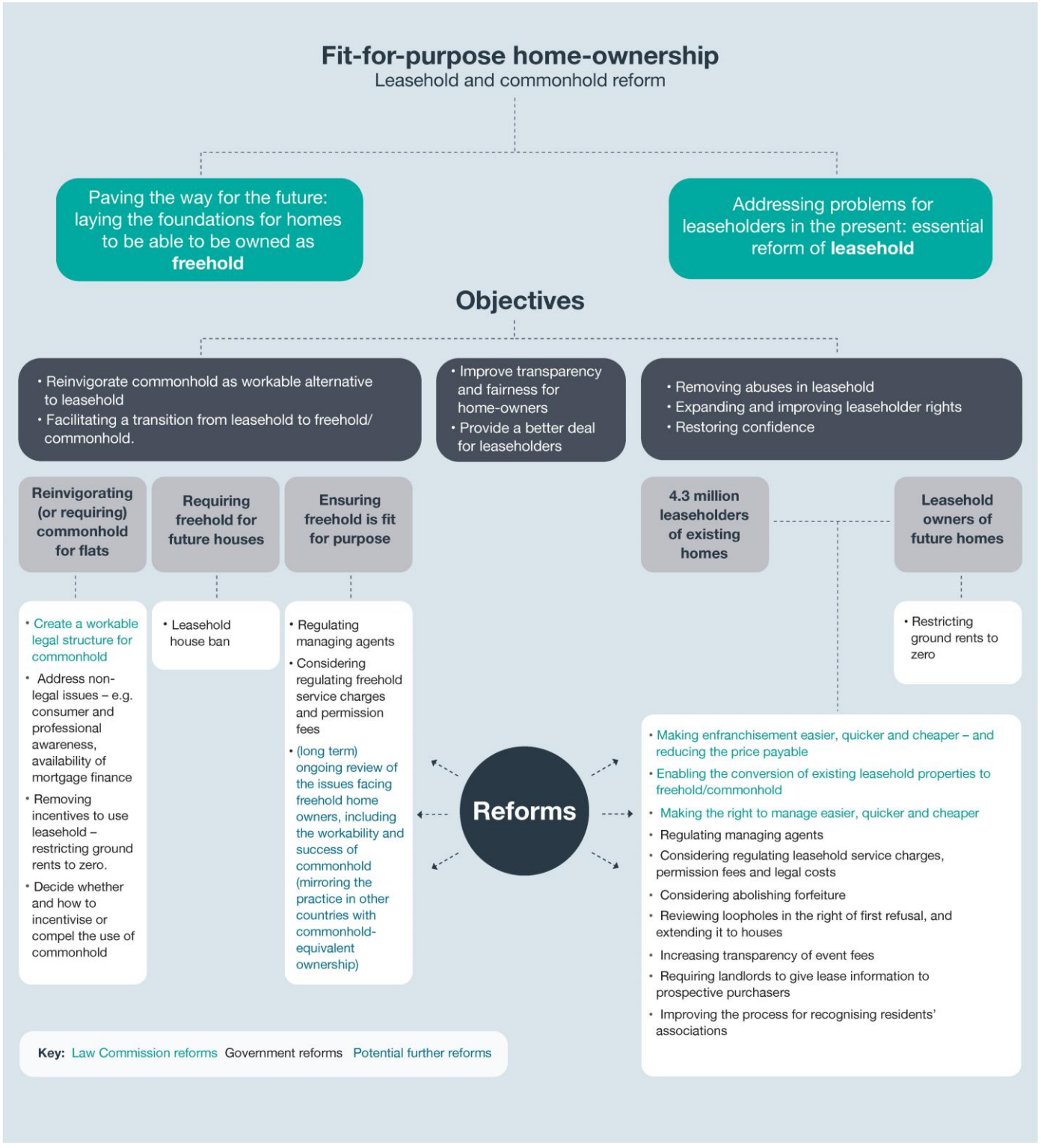
[77] The restriction on ground rents will not change the ground rents in existing leases, so this measure will only affect leaseholders of future homes. Removing ground rent in existing leases can be done through an enfranchisement claim: see para 1.96(1) above.

[78] Indeed the restriction of ground rents to zero is one of the measures that would remove the current incentive to use leasehold, and might therefore go some way to encourage the use of commonhold.

(10) improving the process for recognising residents' associations: see paragraph 1.64(1) above.

1.97 In the following diagram, we summarise how the various reforms fit together.

**Figure 2: The big picture: how the various reform proposals fit together**



# Part I: Introduction

# Chapter 2: Introduction

2.1 In the previous chapter, we outlined the inherent problems with leasehold ownership, and the criticisms made of its features and the way the leasehold market operates.

2.2 In this chapter, we continue the introduction to our commonhold project by setting out what commonhold is and a summary of the key deficiencies in the current law. We then give an overview of our work to date, including the consultation on our provisional proposals for reform and how we analysed the responses to the Consultation Paper. We also provide a summary of the key changes we are recommending in respect of the commonhold regime and the benefits these changes will bring.

## WHAT IS COMMONHOLD?

2.3 Commonhold is a way of owning flats and other structurally interdependent property as freehold, and so avoiding the shortcomings of leasehold home ownership. Before we start exploring commonhold in more detail, we make the point that commonhold must not be viewed through the lens of leasehold. Commonhold is not a system that attempts to replicate leasehold; instead, it is a system built upon the autonomy and control that is associated with freehold ownership, with mechanisms that recognise the importance of the community that arises where properties are interdependent.

2.4 Commonhold provides a solution to managing the relationship between separately owned properties which share common parts, such as communal hallways, or gardens. Indeed, commonhold was introduced in 2004 to make possible the freehold ownership of flats. However, commonhold is equally capable of applying in a commercial context, for example, to regulate the relationship between separately-owned properties within an office block.

2.5 In commonhold, an individual property, such as a flat, is referred to as a "unit". Each unit is owned freehold by a "unit owner". Unit owners will also be members of a company, called the "commonhold association",[1] which owns and manages the common parts.

2.6 The rights and obligations of all the unit owners and the commonhold association are set out in a document called the "commonhold community statement" (the "CCS"). The terms of the CCS are largely in a standard form, set down in legislation, which makes it easier for homeowners to understand their rights and obligations, and which should make conveyancing simpler and cheaper. There is the flexibility for unit owners to decide on "local rules", which are specific to their building. It is possible for the rules to be updated, for example, to respond to changing needs, standards or advances in technology.

2.7 The "flexibility" inherent in commonhold might lead to worries that the regime breeds uncertainty, for unit owners and their lenders, but the flexibility is measured. We

[1] In commonhold, the commonhold association must be a company limited by guarantee, for further details see CP, para 7.4 onwards.

mention above that commonhold establishes a regime of autonomy and control for unit owners, but it is designed to also ensure the common interests of the commonhold community and its members are recognised.

### The contrast between commonhold and leasehold

2.8 We explain above that commonhold must not be viewed through the lens of leasehold. That said, it is useful to draw a contrast between commonhold and leasehold in order to see the advantages of commonhold. We explain that contrast below. However, before doing so, we mention our work on the enfranchisement regime, because it is relevant when exploring that contrast.

2.9 As explained in Chapter 1, we have, alongside this Report, published the Enfranchisement Report, which contains recommendations to reform the enfranchisement regime. One aspect of that regime is the right for leaseholders[2] to act together to buy their landlord's interest in a property. In our Enfranchisement Report we call that process collective freehold acquisition ("CFA"). We explain CFAs in Chapter 5 of the Enfranchisement Report.

2.10 CFAs attempt to address some of the more harsh effects of leasehold ownership on leaseholders, but they do not remove the leasehold ownership structure or its inherent defects. When leaseholders undertake a CFA, it may be because they wish to replace a landlord who is felt to be doing a poor job, or not operating in a way that benefits the leaseholders. However, despite the aspirations of leaseholders when a CFA is undertaken, it remains the case that, following a CFA, the leasehold structure is still in place and there is a landlord that sits at the "apex" of the community.

2.11 We now explore the key contrasts between the commonhold and leasehold regimes.

(1) Commonhold allows people to own their properties forever, with a freehold title, unlike leasehold interests, which expire at some point.

(2) There is no landlord in commonhold, and no requirement to pay ground rent.

(3) There is no risk of forfeiture in commonhold. In leasehold, if a leaseholder breaches the terms of the lease, the landlord may take back the property and the leaseholder loses everything that he or she invested in it.

(4) All the rights and obligations in a commonhold are contained in the CCS and there is greater standardisation inherent in the regime. It follows that commonhold should result in savings, in particular during the conveyancing process. In leasehold developments, leases will vary, perhaps significantly, between developments and, sometimes, within developments.

(5) The mechanisms for setting costs and resolving disputes within commonhold reflect the reality that there is a community of unit owners. In leasehold, the landlord will set the costs to be paid, and mechanisms for the resolution of

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2 We generally use the term "leaseholder" instead of "tenant" in this Report. We do so because "leaseholder" is typically used to denote those who own their property through a long lease, whereas "tenant" is generally used to refer to those who rent their property on a short lease (such as a one-year "assured shorthold tenancy").

disputes between the landlord and the leaseholders are based largely on the assumption that a landlord needs to attempt to enforce the terms of the lease against leaseholders.

(6) Membership of the commonhold association is mandatory for all unit owners. Even following a CFA the company landlord often has to resort to various devices to attempt to ensure that new leaseholders become members (and that those who no longer own a lease do not continue to be members).

(7) Our recommendations will make it easier for commonholds to raise funds to carry out emergency repairs through granting charges over the common parts or the income of the commonhold association. It is rarely possible for the company landlord, following a CFA, to borrow on the security of its freehold reversion.

(8) Commonhold offers a more fair and orderly way of dealing with redevelopment when a building has reached the end of its useful life. Leasehold makes poor provision for how a block of flats, for example, should be redeveloped when it is no longer capable of being repaired or renovated.

2.12 Some differences between commonhold and leasehold warrant more detailed explanation, and we explore these below.

2.13 In commonhold, homeowners can make democratic decisions about how their building is run, rather than a third-party landlord retaining control, which will be the case in leasehold blocks unless the leaseholders undertake a CFA. The structure of commonhold is intended to foster participation; as members of the commonhold association, unit owners can vote on decisions about how their building is managed.[3] Unit owners in commonhold can also respond to changing circumstances by amending the CCS.[4] We explained above that this makes commonhold a "flexible" system.

2.14 In contrast, while the terms of a lease might give a degree of certainty, it can result in inflexibility; so even if it is possible, changing the terms of every lease to standardise them, or to adapt to changes in circumstances, can be time-consuming and costly. However, we note that leases *can* be drafted (either deliberately, or through inadvertence) to provide for flexibility, but whether that is good, bad or neutral for leaseholders will depend on the behaviour and priorities of the current landlord and leaseholder.

2.15 In leasehold, landlords will often have different motivations from homeowners. Landlords may see leasehold as an investment opportunity or a way of generating income, such as through the receipt of ground rents. The landlord will make decisions about how a building is run, the rules which apply to the occupiers and the amount

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[3] Management decisions could include, if it were thought desirable, the appointment of professional managing agents.

[4] We note here that, when there is a pressing need to provide generally for some matter of widespread concern to homeowners, Government would be able to respond by updating the CCS of all commonholds by regulation. Government might, for example, do this to make provision for energy-saving measures, or to improve fire safety.

those occupiers will need to pay towards maintaining the property. But the landlord will not need to comply with these rules about occupation, or pay the costs. The relationship of landlord and leaseholder is one in which the parties' interests in the property are different; it is inherently based on an adversarial "us and them" footing. Even in a situation where there is a CFA, there remains a tendency towards the creation of an adversarial relationship between the landlord and leaseholders.[5]

2.16 In commonhold, the interests of those who make the decisions, and those who are affected by them, are aligned. It is a relationship between parties with the same interest in the property, and is inherently based on a footing of "we and ourselves". The commonhold structure favours decisions which are fair and tailored to the needs of unit owners. For example, owners in a commonhold will be at a lower risk of excessive payments, and they will find it easier to install energy efficiency improvements within their building. That is because the same people who benefit from the upgrades will be those who are paying for them.[6]

2.17 In leasehold – for example, in a block of leasehold flats – there is a tendency to create an adversarial relationship between those who own the flats and those who manage the building. Commonhold is designed to remove this adversarial system and replace it with a more democratic system of home ownership. There are bespoke provisions which govern every aspect of the commonhold's management. In particular, the collective management of the building is simplified by having one document – the CCS – which sets out the rights and obligations of all parties in the building, rather than numerous leases, the terms of which might be inconsistent with each other.

2.18 In commonhold, unit owners have greater control over expenditure within their building. The procedures which apply in commonhold in relation to consultation on commonhold contributions have been designed with the commonhold in mind. The procedures recognise that there is a commonality of interests between the directors of the commonhold association and the unit owners. The consultation procedures, and regulation of service charge contributions which apply in leasehold including the period after a CFA, take as a starting point that there is an external landlord.

2.19 Following on from the above, the expenses relating to the administration of the commonhold association can automatically be included in the contributions to shared costs. These expenses include items such as accountancy fees, fees payable to Companies House and the costs incurred in holding meetings of the members and directors. However, landlords which own the freehold, including following a CFA, may sometimes have difficulty in recovering these expenses.

### An international perspective

2.20 Systems of ownership analogous to commonhold ("analogous systems") feature extensively in other countries, including the USA, Canada, Australia, New Zealand

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5 See para 3.48, below.

6 In leasehold, by contrast, proposals for the installation of energy efficiency measures create practical difficulties since (a) energy efficiency measures will generally be improvements and leases often allow only the costs of repairs and maintenance to be recovered through the service charge, and (b) landlords have little incentive to arrange installation, since it is leaseholders (and not landlords) who gain the benefits of energy efficient measures from reduced energy bills.

and across Europe.[7] However, while commonhold has been available in England and Wales since 2004,[8] take-up has been poor; fewer than 20 commonholds have been created.

2.21 In the course of our work, we have considered whether there have been calls for the replacement of the analogous systems in countries where they are established, in order to see whether the significant dissatisfaction with leasehold in England and Wales is also found in analogous systems. If there was evidence of such calls, then it might indicate that there is a wider concern around home ownership in interdependent properties (and that dissatisfaction with leasehold is a symptom of that wider concern), or that the analogous systems, and therefore commonhold, might not in fact be the solution to the problems found within leasehold. We have come across nothing to suggest that there are, or have been, calls to replace wholesale the analogous systems.

2.22 However, the experience of other systems does cast light on the divergent history and culture of land ownership, which help explain how leasehold came to be used in England and Wales, and the more recent calls for reform.

2.23 We explained in Chapter 1 that describing the landlord-tenant relationship as "feudal" is a misdescription, but it is not necessarily a mischaracterisation.[9] The history of England and Wales is such that large parcels of land were held by a relatively small, "landed" group. That is not necessarily the case in other countries. As Dr Cathy Sherry explained to us,[10] in England and Wales:

> [w]hen feudalism [ended], land was not taken away from the aristocracy. They retained their ownership of far more land than they could ever personally use. They then used long … leases … as a way of allowing others to exploit land for the benefit of both landlords and tenants.
>
> 'New World' countries like Australia, the United States, Canada and New Zealand, never had feudal systems or aristocracies. … Australia has never had a small section of the population who owned the vast majority of land, and if some people began to amass more land than they could ever reasonably use, government policy broke up those large land holdings. The result is that freehold titles are widely dispersed in the Australian population.

Dr Sherry went on to observe that:

> The English leasehold system is a result of its history. Countries like Australia, that do not share that history, do not share a leasehold tradition.

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7 Systems equivalent to commonhold go by a number of different names in different jurisdictions, for example "strata, or "condominium".

8 Commonhold was introduced by the Commonhold and Leasehold Reform Act 2002 ("CLRA 2002"), which came into force in 2004.

9 See para 1.24, above.

10 Associate Professor at the University of New South Wales, Sydney, Australia and member of our Overseas Advisory Group.

2.24 Leasehold ownership is not banned in Australia, rather, as Dr Sherry observed, it is associated with temporary housing.

2.25 That message – that residential leasehold is not seen as "ownership" in some other parts of the world – has been heard by us on a number of occasions, including by experts in countries where systems analogous to commonhold are long established.

2.26 The position in England and Wales is different. The exploitation of land has been shared: landlords give to leaseholders the use of their properties for something in return, usually money, and the leaseholder uses the land. For various reasons, the leasehold regime has been accepted, or at least tolerated, as a method of owning land in England and Wales, whereas in other nations, it has not.

2.27 However, "sharing" implies a degree of mutual benefit. The clarion call to address a significant number of issues affecting residential leasehold,[11] including demands for leasehold to be used only where it is justified,[12] or for leasehold to be abolished altogether[13] suggests that homeowners are unlikely to think the bargain is fair. In hindsight, it is arguable that a change in attitude to land ownership in England and Wales has been a long time coming; the right to manage,[14] enfranchisement rights[15] and a number of other rights and protections for leaseholders, have been building for some considerable time; the state has had to step in to try to make more fair the way in which land is "shared". But despite these changes, the message heard from other countries – that leasehold is not seen as ownership – is increasingly being echoed in England and Wales; and that message is being given to us most strongly by leaseholders' powerful accounts of their personal experience of leasehold.

2.28 Commonhold takes change to the next step, and delivers the sense of ownership, autonomy and control that homeowners in other jurisdictions, without our feudal past, have had for some time.

## PROBLEMS WITH THE CURRENT LAW

2.29 To help us identify defects in the current law, we launched a public Call for Evidence in February 2018. In the Call for Evidence we set out the problems with the law of commonhold that we had been told about and which we had uncovered in our research. We asked whether those issues created a problem in practice and whether there were any other problems that we had not identified.

2.30 Alongside the Call for Evidence, we reached out to existing commonhold unit owners and those managing commonholds to complete a survey in order to share their

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11 See para 1.25 onwards, above.

12 See, for example, MHCLG, *Implementing reforms to the leasehold system in England: Summary of consultation responses and Government response* (June 2019), para 2.1 and following, at https://www.gov.uk/government/consultations/implementing-reforms-to-the-leasehold-system.

13 See MHCLG, *Implementing reforms to the leasehold system in England: Summary of consultation responses and Government response* (June 2019), para 2.3 and the Enfranchisement Report, para 2.54(1), at https://www.gov.uk/government/consultations/implementing-reforms-to-the-leasehold-system.

14 See the RTM Report.

15 See the Enfranchisement Report.

personal experiences. Responses received were invaluable in identifying how issues with the current law might affect individuals in practice, and brought to light a number of additional concerns.

2.31 The following issues with the current law of commonhold have been identified and they form the basis of our recommendations for reform that we set out in this Report.

### Lack of flexibility in new commonhold developments

2.32 The commonhold legislation has been criticised for not being sufficiently flexible to cater for developments which combine both residential and non-residential elements, such as shops and leisure facilities.

2.33 Additionally, it is not currently possible to accommodate shared ownership leases within commonhold. These leases play an important role in Government's plans to increase the availability of affordable housing.

2.34 There is also a concern that the current commonhold legislation does not strike the correct balance between:

(1) providing the developer with flexibility to complete the development once some, but not all, of the commonhold units have been sold; and

(2) providing certainty to those unit owners who buy before the development is complete.

### Difficulty converting existing buildings to commonhold

2.35 Leaseholders can join together to convert their building (or buildings) to commonhold and replace their existing leasehold structure with the commonhold structure. Under the current law, to convert a building to commonhold, it is necessary to obtain the consent of everyone with a significant interest in the property, including the freeholder and all the leaseholders and their mortgage lenders. In practice this will be almost impossible to achieve, especially in larger buildings.

### Lack of effective enforcement powers to recover commonhold costs

2.36 Unit owners contribute towards the commonhold association's costs of running the commonhold and maintaining the common parts through the payment of "commonhold contributions". Those contributions are to ensure the property is well maintained and to pay contractors. Where unit owners fail to pay their share on time, there is a concern that other unit owners may need to make up the shortfall until the debt can be recovered. In an extreme case, a shortfall in contributions might put the solvency of the commonhold association at risk. Furthermore, despite the importance of ensuring sums are paid, there is currently no quick and effective way for an association to recover money from those who fail to pay.

### Limited control over expenditure and lack of flexibility in apportioning costs

2.37 Commonhold unit owners must contribute a percentage towards the cost of the commonhold. However, a unit owner must contribute that percentage towards every cost, regardless of the extent to which the commonhold's facilities or services benefit

that person. The lack of flexibility in the apportionment of costs has the scope for unfairness.

2.38 Furthermore, the expenditure will be controlled by the commonhold association's directors. While unit owners can appoint and remove the directors, unit owners currently have limited direct say on the level of expenditure in the commonhold and, therefore, on how much each unit owner much contribute.

2.39 It has also been argued that there are insufficient remedies available to protect unit owners against excessive expenditure on improvements to the building's structure, or on services provided to the commonhold. As the principle of democracy applies within commonhold, there is no provision to challenge the decision of a majority in respect of costs.

### Insufficient protection for those affected by commonhold decisions

2.40 One of commonhold's key advantages is that each commonhold exists with a view to benefiting the community comprised of its unit owners. Commonhold achieves that outcome by giving to unit owners a vote in collective decisions about how the commonhold is run.

2.41 Currently, the majority of unit owners decide what is to happen and there is no remedy for those in the minority who are disadvantaged by a decision. There is a concern that the existing law does not go far enough to protect those who might be adversely affected by the decisions of a majority.

2.42 The concern about protecting those who might be disadvantaged by a decision extends beyond the running of the commonhold. Over and above the prescribed rules of the CCS (which will be the same in every commonhold and cannot be amended), unit owners can vote to add and vary local rules, which are specific to their commonhold. Local rules can cover almost anything; for example, the rules might dictate whether unit owners can run a business from their properties, or keep a pet.[16]

2.43 Currently, local rules can be changed by a majority vote of those attending a meeting. However, it has been argued that some rules should be harder to change to help protect the expectations of unit owners when they purchase their units.

### Lack of certainty surrounding the effects of insolvency and voluntary termination

2.44 Consultees reported a lack of certainty surrounding the effect of a commonhold association's insolvency and the voluntary termination of the association by the unit owners. Mortgage lenders were particularly concerned about the impact these events might have on their security interests within a commonhold.

2.45 There is also a concern that the current process by which unit owners can voluntarily agree to bring a commonhold to an end does not afford sufficient protection to those opposed to the termination.

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[16] For more information about what may be covered by local rules, see Ch 10 below.

### Inefficiencies in the dispute resolution process

2.46 Disputes and tensions between neighbours are unavoidable, and they can be compounded where individuals live in close proximity, which will often be the case in commonhold. Commonhold has its own, bespoke dispute resolution process. However, the existing process can be inefficient and there is a concern that its reliance on prescribed forms represents a trap for the unwary.

## OUR PROJECT - REINVIGORATING COMMONHOLD

2.47 A project on commonhold was included in our Thirteenth Programme of Law Reform,[17] published in December 2017, following discussions with Government. Government supported the inclusion of the project in our Thirteenth Programme, as required by our Protocol with Government.[18]

### Terms of Reference

2.48 While we work independently from Government, our project is designed to pursue certain objectives, which have been identified by Government and which are set out in Terms of Reference that span all three residential leasehold and commonhold projects.[19] The Terms of Reference are not neutral.

2.49 So far as our work on commonhold is concerned, and in addition to two general objectives,[20] our Terms of Reference make clear our objective is to "re-invigorate commonhold as a workable alternative to leasehold, for both existing and new homes".

2.50 As mentioned at paragraph 1.59 above, our project seeks to address the perceived shortcomings in the legal design of the commonhold regime. In addressing those shortcomings, and in accordance with our Terms of Reference, we have analysed the aspects of the law which have so far impeded commonhold's success, for example, by affecting market confidence or making the regime unworkable. We have made recommendations to meet the objective of reinvigorating commonhold as a workable alternative to leasehold, for both existing and new homes.

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17 See the Thirteenth Programme of Law Reform (2017) Law Com No 377, para 2.32 and following. Details of the Law Commission's Thirteenth Programme of Law Reform are available at https://www.lawcom.gov.uk/project/13th-programme-of-law-reform/. For information about how this project was included in the Thirteenth Programme of Law Reform, see Enfranchisement CP, paras 1.15 and 1.16 and CP, n 31.

18 Protocol of 29 March 2010 between the Lord Chancellor (on behalf of the Government) and the Law Commission (2010) Law Com No 321, available at https://www.lawcom.gov.uk/document/protocol-between-the-lord-chancellor-on-behalf-of-the-government-and-the-law-commission/; and Protocol of 10 July 2015 between the Welsh Ministers and the Law Commission, available at https://www.lawcom.gov.uk/document/protocol-rhwng-gweinidogion-cymru-a-comisiwn-y-gyfraith-protocol-between-the-welsh-ministers-and-the-law-commission/. Also see para 2.85 below.

19 See para 1.48 onwards and Appendix 1.

20 The general objectives set out in our Terms of Reference are (1) to promote transparency and fairness in the residential leasehold sector; and (2) to provide a better deal for leaseholders as consumers.

## THE CONSULTATION PAPER AND CONSULTATION PROCESS

### The Consultation Paper

2.51 In December 2018, we published the Consultation Paper. In that paper, we made provisional proposals and asked questions about how the law of commonhold might be improved, in response to the issues highlighted above.

### Consultation events

2.52 During the consultation period, we organised and attended a large number of events in England and Wales in order to explain our provisional proposals for reform, encourage discussion and debate about our proposals, gather attendees' views and encourage people to provide written responses to the Consultation Paper. We encouraged attendance from all those affected by our proposals for reform, including leaseholders and prospective homeowners, legal professionals, social and private landlords, mortgage lenders, residential management companies and developers.

2.53 We held consultation events in Birmingham, Brighton, Cardiff, London, Manchester, Newcastle and Southampton, including symposia at the law faculty at University College London and at Manchester Metropolitan University. We also attended several events and meetings hosted by other organisations. We heard from a wide range of stakeholders with diverse perspectives.

### The consultation responses

2.54 We received 524 responses to the Consultation Paper,[21] from a wide range of consultees including leaseholders, residents' management companies, commercial freeholders, charity freeholders, social housing providers, developers, law firms, surveyor firms and other professional bodies, and organisations representing leaseholders.

2.55 Most consultees answered at least one question in the Consultation Paper. However not all questions received the same level of engagement. Questions on conversion to commonhold and financing the commonhold attracted the greatest number of responses. This suggests that conversion to commonhold, coupled with a robust regime to manage how a commonhold is financed, is of most significance to consultees. This is unsurprising given the criticisms that have been made of leasehold ownership in recent years and the reports of excessive, or opaque fees charged by landlords.[22]

### The analysis of responses

2.56 Since our consultation closed in March 2019, we have been analysing the responses as part of the process of developing our recommendations that we set out in this Report.

2.57 In framing our recommendations, we have carefully considered all consultees' comments and the reasons why they favoured or opposed a provisional proposal, and

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21 Consultees are listed in Appendix 2. Responses were received via our online form, by email and by post.

22 See para 1.28, above.

weighed the arguments made. So, while the number of responses for or against a proposal was helpful in deciding whether to pursue the proposal, the level of support received was not the only factor in our decision making.

2.58 To assist in us in making our recommendations, we prepared a statistical analysis of the responses received to the Consultation Paper. A copy of this analysis has been published on our website alongside this Report.

2.59 We categorised consultees into a number of categories. For example, some individuals identified as leaseholders and others said that they were responding on behalf of an organisation such as a law firm, a housing association, or a particular trade association.

2.60 Categorising consultees assisted our understanding of how different groups of consultees responded to the issues raised in the Consultation Paper, including which topics were supported or opposed by which groups, and helped us to ensure that we had properly accounted for the breadth of different views. Our categorisation sets out those consultees who broadly have the same or similar interests. However, we do not wish to suggest that everyone within a given category would have a single opinion, or one that is necessarily different from those in other categories.

2.61 When analysing the responses received, we acknowledged that certain groups of consultees have particular expertise or experience in relation to certain topics. For example, developers' views have been particularly helpful in preparing our recommendations to make commonhold work in larger, mixed-use developments. Those who will eventually live in a commonhold, such as current leaseholders or prospective purchasers, will have a greater understanding of whether our proposals to resolve disputes, or to change local rules, will work satisfactorily.

2.62 Some proposals in the Consultation Paper might have had a particular impact on certain groups, which might influence whether they favoured or opposed a proposal. For example, leaseholders are likely to favour removing as many barriers to conversion as possible, including removing the need for a freeholder's and mortgage lender's consent, whereas freeholders and lenders would be likely to argue the opposite. Additionally, consultees' responses are likely to be coloured by the broader issue of whether they are in favour of, or are opposed to, the reinvigoration of commonhold. Leaseholders are generally strong proponents of the commonhold model of ownership, as it has the potential to overcome many of the problems that they have seen or experienced in the leasehold context. Other categories of consultees might object, or be more equivocal in their support, possibly because a proposal would require them to alter existing practices, or might result in the loss of an income stream.

## THIS REPORT AND OUR RECOMMENDATIONS FOR REFORM

2.63 In this Report, we present consultees' views in response to the Consultation Paper and make 121 recommendations.

2.64 Our recommendations will result in a commonhold regime that is fit for purpose for all those involved with a commonhold, whether because they wish to convert leasehold premises to a commonhold, are living in a commonhold, are building a new

commonhold, or are lending in respect of a commonhold. The recommendations we make will deliver a fair and cost-effective commonhold regime that has the flexibility, safeguards and streamlined processes that are necessary for modern life. Our recommendations will improve confidence in commonhold across the property sector and will assist in making commonhold a prevalent form of ownership in England and Wales.

2.65 We are confident that our recommendations will ensure that the commonhold regime offers not just a *workable* alternative to residential leasehold for all involved, but a *preferred* alternative.

### Key policy considerations

2.66 When preparing our recommendations, we have considered the various ways in which the law might be improved and its current problems addressed. When deciding which route to pursue, we have benefited enormously from the input of consultees, as well as the experience from other countries where analogous systems to commonhold are the prevalent means by which flats are owned. We have also been guided by certain key objectives and policy considerations, which we set out below. Those objectives take into account our Terms of Reference as well as the wider context of our, and Government's, work on leasehold.[23]

2.67 First, we have sought to produce a scheme which, so far as possible, prevents the abuses which have been seen in the leasehold sector being replicated within commonhold.

2.68 Second, we have aimed to provide unit owners with the real benefits of autonomy and control associated with freehold ownership, while acknowledging that that must be shared with other unit owners in the commonhold community in view of the interdependence of units.

2.69 Third, we have aimed to produce a regime that balances the interest of parties where unanimity is not forthcoming. Any scheme in which the management of the building is controlled by the homeowners requires mechanisms to overcome stalemate where unanimity among owners is not achievable. In those circumstances, we think the prevalence of the wishes of the majority is the most desirable principle and, we suspect, is in keeping with most people's expectations. However, we have been conscious of the impact of a majority's decision on those who object, and we have developed protections within the commonhold regime to ensure that the minority are protected where necessary.

2.70 Fourth, we have sought to help preserve the solvency of the commonhold association. The commonhold association plays a fundamental role in the management of the commonhold by ensuring that the common parts are adequately maintained and by overseeing unit owners' compliance with the CCS. Properly functioning commonhold associations are inextricably linked to unit owners' enjoyment of their commonhold units; in order to function properly, a commonhold association must have sufficient resources.

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[23] See para 1.45 onwards and para 1.61 onwards above.

2.71 Fifth, we have pursued simplicity over complexity. So, for example, our approach has been to adopt the same general rules for commonhold associations that apply to all companies, wherever possible, rather than create new, bespoke rules.

2.72 Finally, where there is no clear evidence that a particular reform would improve the existing commonhold model, we have not made a recommendation. In some cases, we have suggested that the law should be kept under review.

### Key recommendations and benefits

2.73 Our key recommendations to reinvigorate commonhold will ensure the following.

(1) That commonhold is sufficiently flexible to cater for large, mixed-use developments. Our recommendations will ensure developers have a number of mechanisms at their disposal to tailor a commonhold scheme to suit its context. In particular, developers will be able to set up different "sections" within a commonhold to separate the management of different types of interest, such as residential and commercial interests. Sections will enable commonholds to be established where only the unit owners within a particular section are able to vote on matters affecting that section, and only those who benefit from a particular service or facility will be responsible for paying for it.

(2) That developers can build new commonhold developments in phases, allowing for units in completed phases to be sold, while retaining control of the parts of the site still under development. Our recommendations will provide developers with the flexibility and control they need to complete the development through the reservation of rights in the CCS. However, our revised scheme carefully balances the needs of the developer in completing the development with the needs and rights of unit owners who have bought their units before the development is complete.

(3) That commonhold developments are made more attractive by enabling them to accommodate shared ownership leases and lease-based financing (called home purchase plans).

(4) That it is much easier for leaseholders to convert from leasehold to commonhold. Our recommendations will enable conversion to commonhold to be possible without the agreement of every person with an interest in the property. At the same time, we ensure safeguards are in place to protect those who have not agreed to the conversion. The process of converting to commonhold will also become easier, quicker and more cost-effective. Our reforms will place leaseholders in control of the conversion process and will prevent tactical delays by those who are opposed.

(5) That there is a robust financing regime that is appropriate for all commonholds, regardless of their size and facilities. Our recommendations provide flexibility in how commonhold costs are apportioned between unit owners; will ensure unit owners have greater involvement in approving commonhold costs, by enabling them to vote on the budgets proposed by the directors; will also provide greater protection to unit owners, by giving them a new right to challenge certain costs in the First-tier Tribunal (Property Chamber) in England or the Leasehold

Valuation Tribunal in Wales (the "Tribunal"); to protect unit owners from disproportionate contributions to the commonhold's expenditure; and ensure that commonholds have adequate funds available for future routine repairs or unexpected expenditure.

(6) The powers of commonhold associations to recover contributions from unit owners who fail to pay their share are enhanced. We recommend a new right for an association to apply to court for the sale of a commonhold unit in order to recover arrears. This new right will help to preserve the solvency of the association and will protect other unit owners from being required to cover the defaulting owner's share. We build protections into this process to ensure unit owners are not at risk of losing their properties in respect of trivial amounts, and to ensure lenders are kept informed of the arrears and can take steps to protect their security. Our recommendations will also mean that defaulting unit owners retain the balance after the arrears and any mortgage lenders have been paid.

(7) That commonhold associations can respond effectively to emergencies by raising the necessary finance to undertake essential works. We recommend an express power for commonhold associations to offer the common parts as security to lenders, enabling them to access finance on favourable terms, and provide safeguards for unit owners and their lenders to ensure that this action is only taken where necessary. We further recommend protections for unit owners where a commonhold decides to sell part of its land in order to raise emergency funds.

(8) That directors of the commonhold association are appointed in a fair and democratic manner and can be removed if they are failing to comply with their duties. The directors play an important role in managing the commonhold on behalf of unit owners. The failure of the directors to comply with their obligations can impact negatively on unit owners, lenders and anyone else with a stake in the commonhold. Our recommendations ensure that directors are subject to the oversight of unit owners and can be removed and replaced if they fail to comply with their duties.

(9) That unit owners adversely affected by a decision of the commonhold association are protected by providing a right to apply to the Tribunal for an appropriate remedy. Our recommendations ensure that unit owners in the minority are able to challenge decisions that are not in their interests, while still enabling the commonhold association to function effectively on democratic lines.

(10) The CCS is made a more transparent and easy to navigate document for unit owners. Our recommendations will also ensure that the CCS provides unit owners and other occupants with certainty as to their rights and obligations, while retaining sufficient flexibility to change the rules of their commonhold when desirable.

(11) That the commonhold is kept in good repair and properly insured. It is vital for all unit owners that the fabric of the building is properly maintained and protected in the event of damage. Our recommendations clarify how the commonhold association should deal with routine management and

maintenance of the common parts, and ensures that adequate insurance can be procured.

(12) That lenders in the commonhold regime are reassured and their positions protected, including in the unlikely event of a commonhold association's insolvency, or on the voluntary termination of the commonhold. Our recommendations also ensure that the court has a greater role in safeguarding the interests of unit owners who oppose termination.

(13) That there is improved efficiency and cost-effectiveness in resolving disputes through the encouragement of early communication between unit owners and the commonhold association. We make recommendations to simplify the dispute resolution processes and prevent owners from being caught out by technicalities. We also recommend that unit owners, who breach the terms of the CCS, should be required to reimburse those who have incurred legal and other costs when taking action.

### Implementing our recommendations for reform

2.74 Reforming the law of commonhold will necessitate changes to both primary and secondary legislation. The law which governs commonhold can be found in a mix of statute – the Commonhold and Leasehold Reform Act 2002 (the "2002 Act") – and secondary legislation:

(1) the Commonhold Regulations 2004[24] (the "Commonhold Regulations"), as amended by the Commonhold (Amendment) Regulations 2009[25] (the "2009 Amendment Regulations"); and

(2) the Commonhold (Land Registration) Rules 2004.[26]

2.75 There are 70 sections in the 2002 Act, leaving the Commonhold Regulations to provide much of the detail of how commonhold operates. For example, regulations set out the provisions which must be contained in every CCS, and the rules which govern the commonhold association.

2.76 Leaving the detailed operation of the commonhold regime to regulations is advantageous. It "future-proofs" the law of commonhold by allowing Government to update, relatively easily, but with due scrutiny, the terms of the CCS and the rules which apply to every commonhold in order to respond to changing needs. For example, Government could introduce terms which improve fire safety measures (or other health and safety measures) and encourage the use of "green" energy initiatives such as electric car charging points. We recognise that such flexibility is a key advantage of the commonhold legislation and our recommendations ensure this benefit is retained upon implementing our reforms.

2.77 In addition to legislation, we suggest, at various points throughout this Report, that practical guidance should be introduced. Given that commonhold is a relatively

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24 SI 2004 No 1829.

25 SI 2009 No 2363.

26 SI 2004 No 1830, as amended.

unfamiliar form of ownership at present, the existence of guidance will act to encourage best practice, reduce the risk of disputes about how the law should be interpreted and bring confidence to the market. We suggest, for example, that guidance could be produced which will assist:

(1) developers when building new commonhold developments and when reserving development rights in the CCS;

(2) the commonhold association's directors in understanding their obligations, both under commonhold legislation and company law;

(3) those preparing the CCS (which may be the developer in new developments or the leaseholders on a conversion to commonhold) to decide on which local rules would be appropriate for their building or development, or on how to allocate expenditure between different units; and

(4) the unit owners and the commonhold association to resolve disputes informally and to know when it is appropriate to take more formal action.

2.78 Furthermore, as part of Government's wider measures to reinvigorate commonhold, it would be helpful for a consumer guide to be produced which covers the key features of commonhold ownership.

## WIDER MEASURES TO REINVIGORATE COMMONHOLD

2.79 Alongside our work to reform the commonhold regime, Government is separately considering wider measures to help reinvigorate commonhold.

2.80 In the Consultation Paper, we asked two questions, which were intended to ascertain consultees' views on whether our proposals would be sufficient in themselves to reinvigorate commonhold, and how far additional Government measures were likely to be necessary.[27] Consideration of these issues falls to Government, rather than the Law Commission. However, we report on consultees' views in Appendix 3.

## THE IMPACT OF REFORM

2.81 Our recommendations constitute a significant revision of the law of commonhold. The recommendations, when implemented, will have financial and non-financial implications for a wide range of actors in the property market, including existing leaseholders, future homeowners, developers and mortgage lenders.

2.82 We have had in mind the potential impact of our recommendations throughout their development. We are confident that our recommendations will address problems and inefficiencies in commonhold's existing legal framework.

2.83 We have agreed with Government that, if it accepts our recommendations, it will take the lead on the formal impact assessments to ascertain the effects of implementing our reforms and which accompany legislation as it passes through Parliament.

2.84 In order to assist Government in preparing the impact assessments, we used the Consultation Paper to gather evidence from consultees on the likely impact of our

[27] See CP, Consultation Question 105, para 16.43 and Consultation Question 106, paras 16.48 and 16.49.

provisional proposals. For example, we asked consultees about the time and cost savings that are likely to arise through transferring the jurisdiction for resolving commonhold disputes from the court to the Tribunal. We have shared the responses received with Government.

## THE LAW IN WALES

2.85 The extent of Welsh devolution in relation to commonhold is unclear. "Housing" was expressly devolved to Wales in the Government of Wales Act 2006.[28] Following the Wales Act 2017, rather than expressly devolving competence in certain areas, competence is devolved unless expressly reserved. The Senedd Cymru (Welsh Parliament) cannot modify "the private law", which includes the law of property. But that does not apply if the modification "has a purpose (other than modification of the private law) which does not relate to a reserved matter".[29] In other words, the Senedd Cymru has power to amend the law of property in Wales, provided the purpose of the amendment is related to a matter which is devolved (for example, housing).

2.86 Under our Protocol with the Welsh Ministers, the Law Commission will only undertake a project concerning a matter that is devolved to Wales if it has the support of the Welsh Ministers.[30] To the extent that any of the matters in our Terms of Reference are devolved to Wales, the Welsh Ministers have indicated their support for the Commission undertaking this project.

2.87 Our project, therefore, is intended to cover both England and Wales, and to result, where reasonably possible, in a uniform set of recommendations that are suitable for both England and Wales. Nevertheless, in Chapter 16 of the Consultation Paper, we asked consultees whether any specific considerations in England or in Wales call for particular issues to be treated differently.

2.88 The overwhelming majority of consultees who answered that question thought that there should not be any difference in how commonhold is treated in England and Wales.

2.89 Only two consultees suggested ways in which the approaches in England and Wales might differ.

(1) The Property Bar Association thought that commonholds based in Wales should be required to produce their CCS in both English and Welsh, and should be required to identify which should be treated as the primary document for interpretation purposes.

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28 Government of Wales Act 2006, sch 7, Pt I, para 11.

29 Wales Act 2017, s 3 and schs 1 and 2 (and the new schs 7A and 7B).

30 Protocol of 10 July 2015 between the Welsh Ministers and the Law Commission, https://www.lawcom.gov.uk/document/protocol-rhwng-gweinidogion-cymru-a-comisiwn-y-gyfraith-protocol-between-the-welsh-ministers-and-the-law-commission/.

(2) One consultee thought that, if the Welsh Government wished to proceed faster than England, it should be able to do so.[31]

2.90 The need for, and status of, a CCS that is produced in both English and Welsh is an issue that arises whether or not legislative competence in respect of commonhold is devolved. When implementing our reforms, Government should consider whether, and the extent to which, prescribed documents (and any relevant guidance) that will be used within the commonhold regime should be produced in both English and Welsh.

2.91 The question of whether our recommendations could be implemented at a different point in time in England and in Wales will depend on whether legislative competence on commonhold is devolved. We explained above that the answer to that question is not simple. However, we do not think it is a question which requires us to reach a conclusion. That is because neither of the consultee responses mentioned above, nor anything else, has caused us to question whether our recommendations should apply equally to properties in England and Wales.

## STRUCTURE OF THIS REPORT

2.92 This Report consists of 21 chapters - considering each stage in the life of a commonhold, from creation, to operation, to termination – separated into eight parts and three appendices.

Chapter 1 comprises an overview of our three residential leasehold and commonhold projects, how they interrelate and how these projects fit into Government's own leasehold reform work. This chapter also sets out our post-reform vision for home ownership.

(1) *Part I: Introduction*

This Chapter 2 introduces our project, our consultation process and this Report.

(2) *Part II: Conversion to commonhold*

Chapter 3 explains what we mean by "conversion to commonhold" and how it compares with buying a "share of the freehold" in a collective freehold acquisition claim.

Chapter 4 explains the difficulties currently caused by the requirement for unanimous consent to convert and sets out recommendations to enable conversion without the agreement of every interested person (including the freeholder and all leaseholders).

Chapter 5 sets out two potential models for conversion to commonhold and explains how each would work in practice, including the safeguards that should be put in place to protect those who have not agreed to the conversion. The recommendations we make in this chapter are summarised in Chapter 6. However, we provide a more detailed analysis in Chapter 5 for completeness,

[31] Phyllis Buchanan (leaseholder).

and for those who wish to consider the operation of the two options in more detail.

Chapter 6 analyses the main advantages and disadvantages of both conversion options and puts forward our preferred option to Government.

Chapter 7 makes recommendations that will ensure the practical steps involved in converting to commonhold are as straightforward and as cost-effective as possible.

(3) *Part III: New commonhold developments*

Chapter 8 concerns the commonhold regime's ability to accommodate complex mixed-use and multi-block developments. We make recommendations for the introduction of sections to facilitate the separation of different interests within a commonhold.

Chapter 9 explains how developers may create new commonhold developments. Our recommendations will provide developers with the flexibility they need to complete new commonhold developments while ensuring sufficient protections are in place to protect unit owners who buy whilst the development is ongoing.

(4) *Part IV: The commonhold community*

Chapter 10 sets out our recommendations to reform the commonhold community statement. We make recommendations that will strike a better balance between flexibility and certainty and achieve greater transparency by targeting both the content and the form of the CCS.

Chapter 11 considers the exceptions to the prohibition of long leases in commonhold that we recommend should be made for leases and lease-based products. We set out proposals for giving those with shared ownership leases and lease-based home purchase plans a greater say in the management of the commonhold and binding them closer to the commonhold rules.

(5) *Part V: Managing and financing the commonhold*

Chapter 12 makes recommendations to assist the directors of commonhold associations in managing and maintaining commonholds, and provides unit owners with protections to ensure that their developments are kept in good repair.

Chapter 13 concerns how a commonhold sets its expenditure and raises the necessary funds from unit owners. We make recommendations to ensure that unit owners have a greater degree of control over expenditure, to protect unit owners against excessive expenditure and disproportionate contributions, and to ensure that the commonhold association can recover arrears upon the sale of a unit.

Chapter 14 sets out our recommendations to ensure that commonholds build up adequate funds to cover the cost of future repairs.

Chapter 15 explains how the commonhold may cover the cost of emergency repairs. We make recommendations for mechanisms to finance such works, while protecting the interests of unit owners and third parties.

(6) *Part VI: Dispute resolution, minority protection and enforcement*

Chapter 16 sets out proposals for making the existing commonhold dispute resolution procedure more transparent and accessible to users, with greater protection for unit owners who have suffered losses following a dispute. We make recommendations to give greater prominence and importance to alternative dispute resolution ("ADR") and to better integrate ADR into the dispute resolution process. Finally, we make recommendations in respect of the Tribunal's jurisdiction and the potential roles for the New Homes Ombudsman and a possible regulator.

Chapter 17 concerns our recommendations for the protection of the minority in a commonhold, following a majority vote which affects their interests. We make recommendations dealing with the circumstances in which unit owners should have the right to apply to the Tribunal to protect their interests, the test that should be applied by the Tribunal in such cases and the remedies that the Tribunal should be able to grant.

Chapter 18 considers the powers available to the commonhold association to enforce compliance with the CCS. We make recommendations that will enable the association to take much swifter action against owners who fail to pay their share of the commonhold costs on time.

(7) *Part VII: Insolvency and termination*

Chapter 19 considers how unit owners in a commonhold should be protected from the consequences of the commonhold association's insolvency or striking-off. We make recommendations that protect unit owners from inroads being made into their limited liability and to ensure that a successor association can be set up to take over the role and functions of an insolvent commonhold association.

Chapter 20 sets out our recommendations to enable the redevelopment of commonholds following substantial damage, or which have reached the end of their life. We make provisions to protect both unit owners and lenders during the termination process.

(8) *Part VIII: Summary of our recommendations*

Chapter 21 gathers together all of the recommendations we make in this Report.

(9) Appendix 1 sets out our Terms of Reference.

(10) Appendix 2 contains a list of consultees.

(11) Appendix 3 sets out a summary of consultees' views about the steps necessary to reinvigorate commonhold.

## NEXT STEPS

2.93 The recommendations we make in this Report will not directly change the law; rather, they will be considered by Government and a decision made as to whether to implement them.

2.94 Assuming that our recommendations are accepted, then there are a number of steps to take before our recommendations become law. One of the most important steps would be Parliament's consideration of a Bill.

2.95 Unlike some of our work, there is no draft Bill attached to this Report. The process of drafting a Bill is valuable. It can assist in clarifying certain aspects of policy. That process may be particularly valuable in the case of our Reports on residential leasehold and commonhold, because, not only do our Reports interact, to a greater or lesser degree, with one another, they may also interact with work that Government is undertaking.

2.96 During the implementation process, including the drafting of the Bill, we will assist Government with any need for clarification of policy, or other matters relating to implementation, that may arise.

## PUBLICATIONS ACCOMPANYING THIS REPORT

2.97 Alongside this Report, we have published on our website:[32]

(1) a summary of our three residential leasehold and commonhold law reform projects;

(2) the responses to the Consultation Paper, which have been redacted to remove consultees' personal information, and to protect those who have provided their responses confidentially or anonymously; and

(3) a statistical summary of how consultees responded to the consultation questions.

## ACKNOWLEDGEMENTS

2.98 We are very grateful to everyone who responded to the Consultation Paper, listed in Appendix 2.

2.99 During the course of preparing this Report, we have held a number of meetings with individuals and organisations. We are grateful to them all for giving generously of their time and expertise.

[32] Available at https://www.lawcom.gov.uk/project/commonhold/.

2.100 We are also grateful to all those who attended and contributed at the events that we hosted and attended,[33] and also to those who allowed us the use of their facilities.

2.101 In particular, we extend our thanks to the members of our advisory groups, whose details were listed in Appendix 2 to the Consultation Paper. We also extend our particular thanks to: Sir Peter Bottomley MP, Justin Madders MP and Sir Edward Davey MP (co-chairs of the All Party Parliamentary Group on Leasehold and Commonhold Reform) and Jim Fitzpatrick, who was co-chair before standing down from Parliament; the Leasehold Knowledge Partnership; and officials from the Ministry of Housing, Communities and Local Government and the Welsh Government. We also thank UK Finance and Berkeley Group Holdings PLC for their continuing engagement on technical aspects of our recommendations.

2.102 Finally, we would like to acknowledge here the assistance of Louie Burns and Professor James Driscoll, both of whom were members of advisory groups associated with our projects on residential leasehold and commonhold, and who sadly died prior to publication of this Report.

## THE TEAM WORKING ON THE REPORT

2.103 The following members of the Law Commission's Property, Family and Trust Law team have contributed to this Report:[34] Gary Bennett; Emily Fitzpatrick; Matthew Jolley; Alicia Kaupp-Roberts; Christine Land; Simon Marciniak; Colin Oakley; Rachel Preston; Nicholas Roberts; Daniel Robinson; Harley Ronan; and Shani Taggart.

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33 See paras 2.52 to 2.53 above.

34 The list of contributors includes those who have worked on the Report full- or part-time and includes past and present members of Law Commission staff.

# Part II: Conversion to commonhold

# Chapter 3: What is conversion to commonhold?

3.1 Commonhold offers leaseholders an alternative way of owning their flats. It enables leaseholders to own the freehold of their flats, and provides a structure to regulate the relationship between them and manage any shared areas. Conversion is the process by which leaseholders can take advantage of the commonhold structure, and obtain the freehold of their homes. Leaseholders can join together to convert their building (or buildings) to commonhold and replace their existing leasehold structure with the commonhold structure.

3.2 The overall aim of our commonhold project is to "reinvigorate commonhold as a workable alternative to leasehold, for both existing and new homes".[1] Commonhold therefore needs to be available to both prospective homebuyers and existing leaseholders. Conversion is the means by which commonhold is made available to existing leaseholders. However, currently it is extremely difficult for leaseholders to convert their building to commonhold. As conversion results in property interests being changed, the consent of everyone with a property interest in the building is needed, including the freeholder, all leaseholders and their mortgage lenders. This requirement for unanimity makes conversion to commonhold almost impossible, in all but the smallest buildings.

3.3 In this Part of the Report, we make numerous recommendations that will make it easier for existing leaseholders to convert to commonhold. Our recommendations will also ensure that a workable management structure is in place once conversion has occurred.

3.4 While we refer frequently in this Part to leaseholders in a block of flats converting to commonhold, we acknowledge that conversion has wider application. For example, owners of houses on an estate might wish to put in place the commonhold structure to manage the common parts between their houses. However, we anticipate that it will be predominantly leaseholders in blocks of flats who seek to take advantage of the conversion process. We therefore adopt the terminology "leaseholder" and "flat" throughout for simplicity, and explain how our recommendations will apply to house owners specifically in Chapter 4.[2]

3.5 There are five chapters in this Part of the Report which address the following questions.

(1) What is conversion to commonhold? In this chapter, we provide an overview of our recommendations for conversion. We describe what happens, practically speaking, when a building converts from leasehold to commonhold and explain why conversion currently requires unanimous agreement. We also discuss how

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1 Our full Terms of Reference are set out in Appendix 1.

2 See paras 4.28 to 4.32, below.

conversion compares with buying a "share of the freehold", through a process known as "collective freehold acquisition".

(2) When should conversion be possible? In the next chapter, Chapter 4, we revisit the unanimity requirement. We consider the circumstances in which it should be possible to convert to commonhold without the agreement of every person with an interest in the building.

(3) How will conversions Options 1 and 2 operate? In Chapter 5 we consider two different ways in which conversion to commonhold might operate which we refer to as "Option 1" and "Option 2". The differences between these two options stem from the interest that those leaseholders who have not agreed to the conversion will receive at the point of conversion, but each option has wider implications for others in the building. We refer to leaseholders who have not agreed to the conversion as "non-consenting leaseholders".

After conversion under Option 1, non-consenting leaseholders' leases would simply continue, although they may be required to take the title to their commonhold unit at some point in the future. Under Option 2, non-consenting leaseholders would be required to take the title to their commonhold unit at the point of conversion, in exchange for their leasehold interest. In the Consultation Paper, we asked a number of questions about how conversion Options 1 and 2 might operate in practice, if adopted by Government. In Chapter 5 we consider each of these consultation questions in turn, setting out consultees' responses and our recommended approach. The recommendations we make in this chapter are summarised and discussed in Chapter 6. However, we provide a more detailed analysis in Chapter 5 for completeness, and for those who wish to consider the operation of Options 1 and 2 in more detail.

(4) Which is our preferred conversion option? In Chapter 6, we summarise how each conversion option will operate under our recommendations and explain which option was preferred by consultees. We analyse the main advantages and disadvantages of both options before recommending Option 2 as our preferred approach to Government.

(5) What is the procedure for converting? In Chapter 7 we make recommendations that will ensure the practical steps involved in converting to commonhold (such as preparing the commonhold community statement ("CCS") and registering the commonhold at HM Land Registry) are as straightforward and as cost-effective as possible.

3.6 We begin, however, in this chapter, by introducing the key features of conversion to commonhold and the relevant terminology that will form the basis for discussion in subsequent chapters.

## WHAT HAPPENS ON CONVERSION TO COMMONHOLD?

3.7 Following both conversion Options 1 and 2, the freehold of each individual flat in a building (referred to as a "commonhold unit" after conversion) will be owned by a commonhold "unit owner". Leaseholders who consent to the conversion to commonhold under both options (the "participating leaseholders"), will obtain the

freehold of their flats and become the commonhold unit owner, in exchange for their leasehold interest. Depending on whether conversion Option 1 or Option 2 is pursued, leaseholders who did not agree to the conversion ("non-consenting leaseholders") will either retain their leasehold interest or take a commonhold unit on conversion.[3]

3.8 On taking commonhold units, the former leaseholders (now as unit owners) will no longer be bound by the terms of their lease or by leasehold legislation. Instead, the former leaseholders will comply with the rules of their commonhold building and with commonhold legislation. The rules of their building will be set out in the CCS. So rather than each leaseholder having their own rights and obligations set out in their lease, there will be one document relating to the whole building which sets out the rights and obligations of all the unit owners.

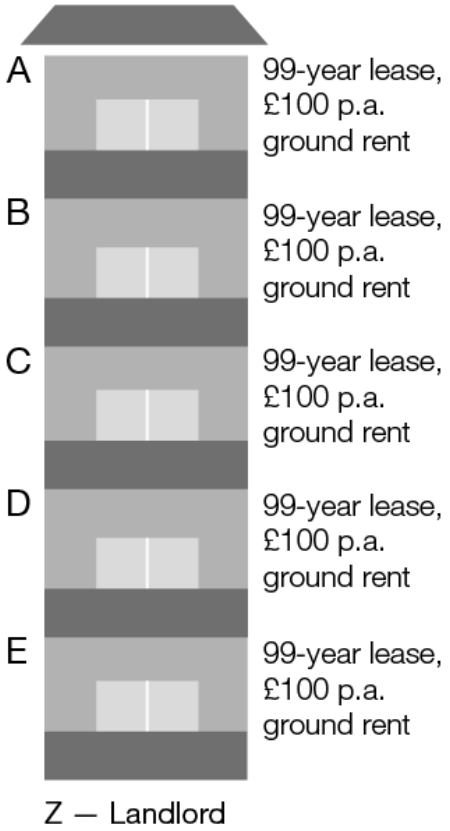
3.9 Before converting to commonhold, leaseholders will need to set up a company which will own and manage the common parts of the building following conversion. This company is called the "commonhold association". The association has articles which are prescribed by regulations and which govern how the company is run (for example how directors are appointed). Each unit owner will be a member of the commonhold association, and will be able to vote in decisions about the commonhold.

### A worked example

3.10 To best illustrate the effects of conversion, we provide a worked example of a block of five leasehold flats that converts to commonhold. In this example, we assume that each leaseholder is a participating leaseholder. The situation can become more complicated where not all leaseholders agree, and in paragraph 3.36 below we discuss the consequences where some leaseholders have not consented to the conversion. To start with, however, we adopt a simple scenario for illustrative purposes only.

[3] Where non-consenting leaseholders retain their leasehold interest under Option 1, who will own the commonhold unit will depend on how non-consenting leaseholders' shares of the freehold purchase have been financed. See discussion from para 5.57.

**Figure 3: Leasehold structure before the conversion**




3.11 In this block of five flats, each flat is held by a leaseholder under a long lease of 99 years. Each lease requires the leaseholder to pay an annual "ground rent" to Z, an external landlord[4] who owns the freehold of the block. Ground rent is a sum payable at regular intervals under the terms of the lease (usually every year) over and above the initial purchase price.

3.12 The relationship between the leaseholders and Z is governed by the terms of the leases and by leasehold legislation. For example, the leaseholders are likely to be required to pay service charges to Z under the terms of their leases. These charges would pay for Z's costs of managing the block, such as the cost of insuring and repairing the block. Service charges payable to Z under the leases are subject to a statutory requirement that the costs must be reasonable, and expenditure above certain levels requires Z to consult with the leaseholders in advance.[5]

3.13 The leaseholders will have statutory "enfranchisement" rights.[6] These rights are the subject of a separate Law Commission project. First, leaseholders have a statutory right to a lease extension. Currently, on exercising this statutory right, leaseholders

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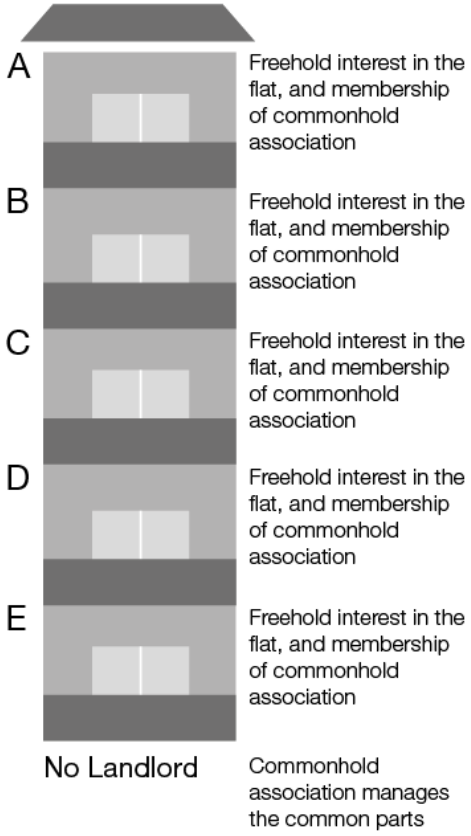
4 At para 3.17 below, we explain what we mean by "external" and how this compares with the position where the freehold is "leaseholder-controlled".

5 Landlord and Tenant Act 1985, ss 18 to 20.

6 See paras 1.52 to 1.54 above and Enfranchisement Report Ch 2 for an overview of these rights and our recommendations for reform.

will receive a new lease which extends their remaining lease term by 90 years. We recommend in the Enfranchisement Report that leaseholders should instead be able to require their landlord to grant them a new lease which extends their remaining lease term by 990 years.[7] In the example above therefore, A could require Z to grant him or her a new lease of 1089 years (calculated by adding a further 990 years to A's remaining 99-year lease). Additionally, some or all of the leaseholders can join together to purchase the freehold of their block from Z. This collective right to acquire the freehold is currently known as the "right of collective enfranchisement". In the Enfranchisement Report, we refer to this right as the right of "collective freehold acquisition" ("CFA") and we adopt this new terminology in this Report. On exercising either of these enfranchisement rights, leaseholders will be required to pay compensation to Z for the improved property interest they will acquire. We discuss the value of the freeholder's interest, and the amount it will cost to buy this interest, when considering the freeholder's position from paragraph 3.16 below.

**Figure 4: Commonhold block following conversion**




3.14 Following conversion, each former leaseholder (now as a unit owner) will own their flat (or "unit") on a freehold basis and the common parts will be owned by the commonhold association. In particular, on conversion:

[7] See Enfranchisement Report, para 3.62.

(1) the former leaseholders would become commonhold "unit owners" and the freehold owners of their homes;

(2) the former leaseholders' property interests would no longer be time-limited, and they would not be required to pay ground rent;

(3) the former leaseholders would become members of the commonhold association, which owns and manages the common parts of the building;

(4) there would be no requirement to pay service charges; rather, the commonhold association would demand "commonhold contributions" from the unit owners to cover the shared costs of (for example) repairing the block and maintaining the reserve fund;

(5) each unit would be allocated a percentage share of the votes in decisions of the commonhold association and a percentage contribution towards the commonhold's costs of managing the common parts. The percentage allocation will likely to vary from unit to unit, depending, for instance, on the size and of the particular unit;

(6) the leases, and the statutory regulation of leasehold ownership, would disappear. The mutual rights and obligations between the unit owners and the commonhold association would instead be governed by the terms of a CCS, and by the statutory regulation of commonhold;

(7) there would be no landlord controlling the building;

(8) two or more directors would be appointed by the unit owners (who could be the unit owners themselves or external third-parties) to carry out the management functions of the commonhold association; and

(9) the unit owners would be able to vote on decisions about the management of the building by majority.

## WHY DOES CONVERSION CURRENTLY REQUIRE UNANIMOUS AGREEMENT?

3.15 As can be seen from the above example, commonhold results in leaseholders taking a commonhold unit and changing their property interests from leasehold to freehold. Conversion also results in the freeholder losing his or her property interest. Before the conversion, the external landlord (Z) owns the freehold of the whole building. After conversion, the former leaseholders will own the freehold of their flats, and the commonhold association will own the freehold of the common parts. The way the current law protects the leaseholders and the freeholder from changes to their interests is simply by requiring everyone to agree to the conversion in order for the conversion to take place. In the above example, therefore, Z would need to agree to the conversion, as would each of the leaseholders. Requiring this level of agreement can quickly create difficulties, especially in larger blocks. In this Part, we therefore recommend an alternative regime which will allow conversion to proceed without unanimous agreement, while still protecting those whose interests stand to be affected. We now look at the freeholder's interest, and that of the leaseholders, in more detail.

## THE FREEHOLDER'S INTEREST ON CONVERSION

3.16 On conversion to commonhold, the freeholder will lose his or her interest in the building. The freeholder's consent to the conversion is therefore currently required. Consent will be more likely forthcoming where the leaseholders already own the freehold collectively.

### What is the difference between freeholds owned by an "external landlord" and "leaseholder-controlled" freeholds?

3.17 In the worked example above, we refer to Z as an "external landlord". By external landlord we mean that the freehold of the building is owned by a third-party, rather than by the leaseholders collectively. In some instances, the freehold of the building may already be owned, or rather "controlled", by the leaseholders collectively. For example, leaseholders may have already bought the freehold of the building through a collective freehold acquisition claim (see paragraph 3.13 above), or the building may have been structured so as to be leaseholder-controlled from the outset.

3.18 Where the freehold is leaseholder-controlled, a company will often have been set up to own the freehold of the building. The leaseholders will then be members of (or shareholders in) this company and will be able to vote in decisions affecting the building. Leaseholders in this scenario are often referred to as owning a "share of the freehold". While they remain leaseholders (and not freeholders) of their individual flats, leaseholders who own a share in the freehold will have a say in how the building is run due to their membership of (or shares in) the company which owns the freehold.[8] Where the freehold is owned in this way, the need for the freeholder's consent to the conversion will not present much of an obstacle. The leaseholders themselves will be in control of the freeholder's decisions (through their membership or shares in the freehold company) which will include the decision to convert. Following conversion of a building which is leaseholder-controlled, the leaseholders would still control the freehold together, but in a different way. Each individual leaseholder would obtain the freehold of their individual flat in exchange for their lease, and would participate in decisions about the building through their membership of the commonhold association.

3.19 Conversely, where an external landlord owns the freehold, the freeholder will be much less likely to agree to the conversion, as conversion will result in the freeholder losing his or her interest in the building. The freeholder's interest is often very valuable.

### Why is the freehold interest often valuable?

3.20 The freeholder will often have the right to receive some or all of the following sums from the leaseholders.

(1) The terms of the lease may require the leaseholders to pay ground rent to the freeholder, which can range from a nominal sum to a large annual sum and

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8 In some instances, however, the management obligations in the lease will be performed by another individual or company who will have entered into a contractual obligation in the lease to perform those management services.

may increase on a periodic basis.[9] In figure 3 above, leaseholders pay the freeholder, Z, an annual ground rent of £100.

(2) The terms of the lease may also require the leaseholders to pay the freeholder for the performance of administrative tasks, such as giving permission for alterations to be made to their flats.

(3) The freeholder will benefit from the fact that leases will expire at some point in the future. The freeholder will receive an amount of money (referred to as "a premium") when leaseholders exercise their statutory right to a lease extension and/or when granting new leases when existing leases expire.

(a) Leases are granted for a fixed period of time, for example, 99 or 125 years. At the end of that period, the leases expire. Leases lose value over time as their length reduces and are therefore referred to as "wasting assets". At the same time, the freeholder's interest (which is worth more when not subject to any leasehold interests) will increase in value. When the leases expire, the freeholder will be free to grant a new lease over the property, and can charge a premium for doing so.

(b) To avoid losing their property on expiry of their lease, leaseholders may exercise their statutory right to a lease extension, which involves paying the freeholder for a new lease, adding a further 990 years to their original term (under our recommendations in the Enfranchisement Report). Such new leases are granted with a peppercorn ground rent which will replace the ground rent previously payable.[10] Leaseholders might alternatively agree a lease extension with the freeholder on a voluntary basis (that is, without invoking the statutory rights). In order to obtain a lease extension, leaseholders must pay a premium to the landlord and that right to receive a premium is a valuable right. The premium compensates the landlord for the loss of income received through the ground rent and for the fact that the property will be subject to a lease for an additional 990 years.

### What happens if the freeholder does not agree to the conversion?

3.21 We explain above that where the freeholder is an external landlord, he or she is unlikely to agree to a conversion to commonhold. However, under the current law, leaseholders wishing to convert to commonhold could rely on their existing enfranchisement rights as a stepping-stone to conversion. As noted above, leaseholders have an existing statutory right to join together to buy the freehold of their building (or buildings[11]) without the freeholder's consent, through the process of

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9 As explained at para 1.63(2) above, Government is introducing a ban on ground rents in new leases, although ground rent may continue to be payable under existing leases.

10 Many long leases reserve an annual ground rent of a peppercorn. Strictly, the landlord in these cases could require the leaseholder to provide him or her with a peppercorn annually, but invariably this is not demanded. A peppercorn rent is used in circumstances where it is deemed appropriate for there to be no substantive rent payable. Currently any statutory lease extension must be granted at a peppercorn rent and we recommend in the Enfranchisement Report that this position should continue under our revised scheme.

11 As explained at paras 4.28 to 4.32 below, the Enfranchisement Report introduces the ability for leaseholders to bring a "multi-building" CFA claim. At present, CFA claims must be brought on a building-by-building basis. Under our recommendations in the Enfranchisement Report, provided that each building meets the

collective freehold acquisition. After exercising this right, the freehold would be "leaseholder-controlled". The leaseholders would be in control of the freeholder's decisions and so could control the decision to convert.[12]

3.22 The legislation relevant to CFA claims[13] sets out the circumstances in which leaseholders might acquire the freehold compulsorily, and what they should pay the freeholder to compensate him or her for the loss of the freehold interest. We conclude in Chapter 4 that the freeholder's consent to the conversion should not be required, provided that the leaseholders carry out a CFA as part of the process of converting to commonhold. Carrying out the CFA claim will protect the freeholder, and will ensure he or she is sufficiently compensated for the freehold interest.

### How much will it cost to buy the freehold?

3.23 Where the freeholder does not consent to the conversion to commonhold, the leaseholders will therefore need to carry out a CFA and, as part of the CFA process, pay for Z's freehold interest, in order to convert.

3.24 It should be noted that the amount that leaseholders will be required to pay to the freeholder when acquiring the freehold in order to convert will not be any different to where leaseholders are simply acquiring the freehold on an ordinary CFA claim and not also converting.[14]

3.25 The amount of money that will need to be paid to acquire the freehold as part of the CFA claim is the subject of a separate Law Commission report. In the Enfranchisement Valuation Report, we present options to Government to reduce the price payable to acquire the freehold on a CFA claim, while ensuring that sufficient compensation is paid to the freeholder to reflect his or her legitimate property interests. The valuation options presented in the Enfranchisement Valuation Report will compensate the landlord for the loss of his or her right to receive some or all of the payments listed at paragraph 3.20 above.

#### A worked example

3.26 Taking the block of flats depicted in figure 3 above, assume that Z does not agree to the conversion. A, B, C, D and E therefore need to pursue a CFA claim as part of the conversion to commonhold. In this example, each participating leaseholder contributes towards the cost of purchasing the freehold from Z in an equal amount. Figure 5 demonstrates how the purchase price might be paid.

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necessary qualifying criteria, the leaseholders of two or more buildings can submit a single claim to acquire the freehold of their buildings.

12 The leaseholders would need to approve the decision in accordance with the freeholder company's articles, for example by approving the decision by a certain majority of votes.

13 Currently the law refers to the right of collective enfranchisement, and the right is governed by the Leasehold Reform, Housing and Urban Development Act 1993.

14 Although, as we explain in Ch 5, the ways in which participating leaseholders might raise the necessary finance might differ as between ordinary CFA claims and where leaseholders are acquiring the freehold on a conversion.

**Figure 5: Purchasing the freehold**


3.27 In the figure above, Z is entitled to be paid compensation of £15,000, in order for the leaseholders to acquire the freehold. The sums used in the figure are, however, purely illustrative. The cost of buying the freehold will vary from building to building and will often be higher. Additionally, the amount each leaseholder may have to contribute can vary, for example, depending on the number of years remaining on the lease and the size of the flat.

3.28 The above example also assumes that each flat in the building is owned by a leaseholder who participates in the conversion. At paragraph 3.36 below, we explain the consequences (including in relation to financing the freehold purchase), where not all leaseholders participate.

### What process will leaseholders follow to buy the freehold and convert to commonhold?

3.29 Where the freeholder does not agree to the conversion, converting to commonhold will involve two processes:

(1) buying the freehold of the building through a CFA claim. The CFA legislation sets out a process to determine matters such as the purchase price payable to the freeholder and the land to be acquired. In the Enfranchisement Report and Valuation Report, we make a number of recommendations which will make the process of acquiring the freehold easier, quicker and cheaper; and

(2) putting in place the commonhold management structure, which will include preparing the CCS and registering the new commonhold at HM Land Registry.

3.30 To avoid the delays and costs which might otherwise be created by following two distinct processes, in Chapter 7, we explain how leaseholders will be able to streamline the processes of acquiring the freehold through a CFA claim and putting in place the commonhold management structure. We recommend a bespoke "acquire and convert" procedure that leaseholders wishing to convert can choose to follow. The acquire and convert procedure incorporates all the procedural steps required in a CFA claim, and any additional steps necessary to convert to commonhold.

## THE LEASEHOLDERS' INTERESTS ON CONVERSION

3.31 Conversion to commonhold under our recommendations will result in some or all (depending on which conversion option is pursued) of the leaseholders in the building, who are eligible to participate in the conversion, upgrading their leasehold interest to a freehold commonhold unit.

### Which leaseholders are eligible to participate in the conversion?

3.32 As, in many cases, leaseholders will be following the "acquire and convert" process described above, we consider it logical that the same leaseholders should be eligible to participate in both the CFA and conversion claims. As explained in Chapter 4, it would add too much complexity if a different group of leaseholders were eligible to participate in the CFA claim and the conversion to commonhold. We recommend that the same category of leaseholders who are eligible to participate in a CFA claim should therefore be able to participate in the conversion to commonhold.

3.33 In the Enfranchisement Report we consider which leaseholders should be eligible to participate in a CFA claim.[15] In summary, a leaseholder will be eligible to participate in a CFA claim (and therefore participate in a conversion to commonhold) if:

(1) The leaseholder has been granted a "long lease". Subject to certain exceptions,[16] a "long lease" is a lease which has been granted for more than 21 years.

(2) The lease has been granted over a "residential unit". The term "residential unit" is explained in full in the Enfranchisement Report.[17] For the purposes of this Part of the Report, however, it suffices to explain that individual flats within a purpose-built block of flats are intended to fall within the definition of residential unit. As we anticipate that it will be predominantly leaseholders in blocks of flats

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15 See Enfranchisement Report, Ch 6.

16 In Ch 7 of the Enfranchisement Report, we consider the circumstances in which leaseholders should be excluded from enfranchisement rights. As one example, as a matter of Government policy, shared ownership leaseholders, who have not yet staircased to 100% ownership, will not be eligible to participate in a CFA claim. We discuss the position of shared ownership leaseholders on a conversion to commonhold in more detail in Ch 11 of this Report.

17 See Enfranchisement Report, paras 6.24 to 6.45. Houses can also fall within the definition residential units. We explain in Ch 5 of the Enfranchisement Report, that leaseholders of houses will be eligible to participate in a multi-building CFA claim.

who will seek to convert, we retain the terminology of "flats" for simplicity, rather than adopting the term "residential units".

(3) The lease is not a "business lease".[18]

(4) The leaseholder (who would otherwise be eligible) has not sub-let his or her flat to another long leaseholder who satisfies the eligibility criteria above. There can only be one leaseholder in respect of any one flat who is eligible to participate in the CFA claim and therefore the conversion. For example, in the diagram below, if long leaseholder (A) sub-lets his or her flat to another long leaseholder (B), it would be the latter, (B) who would be eligible to participate in the CFA claim, and therefore the conversion.

**Figure 6: Eligible leaseholder on sub-letting**


3.34 In summary therefore, a leaseholder of a flat who has a residential lease of over 21 years, and who has not sub-let his or flat on a long lease, will be eligible to participate in a CFA claim and the conversion to commonhold. In this Part, we refer to leaseholders who are eligible to participate in a decision to convert, and who do in fact participate, as "participating leaseholders".

3.35 Conversely, individuals who have been granted tenancies of 21 years or less, or of commercial premises, or who have been granted business leases will not be eligible. Additionally, where a leaseholder who would otherwise be eligible has sub-let his or her flat to another leaseholder on a residential lease of over 21 years, he or she would not be eligible.

[18] See Enfranchisement Report, paras 6.48 to 6.68 for an explanation of which leases should be treated as business leases and consequently should be excluded from enfranchisement rights.

### What happens where a leaseholder, who is eligible to participate, does not agree to the conversion?

3.36 There may be leaseholders in the building who, despite being eligible to participate in the decision to convert, do not agree to the conversion to commonhold. We refer to these leaseholders as "non-consenting leaseholders". Such leaseholders may have specific reservations about the commonhold model or may be unable to afford to participate in the conversion. Leaseholders who fail to respond to a request for consent due to apathy would also fall within the category of non-consenting leaseholders.

3.37 Currently, conversion to commonhold would require the consent of every leaseholder in the building. Consultees told us that this level of support would, in most cases, be impossible to achieve. In order to make commonhold a realistic alternative for existing leaseholders, we therefore recommend in Chapter 4 that conversion to commonhold should be possible where eligible leaseholders of at least 50% of the flats in the building support the conversion. That is the same threshold of leaseholder support as is required for leaseholders to bring a CFA claim.[19] If leaseholders are able to acquire the building collectively through a CFA claim they will also be able to convert to commonhold under our recommendations. In Chapter 5 we recommend a new system of safeguards that will protect leaseholders (and others) who have not agreed to the conversion.

3.38 The consequences of conversion for non-consenting leaseholders will depend on whether conversion Option 1 or Option 2 is adopted. Under conversion Option 1, non-consenting leaseholders will retain their leasehold interest at the point of conversion. However, in order to ensure the full advantages of commonhold are realised at some point in the future, the continuation of leases under Option 1 will be a temporary, transitional measure. At some stage in the future, all non-consenting leaseholders will be required to upgrade their leasehold interest to a commonhold unit. Under Option 2, all non-consenting leaseholders will be required to take a commonhold unit at the point of conversion to commonhold. In Chapter 6 we compare the main advantages and disadvantages of both conversion options. We explain that conversion Option 2 creates the most desirable management structure as all leaseholders would obtain the same type of interest from the point of conversion. However, there are certain practical difficulties when it comes to implementing Option 2, particularly when it comes to the method of financing the freehold purchase.

### Financial consequences where not all flats are held by participating leaseholders

3.39 The figure at 5 above assumes that each flat in the building is held by a leaseholder who is eligible to participate and who also agrees to the conversion (a "participating leaseholder"). In reality, a number of the flats in the building may be held by leaseholders who, while eligible to participate, do not consent to the conversion ("non-consenting leaseholders"). Other flats might not be let to a leaseholder who is eligible to participate. For example, flats which are empty, or have been let by the freeholder

[19] Albeit that the Enfranchisement Report refers to leaseholders of 50% of *residential units* supporting the claim. See para 3.33(2), above.

to business tenants or to tenants on short-term agreements. Where this is the case, participating leaseholders will need to find a way to finance:[20]

(1) their own share of the freehold value attributable to their own flats;

(2) a share of the freehold value attributable to flats which have been let to non-consenting leaseholders; and

(3) a share of the freehold value attributable to flats which have not been let to any leaseholder who is eligible to participate.

3.40 So, as a variation to the worked example in figure 5 above, if only A, B and C were participating leaseholders, D was a non-consenting leaseholder and E was a business tenant (and therefore not eligible to participate), A, B and C would need to finance (with or without external assistance):

(1) £3,000 each in respect of their own flats;

(2) £1,000 each in respect of D's flat; and

(3) £1,000 each in respect of E's flat.

3.41 That is assuming A, B and C contribute equally to the purchase price. In Chapter 5 we explain the ways in which leaseholders might be able to finance non-consenting leaseholders' shares of the freehold value, and the shares relating to any flats which have not been let to an eligible leaseholder.

## A COMPARISON WITH COLLECTIVE FREEHOLD ACQUISITION

3.42 We note above that leaseholders already have the right to acquire their freehold collectively through a CFA claim. The question arises therefore, as to what differences there are between a CFA claim and conversion to commonhold, and what additional advantages commonhold offers.

### A worked example: where all leaseholders participate in a CFA claim

3.43 Considering again the block of five leasehold flats depicted in figure 3. If the five leaseholders in the block wished to carry out a CFA, they would nominate a person (or persons) known as the "nominee purchaser" to acquire the freehold from Z on their behalf. The nominee purchaser is usually a company, and the leaseholders will be members of (or shareholders in) this company.

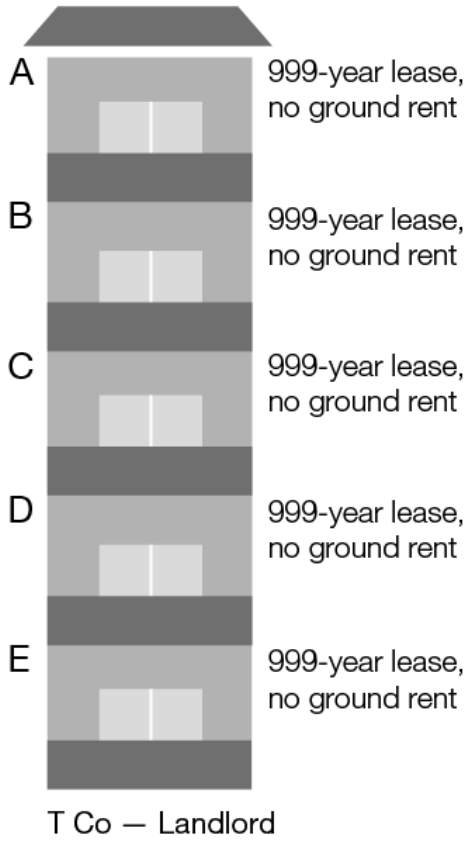
3.44 The only immediate change following a CFA is that the freehold of the building will be owned by the nominee purchaser, rather than the external freeholder Z, after the CFA claim. The leaseholders will retain their leasehold interests and will continue to be bound by the terms of their leases and by leasehold legislation. As the leaseholders will control the decisions of the nominee purchaser that acquires the freehold, they will

[20] Although, as we explain in Ch 5, the leaseholders may be able to require the former freeholder to take a leaseback or the commonhold unit (depending on which conversion option is adopted) over certain flats which means that the value attributable to such flats does not need to be raised.

be able to make certain changes to their leasehold interests. Usually, they will arrange to grant themselves 999-year lease extensions at a peppercorn ground rent.

3.45 Where all five leaseholders in the block participate in the CFA claim, and vary their leases subsequently, the position following the CFA would look like this:

**Figure 7: Position following a CFA claim where all leaseholders participate**




3.46 Here, the leaseholders have set up a company "T Co" as the nominee purchaser which acquires the freehold from external landlord Z. The leaseholders are all members of T Co. Following the CFA:

(1) the leasehold structure remains, but T Co is now the freeholder in place of Z. T Co is the landlord of each of the leaseholders. While the leaseholders now, together, control the building, the two opposing interests (landlord and leaseholder) continue to exist. Effectively, the leaseholders "wear two hats", both as leaseholders and as members in T Co;

(2) the relationship between the leaseholders and T Co continues to be governed by the terms of the leases, and by leasehold legislation. For example, the statutory regulation of service charges continues (meaning that T Co, as landlord, must still consult the leaseholders before incurring costs above a certain amount and the leaseholders would be able to challenge the reasonableness of service charge costs levied by T Co); and

(3) the leaseholders, as shareholders or members of T Co, have control over the management of the building (or could appoint a third-party to manage it), including, for example, setting the service charges.[21]

3.47 While following a CFA claim the leaseholders will gain control of the building, the CFA claim will not provide the leaseholders with the full advantages of converting to commonhold. Collective freehold acquisition and other enfranchisement rights attempt to address some of the harsher effects of leasehold ownership, but do not remove the leasehold ownership structure, or its inherent defects. After exercising a CFA claim, leaseholders will retain a leasehold interest which will expire at some point in the future (or will need to be extended), can be brought to an end through forfeiture and is inflexible to changing needs. For this reason, CFA has been described to us as "commonhold lite". Only on conversion to commonhold can leaseholders obtain the freehold of their flats, remove the landlord and tenant relationship and the risk of forfeiture, and receive greater flexibility to set the rules of their building.

3.48 Many other advantages of conversion over a CFA claim stem from the fact that the commonhold legislation has been designed specifically for the collective ownership of buildings without an external landlord. Following a CFA claim, leaseholders will remain bound by leasehold legislation which has been designed to suit an adversarial relationship between those who own the flats and those who manage the building. Commonhold removes this adversarial system. In commonhold, the same individuals who decide on the rules of the commonhold and set the costs (the unit owners, through their membership in the association), will be responsible for complying with these decisions and paying the costs (also the unit owners). The commonhold legislation has been tailored to suit this context. The legislation provides for unit owners to make collective decisions about the management of their building and there are bespoke provisions which govern every aspect of the commonhold's operation. This generates a number of advantages over CFA claims. We provided a list of these advantages at paragraph 1.33 of the Consultation Paper, but some examples include:

(1) the collective management of the building will be simplified by having one document (the CCS) which sets out the rights and obligations of all owners in the building, rather than numerous leases, the terms of which might be inconsistent with each other.

(2) the mechanism for setting costs and resolving disputes within the commonhold reflect the fact that there is a community of owners in the building who share control of the building, rather than a landlord who dictates the costs to be paid, and enforces the rules against the owners, which is the starting point in leasehold.

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[21] In some cases, the management might already be undertaken through a residents' management company (RMC) (or a "right to manage" company under the CLRA 2002) of which the leaseholders are members. "RMC" is defined in the Glossary. Usually where there is an RMC it will have been the "third-party" to each lease, when originally granted, in addition to the landlord and the leaseholder. We have made recommendations to reform the right to manage in our separate Right to Manage Report. See paras 1.55 to 1.56 above for an overview of our recommendations in this separate report.

(3) Additionally, there are provisions that will make it easier for unit owners to raise funds to carry out emergency repairs, and to redevelop the commonhold when the building has come to the end of its useful life.

### Worked example: where some, but not all, of the leaseholders participate in a CFA claim

3.49 The adversarial leasehold relationship which exists following a CFA claim is more pronounced when not all leaseholders in the block participate in the CFA. As we note above, a CFA claim is possible where eligible leaseholders of at least 50% of the flats in the building support the claim. It will usually be the case, especially in larger blocks, that the claim takes place without unanimous agreement. Where some, but not all of the leaseholders participate, the participating leaseholders and non-participating leaseholders will hold different interests after exercising the claim. At present, this inequality is permanent.[22] There is no mechanism for non-participating leaseholders to buy a share of the freehold after the CFA claim has taken place.[23] After the claim:

(1) The leaseholders who participated in the CFA claim, will acquire "a share of freehold" and gain control of the building. As these leaseholders would now control the building, they would be able to vary the terms of their own leases, for example by extending the term of their leases to 999 years and by removing any requirement to pay ground rent. However, they would not be able to vary the terms of non-participating leaseholders' leases. In managing the building those who had purchased a share of the freehold would still need to comply with the (unchanged) terms of the non-participating leaseholders' leases.[24]

(2) The leaseholders who do not participate in the CFA claim would continue to own their leases on the same terms and from their point of view, the only change would be the identity of the freeholder. Those who participated in the CFA claim would become their landlord.[25] Non-participating leaseholders would continue to pay any ground rent due under the terms of their lease and any premiums for a lease extension to the participating leaseholders.[26]

3.50 Using the same example at figure 3, it might be that leaseholders A, B, C and D want to participate in the CFA claim, but E does not wish to do so. Since a CFA claim can be made by the leaseholders of 50% of the flats in a building, the claim can go ahead without E's agreement.[27] After the purchase, T Co might grant A, B, C and D lease

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22 Or at least until another group of leaseholders bring a CFA claim.

23 In the Enfranchisement CP, we proposed the introduction of a new right for leaseholders, who did not participate in the initial CFA claim, to buy a share a share of the freehold at a later date. We referred to this right as the "Right to Participate". However, for reasons discussed in the Enfranchisement Report, we will not be taking this proposal forward at this stage. See Enfranchisement Report, para 5.222 to 5.246.

24 Technically, the building will be managed by the freeholder company, of which the leaseholders are members or shareholders.

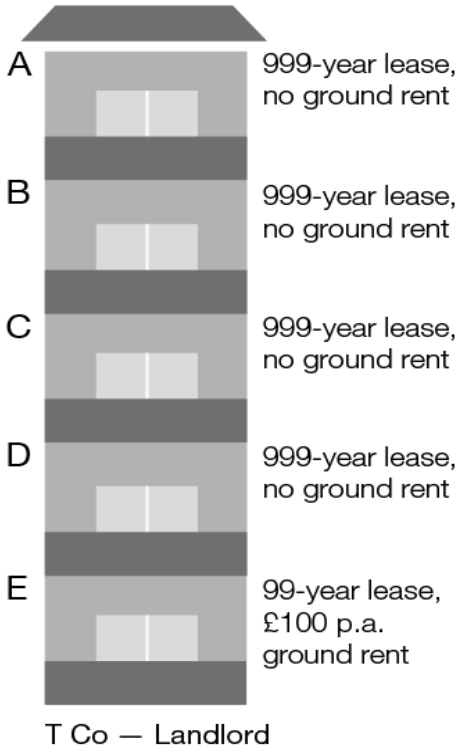
25 Or, more precisely, the company which acquires the freehold and is controlled by those leaseholders, will be their landlord.

26 The payment would be made to the freeholder company, who would share these receipts with the members.

27 Assuming the other criteria for collective freehold acquisition can be satisfied. See para 4.8 below.

extensions. E's lease would remain unchanged. A, B, C and D would each have "a share of the freehold". E would not.

**Figure 8: Position following a CFA claim where not all leaseholders participate**




3.51 Following a CFA claim where not all leaseholders participate:

(1) T Co is the freeholder in place of Z. A, B, C and D are members of T Co and have control over the management of the building.

(2) A, B, C and D have 999-year leases with no ground rent. By contrast, E retains his or her 99-year lease and will continue to pay ground rent. E will now pay this ground rent to T Co.

(3) E would have a statutory right to extend his or her lease by 990 years under our recommendations in the Enfranchisement Report but would not have any right to acquire a share in T Co subsequently. Any premium payable for a lease extension would be paid by E to T Co.

3.52 While the majority of the leaseholders now, together, control the building, the two opposing interests (of landlord and leaseholder) would continue to exist. Indeed, the opposing interests are more prominent, and have more potential to cause problems in the future, given the two tiers of interest in the building. E's interest in his or her flat is a lesser interest than that of the other leaseholders in the block: E has a shorter lease, must continue to pay ground rent, and has no say (through T Co) in the management of the block. Commonhold, by contrast, is intended to put all owners on the same footing, as freehold unit owners, and to remove such tiers of interest. All owners will

collectively own and manage the common parts by virtue of their ownership of the units.

3.53 We acknowledge in Chapter 6 that the position following conversion Option 1 has similarities with a CFA claim where not all leaseholders participate. Following conversion under Option 1, non-consenting leaseholders would retain their leasehold interests, whereas participating leaseholders would take commonhold units and become members of the commonhold association. This would create two tiers of interest in the building. However, unlike the position following a CFA, this inequality of interests will be a temporary, rather than a permanent, feature. Following conversion under Option 1, leaseholders who did not participate at the outset, will have a right to buy their commonhold unit at a later date and become members of the commonhold association. We also recommend other measures to ensure that, at some point in the future, all leaseholders in the building will upgrade their interest to a commonhold unit and the full advantages of commonhold can be realised.

## CONCLUSION

3.54 In this chapter, we have set out the fundamental concepts which underpin conversion to commonhold. We have explained why conversion to commonhold currently requires unanimous agreement, looked at issues surrounding the freehold purchase, and compared the position with both leasehold and “share of freehold” arrangements. In the table below, we summarise the key differences between leasehold with an external landlord, collective freehold acquisition and commonhold.

**Figure 9: Key differences between leasehold with an external landlord, collective freehold acquisition, and commonhold**

| Issue | Leasehold with external landlord | Leasehold following collective freehold acquisition | Conversion to commonhold |
|---|---|---|---|
| The property interest | Leasehold – time-limited | Leasehold, and share of freehold (if participator) | Freehold – perpetual |
| Control | Lack of autonomy | Control through T Co (but only for those who participated) | Control through commonhold association |
| Existence of landlord | External landlord | T Co is a landlord, though controlled by (participating) leaseholders | No landlord |
| Payments for shared facilities | Service charge, regulated by lease and leasehold legislation | Service charge, regulated by lease and leasehold legislation | Commonhold contributions, regulated by CCS and commonhold legislation |
| Rules | Individual leases | Individual leases | CCS for all |
| Forfeiture | Lease can be brought to an end by forfeiture | Lease can be brought to an end by forfeiture | No forfeiture |

# Chapter 4: When should conversion be possible?

## INTRODUCTION

4.1 Commonhold facilitates the freehold ownership of flats. Currently, leaseholders can – in theory – obtain the freehold of their flats by converting their building to commonhold. However, conversion to commonhold requires the agreement of almost every person who has an interest in the property. Agreement is required because conversion results in various property interests being lost or changed. In the Consultation Paper, we explained that, under the existing law, conversion requires the consent of the following persons for the following reasons.[1]

(1) The freeholder. On conversion, the freeholder's interest in the property will be lost.[2] The freeholder's consent to conversion is therefore required. However, where the freeholder does not agree, leaseholders will have a legal mechanism to buy the freehold without the freeholder's consent, through the right of collective freehold acquisition ("CFA").[3]

(2) The leaseholders. On conversion, all leasehold interests originally granted for more than 21 years will be brought to an end and replaced with permanent commonhold interests in the flats. Each individual leaseholder must therefore consent to the conversion.

(3) Tenants. Any tenancies originally granted for 21 years or less will be terminated at the point of conversion, and unless the tenants will be regranted new tenancy agreements after the conversion, they must also consent to the conversion.

(4) Lenders.[4] On conversion, lenders will lose any charges (such as mortgages) they have over the leasehold flats to secure the repayment of their loans. Lenders must therefore agree to the conversion. As lenders would be losing their security on conversion, it is inevitable that a lender would only agree to the conversion if it was willing to accept a new charge over the commonhold unit following the conversion.

4.2 Not surprisingly, stakeholders have told us that, in all but the smallest blocks of flats, it will be almost impossible to obtain the unanimous agreement of every interested party. Conversion to commonhold may therefore be out of the reach of the vast majority of existing leaseholders.

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1 CP, para 3.5.

2 See worked example at paras 3.5 to 3.15.

3 As we note in para 4.7 below, this right is currently known as collective enfranchisement. Under our recommended reforms to the enfranchisement regime, this right is known as the right of "collective freehold acquisition".

4 We refer to "lenders" as shorthand. The current law requires the consent of any registered proprietor of a charge over the whole or part of the land to form the commonhold: CLRA 2002, s 3(1)(c).

4.3 Our Terms of Reference require us to reinvigorate commonhold as a workable alternative to leasehold, not only for new homeowners, but also existing homeowners. In order to make commonhold accessible to existing leaseholders, it will need to be possible to convert to commonhold without unanimous agreement.

4.4 In this chapter, we make a number of recommendations that will make it easier for leaseholders to convert to commonhold and obtain the freehold ownership of their flats. At the same time, we ensure safeguards are in place to protect those whose property interests will be affected by the conversion to commonhold. In particular, we recommend that:

(1) conversion should be possible without the freeholder's consent, provided that the leaseholders carry out a CFA claim as part of the conversion process;

(2) conversion should be possible where leaseholders of 50% of the flats in the building support the decision to convert – subject to appropriate safeguards;

(3) tenancies should automatically continue on conversion, and so the consent of tenants should not be required; and

(4) mortgages should transfer automatically from the lease to the commonhold unit – but only if Government works with lenders to ensure that such an automatic transfer will be accepted.

4.5 We now consider, in more detail, the circumstances in which it might be possible to convert to commonhold without the agreement of each interested party listed above.

## WHEN SHOULD CONVERSION BE POSSIBLE, WITHOUT THE FREEHOLDER'S CONSENT?

4.6 As noted above, conversion to commonhold will result in the freeholder losing his or her interest in the building.[5] The freeholder's consent to conversion is therefore currently required. In the previous chapter, we explained that where leaseholders already own the freehold collectively, the need for freeholder consent will not present much of an obstacle. But where an external landlord owns the freehold, the freeholder will be less likely to agree to the conversion. The freeholder's interest is often a very valuable asset which the freeholder will be reluctant to give up voluntarily.[6]

4.7 However, even where the freeholder does not agree to the conversion, that is not necessarily the end of the matter. Leaseholders already have a statutory mechanism available to acquire the freehold collectively, without the freeholder's consent. After obtaining the freehold, the leaseholders will then be able to consent to the conversion to commonhold on the freeholder's behalf. This mechanism to acquire the freehold is currently known as the right of "collective enfranchisement". In the Enfranchisement

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5 Following conversion, the freehold of the common parts of the building (such as the structural parts of the building and any shared communal areas) will be owned by the commonhold association. The freehold of each individual flat will be owned by the former leaseholders (now referred to as "unit owners") who will be members of the commonhold association.

6 See paras 3.16 to 3.20.

Report we refer to this right as "collective freehold acquisition" ("CFA"), and so we adopt that terminology throughout this Report.

4.8 The enfranchisement legislation sets out:

(1) Qualifying criteria

These are the criteria that need to be met before a CFA claim can be made. The criteria are designed to identify the conditions that should have to be satisfied before a group of leaseholders can acquire the freehold compulsorily. We consider the qualifying criteria in detail in our Enfranchisement Report.[7] In summary, to bring a CFA claim under our revised regime:

(a) there must be at least two flats[8] in the building which are held by leaseholders who are eligible to participate in the CFA claim. We explain which leaseholders are eligible to participate in a CFA claim in the previous chapter at paragraph 3.32, but in general a residential leaseholder who has been granted a lease of more than 21 years over a flat will be eligible;

(b) at least two-thirds of the flats in the building must be held by leaseholders who are eligible to participate in the CFA claim;

(c) eligible leaseholders of at least 50% of the flats in the building must participate in the CFA claim; and

(d) no more than a certain percentage of the floor space in the building can be occupied for non-residential use. Under the existing law, no more than 25% of the internal floor area (excluding common parts) may be occupied or intended to be occupied for non-residential use (for example, commercial purposes). However, as we explain below, we recommend increasing this limit to 50% in the Enfranchisement Report.

(2) Procedure

This is the procedure for bringing a CFA claim. In particular, the procedure provides a mechanism to determine the amount of compensation to be paid to the freeholder, and the extent of the freeholder's land that can be acquired. In our Enfranchisement Report and Valuation Report, we make recommendations that will make the process of acquiring the freehold cheaper and more efficient.

4.9 In the Consultation Paper, we proposed that, in order to convert to commonhold where the freeholder does not consent to the conversion, the participating leaseholders would need to satisfy the same qualifying criteria as for a CFA claim and acquire the freehold through the CFA procedure.[9] Given the existing legal framework

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7 For a full description the existing qualifying criteria, see Enfranchisement Report, Ch 6.

8 The Enfranchisement Report adopts the terminology "residential unit". See Enfranchisement Report, para 3.33(2).

9 In the CP, we asked consultees two separate consultation questions. At para 3.31 we asked consultees whether they agreed that it should only be possible to convert to commonhold if either the freeholder

for acquiring the freehold compulsorily, we considered it unnecessary and undesirable to create a similar, but slightly different procedure to enable leaseholders to acquire the freehold as part of the conversion to commonhold. Under our proposals, where the freeholder does not consent to the conversion, leaseholders would therefore need to satisfy the same qualifying criteria that apply to CFA claims.[10] We were concerned that if leaseholders could convert to commonhold, and obtain the freehold as part of the process, with different or less stringent qualifying criteria than for a CFA claim, leaseholders might be able to circumvent the qualifying criteria for CFAs.

### Consultees' views

4.10 The majority of consultees agreed that, where the freeholder does not consent to the conversion to commonhold, leaseholders should need to satisfy the same qualifying criteria as for a CFA and acquire the freehold through the CFA procedure.

4.11 Those in favour argued that it made practical sense to use the right of CFA as a basis for conversion to commonhold, particularly in the light of the Commission's plans to improve the CFA process, and reduce the cost of acquiring the freehold for leaseholders.[11] FirstPort (managing agents) said:

> Enfranchisement being a current right and a tested process would seem to be the logical route to begin a conversion and it must be right that this is the minimum requirement should the freeholder not consent from the outset.

4.12 The Property Bar Association ("PBA") commented that our proposal made sense "given that the criteria for collective enfranchisement are tried and tested and have been held to strike a fair balance between freeholder/leaseholders".

4.13 Those who disagreed with our proposal were generally leaseholders, residents' associations and individuals. These consultees referred to the complexity of the CFA process and said that the qualifying criteria for CFA claims were too restrictive. Consultees were especially critical of the current restriction on exercising a CFA claim where more than 25% of the building's floor space is occupied (or intended to be occupied) for non-residential use. Joy Dickinson (leaseholder) referred to the increasing number of mixed commercial and residential developments in England and Wales which would be prevented from converting:

> The proposal to keep the 25% rule on non-residential premises is wrong. You are excluding many, many leaseholders from being able to move on to a better system and revive their property values. Mixed-use schemes are common in the city centres.

4.14 Consultees were also concerned that if commonhold takes off for new-build developments, leaseholders who do not meet the qualifying criteria for a CFA claim

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consents, or the leaseholders satisfy the qualifying criteria for a CFA claim. At para 4.18 we asked consultees whether they agreed that, where the freeholder refuses to consent to the conversion, the leaseholders should need to follow the CFA process to purchase the freehold in order to convert. These questions covered overlapping issues and generated very similar responses. We therefore present consultees' views and our recommendations for reform in relation to the two questions together here.

10 See CP, paras 3.14 to 3.30.

11 See paras 1.52 to 1.54.

could be trapped in a discredited form of homeownership. Alice Brown (leaseholder) explained:

> Other existing leaseholders that qualify for collective enfranchisement will be able to benefit from a more secure homeownership structure and an asset that is not wasting like our leases. This will put the leaseholders such as the five flats in our building at a further disadvantage in comparison.

4.15 One leaseholder, responding confidentially, argued that there is more scope for "profit extracting" within mixed-use developments and so the need for commonhold is even greater. The Leasehold Knowledge Partnership ("LKP") and the All-Party Parliamentary Group on Leasehold and Commonhold Reform ("APPG") said that the proposed ability to use sections[12] to separate out the management of different types of interest in commonhold would remove the need for the 25% restriction.

4.16 A number of consultees went further and argued that conversion should happen "automatically", without needing to satisfy any particular criteria or making any form of payment to the freeholder. Some consultees referred to the automatic conversion of leasehold interests into outright ownership which took place in Scotland in 2015. In addition, several consultees suggested that there should be an individual right for leaseholders to convert their flats into commonhold.

4.17 Other consultees did not answer the question specifically, but argued that certain types of property (for example, land held by the National Trust, for charitable purposes or for the provision of specialist housing with care) should be excluded from enfranchisement rights, and from the right to convert. In these scenarios, they argued, it was important for the land to remain in the ownership of the existing freeholder.

## Discussion

### Could conversion to commonhold happen automatically?

4.18 Several consultees argued that leaseholders should acquire the freehold of their flats "automatically", and a number referred to the Scottish model.[13] However, the position in England and Wales is very different from the position in Scotland, with the result that the analogy is not an appropriate one.

4.19 Although the conversion of leasehold interests happened automatically in Scotland, leaseholders were still required to pay an amount of compensation to their landlord to purchase the freehold of their properties. Leaseholders were able opt out of the conversion, for instance, where they were unable to pay the statutory compensation to

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12 See Ch 8 for discussion on the use of sections.

13 A smaller number of consultees referred to the ability to redeem rentcharges under the Rentcharges Act 1977. This Act allowed the owner of land which is subject to a rentcharge to redeem it by paying an equivalent capital sum to the owner of the rentcharge. Rentcharges, like the leases to which the Long Leases (Scotland) Act 2012 applies, have no reversionary value, allowing a simple valuation formula to be applied to calculate the compensation payable. As we explain, it would not be possible to create one statutory formula that would offer the freeholder sufficient compensation for the freehold of every leasehold flat in England and Wales.

the landlord.[14] As we explained further in the Enfranchisement Valuation Report, in Scotland it was possible to apply a relatively simple formula to calculate the amount of compensation that each leaseholder should pay for their freehold interest.[15] That is because the Scottish legislation only applied to very long leases with little or no reversionary value and with a very low annual rent.[16]

4.20 In the Enfranchisement Valuation Report, we explained that it would be impossible to create one statutory formula in England and Wales that would offer sufficient compensation to the freeholder in respect of every leasehold flat.[17] A compensation scheme similar to that used in Scotland could be introduced in respect of leases which are similar to those covered by the Scottish scheme, namely very long leases (so with little or no reversionary value) where the ground rent is fairly low. But many leases in England and Wales would not fall within a scheme based on the Scottish legislation. That is because a wide range of leases exist in England and Wales, including those with more significant reversionary value, or with high ground rents or complex rent review structure.

4.21 There is also a significant difference of scale. At the time the Scottish Law Commission recommended the automatic conversion of long leases to freehold ownership, there were fewer than 13,000 leasehold interests in Scotland.[18] By contrast, it is estimated that there are at least 4.3 million leasehold properties in England alone. Practically speaking, it would therefore be much harder in England and Wales to ensure the registration of all the converted leasehold interests.

4.22 However, given that, in response to the Consultation Paper, several consultees called for an automatic conversion process, we have explored whether there might be a different way of facilitating an "automatic" conversion to commonhold which is better suited to the position in England and Wales.

4.23 We considered an alternative approach, whereby the freeholder's interest in the building could be broken down so that he or she would become the owner of all the commonhold units in the building at the point of conversion (rather than being the freehold owner of the building as a whole). The leaseholders could then be given an individual right to buy their commonhold unit from the freeholder. The freehold of each flat could be valued on a case-by-case basis, rather than relying on a statutory formula. Under this approach, conversion would be automatic in the sense that the commonhold structure would be put in place at the point of conversion, albeit that the

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14 Long Leases (Scotland) Act 2012, s 63. The conversion took place automatically on 28 November 2015, however leaseholders were able opt out of the conversion by registering an exemption notice two months beforehand.

15 Valuation Report, paras 5.11 and 5.28 to 5.29.

16 "Reversionary value" refers to the value of the landlord's right to have the property back when the lease expires. The shorter the lease, the higher the reversionary value and vice versa. See further the Valuation Report, para 2.28. Conversion in Scotland only applied to leases granted for more than 175 years, with more than 100 years left to run in respect of houses, and more than 175 years left to run otherwise. Conversion also only applied where the annual rent was less than £100: Long Leases (Scotland) Act 2012, s 1.

17 Valuation Report, para 5.30.

18 Report on Conversion of Long Leases (2006) Scot Law Com No 204, para 1.4, 1.8 and Appendix C, para 9.

freeholder would be the owner of all the individual commonhold units at the point of conversion, and the leaseholders would retain their leases. Each leaseholder in the building would be able to decide whether or not to buy the commonhold unit of his or her individual flat, rather than needing to rely on the leaseholders making a collective claim. Obtaining a commonhold unit would not, under this approach, depend on whether the leaseholder's neighbours were willing or able to purchase their own units. To put this alternative structure into place:

(1) the freeholder's interest in the building could be broken down, so that rather than owning the freehold of the entire building, the freeholder would be the commonhold unit owner of each of the flats in the building;

(2) the common parts of the building could be transferred to the commonhold association at the point of conversion;

(3) a commonhold community statement ("CCS") would need to be prepared, to replace the leases in the building;

(4) the freeholder could be required to delegate his or her voting rights in the commonhold association to the existing leaseholders, so that the leaseholders would take over the management of the building from that point; and

(5) to obtain greater security in their properties, the leaseholders would be able to buy their commonhold units from the freeholder.

4.24 However, this alternative approach would be complicated to achieve in practice. It is difficult to see how the steps required to facilitate this alternative scheme could happen "overnight". In particular: (1) the freeholder would need to become the registered owner of each of the individual commonhold units at HM Land Registry; (2) a commonhold association would need to be created and registered at Companies House; (3) a CCS would need to be agreed upon, which would replace all the leases in the building; and (4) it may be necessary to compensate the freeholder for any development value attached to the common parts.[19]

4.25 More fundamentally, as the leaseholders would not be required to purchase the freehold collectively, the freeholder's interest in the building would continue until all the leaseholders had decided to exercise their individual right to buy the freehold of their flat. Leaseholders would not, under this alternative approach, be able to acquire the whole of the freehold at the point of conversion. In response to the Consultation Paper, many leaseholders were sceptical about the freeholder's ongoing role in the building following conversion. For many, the main purpose of converting to commonhold would be to remove the freeholder's interest in the building, and to assume collective control.

4.26 We therefore remain of the view that the most sensible and practical approach is for the leaseholders to make a collective decision to acquire the freehold collectively from the freeholder.

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[19] See discussion at para 5.18.

### Cost, complexity and qualifying criteria

4.27 We note that the main objection to our proposal for leaseholders to carry out a CFA claim in the absence of the freeholder's consent was that it would prevent existing buildings, where more than 25% of the building is in non-residential use, from converting to commonhold. In the Enfranchisement Consultation Paper, we provisionally proposed retaining the existing 25% restriction.[20] However, as we explain in the Enfranchisement Report, we have been persuaded by consultees that this criterion should be expanded so as to enable more leaseholder to exercise CFA rights. We have therefore recommended increasing the 25% limit to 50%.[21] Following our recommendations in the Enfranchisement Report, leaseholders will be able to enfranchise, and therefore convert to commonhold, where up to 50% of the building is occupied (or intended to be occupied) for non-residential use.

4.28 In the Enfranchisement Report, we also recommend the introduction of a right for leaseholders to pursue a "multi-building CFA" claim. This right would enable leaseholders of multiple buildings to bring a joint claim to acquire the freehold of each of those buildings and convert to commonhold. At present, a CFA claim can only be brought in respect of a single building. Under our recommendations in the Enfranchisement Report, provided that each building meets the necessary qualifying criteria, the leaseholders of two or more buildings would be able to make a single claim to acquire the freehold of those buildings and certain additional land or premises. The introduction of such a right was strongly supported by consultees, who said that it would provide leaseholders with more control over their surroundings, improve the management of estates, and save costs due to economies of scale.[22]

4.29 Under our recommendation in the Enfranchisement Report, leaseholders of houses, as well as of flats, would be able to join in with a multi-building CFA claim, as long as they were able to meet the eligibility requirements set out above at paragraph 4.8(1) (for example, they must have a lease which was granted for more than 21 years which is not a business lease). Consequently, it will be possible for leaseholders (of both houses and flats) on a shared estate to join together to acquire the freehold and convert to commonhold.

4.30 In response to the Consultation Paper, some consultees asked whether freehold house owners on an estate would be eligible to convert. As a result of adopting the same qualifying criteria as for a CFA, the answer to this question will depend on the eligibility of freehold house owners to join in a multi-building CFA.

4.31 The qualifying criteria set out in our Enfranchisement Report have been carefully considered and rationalised, so that there will now be one "unified scheme" of qualifying criteria that will apply across all buildings in England and Wales. To qualify for rights under this unified scheme, it is necessary to be a leaseholder. Enfranchisement legislation has been designed to provide *leaseholders* with greater security in their properties by enabling them to buy the freehold of their homes. Freehold house owners will already have a permanent interest in their homes, and so

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20 Enfranchisement CP, para 8.144.

21 Enfranchisement Report, paras 6.317 to 6.338.

22 For discussion of multi-building CFAs see Enfranchisement Report from para 5.73 onwards.

are not provided with enfranchisement rights. Freehold house owners on a shared estate would therefore not be eligible to be part of a multi-building CFA claim or to convert to commonhold. However, if the house owners were to grant themselves leases over their properties (meeting the necessary eligibility requirements), they would then be able to participate in the CFA claim, and the conversion to commonhold.

4.32 As we note below, it may be possible in the future to establish different, less stringent qualifying criteria where leaseholders are converting to commonhold. If different criteria are established in the future, which exist independently of the CFA regime, it would be possible to reconsider the ability of freehold house owners to participate in the conversion process (without first needing to grant themselves a lease), if there is a demand for such a right.

4.33 We note the concerns of some consultees responding to this question that it should not be possible for leaseholders to acquire certain types of property compulsorily. In our Enfranchisement Report, we consider the types of property which should be exempt from enfranchisement claims, and which should not be capable of being acquired compulsorily by leaseholders.[23] The result of adopting the same criteria as for CFA claims will be that land which cannot be acquired compulsorily by leaseholders pursuing a CFA claim also cannot be acquired without the freeholder's consent on a conversion to commonhold.

4.34 With regard to the cost and complexity of pursuing a CFA claim, in the Enfranchisement Report we make numerous recommendations that will make the CFA process quicker and simpler. These recommendations include, for example, the introduction of simple, prescribed notices which will help leaseholders navigate the acquisition process. Technical mistakes on these forms will not invalidate the leaseholders' claim. Separately, the Enfranchisement Valuation Report presents options for Government to reduce the price payable to acquire the freehold under a CFA. The Enfranchisement Reports therefore go a long way to alleviating consultees' concerns about the complexity and cost of the freehold acquisition process, and requiring the same qualifying criteria to be satisfied.

4.35 Further, in Chapter 7 of this Report, we explain how leaseholders will be able to streamline the processes of buying the freehold through a CFA claim and putting in place the commonhold structure, which will save leaseholders' time and expense.

### Recommendations for reform

4.36 Having carefully considered consultees' concerns, we remain of the view that, where the freeholder does not consent to the conversion, leaseholders should be required to pursue a CFA claim as part of the process of converting to commonhold.

4.37 Relying on an established procedure is logical, and will avoid creating an additional layer of complexity. Further, the CFA criteria are set in such a way as to carefully balance the interests of the leaseholders and the freeholder. As conversion to commonhold will also result in the freeholder losing his or her interest, we think the

[23] See Enfranchisement Report, Ch 7.

CFA criteria should be the starting point for deciding whether it should be possible to dispense with freeholder consent.

4.38 In the Consultation Paper, we did not rule out the possibility that in the future, to incentivise conversion to commonhold, Government might wish to revisit the qualifying criteria for conversion to commonhold. Adopting the same process and qualifying criteria as for a CFA reflects the current position that commonhold is rarely used. But as commonhold becomes more prevalent, different considerations will apply. For example, leasehold could be seen in the market as a less desirable or valuable asset when compared to commonhold. It might become undesirable simply to make a CFA claim and retain the leasehold structure, as opposed to converting to commonhold. As commonhold becomes more prevalent, and as the market, practice, expectations and housing policy develops, it would be appropriate to revisit the circumstances in which leaseholders might acquire the freehold in order to convert to commonhold.[24]

**Recommendation 1.**

4.39 We recommend that it should be possible to convert to commonhold if either:

(1) the freeholder consents; or

(2) the leaseholders carry out a collective freehold acquisition claim as part of the process of converting to commonhold.

4.40 We recommend that the circumstances in which leaseholders may acquire the freehold on conversion to commonhold without the freeholder's consent should be kept under review.

## WHEN SHOULD CONVERSION BE POSSIBLE, WITHOUT THE UNANIMOUS CONSENT OF LEASEHOLDERS?

### Removing the requirement for unanimity

4.41 Given our objective of making conversion to commonhold a viable option for existing leaseholders, we provisionally proposed in the Consultation Paper that it should be possible to convert to commonhold without the unanimous agreement of leaseholders.[25]

#### Consultees' views

4.42 The vast majority of consultees supported our provisional proposal to remove the unanimity requirement amongst leaseholders. In particular, almost all leaseholders, leaseholder representative groups, individuals and residents' associations were in

[24] We explained in the CP that if Government decided to introduce less stringent qualifying criteria for conversion than the criteria that are required for a CFA claim, it would be necessary to put anti-avoidance provisions into place. These provisions would ensure that leaseholders, who are relying on the less stringent qualifying criteria for conversion, do in fact convert to commonhold and do not simply acquire the freehold collectively when they are not entitled to do so. See CP, para 3.27 to 3.28.

[25] CP, Consultation Question 2, paras 3.39 to 3.41.

favour. Support for our proposal was also strong amongst law firms and legal representative bodies. Conversely, two developers and three commercial freeholders responding to this question disagreed with our proposal.

4.43 The arguments raised in support of our provisional proposal largely reflected those given in response to the Call for Evidence. Namely, that conversion with unanimous agreement would be virtually impossible, and that reducing the threshold of leaseholder support would be necessary for commonhold to suceed. One consultee, Colette Boughton, argued that if unanimity were not removed, there would be "no reform".

4.44 Consultees offered numerous reasons why obtaining the agreement of all leaseholders is difficult. LKP summarised:

> At any one point, in a large block there will be a number of properties which are a) in the process of being sold, b) have leaseholders who cannot be contacted, c) have leaseholders who may be under the court of protection and d) be awaiting probate or part of an ongoing disputed inheritance.

4.45 Lucas Burchard said that it would not be fair to allow a minority of leaseholders to "hold current leaseholders 'hostage'" and prevent them from benefiting from the commonhold structure. Christopher Harris agreed that removing unanimity "is essential to prevent single objections, inertia, or misunderstandings preventing many people from getting to commonhold".

4.46 Consultees who disagreed with our proposal said that removing the unanimity requirement could cause tensions and resentment within the commonhold, leading to disputes. The Wallace Partnership Group Ltd (landlord) argued that interests "cannot be said to be aligned" without the unanimous agreement to convert to commonhold. Several consultees argued that leaseholders may have good reasons for not wanting to convert, in particular, elderly residents may not want to be responsible for the management of their building. Other consultees said that the practical difficulties created where unanimity is removed are so great that it would be preferable to retain unanimity.

### Discussion and recommendations for reform

4.47 We note concerns that, without the unanimous agreement of leaseholders, conversion might cause a division between "consenters" and "non-consenters" in the commonhold, which might sustain the "them and us" mentality. In the Consultation Paper, we explained that one of commonhold's advantages was in removing such a mentality.[26] We said that, in leasehold, the landlord is likely to have different interests from the leaseholders, which can foster an attitude of "them and us". The landlord may see leasehold as an investment opportunity or a way of generating income, whereas for most leaseholders, the leasehold property is their home. It is this disparity between the freeholder's and the leaseholders' interests which conversion to commonhold will overcome by placing control in the hands of the owners. Conversion to commonhold will create an alignment of interests between those who set the commonhold's rules

[26] CP, para 1.28(2).

and decide on the costs to be incurred, and those who are required to comply with the rules and pay the costs.

4.48 It would be impossible to create a system under which every owner in the building had the same priorities and the same degree of interest in managing the building. However, commonhold is set up to cater for these differences. In commonhold, decisions will be taken democratically through a vote of the unit owners, or by the directors appointed by them. At the same time, unit owners who stand to be particularly affected by decisions of the majority will receive protection under our recommendations for minority protection see Chapter 17. In addition, commonhold offers a robust dispute resolution procedure which has been specifically designed for its context. Further, each unit owner will be able to choose his or her own level of engagement in the commonhold. Unit owners who are interested in managing the building can actively attend meetings and can put themselves forward as the commonhold's directors. Others who do not wish to be so involved do not have to attend the meetings, or can appoint a proxy to exercise their vote.[27] Unit owners are also free to appoint professional directors and managing agents who, in providing their services, will be answerable to the owners, rather than an external landlord.

4.49 We also acknowledge concerns about the practical difficulties that arise where unanimity is removed. We agree that conversion to commonhold without unanimous agreement does throw up challenging practical issues. However, the difficulties are not insurmountable. In this Part we set out a workable scheme for facilitating conversion to commonhold. Although some level of complexity is inevitable, this complexity is justified by the need to make commonhold a realistic alternative for existing homeowners.

4.50 Given the strong support for this proposal, and our objective of reinvigorating commonhold not only for new but also for existing homeowners, we recommend that the requirement for unanimity be removed and replaced with a new threshold of leaseholder support.

**Recommendation 2.**

4.51 We recommend that conversion to commonhold should be possible without the unanimous agreement of the leaseholders.

### Setting a new threshold of leaseholder support

4.52 As a result of our recommendation to remove the requirement for unanimous agreement amongst leaseholders, the following questions arise.

(1) Which leaseholders should be eligible to participate in the decision to convert to commonhold?

[27] See para 12.72 for a discussion proxy voting in commonhold.

(2) What percentage of leaseholders should be required to support a decision to convert to commonhold?

### Which leaseholders should be eligible to participate in a decision to convert?

4.53 We provisionally proposed in the Consultation Paper that the same individuals who are eligible to participate in a CFA claim should be eligible to participate in a conversion to commonhold.[28] We considered this to be a logical conclusion given that leaseholders will need to carry out a CFA claim as part of the conversion to commonhold where the freeholder does not consent. We explained that using the same eligibility criteria would help to facilitate a streamlined procedure under which leaseholders could simultaneously acquire the freehold and convert to commonhold. We discuss this streamlined procedure in Chapter 7. It would add significant complexity to the process if a different group of leaseholders were eligible to participate in a CFA claim and the conversion to commonhold.

4.54 In the previous chapter we explained which leaseholders will be eligible to participate in a CFA claim. In general, residential leaseholders who have been granted a lease of longer than 21 years will be eligible. Leaseholders of commercial property or who have been granted business leases will not be eligible. Nor will tenants on short-term tenancy agreements. Additionally, Government has decided that, as a matter of policy, shared ownership leaseholders ("shared owners") will not be eligible to participate in a CFA claim prior to having purchased 100% of the value of their property.[29]

4.55 In the Consultation Paper we said that the 21-year requirement had the additional advantage of distinguishing between those who are likely to have paid a substantial premium for their lease, and to separate out "owners" from "renters". We thought that only "owners" of a lease should be eligible to take a commonhold unit on conversion.

### Consultees' views

4.56 Our provisional proposal to adopt the same eligibility requirements as are used in CFA claims received support from the majority of leaseholders, individuals and professionals responding to this question, largely for the same reasons as those we set out in the Consultation Paper.

4.57 The British Property Federation, who agreed with our provisional proposal, said that only those "with a material financial stake in the building should be able to make this decision which will have legal and financial consequences". FirstPort and Peter Smith (academic) commented that our proposal would be necessary to streamline the processes of acquiring the freehold and converting to commonhold.

4.58 However, certain consultees said that it would be wrong to prevent shared owners from participating in a decision to convert. Teresa Velasco, for example, said that our proposal would put shared owners "in a disadvantaged situation in relation to other leaseholders". A number of consultees also argued in favour of business tenants being able to participate in a decision to convert. For example, Berkeley Group Holdings PLC (developer) said that "commercial tenants should be given the choice to

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28 CP, Consultation Question 3, paras 3.43 to 3.54.

29 See Terms of Reference set out in Annex 1 to this Report.

be able to fully participate in the commonhold, given their long term interest and investment in the property".

4.59 Other consultees argued that only owner-occupiers' views should be taken into account and the decision should exclude properties where the leaseholder is connected to the freeholder.

### Discussion and recommendations for reform

4.60 As we are recommending that participating leaseholders should carry out a CFA claim where the freeholder does not consent, and streamlining the CFA and conversion procedures, it makes practical sense to ensure that the same individuals can participate in both claims. It would be an odd result if someone could not buy a share of the freehold (under a CFA claim) but could buy a commonhold unit – and vice versa.[30] We therefore recommend that only leaseholders who are eligible to participate in a CFA claim should be eligible to participate in the conversion to commonhold and to take a commonhold unit.

4.61 We understand concerns that adopting the same eligibility requirements as used in CFA claims would mean that shared owners would be prevented from participating in a conversion to commonhold, prior to purchasing 100% of the value of their property. However, as we note above, this reflects a policy decision made by Government. In Chapter 11 we consider the position of shared owners following conversion to commonhold. Our recommendations will ensure that the terms of any shared ownership leases will be preserved following conversion, and that the relationship between the shared owner and the shared ownership provider will remain intact. Additionally, under our recommendations in Chapter 11, should a shared owner staircase to 100% ownership after the conversion has taken place, the shared owner would then become entitled to buy his or her commonhold unit at that later date.

4.62 We also note that, as a result of adopting the same eligibility requirements as for a CFA, tenants of commercial property would be prevented from participating in a decision to convert to commonhold, and would not have a statutory right to obtain the freehold of their units.[31] This position is consistent with the purpose of enfranchisement legislation, which has always been directed towards providing residential tenants, rather than commercial tenants, with greater security in their homes.[32] While there would be nothing to prevent a commercial tenant from negotiating with the participating leaseholders to buy a commonhold unit on a voluntary basis, our understanding is that most commercial tenants prefer to rent business premises on short-term agreements (rather than own their freehold), in order to maintain flexibility. We acknowledge that, while primarily designed to enable the freehold ownership of residential flats, commonhold is equally capable of applying in a commercial and mixed-use context. Should a different procedure for conversion be adopted in the future which is independent of CFA legislation, and has different qualifying criteria, it would be possible to consider whether business tenants should also be provided with a right to participate in a decision to convert and take a

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30 At para 3.51 of the CP, we provide a diagram which illustrates this difficulty.

31 Their tenancies will instead continue automatically on conversion to commonhold: see from para 4.91.

32 See, for example, Enfranchisement Report, para 6.49.

commonhold unit on conversion, if there is a demand. However, such a right should only then be available to commercial tenants on leases of over 21 years, rather than short-term tenancies, as the latter would not have a sufficient stake in the building.

**Recommendation 3.**

4.63 We recommend that leaseholders who are eligible to participate in a collective freehold acquisition claim should have a statutory right to participate in a decision to convert to commonhold and take a commonhold unit on conversion.

### What percentage of eligible leaseholders should be required to support a decision to convert?

4.64 In the Consultation Paper, we presented two options for how the revised threshold of leaseholder support could be set.[33] We said that the percentage of leaseholder support required for conversion should take account of the interests and rights that leaseholders who do not participate in the conversion ("non-consenting leaseholders") would receive following conversion.

4.65 We explained that any change to non-consenting leaseholders' interests should be considered in accordance with leaseholders' rights under Article 1 of Protocol 1 to the European Convention of Human Rights ("A1P1"). A1P1 gives every person the right to peaceful enjoyment of his or her possessions, which includes property interests. Changing leaseholders' property rights on conversion will only be justifiable where the change is in pursuit of a legitimate aim and is a proportionate way of achieving that aim.

4.66 Our view, expressed in the Consultation Paper, was that if the interests and rights of non-consenting leaseholders would not be substantially affected by the conversion, then conversion with a lower percentage of leaseholder support might be justifiable. Conversely, if leaseholders' interests were to change substantially as a result of the conversion, it would be harder to justify this change unless a higher proportion of leaseholders supported the conversion.

4.67 The following two options were presented.

(1) "Option 1" would be a threshold of 50% support, on the basis that non-consenting leaseholders would retain their leasehold interests on conversion to commonhold. That would be adopting the same threshold of leasehold support as is required to bring a CFA claim see paragraph 4.8 above. Our view was that, following conversion under Option 1, non-consenting leaseholders would be placed in a similar position to leaseholders who have not participated in a CFA claim. As explained in Chapter 3 both following a CFA claim and conversion under Option 1, non-consenting leaseholders would retain their leases but the management of the building would change. We therefore

[33] CP, paras 3.65 to 3.147.

considered that the same threshold of support as required for a CFA claim should be required to convert under Option 1.

(2) "Option 2" would be a higher threshold of 80% support, on the basis that all non-consenting leaseholders would be required to take a commonhold unit on conversion, alongside the participating leaseholders.

4.68 In respect of both options, we asked consultees whether they agreed or disagreed with our proposed threshold.[34]

### Consultees' views

#### Option 1 non-consenting leaseholders retain their lease: threshold of 50%

4.69 Most consultees responding to this question agreed that the threshold of 50% was appropriate for Option 1. One confidential consultee, for example, argued that a threshold of 50% was an obvious choice as the will of the majority should prevail, while careful though would be needed to protect the minority who couldn't afford to participate.

4.70 A number of consultees supported our proposal for the reason provided in the Consultation Paper, that the threshold is consistent with a CFA claim. These consultees argued that non-consenting leaseholders' position would not be significantly affected by the conversion under Option 1; they would simply have a different landlord following the conversion. Rowan Hodgson, for example, said "those wishing to stay as leaseholders will simply have those in the commonhold as their landlord".

4.71 Of those who opposed our proposal, in general, more leaseholders, individuals and residents' associations said that the proposed threshold of 50% was too high, whereas other categories of consultees who disagreed (including the only developer, the two commercial freeholders and two housing associations responding) argued that the proposed threshold was too low.

4.72 Leaseholders, individuals and residents' associations who thought 50% was too high explained that it is currently very difficult to reach the threshold of 50% support necessary to bring a CFA or right to manage claim, predominantly due to leaseholder apathy or difficulty contacting absent leaseholders. The Chartered Institute of Legal Executives ("CILEx") also felt the threshold of support could be reduced, but for a different reason. This consultee argued that a minimum threshold would be unnecessary as a result of our separate proposal to provide non-consenting leaseholders with a statutory right to buy their commonhold unit at a later date on which see 5.8 onwards.

4.73 Other consultees said that the proposed threshold was too low and would not justify the interference with non-consenting leaseholders' property rights. The Association of

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[34] We asked two separate questions about the threshold to convert in the CP. At para 3.104(1) we asked consultees whether conversion under Option 1 should be possible with the support of leaseholders of 50% the flats. At para 3.142(1) we asked consultees whether conversion under Option 2 should be possible with the support of leaseholders of 80% of the flats. Both questions generated similar arguments, and we consider the responses together here.

Residential Managing Agents ("ARMA") argued that the position of non-consenting leaseholders following conversion Option 1 would be very different to that of leaseholders who have not participated in a CFA claim. In particular, ARMA argued that following conversion under Option 1, leaseholders would be left in a more complex management structure, due to the mix of long leasehold and commonhold interests in the building. Additionally, one consultee responding confidentially said that non-consenting leaseholders would be prejudiced by our separate proposals to phase out leasehold interests and replace them with commonhold units in the future.[35]

4.74 A few other consultees were concerned that a threshold of 50% could leave "just as many leaseholders opposing the conversion" as supporting it. Christopher Jessel (solicitor) and Villandry Property Ltd thought that conversion might cause resentment within the commonhold unless a clear majority could be obtained. Additionally, a number of consultees argued that unanimity should be retained.

### Option 2 non-consenting leaseholders take a commonhold unit: threshold of 80%

4.75 Consultees were less supportive of the proposed threshold for Option 2. Only slightly more consultees supported than opposed it. Most categories of consultee were divided on the question, including law firms and housing associations. More leaseholders opposed than supported the proposal.

4.76 Of those providing a comment in support of the proposal, many said that the threshold of support needed to be high to reflect the fact that non-consenting leaseholders' property interests would be altered by the conversion. Peter Smith acknowledged that the threshold might "significantly reduce access to commonhold" but "given the element of compulsion against non-consenting qualifying long lessees envisaged, adopting a higher consent threshold to conversion would seem to strike the right balance".

4.77 Millbank Residents Company Ltd also agreed with the proposal on the basis that a high threshold would demonstrate leaseholders' commitment to the commonhold structure. A further consultee, Iain Macfarlane (solicitor), felt that if the threshold for conversion were not met, the leaseholders would have other leasehold rights to fall back on, such as the right to a CFA, which only requires 50% support.

4.78 Of those who opposed the proposal, again there was a divide between the categories of consultees who thought the threshold was too high and those who thought the threshold was too low. Leaseholders and other individuals generally argued that the threshold was too high whereas other consultees who disagreed with the proposal tended to conclude that the threshold was too low.

4.79 A significant number of consultees who opposed the proposal argued that a threshold of 80% would be too high. Consultees again referred to the difficulties obtaining leaseholder support, particularly where a number of leaseholders are absent from the property. Several leaseholders responding advised us that buy-to-let landlords would not be interested in the conversion or would be difficult to contact. Some consultees said that the proposal would have a particularly unfair impact on leaseholders in smaller properties, including Antonia Batty (leaseholder) who noted that in a building

[35] See discussion from para 5.6 onward.

of four flats, a threshold of 80% would require each leaseholder to agree, which would be an “unlikely outcome for many”.

4.80 Some consultees said that to impose a higher threshold than that required to carry out a CFA claim would lead leaseholders to acquire the freehold collectively rather than convert, and would defeat the object of reinvigorating commonhold as a viable alternative to leasehold.

4.81 Many consultees responding therefore suggested a lower threshold of 50% in order to convert under Option 2. Jo Darbyshire (leaseholder) for example, said:

> I would like to see a lower percentage; 50%. 80% is simply too high. 50% is consistent with collective enfranchisement. The default position must be to make conversion to commonhold as easy to achieve as possible. 80% creates a huge barrier in large blocks, of which we have many in city centres across England and Wales, and will only perpetuate leasehold and its associated abuses for years to come.

4.82 Paul Stevens agreed with Jo Darbyshire on the basis that:

> if 50% of leaseholders can decide to enfranchise, that same proportion should be acceptable for a commonhold conversion. The non-consenting leaseholder is not really losing their actual property (i.e. the flat/unit itself); they are simply being forced to adapt to a new legal regime for flat-ownership.

4.83 Other consultees suggested that the threshold should take into account the percentage of those who “actively object” to the conversion so that apathy does not prevent a majority of leaseholders in favour from proceeding. Thomas Bygott explained that:

> currently when considering a joint purchase of a freehold, there can be a large amount of inertia, with many leaseholders not particularly interested or motivated in the outcome. It may be that a large proportion of leaseholders want to ‘wait and see’. It would be better to say that no more than 20% actively object.

4.84 A smaller number of consultees thought that the proposed threshold of 80% was too low, including several who argued that conversion should not be possible without the unanimous agreement of leaseholders. These consultees argued that a threshold of 80% support would not be sufficient to justify the interference with non-consenting leaseholders’ property interests.

### Discussion and recommendations for reform

4.85 If commonhold is to provide a workable alternative to leasehold in existing developments, the threshold of support required to convert needs to be realistic. We are persuaded by arguments that it is already very difficult for leaseholders to obtain the degree of support necessary to bring a CFA claim. Requiring leaseholders to meet any higher threshold would likely prevent conversions from taking place in most buildings, despite our reforms. We also do not think that the threshold could be any lower than 50%. A change in the management structure of the building should be supported by at least half of leaseholders in the building.

4.86 We therefore recommend that, in order to facilitate Government's objective of making commonhold available to existing leaseholders, the threshold for conversion needs to be the same as for a CFA claim. Namely, conversion to commonhold should be possible where eligible leaseholders of at least 50% of the flats in the building support the conversion. If leaseholders are able to acquire the property collectively, they should also be able to convert to commonhold.

4.87 Adopting the same threshold as for a CFA claim has the additional advantage of allowing a streamlined process to be put in place whereby the same leaseholders can acquire the freehold under a CFA claim and convert to commonhold. Taking this approach would therefore preclude introducing an additional percentage threshold of "active objectors" as suggested by some consultees or having two schemes operating in tandem.

4.88 For the avoidance of doubt, we consider that our recommended threshold of 50% should also be required even if the freeholder of the building *does* consent to the conversion, and a CFA claim is not required.[36] To balance the interests of those leaseholders who wish to convert, and those who may not want to convert, eligible leaseholders of at least 50% of the flats should still support the decision to convert.

4.89 We acknowledge concerns that both conversion options might, in one way or another, alter the way in which leaseholders own their homes. However, these changes are being made to enable leaseholders to access an improved form of homeownership. We note that few leaseholders raised concerns about the impact of the conversion on their interests, and in fact, many argued that the threshold of leaseholder support should be lower. On reflection, we do not consider that the lower threshold creates questions of compatibility with A1P1 as long as sufficient protections are in place to protect those whose interests would be affected by the conversion. In Chapter 5 we consider in detail how each conversion option will operate in practice, and the safeguards that should be built into the process.

**Recommendation 4.**

4.90 We recommend that, to convert to commonhold, eligible leaseholders of at least 50% of the flats in the building must support the decision to convert.

## WHEN SHOULD CONVERSION BE POSSIBLE, WITHOUT THE CONSENT OF TENANTS?

4.91 Currently, all tenancies granted for 21 years or less will be brought to an end on conversion to commonhold. However, it is not necessary to obtain the consent of such tenants if (1) they will be regranted new tenancy agreements after conversion and (2) the right to a new tenancy agreement has been protected by registration at HM Land Registry. We argued in the Consultation Paper that the current approach creates an unnecessary administrative burden. We provisionally proposed that

[36] This scenario is more likely to arise where the freehold of the building is owned by the leaseholders collectively, rather than by an external landlord. See discussion above from para 3.17 onwards.

tenancies simply to continue automatically on the conversion to commonhold, rather than requiring tenants' consent.[37]

### Consultees' views

4.92 Our provisional proposal was overwhelmingly supported by consultees. Consultees agreed that if tenancies granted for 21 years or less were simply to continue on conversion, tenants' consent should not be required. Further, consultees argued that the proposal would simplify the conversion process and remove unnecessary barriers. Peter Smith said:

> Requiring the consent of such tenants to conversion is an example of an unnecessary barrier to conversion, especially as tenants ordinarily do not have a substantial interest in the property.

4.93 Chris Marshall (leaseholder) agreed that allowing tenancies to continue automatically would "cause the least disruption and minimise uncertainty for renting tenants".

4.94 Those who opposed the proposal argued that the consent of tenants should be required in every case. Lucy Shepherd (solicitor) argued that it is:

> over simplistic and inaccurate to say the interests of short-term lease tenancies will not be affected by conversion to commonhold. The 'landlord' will be a different entity with different interests than before and the views of such tenants could be completely disregarded.

### Discussion and recommendations for reform

4.95 While we accept that the identity of the freeholder of the building will change on conversion, the fact of this change is not sufficient to justify requiring tenants' consent to a conversion. The freeholder of a building can already change without any requirement of consent on the part of the tenants. That is the case, for example, if the freeholder were to sell the freehold to another landlord or if the leaseholders acquired the freehold collectively.

4.96 Further, our proposal does not alter the existing position of tenants on conversion. Under the current procedure, if tenants are regranted tenancy agreements on equivalent terms following conversion, their consent is not required. Our proposal replicates this position but without additional administrative steps. The tenancy will simply continue on conversion, rather than needing to be terminated and regranted.

4.97 Finally, we recommend above that in order to facilitate a streamlined procedure of acquiring the freehold and converting to commonhold, the same individuals who can participate in a CFA claim should be able to participate in a decision to convert and take a commonhold. Only leaseholders who have been granted a residential lease of more than 21 years will be entitled to participate in a CFA claim and, therefore, a decision to convert to commonhold. Any tenancies which are not so eligible should simply continue automatically on conversion, without requiring the tenants' consent. Tenancies which continue on conversion would therefore include any residential tenancies of 21 years or less, any business tenancies (irrespective of their term) and

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[37] CP, Consultation Question 8, paras 3.148 to 3.152.

any shared ownership leases, where the shared owner has not yet staircased to 100% ownership.

**Recommendation 5.**

4.98 We recommend that, on conversion to commonhold, any tenancies which are not held by individuals who are eligible to participate in a collective freehold acquisition claim, should continue automatically on conversion and that the consent of such tenants should not be required in order to convert to commonhold.

## WHEN SHOULD CONVERSION BE POSSIBLE, WITHOUT THE CONSENT OF LENDERS?

4.99 Currently, all lenders who have an interest (such as a mortgage) secured over any of the leases in a building must consent to conversion. This requirement exists because, under the current law, all leases will be brought to an end by the conversion and the lenders' security would therefore be lost. In the Consultation Paper, we asked consultees whether it should instead be possible for mortgages over leaseholders' flats to transfer automatically to the commonhold units on conversion without requiring the consent of lenders.[38]

4.100 We drew an analogy with our proposals for enfranchisement reform set out in the Enfranchisement Consultation Paper. Under these proposals, where a leaseholder of a house or a flat obtains a lease extension, any charge secured over the lease would transfer automatically to the new extended lease, without requiring the lender's consent. (We explained that, while referred to as a "lease extension", what happens as a matter of law is that the existing lease is brought to an end, and a new lease is granted for the remaining term plus an additional number of years). Further, where a leaseholder of a house is looking to buy his or her freehold, the charge could (under our enfranchisement proposals) transfer automatically to the freehold.[39] These provisional proposals were made on the assumption that a lender would generally prefer to take security over a new, longer lease or the freehold title in exchange for their existing security.

4.101 As commonhold would offer lenders security over a freehold commonhold unit (which, unlike a lease, would not reduce in length or be at risk of forfeiture), it can be argued that commonhold offers lenders an improved security and that the charge should transfer automatically.

### Consultees' views

4.102 The vast majority of consultees, and particularly leaseholders and individuals, argued that charges should transfer automatically from the leasehold title to the commonhold unit title on conversion to commonhold and that lender consent should not be required. These consultees said that conversion needs to be simple, removing as

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38 CP, paras 3.158 to 3.172.

39 Enfranchisement CP, paras 11.174 to 11.175.

many barriers to conversion as possible. Further, they argued that lenders should not object to a transfer of their security because they will be in at least the same, if not a better, position following conversion. Trowers & Hamlins LLP (solicitors), for example, made the point that following conversion, "the land will be the same, and the estate will be freehold, albeit within a different structure". Consultees also referred to the lack of forfeiture within commonhold and to the permanent nature of commonhold units which offer lenders an advantage over leasehold security.

4.103 A number of consultees made reference to anaologous situations where a lender's charge can transfer automatically to a different interest without requiring the lender's consent, including where a leaseholder seeks a lease extension. Paul Stevens said that:

> Conversion to commonhold is of course more than just extending the lease, but much the same principle applies, in that lender consent should not be required for something that clearly benefits the subject matter of the security.

4.104 However, the Building Societies Association and UK Finance (trade associations representing building societies and mortgage lenders respectively) argued strongly that lender consent should be required to transfer the lender's security from the lease to the commonhold unit. These consultees said that it would not be acceptable to interfere with a lender's commercial decision whether or not to lend on commonhold units. The Building Societies Association warned of adverse implications if such an automatic transfer were to be made possible:

> Lenders should retain the right to object to a conversion as the 1st charge holder and the independent commercial decision to either adopt commonhold or chose not to should be respected. Any compulsion would have unintended consequences which could lead to a much more cautious approach to property risk and lending generally which could have a wider impact.

4.105 Irwin Mitchell LLP (solicitors) gave a similar warning, suggesting that lenders would react by "treating leasehold/commonhold units differently when considering if they are adequate security for borrowing, or when considering the terms of mortgages or re-mortgages".

4.106 UK Finance referred to additional practical difficulties which would arise if the charge were to transfer automatically:

> In many cases existing contracts with consumers may not mention commonhold at all, which would potentially cause legal difficulties during the lifetime of the mortgage, not least around the enforcement of security where there are arrears. It is of significant concern that the terms and conditions governing existing mortgages may be incompatible with commonhold. The legal rights and obligations of lenders and consumers could be adversely affected by the imposition of a conversion to commonhold.

4.107 Some other consultees argued that lenders should have the opportunity to consent on the basis that other proposals in the Consultation Paper might have an adverse impact on lenders. Consultees referred, for example, to our proposal to provide the commonhold association with a first-ranking charge over the commonhold units for the

payment of commonhold contributions.[40] However, for reasons explained in Chapter 18 of this Report, we have decided not to take that proposal forward.

4.108 In addition, some consultees expressed the view that the security available over commonhold units cannot be compared with that over a freehold house, and that lenders should have a choice whether to accept units as adequate security. Consensus Business Group (landlord), for example, suggested that lenders may be concerned about the collective decision-making powers of commonhold owners, rather than decisions being made by a single freehold owner. Additionally, a few consultees said that commonhold units should be distinguished from freehold houses on the basis that commonhold is an unfamiliar form of ownership "which is largely untried and untested in the market".[41] And lenders should be able to "view each transfer on its merits pending greater familiarity with this procedure".[42]

4.109 Jo Darbyshire and the National Leasehold Campaign commented, however, that lenders' willingness to accept commonhold would increase over time:

> as the prevalence of commonhold increases, mortgage lenders will be under pressure from consumers and in respect of their competitive position to lend on commonhold.

4.110 Several consultees argued that Government has an important role to play in encouraging lenders to accept commonhold. A number argued that Government could provide incentives for lenders to accept commonhold. The British Property Federation went further, suggesting "it may initially be necessary for Government to underwrite or guarantee such title (as occurred in America when condominium was introduced, and mortgagees were suspicious of commonhold-equivalent units)". Belgravia Residents Association suggested "the Government may wish to legislate to compel them [lenders] to accept as mainstream this form of tenure".

### Discussion and recommendations for reform

4.111 Our view, as supported by the majority of consultees, is that commonhold will offer lenders security superior to that available over leasehold interests and that it ought, in principle, to be possible for charges to transfer automatically from the lease to the commonhold unit. In exchange for the lender's security over the time-limited leasehold interest, which would reduce in value as the term runs down, the lender would receive security over a permanent, freehold interest on conversion. In addition, leasehold interests are susceptible to forfeiture. Forfeiture enables a landlord to bring the leasehold interest to an end where the leaseholder breaches a term of the lease and, on forfeiting the lease, the lender would lose its security over the leasehold interest. An advantage of commonhold for lenders is that a commonhold unit can never be forfeited or terminated. We discuss the implications of leasehold forfeiture, and the Law Commission's recommendations to replace the law of forfeiture in more detail in Chapter 18.

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40 This is despite our view that, even with a charge in place, the security offered over commonhold units would be an improvement to that available over leasehold interests.

41 Damian Greenish (solicitor).

42 PM Property Lawyers Limited (solicitors).

4.112 The automatic transfer of a charge from one interest to another is already provided for in enfranchisement legislation. Where a leaseholder of a *flat* exercises his or her statutory right to a lease extension, a charge secured on the existing lease will automatically transfer to the new longer lease. In the Enfranchisement Report, we recommend that charges should also transfer automatically to the new lease where a leaseholder of a *house* seeks a lease extension.[43] Additionally, we recommend in that Report that where a leaseholder of a house exercises his or her right to buy the freehold (and the leaseholder wishes to merge the leasehold and freehold titles) a charge over the lease (along with all other proprietary interests affecting the lease) should transfer automatically to the freehold title.[44] Our view, expressed in the Enfranchisement Report, is that the freehold title should provide the lender with greater security than the leasehold interest.

4.113 The automatic transfer of charges from leases to commonhold units, without requiring lender consent, would greatly simplify the process of converting to commonhold.[45] From a purely administrative perspective, obtaining the consent of every mortgage lender in the building would be a difficult and time-consuming task and would present a significant barrier to conversion. While lenders would receive an improved interest on conversion, a number of lenders may simply fail to respond to a request for consent or take a standard approach of denying every request. As a result of these difficulties, leaseholders may instead decide to acquire the freehold through a CFA claim (which would not require the consent of every mortgage lender)[46] and not convert to commonhold. Without the automatic transfer of charges, therefore, there remains a concern that conversion to commonhold will not offer leaseholders, particularly in larger blocks, a realistic alternative to leasehold.

4.114 Lenders' acceptance of commonhold is, however, fundamental to the reinvigoration of commonhold. We note that many of the concerns raised by those opposed to the automatic transfer of charges stem from the fact that currently commonhold is a relatively unfamiliar form of ownership. Government is however considering wider measures to raise awareness and encourage the reinvigoration of commonhold. As pointed out by consultees, lenders' willingness to accept commonhold should increase

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43 Enfranchisement Report, para 3.240.

44 Enfranchisement Report, discussion from para 10.123. In the Enfranchisement CP, we provisionally proposed that the charge should transfer automatically from the leasehold title to the freehold title on merger, unless the lender had objected to such a transfer. However, following consultation, we are recommending an alternative way of protecting lenders' interests. Rather than providing the lender with an opportunity to object to the transfer of his or her interest, our recommendations will ensure that lenders are not prejudiced by such a transfer and so their consent will not be required. In particular, we recommend that the right for the leaseholder to merge the leasehold and freehold titles (and transfer the charge) should only be available at the time the freehold is transferred to the leaseholder. Otherwise, there would be nothing to prevent the leaseholder from electing to merge the titles several years later after taking steps to reduce the value of the freehold interest (for example by burdening it with onerous covenants). We also recommend that the automatic transfer of a mortgage (and all other proprietary interests) affecting the lease to the freehold should not affect their nature or duration, and should preserve their relative priority to other interests affecting the lease or the freehold.

45 Indeed, in Ch 6, we explain that conversion Option 2 would not be workable unless the automatic transfer of charges from the lease to the commonhold unit can be facilitated.

46 We explain in Ch 3 that following a CFA, leaseholders will retain their existing leasehold interests, and so the lender's charge would remain over the same interest. The enfranchisement legislation does not, therefore, require lender consent to the CFA.

as their familiarity with commonhold increases. In response to the Call for Evidence, UK Finance advised us that a "significant number of lenders" were already willing to accept commonhold and that:

> other lenders would probably be prepared to offer mortgages on commonhold properties but have not made provision to because of the very low numbers of commonhold properties […]. Mortgage lenders are generally open to the possibility of lending on commonhold properties.

4.115 To facilitate the automatic transfer of charges from leasehold interests to commonhold units on conversion, we recommend that Government works with lenders as part of its wider measures to reinvigorate commonhold, in order to raise awareness of commonhold and its advantages for lenders, and to ensure lenders will accept the transfer of their security to the commonhold units on conversion.

**Recommendation 6.**

4.116 We recommend that Government work with lenders to facilitate the automatic transfer of charges from the leasehold title to the commonhold unit title on conversion.

## CONCLUSION

4.117 In this chapter, we have made several recommendations that will make it much easier for leaseholders to convert to commonhold. Conversion will no longer require the agreement of every interested party in the building. Rather than requiring unanimous agreement, the interests of those who have not agreed to the conversion will be safeguarded in other ways. In the following chapter, we consider how conversion to commonhold will operate, and the safeguards that will need to be in place to protect the interests of those who have not consented to the conversion.

# Chapter 5: How would conversion Options 1 & 2 operate?

## INTRODUCTION

5.1 In the Consultation Paper, we presented two potential schemes for conversion to commonhold. The differences between these two schemes stem from the interest that non-consenting leaseholders[1] will hold following conversion, but each option has wider implications for others in the building.

5.2 Under the first option ("Option 1"), non-consenting leaseholders' leases will continue on conversion to commonhold. Under the second option ("Option 2"), non-consenting leaseholders will be required to take a commonhold unit at the point of conversion, in exchange for their leasehold interest. We made a number of provisional proposals about how each conversion option might operate in practice, including how the freehold purchase price might be financed and the safeguards that should be put in place to protect those who have not consented to the conversion.

5.3 The effects of conversion on those who have not agreed to the conversion warrants close attention. We recommend in the previous chapter that, to make conversion a realistic option for existing leaseholders, conversion will need to be possible without the unanimous agreement of all interested parties. We recommend that leaseholders should be able to convert to commonhold without the freeholder's consent. However, as conversion would result in the freeholder losing his or her interest in the property, leaseholders should acquire the freehold compulsorily though a collective freehold acquisition ("CFA") claim as part of the process of converting.[2] Pursuing a CFA claim will ensure that the freeholder is compensated fairly for his or her freehold interest. In addition, we recommend that conversion to commonhold should be possible (under both conversion options) where at least half of the leaseholders in the building support the decision to convert. We express our view that, if the threshold of leaseholder support were any higher, conversion to commonhold would likely be prevented in the majority of leasehold blocks. Sufficient safeguards will therefore be necessary to protect those leaseholders who have not consented to the conversion.

5.4 In this chapter, we present consultees' views on the operation of each conversion option, including the safeguards that should be in place. We then make recommendations for how each option should work in practice if adopted by Government. In the following chapter, after providing a brief summary of the recommendations made so far in respect of each option, we explain which option

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1 Non-consenting leaseholders are leaseholders who are eligible to participate in a decision to convert but have chosen not to. As explained at para 3.32, subject to certain exceptions, leaseholders who have a residential lease of over 21 years will be eligible to participate.

2 This right is currently referred to as the right of collective enfranchisement but we refer to it as the right as collective freehold acquisition in this Report. Collective freehold acquisition is the term used in the Enfranchisement Report to describe our recommended revised scheme whereby leaseholders can join together to acquire the freehold without the freeholder's consent.

received the most support from consultees and we recommend our preferred option to Government.

## OPERATION OF OPTION 1

5.5 In the Consultation Paper, we asked consultees several questions about how conversion under Option 1 might operate in practice. As noted above, we have already considered the threshold of support required to convert in Chapter 4.[3]

### The replacement of leases with commonhold units under Option 1

5.6 In the Consultation Paper we explained our view that, if non-consenting leaseholders were to retain their leasehold interest on conversion, they should only do so as a temporary measure.[4] At some stage in the future, non-consenting leaseholders should upgrade their leasehold interest to a commonhold unit. As commonhold was designed to improve the way in which flats are owned, and to overcome the shortcomings of leasehold ownership, it would be counterproductive to allow these leases to continue indefinitely.

5.7 We put forward the following mechanisms by which non-consenting leaseholders might exchange their leasehold interest for a commonhold unit.

#### A new statutory right to buy the commonhold unit

5.8 We provisionally proposed that non-consenting leaseholders should be provided with a statutory right to purchase the freehold of their unit at a later date.[5] After exercising this right, the individual would no longer be a leaseholder but a unit owner and a member of the commonhold association. We asked consultees whether or not they agreed with this proposal.

#### Consultees' views

5.9 This proposal received almost unanimous support. Consultees felt that, as a matter of fairness, non-consenting leaseholders should not miss the opportunity to own a commonhold unit. Consultees argued that non-consenting leaseholders may want to take a commonhold unit after commonhold becomes a more familiar form of ownership. Elizabeth Charmian Spickernell (leaseholder) for example, said that "once leaseholders see that commonhold can work well, they may want to convert especially as it will make the sale of their flat or house easier". Alternatively, as consultees pointed out, leaseholders may not have been in a position to pay for a commonhold unit at the point of conversion. Zaman Ali (leaseholder) argued that "we have to give people a chance to save up so they can purchase when they can afford to".

5.10 Other consultees, including The Guinness Partnership (housing association), supported the proposal as it would speed up the point at which every leaseholder in the building owns a commonhold unit (and therefore the point at which the building's management structure would be simplified).

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3 See para 4.46.

4 See CP, paras 3.80 and 3.104(3).

5 CP, Consultation Question 4, para 3.80(1) and 3.104(2).

5.11 Most consultees who opposed the proposal reiterated their general disagreement with Option 1, rather than raising specific objections about the new statutory right. However, Christopher Jessel (solicitor) (who neither agreed nor disagreed with the proposal), expressed concern that an ability for leaseholders to join in at a later stage might disincentivise participation at the outset. He said that "the non-consenters could let others do all the work and raise the money and then join in later".

5.12 To address the potential lack of incentive to participate in the conversion, the Federation of Private Residents' Associations ("FPRA") suggested:

> the price paid by latecomers should be more than it would have been at the start to encourage as many leaseholders as possible to participate and convert as soon as possible.

5.13 A couple of other consultees suggested than an amount of interest could be added to the cost of buying the commonhold unit. However, other consultees stressed that the cost of buying the unit at a later date needs to be affordable, and some suggested Government assistance should be available.

### Discussion and recommendations for reform

5.14 We agree with consultees that leaseholders who are unable to, or choose not to, buy a commonhold unit at the point of conversion under Option 1 should not be deprived of the opportunity to own a unit in the future. In addition, providing leaseholders with a right to buy their unit would expedite the point at which all flats in the building are owned on a commonhold basis. We take Christopher Jessel's point that the ability to buy a unit in the future might create a disincentive to participate in the conversion at the outset. However, there would be financial incentives to participate in the initial claim. The costs associated with the conversion process would be shared between all participating leaseholders,[6] whereas the cost of buying a commonhold unit at a later date would fall on that individual leaseholder alone.

5.15 We therefore recommend that, if Option 1 is adopted, there should be a statutory right for non-consenting leaseholders to buy their commonhold unit at a later stage.

5.16 We note that some consultees queried the cost of buying the commonhold unit. Leaseholders would be required to pay a premium to purchase the freehold of their unit, which would be calculated in the same way as existing enfranchisement rights. How this premium would be calculated would therefore depend, to a large extent, on which option Government adopts to reduce the price payable on the exercise of enfranchisement rights.[7]

5.17 Our view is that the cost of buying the commonhold unit should be calculated at the time the leaseholder wishes to exercise his or her right to buy the commonhold unit, rather than being "fixed" at the time the conversion takes place. In other words, the leaseholder would be required to pay the market value for the commonhold unit at the time he or she decides to exercise the right. There would therefore be an inherent

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6 That is, leaseholders who are eligible to participate in the conversion and who also decide to participate. See para 3.32 for a discussion on which leaseholders will be eligible to participate.

7 See para 3.25.

incentive for leaseholders to buy their commonhold unit sooner rather than later because, as the leaseholder's term continues to run down, the premium payable to buy the commonhold unit would increase. The amount that the participating leaseholders actually paid to acquire the freehold from the freeholder as part of the conversion would therefore not be factored into the calculation. Our view is that this is the correct approach, given that non-consenting leaseholders will not have had any control over the purchase price paid to the freeholder by the participating leaseholders.

5.18 Depending on a number of variables, a leaseholder, on buying his or her commonhold unit, may also contribute towards the commonhold's "development value". Under existing valuation methods, on acquiring the freehold compulsorily, participating leaseholders might need to pay an additional amount to the freeholder to compensate him or her for the loss of certain development opportunities. For example, there may be potential to build a further floor of flats on the roof. When the participating leaseholders acquire the freehold to the block, they will then have the ability to build an extra floor of flats and realise that development value. Whether a non-consenting leaseholder would pay any additional amount in respect of development value on purchasing his or her commonhold unit would depend on a number of factors.

(1) Whether the common parts of the building (or buildings) do in fact have any development potential.

(2) Which valuation methodology Government adopts in the light of the Enfranchisement Valuation Report. We suggest, as one of the potential options to reduce the cost of acquiring the freehold, that participating leaseholders might be able to elect to take a type of restriction on development, rather than paying development value to the freeholder.[8]

(3) Whether the participating leaseholders wish to retain the benefit of any development potential between themselves, or to allow a leaseholder to "buy into" this development potential on purchasing a commonhold unit.

**Recommendation 7.**

5.19 We recommend that, if conversion Option 1 is adopted, non-consenting leaseholders should be provided with a statutory right to buy the commonhold title in respect of their unit following the conversion to commonhold.

[8] See Enfranchisement Valuation Report, paras 6.155 to 6.179. This election by the leaseholders would not require the agreement of the landlord, as is the case currently. If the leaseholders, following the acquisition of the freehold, wished to develop the premises, they would be able to negotiate a release from the restriction with the former landlord. The landlord would expect to be paid a premium in order to release the restriction; that premium would therefore be paid instead of the leaseholders having to pay development value at the time of the claim.

### Exchanging leaseholders' existing enfranchisement rights for the new right to buy the commonhold unit

5.20 We provisionally proposed that, should non-consenting leaseholders be provided with a statutory right to purchase the freehold of their unit at a later date, this new right should replace leaseholders' existing statutory right to seek a lease extension. We also proposed that it should not be possible for non-consenting leaseholders to acquire the freehold from the commonhold association compulsorily after the conversion has taken place.[9]

### Consultees' views

5.21 The vast majority of consultees supported this proposal. Support was particularly strong amongst leaseholders, other individuals and residents' associations. Most law firms and legal representatives responding also agreed with the proposal. However, both commercial freeholders responding to the question opposed the proposal.

5.22 The main reason provided in support of this proposal was that it would enable leases to be phased out within commonhold. Stephen Collins argued that:

> lease extensions and such will perpetuate the already outdated leasehold method of ownership. By discontinuing extensions it will allow for them to be phased out quickly.

5.23 Catherine Williams (leaseholder) agreed saying, "it makes sense to promote a move towards commonhold rather than perpetuate feudal leasehold".

5.24 Damian Greenish (solicitor) and Matt Osborne commented that it would also be necessary to prevent non-consenting leaseholders from reacquiring the freehold from the commonhold association by exercising a CFA. Otherwise the "ping-pong problem" would arise, whereby a certain group of leaseholders might convert to commonhold, only for the freehold bought back by a different group of leaseholders.

5.25 Other than general objections about the desirability of Option 1, consultees who disagreed with the proposal raised concerns about consumer choice. They felt that leaseholders should have the option either to obtain a lease extension or to buy their commonhold unit. Irwin Mitchell LLP (solicitors), for example, said "we believe this would be taking away individuals' rights rather than adding to them". The Association of Residential Managing Agents ("ARMA") argued that if "commonhold is successful the market advantage should instead passively influence leaseholders to convert". The argument was also made by Boodle Hatfield LLP (solicitors) and ARMA that this proposal could impose commonhold upon non-consenting leaseholders "by the back door".

5.26 Other consultees queried how the cost of buying a commonhold unit would compare to the cost of a lease extension, and HM Land Registry asked how the proposal would affect shared ownership leaseholders ("shared owners").

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[9] CP, Consultation Question 4, paras 3.80(1) and 3.104(3).

## Discussion and recommendations for reform

5.27 We recommend that, on conversion under Option 1, the non-consenting leaseholders' new statutory right to buy their commonhold unit should replace their existing statutory right to a lease extension. As we explain in more detail below, the difference in value between a lease extension and the commonhold unit will be negligible (if, in fact, there is any difference). However, the commonhold unit will offer the leaseholder greater security than that afforded by a lease extension, and would prevent the perpetuation of leasehold within commonhold. We now consider these points in more detail.

5.28 We note that some consultees viewed the proposal as taking away leaseholders' existing statutory right to a lease extension. However, the right to a lease extension is a by-product of leasehold ownership which carries with it all the inherent limitations of leasehold tenure. Currently, lease extensions are the only way in which leaseholders of flats can obtain greater security in their homes.[10] Outside of the commonhold model, there is no satisfactory way for leaseholders of flats to obtain the freehold of their properties. Where a lease term is running down, the leaseholder will be forced to make a choice between losing his or her leasehold interest, or paying the freeholder for a new, longer term. That new leasehold interest will also expire at some point in the future, due to the wasting nature of leasehold interests.

5.29 Commonhold, however, enables leaseholders to own their flats on a freehold basis, and, as we note in Chapter 1 freehold interests are capable of lasting forever. Given that commonhold enables leaseholders to obtain greater security in their properties, we consider it preferable to replace the limited right to a lease extension (designed for the leasehold context) with a right to obtain a freehold unit (designed for the commonhold model). We also note that this proposal was strongly supported by leaseholders and other individuals: the categories of consultee who would be affected by the replacement of existing statutory rights.

5.30 In addition, given the objective of phasing out leases within commonhold under Option 1, it would be counterproductive to enable existing leaseholders to obtain lease extensions following conversion. Lease extensions would perpetuate the difficulties caused where there is a mix of leasehold and commonhold interests within the same building and would delay the point at which all owners hold the same type of interest.[11]

5.31 Some consultees queried the cost of buying the commonhold unit, as opposed to obtaining a lease extension. In the Enfranchisement Report, we recommend that on exercising the statutory right to a lease extension, the leaseholder will acquire a new lease which adds a further 990 years to the remaining term of his or her existing lease.[12] The difference in value between a 990-year lease extension, and the freehold of the commonhold unit will be negligible, if indeed there is any difference. However, we note above that in certain limited circumstances, leaseholders who take a

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10 Even after pursuing a CFA claim, the way in which the participating leaseholders will obtain greater security in their homes will be by granting themselves lease extensions, often of 999 years (see worked example at para 4.43).

11 See discussion at para 6.37 onwards.

12 Enfranchisement Report, para 3.62.

commonhold unit might also contribute towards the building's development value, which is rarely payable in lease extension claims.

5.32 We also recommend that it should not be possible for leaseholders to exercise a CFA claim once the building has converted to commonhold. While it may be unlikely that there would be a sufficient number of non-consenting leaseholders in the building to pursue a CFA claim following conversion Option 1,[13] we think this possibility should be put beyond doubt. If a further CFA were not prevented, a different group of leaseholders to those who supported the conversion might be able to acquire the freehold of the building compulsorily and revert back to the leasehold structure.[14] Our view is that once a building has converted to commonhold, it should remain as a commonhold, and there should not be a risk of the commonhold reverting back to the leasehold structure. If non-consenting leaseholders wish to participate in the management of their building, they will be able to buy their commonhold unit and become a member of the commonhold association. Preventing further CFAs would also avoid introducing the ping-pong problem often encountered in the context of enfranchisement, into the commonhold model.[15]

5.33 For the avoidance of doubt, we further recommend that, following conversion to commonhold, it should not be possible for non-consenting leaseholders to take over the management functions of the commonhold association by exercising the right to manage.[16] To permit such a right would be to undermine fundamentally the commonhold management structure, whereby the commonhold association owns and manages the common parts, and unit owners can make collective decisions about management through their membership of the association. If non-consenting leaseholders are concerned about how the directors of the commonhold association are managing the building, they will be able to seek the replacement of the directors in

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13 We summarise the eligibility requirements for a CFA claim at para 4.8(1). In order to pursue a CFA claim, it would be necessary for two-thirds of the residential units (ie flats) in the building to be held by leaseholders who are eligible to participate in the claim, and for eligible leaseholders of 50% percent of the flats to participate in the claim. While conversion to commonhold will have required the support of 50% percent of eligible leaseholders in the building, there is no minimum number of leaseholders who must take a commonhold unit on conversion. It would therefore be possible, following conversion under Option 1, for there to remain sufficient numbers of eligible leaseholders in the building to be eligible to pursue a CFA.

14 The leaseholders would likely set up a company which, following the CFA, would be transferred the freehold of the common parts from the commonhold association and the freehold of the individual units from the unit owners. The existing unit owners would be entitled to take 999-year leases of their flats in place of their freehold interest.

15 We discuss the so-called "ping-pong" problem in the Enfranchisement Report at paraS 5.4 and 5.206 onwards. To alleviate difficulties caused by different factions of leaseholders repeatedly reacquiring the property from each other through successive CFA claims, we recommend in the Enfranchisement Report that, once a CFA claim has taken place, the freeholder (or rather the nominee purchaser under the prior successful claim) should be able to prevent further CFAs in that building for a period of 2 years. That is unless the leaseholders are acquiring the freehold and also converting to commonhold under our streamlined "acquire and convert" procedure discussed in Ch 7 of this Report.

16 As with a CFA claim, it is extremely unlikely that there would be a sufficient number of eligible leaseholders in the building to be able to pursue an RTM claim. Two-thirds of the flats in the building must be held by "qualifying tenants" that is, leaseholders who are eligible to participate in the RTM and qualifying tenants of at least 50% of the flats must participate in the claim. However, we were concerned to put the matter beyond any doubt. We consider the qualifying criteria to exercise a RTM claim in the RTM Report, Ch 3.

the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal") under our recommendations in Chapter 12.[17]

5.34 In the above discussion, we only refer to the position of non-consenting leaseholders following conversion Option 1. We note HM Land Registry's specific query about the position of shared owners following conversion. In Chapter 11 of this Report, we consider the position of shared owners in detail, including the enfranchisement rights available to shared owners. However, we summarise the position below for the purposes of clarity.

**Recommendation 8.**

5.35 We recommend that, if conversion Option 1 is adopted, non-consenting leaseholders' statutory right to buy their commonhold unit should replace their existing statutory right to a lease extension.

5.36 We recommend that it should not be possible for leaseholders to carry out a collective freehold acquisition or a right to manage claim once conversion has taken place.

### Requiring an incoming purchaser to buy the commonhold interest

5.37 We invited consultees' views on whether, if a non-consenting leaseholder decides to sell his or her property in the future, the incoming purchaser should be required to buy the commonhold unit (as opposed to the leasehold interest) and become a member of the commonhold association.

### Consultees' views

5.38 The majority of consultees responding to this question were in favour of requiring an incoming purchaser to buy the commonhold unit. However, while more leaseholders, individuals, residents' associations, and the two housing associations responding to this question supported such a requirement, more consultees from other categories, including law firms and legal representatives, were against the requirement.

5.39 The main argument made in support of the requirement was that it would speed up the point at which leasehold is phased out under conversion Option 1. A number of consultees said that the proposal would enable commonhold to replace leasehold as the primary form of flat ownership in England and Wales. Some consultees also questioned why an incoming purchaser would not want to buy the commonhold unit. For example, one consultee who responded anonymously said, "I can't see why a purchaser would not want to purchase a commonhold interest, as it appears highly advantageous compared to leasehold". And Debbie Davies suggested that if the purchaser does not want to buy a commonhold unit "they may wish to reconsider buying the property".

[17] See discussion from para 12.36.

5.40 A number of those who were opposed to the requirement were concerned about the effect of the requirement on the marketability of the property. These consultees felt that the incoming purchaser should have the option of buying the commonhold unit, but that it should not be made compulsory. For example, Boodle Hatfield LLP argued that the requirement would restrict "a non-consenting leaseholder wishing to sell its unit to a limited market i.e. to only those proposed buyers willing to take a commonhold unit". Mark Chick (solicitor) suggested the proposal might disadvantage those with short leases, as the cost of buying the unit would be particularly high,[18] which might deter purchasers. He suggested that those with short leases should be permitted to sell their leasehold interest freely to anyone prepared to buy it. Catherine Isbell thought that the requirement would add complexity to the process which might make the purchase unattractive. Other consultees were concerned that the proposal would limit leaseholders' ability to deal with their property as they wish.

5.41 Christopher Jessel and FPRA queried whether the requirement to buy the commonhold unit would only arise where the leaseholder sells the property, rather than where the property is transferred automatically, such as on the death of the leaseholder. They argued, for example, that it would be inappropriate to require the personal representatives of a deceased leaseholder to choose between buying the commonhold unit or receiving nothing.

### Discussion and recommendations for reform

5.42 We note concerns that a requirement for incoming purchasers to buy the commonhold unit might affect the marketability of the property. However, we do not share these concerns. Our view is that commonhold offers an improved form of flat ownership to leasehold, and, particularly as commonhold becomes more prevalent, there should not be any reason why incoming purchasers would not wish to accept a commonhold unit. Indeed, several consultees responding to this question commented that purchasers would prefer to buy an outright freehold interest, rather than a leasehold interest.

5.43 We also note arguments that those who own short leases should be able to sell their short leasehold interest freely, as the cost of purchasing the unit may be particularly high. However, as has been demonstrated in the leasehold context, there is a restricted market for short leasehold interests. Generally, the shorter the lease, the harder it is to find a mortgage lender who would be willing accept the leasehold interest as adequate security for its lending. An incoming purchaser, who relies on mortgage financing, would therefore require the short lease to be extended as part of the purchase. In the commonhold context, a mortgage lender would also likely require greater security than that offered by the existing short leasehold interest. Rather than obtaining a lease extension (which would not be compatible with our objective of phasing out leasehold interests) the purchaser would be able to obtain greater security by buying the commonhold unit. As we explain above, in most cases there will be negligible (if any) difference in value between the cost of a lease extension and the

[18] This is because the reversionary value would be high. "Reversionary value" refers to the value of the landlord's right to have the property back when the lease expires. The shorter the lease, the higher the reversionary value and vice versa. See further the Valuation Report, para 2.28.

cost of buying a commonhold unit, although the commonhold unit will offer the purchaser greater security.

5.44 Certain consultees framed the proposal in terms of "money being deducted" from the proceeds of sale, and the remainder being paid to the leaseholder. However, in reality, the leaseholder would receive the value of his or her leasehold interest, and any additional value (representing the difference in value between the leasehold interest and the freehold of the commonhold unit) would be paid to the commonhold association. The leaseholder would be in a similar position financially as if he or she had simply sold his or her leasehold interest independently of the commonhold unit.

5.45 Additionally, we do not think that prospective purchasers would necessarily be deterred by the complexity of the conveyancing process. We envisage that the purchase would operate in a similar way to the "back-to-back" staircasing of a shared ownership lease. Before a shared owner has purchased 100% of the value of his or her property, an incoming purchaser would be able to purchase the shared owner's interest and the interest belonging to the shared ownership provider as part of the same transaction.

5.46 As our policy objective is for the existence of leasehold in commonhold to be a temporary measure if Option 1 is adopted, we therefore recommend that incoming purchasers should be required to buy the commonhold unit, not only the leasehold interest. At the point of conversion under Option 1 there may be numerous long leases left in the building (for terms 125 or 999 years, for example). The owners of these leases will already have a significant amount of security in their homes and so may never seek to buy their commonhold unit due to their lease term running down. Without making this recommendation, we cannot see a realistic way of phasing out such existing long leases within the building.

5.47 We agree with comments made by Christopher Jessel and FPRA that the requirement to buy the commonhold unit should not be activated by all transfers of the leasehold interest. In particular, the requirement should not apply to dispositions of the lease that arise "by operation of law". These are dispositions that arise because of a statutory requirement or a court order, rather than because of the voluntary actions of the parties. Such dispositions include, for example, the transfer of a bankrupt's property to the Official Receiver and the transfer of a deceased person's property to his or her personal representatives.[19] The requirement also should not arise where the personal representatives distribute the deceased person's assets following his or her death. In these situations, it would not be appropriate for the person receiving the property to pay an additional amount to buy the freehold of the property. In many cases the person receiving the property may not have the funds available to buy the freehold and should not be required to borrow the money.

[19] Other dispositions that arise by operation of law include orders made by the court in matrimonial finance proceedings and under the Proceeds of Crime Act 2002.

**Recommendation 9.**

5.48 We recommend that, if conversion Option 1 is adopted, on the transfer of a leasehold property owned by a non-consenting leaseholder, the transferee should be required to purchase the commonhold title, as well as the leasehold interest.

5.49 We recommend that a person who receives a leasehold property by operation of law should not be required to buy the commonhold title.

### Position of shared owners on conversion, a summary

5.50 A number of consultees responding to the questions above queried the position of shared owners following a conversion to commonhold. We discuss the position of shared owners in more detail in Chapter 11. However, as there are parallels between the position of non-consenting leaseholders under Option 1 and the position of shared owners once they have staircased to 100% ownership (under both conversion options), we also summarise the position here for clarity.

5.51 In Chapter 11 we explain that, as an exception to the general ban on residential leases of over seven years within commonhold, shared ownership leases will be permitted to be granted. Shared ownership plays a key role in the provision of affordable housing in England and Wales, and a failure to accommodate it could seriously damage commonhold's uptake. Shared ownership leases will therefore be permitted in new commonhold developments and will simply continue following a conversion to commonhold under both conversion options. We make a number of recommendations to accommodate shared ownership leases successfully within the commonhold model. With regards to shared owners' enfranchisement rights, we draw a distinction between the position of the shared owner before and after final staircasing.

### Position of shared owners prior to staircasing to 100% ownership

5.52 As we explain in more detail in Chapter 11, shared owners can buy percentage shares in the ownership of their house or flat through a process known as "staircasing", often with a view to taking full ownership on staircasing to 100%.

5.53 Prior to having staircased to 100%, Government has decided that, as a matter of policy, shared owners should have a statutory right to a lease extension. However, Government's policy is that, prior to final staircasing, shared owners should not have a statutory right to buy the freehold of their properties (either individually or collectively with the other leaseholders in the building). That is because the shared ownership lease is specifically designed to enable those who cannot afford to purchase the property outright to do so in stages, via the staircasing provisions which form part of all shared ownership leases. It would not be the correct result if leaseholders were able to circumvent these provisions by relying on statutory enfranchisement rights to acquire the freehold of their home or building.

5.54 To that end, we consider it correct that, prior to final staircasing, shared owners should not have a statutory right to buy the freehold of their commonhold unit. To provide

otherwise would be to circumvent the staircasing provisions in the shared ownership lease. However, shared owners would retain their right to a lease extension in order to obtain greater security in their homes.

### Position of shared owners on purchasing 100% of the value of their properties

5.55 On staircasing to 100% ownership, the shared owner will retain his or her lease but the terms of the lease which are specific to shared ownership would fall away. From final staircasing, our view is that the shared owner should be treated in the same way as any other leaseholder in a building that has converted to commonhold. In other words, the shared owner should now be in the same position as a non-consenting leaseholder under Option 1. In particular, following final staircasing:

(1) the shared owner would have a statutory right to buy his or her commonhold unit;

(2) this right would replace his or her statutory right to a lease extension (and to participate in a CFA or a right to manage claim); and

(3) an incoming purchaser would be required to buy the commonhold unit, rather than the shared owner's leasehold interest.

5.56 Shared owners would therefore be encouraged to take the freehold of their unit following final staircasing, and become members of the commonhold association.

## Financing the freehold purchase under Option 1

5.57 As we explain in Chapter 4, where the freeholder does not consent to the conversion to commonhold, the participating leaseholders will need to carry out a CFA claim in order to convert to commonhold. As part of the CFA process, participating leaseholders will need to pay for (or find a way of financing):

(1) their own share of the freehold purchase, attributable to their own flats;

(2) a share of the freehold value attributable to flats let to non-consenting leaseholders; and

(3) a share of the freehold value attributable to flats which have not been let to a leaseholder who is eligible to participate (for example flats which are empty or which have been let to short-term or business tenants: see paragraph 3.32).

5.58 In the Consultation Paper, we explained the importance of ensuring that participating leaseholders have a realistic way of financing the shares of the freehold value which belong to the non-consenting leaseholders, and to flats which have not been let to any eligible leaseholder. We look at each of these scenarios in turn.

### Financing Option 1: flats let to non-consenting leaseholders

5.59 On conversion under Option 1, participating leaseholders would have the same options available to finance non-consenting leaseholders' shares of the freehold value as are available on a CFA claim. In the Consultation Paper we explained that non-consenting leaseholders' shares of the freehold value could be financed by:

(1) some or all of the participating leaseholders;

(2) a third-party investor who is then granted a 999-year lease (at a "peppercorn" rent[20]) over flats which are let to the non-consenting leaseholders; or

(3) the leaseholders could require the freeholder to take a new 999-year lease at a peppercorn rent over the flats held by non-consenting leaseholders (referred to as a "leaseback"). Currently, under enfranchisement legislation, leasebacks are matter for negotiation between the freeholder and the participating leaseholders. In the Enfranchisement Report we recommend that the leaseholders should be able to *require* the freeholder to take a leaseback over flats let to non-consenting leaseholders.[21] In contrast to (1) and (2) above – both of which are ways of raising the money – a leaseback means that the value attributed to a non-consenting leaseholder's share of the freehold does not have to be raised, and the price payable to the freeholder is reduced accordingly.

5.60 The person(s) providing the finance, or the former freeholder if taking a leaseback, would then be entitled to receive the following sums from the non-consenting leaseholders during the term of their lease:

(1) any ground rent payable under the non-consenting leaseholders' continuing leases;[22]

(2) the premium payable when non-consenting leaseholders buy the commonhold interest in their property at a later date; and

(3) the additional value realised on the sale of any non-consenting leaseholder's property as a commonhold unit.[23]

5.61 We explained in the Consultation Paper that where participating leaseholders finance non-consenting leaseholders' shares of the freehold purchase (method (1) above),

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20 Many long leases reserve an annual ground rent of a peppercorn. Strictly, the landlord in these cases could require the leaseholder to provide him or her with a peppercorn annually, but invariably this is not demanded. A peppercorn rent is used in circumstances where it is deemed appropriate for there to be no substantive rent payable.

21 Enfranchisement Report, para 5.152.

22 We note in this respect that Government will be implementing a ban on the payment of ground rent in new long residential leases. At the time of writing, existing leaseholders may still be required to pay ground rent. The amount of ground rent payable under the terms of the non-consenting leaseholder's lease will be factored into the premium payable to acquire the freeholder's interest. If non-consenting leaseholders are required to pay ground rent under the terms of their leases, this will increase the amount that those financing the purchase will need to pay towards the non-consenting leaseholders' shares of the freehold. However, those providing the finance will subsequently recoup this expenditure through non-consenting leaseholders' ground rent payments and through any premiums payable if non-consenting leaseholders exercise their right to buy their unit (see para 5.6 above). On the other hand, if non-consenting leaseholders are not required to pay ground rent under the terms of their lease, the premium payable to the freeholder in respect of their shares will be lower, but those financing the purchase will not receive any ground rent payments in respect of these leases thereafter. The premium that those financing the purchase will receive when a non-consenting leaseholder exercises his or her right to buy the unit will also be lower.

23 See discussion from para 5.6 above.

there needs to be a mechanism in place which ensures that only those who have contributed towards the finance would be entitled to receive the above sums from non-consenting leaseholders. Without such a mechanism, there is a risk that a non-consenting leaseholder, who decides to buy his or her commonhold unit at a later date, might stand to receive the above sums from the other non-consenting leaseholders, without having contributed towards the share belonging to those other non-consenting leaseholders. We presented two potential mechanisms to ensure that only those who have paid towards the non-consenting leaseholders' share would stand to receive the above sums and recoup their expenditure.[24]

(1) The commonhold association could own the units let to non-consenting leaseholders on conversion. When any non-consenting leaseholder (or a purchaser of his or her interest, see Recommendation 9 above) acquires the commonhold interest, he or she would have to pay the premium to the commonhold association, which would then be distributed to the members of the commonhold association. The premium payable would need to reflect the incoming unit owner's new right to receive ground rent and premiums from the remaining non-consenting leaseholders.

(2) Alternatively, those leaseholders providing the finance could set up a company solely for the purpose of receiving ground rent and premiums from the non-consenting leaseholders. This company could then own the units which are let to the non-consenting leaseholders on conversion. As the landlord of the non-consenting leaseholders, the company would be entitled to receive the above payments from the non-consenting leaseholders. Only those who contributed towards financing the non-consenting leaseholders' shares would be entitled to be members of the special purpose company and receive these sums. Where a non-consenting leaseholder (or a purchase of his or her interest) acquires the commonhold interest, he or she would become a member of the commonhold association but would not become a member of the special purpose company.

5.62 The various ways of financing the freehold purchase under Option 1 are summarised in figure 10 below.

[24] CP, para 3.97 to 3.99.

**Figure 10: Summary of options for financing non-consenting leaseholders shares under Option 1**

Using the same example of a block of five leasehold flats as depicted in figure 3 (paragraph 3.10 above). Leaseholders A, B, C and D wish to convert to commonhold under Option 1 but E does not consent to the conversion. The price payable to the freeholder to acquire the freehold is £15,000 and each flat's contribution is valued at £3,000. In this example, A, B, C and D each pay £3,000 in respect of the value attributed to their own flats and each take a commonhold unit. E will retain his or her leasehold interest. E's share of the freehold could be funded in one of the following ways.

(1) By A, B, C and/or D. They would then be entitled to receive the £100 per year ground rent payable under E's continuing lease, any premium payable if E buys the commonhold unit, and any additional value realised on the sale of the property. The freehold of E's flat could be held by the commonhold association, with the sums received from E distributed between the members of the association (A, B, C, D), or by a special purpose company made up of A, B, C and/or D.

(2) By a third-party investor. This investor would be granted a new, superior lease over E's flat, and would be entitled to receive the ongoing ground rent of £100 per annum, the premium payable if E buys the commonhold unit, and any additional value realised on the sale of the property.

(3) By granting a leaseback to the former freeholder (Z). A, B C and D could require Z to take a new 999-year lease over E's flat. This would reduce the purchase price for A, B, C and D. The result is that the £3,000 attributable to E's flat never has to be raised and paid because Z's 999-year lease will reflect the value of his or her freehold interest. Z would be entitled to receive the ongoing ground rent of £100 per annum, any premium payable if E buys the commonhold unit, and any additional value realised on the sale of E's property.

5.63 We asked consultees whether the financing options set out from paragraph 5.59 above should be available to fund non-consenting leaseholders' shares of the freehold purchase price, and how participating leaseholders might be protected if they fund these shares between them.

### Consultees' views

#### Finance provided by participating leaseholders

5.64 A high number of consultees said that it would be preferable for the participating leaseholders to fund the freehold purchase between themselves in order to avoid the freeholder, and other parties, retaining an interest in the building following conversion. Teresa Velasco, for example, preferred this method of financing "so that total control of developments can fall into leaseholders' hands once and for all". A number of

consultees were also wary of the former freeholder, and other third parties, diluting the former leaseholders' control on conversion. Katherine Mickleson said it would be "important to keep the decision-making powers with the people who own/live in the building rather than the original freeholder or an outside investor".

5.65 With regard to how participating leaseholders might recoup their initial expenditure (see paragraph 5.61 above) only a handful of consultees expressed a preference. The Property Bar Association ("PBA") thought that it would be more straightforward, both practically and conceptually, for the units of non-consenting leaseholders to be owned by the commonhold association. Conversely, Notting Hill Genesis (housing association) said that "given the experience of enfranchisement" it would be better for leaseholders to set up a special purpose company to own the units. Graham Webb (leaseholder) also thought that the special purpose company would offer greater flexibility in that it (1) could be structured differently from the commonhold association and (2) it would allow other investors to participate in the same company. Damian Greenish suggested that it would only be appropriate for the commonhold association to own the units if all the consenting leaseholders had provided the funding, rather than a proportion of them. He also queried whether it was necessary to specify the funding vehicle.

### Leaseback to the former freeholder

5.66 A smaller number of consultees supported the ability of the participating leaseholders to require the former freeholder to take a 999-year leaseback as a way of funding the shares belonging to non-consenting leaseholders. Several consultees queried whether leaseholders would have the funds available to finance non-consenting leaseholders' shares without such an ability. Aisling Rollason (leaseholder) said that if leaseholders were required to fund consenting leaseholders' shares themselves, conversion might change "from an affordable option to a totally unaffordable option for the leaseholder".

5.67 On the other hand, a few consultees were opposed to the suggestion that the former freeholder might be required to take a leaseback against his or her wishes. Lu Xu (academic) said that it:

> seems rather unfair to the freeholders, who have just been told that the leaseholders collectively would not want their presence in the building anymore, yet they are then compelled to continue to be part of it by having a leaseback forced upon them.

5.68 Other consultees were concerned that, if the former freeholder were required to take a leaseback within the commonhold model, there might be a conflict between the terms of the commonhold community statement ("CCS") and the former freeholder's responsibilities under the 999-year leaseback.

### Finance provided by a third-party investor

5.69 The option of obtaining financing from an external investor, and granting the investor 999-year leases over flats let to non-consenting leaseholders, received the lowest amount of support. Consultees reiterated their scepticism about the role of third-parties in commonhold. A couple of consultees thought that the involvement of external investors might saddle the association or non-consenting leaseholders with

debt. The PBA also felt that it would be unattractive for the third-party investor to become the immediate landlord of the non-consenting leaseholder.

### A flexible model

5.70 Several consultees argued that all options set out in the Consultation Paper should be available to leaseholders when seeking to acquire the freehold and convert to commonhold. The Leasehold Advisory Service ("LEASE") explained:

> ultimately it is down to the preference of those embarking on the conversion process as to how they choose to fund the non-consenting leaseholders' share of the freehold purchase.

5.71 Mark Chick agreed that "if the reforms are to be successful there must be as much commercial flexibility as possible".

### Government assistance

5.72 In addition to the options presented in the Consultation Paper, a number of consultees responding to this question argued that Government funding should be available to help finance the conversion.

### Discussion and recommendations for reform

5.73 We agree with arguments that the funding options should not be prescriptive. We recommend that all the options available to finance a CFA claim should be available where leaseholders are acquiring the freehold and converting to commonhold under Option 1.

5.74 If their funds allow, participating leaseholders will have the option of financing the freehold purchase themselves, and controlling the involvement of external investors and the former freeholder.

5.75 Where participating leaseholders fund the freehold purchase, our view is that it should be open to the leaseholders either to set up a special purpose company to own the units which are let to non-consenting leaseholders, or for the units to be owned by the commonhold association. Which mechanism is appropriate will depend on the circumstances of the case. As was rightly pointed out by consultees, setting up a special purpose company is likely to offer greater flexibility, as it would not be bound by the prescribed rules of the association.[25] However, in some cases, it may be more straightforward for the commonhold association simply to own the commonhold units and distribute income from the non-consenting leaseholders to its members. Currently, there is a prohibition within the commonhold association's articles which would prevent the association distributing profits to its members.[26] We recommend a limited exception to this rule, if Option 1 is adopted, to enable the distribution of ground rent and premiums received from non-consenting leaseholders to the members of the commonhold association. We note Damian Greenish's comment that

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25 For example, because membership of the commonhold association is limited to the unit owners, participating leaseholders may prefer to use a special purpose company if they wish to allow other investors to participate in the same company.

26 Commonhold Regulations 2004, reg 72.

it would only be appropriate for the commonhold association to own the units where all participating leaseholders have contributed to the funding. However, there would be no requirement for the commonhold association to distribute income equally between the members. Participating leaseholders would be able to agree on a level of distribution proportionate to the amount of money they had contributed to the freehold purchase.

5.76 Leaseholders will also be able to require the freeholder to take 999-year leasebacks over flats let to non-consenting leaseholders. This ability will make conversion more affordable, and therefore accessible, to participating leaseholders. We note concerns that the freeholder, when granted a 999-year leaseback, might be required to comply with CCS terms which are inconsistent with the terms of the non-consenting leaseholder's lease. For example, a requirement in the CCS not to keep a pet where the non-consenting leaseholder's lease permits pets. However, this difficulty would not arise. Only unit owners who take a commonhold unit on conversion and their tenants, (and therefore not leaseholders or their tenants) would be required to comply with the terms of the CCS on conversion. The commonhold association would not be able to impose any requirements on the former freeholder which do not exist within the terms of the 999-year lease. The association would be bound by the terms of the former freeholder's 999-year lease, which would be prepared so as to ensure the terms do not conflict with the non-consenting leaseholder's inferior lease.[27]

5.77 Further, the option of granting an investor a 999-year lease over flats let to non-consenting leaseholders would not increase the indebtedness of the association or the unit owners. Simply, the investor would pay for the non-consenting leaseholder's share of the freehold value and, in return, the investor would be entitled to receive the sums set out in paragraph 5.60 above. Nor do we have concerns about the investor becoming the direct landlord of a non-consenting leaseholder. Leases to external investors are already commonplace in CFA claims and leaseholders cannot prevent their landlord granting a head lease to an external investor.

5.78 It should be noted that granting 999-year leases to the former freeholder and/or external investors will not dilute the control of the unit owners. Only those who own a commonhold unit on conversion to commonhold (and not therefore a former freeholder or investor with a leasehold interest) will be members of the commonhold association and will be able vote on management decisions.

5.79 Further, granting the investor or the former freeholder 999-year leases over flats which have been let to non-consenting leaseholders would not perpetuate the existence of leases within commonhold. As explained above, our policy objective is for all the leasehold interests in the building to be phased out and to be replaced with commonhold units. To achieve this objective, all non-consenting leaseholders would, under our recommendations, have a statutory right to buy their commonhold unit, and this right would replace their existing right to a statutory lease extension. The premium payable to buy the commonhold unit would, at the same time, buy out the former

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[27] As we note above, leasebacks to the former freeholder can already take place in CFA claims on a voluntary basis. Where the former freeholder is granted a leaseback over a non-participating leaseholder's flat in a CFA claim, in practice, the landlord's 999-year lease will be short and simply provide for the freeholder to be granted a 999-year lease at a peppercorn rent and on the same terms as the non-participator's lease.

freeholder's/investor's superior 999-year lease.[28] Similarly, if the non-consenting leaseholder decided to sell his or her interest, the incoming purchaser would be required to buy the commonhold unit under our recommendations, and the former freeholder's/investor's lease would be bought out as part of this process. This scenario is to be contrasted with the position where the former freeholder takes a 999-year lease over a flat which has not been let to an individual who is eligible to buy their commonhold unit (considered below). In this scenario, as pointed out by consultees, the new 999-year lease could perpetuate the mix of commonhold and leasehold interests almost indefinitely.

**Recommendation 10.**

5.80 We recommend that, in order to finance the share of the freehold value attributable to flats which are held by non-consenting leaseholders, any of the methods available to finance a collective freehold acquisition should also be available where leaseholders are acquiring and converting to commonhold under conversion Option 1.

5.81 We recommend that, if conversion Option 1 is adopted, the commonhold association's articles of association should permit the association to distribute ground rent and premiums received from non-consenting leaseholders to its members.

### Financing Option 1: Flats which have not been let to eligible leaseholders

5.82 Flats which have not been let to an eligible leaseholder would be particularly expensive to purchase.[29] As explained paragraphs 3.32 and 4.54, this category includes: flats which have been left empty; flats which have been let on tenancies of 21 years or less; flats let to commercial tenants; and flats which have been let to shared owners who have not yet staircased to 100% ownership.

5.83 As a way of financing the shares of the freehold value attributable to such flats, it may be possible for the participating leaseholders to enter into arrangements with external investors for them buy some or all of these flats (as commonhold units) as part of the conversion process.

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28 In theory, the premium payable to buy the freehold of the unit would be shared between the freeholder/investor and the commonhold association. However, as the freeholder/investor would own the material financial stake in the unit, the freeholder/investor would likely receive the entire premium from the non-consenting leaseholder. There would be negligible difference in value (if any) between the 999-year lease and the commonhold interest.

29 This is because the reversionary value of the property will be very high. The value of the freeholder's interest in any particular unit will depend on what interests and rights he or she has granted out of the property and the point at which the freeholder is likely to recover possession. For example, if the freeholder has granted a lease of 999 years, the freeholder's interest is unlikely to be very valuable, as it will be 999 years before the lease ends and he or she will recover possession. Where the freeholder has not granted any interest, or has granted an interest which is for a very short duration, or easily determined, the freeholder's interest will be especially valuable.

5.84 Additionally, it is currently possible in a CFA claim for the freeholder of the building to elect to take a 999-year leaseback over any flats which have not been let to a leaseholder who is eligible to participate. As we explain above, granting the freeholder 999-year leasebacks would reduce the purchase price payable by the participating leaseholders as the value attributable to these flats would not then need to be raised. In the Enfranchisement Consultation Paper, we proposed that the participating leaseholders should be able to *require* the former freeholder to take new 999-year leases of such flats in order to reduce the purchase price.[30] In the Commonhold Consultation Paper, we proposed adopting the same approach on conversion to commonhold.[31]

5.85 In the Consultation Paper we also explained that it may be particularly important for the former freeholder to retain an interest in certain flats which have not been let to an eligible leaseholder.[32] For example, the former freeholder of the building may be a local authority which has let out one or more of the flats in the building on secure tenancies. These tenancies are granted for less than 21 years and so will not be eligible to participate in a conversion to commonhold. Secure tenants benefit from a significant amount of statutory protection, especially when it comes to ending these tenancies. Secure tenants can lose their status and statutory protection if a person other than a local authority becomes their landlord. We therefore proposed that under Option 1, new 999-year leases should always be granted to the former freeholder in respect of flats let to certain statutorily-protected tenants (whether the participating leaseholders or the freeholder request this leaseback or not). Such mandatory leasebacks are already provided for in enfranchisement legislation. In addition, we proposed that new 999-year leases should always be granted to the former freeholder in respect of flats let to shared owners who have not yet staircased to 100% ownership, in order to preserve the shared ownership relationship on conversion.

### Consultees' views

5.86 Well over half of the consultees responding to this question supported the proposal, including a high number of leaseholders and other individuals. However, unfortunately, a number of consultees misunderstood our proposal, taking it to mean that individuals who were not eligible to participate in the conversion should be granted new 999-year leases on conversion. That was not our intention. The proposal related to the ability to require the former freeholder to take a leaseback over such flats in order to reduce the purchase price. The position of those ineligible to participate would not be affected by the conversion under our recommendations. We explain in Chapter 4 that their tenancies would simply continue automatically on conversion to commonhold.[33]

5.87 Consultees who were in favour of an ability to require the freeholder to take a leaseback argued that the proposal would reduce the cost of purchasing the freehold.

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30 Enfranchisement CP, paras 6.16 to 6.26.

31 CP, Consultation Question 4, paras 3.77 and 3.104(5).

32 CP, para 3.78.

33 Para 4.91 onwards.

Conversely, consultees who opposed the proposal generally argued that such a requirement would be unfair to the freeholder. Boodle Hatfield LLP said that:

> to impose upon the freeholder a requirement (rather than offering it a right) to take on a wholly different role (as tenant to the Commonhold Association, and head landlord to an occupational tenant) is unjust.

5.88 Christopher Jessel also disagreed with the proposal on the basis that it "would be simpler to require the former freeholder to take a unit as commonhold from the outset".

5.89 Gerald Eve LLP (surveyors) and the PBA did not agree or disagree with the proposal but pointed out a difficulty with our approach. Both consultees said that granting the former freeholder a 999-year lease over flats let which have not been let to any eligible leaseholder might perpetuate the existence of leases under Option 1 almost indefinitely, so long as the former freeholder wishes to retain ownership of the flat.

5.90 No consultee commented specifically on our recommendation for the former freeholder to be granted, on a mandatory basis, new 999-year leases over flats let to statutorily-protected tenants and shared owners.

### Discussion and recommendations for reform

5.91 We note the high level of support for this proposal. The equivalent proposal in the Enfranchisement Consultation Paper was also strongly supported, and in the Enfranchisement Report, we recommend its adoption.[34] We agree that there needs to be a mechanism in place to reduce the cost payable in respect of flats which have not been let to any eligible leaseholder, as these flats can be particularly expensive to purchase. However, comments made by Gerald Eve LLP and the PBA have caused us to reconsider the mechanism by which this reduction in price might be achieved. Given our objective of making the existence of leases a temporary measure under Option 1, it would be inconsistent for the former freeholder to be granted new 999-year leases over such flats. Unlike where the former freeholder has taken a leaseback over a flat let to a non-consenting leaseholder (see discussion from paragraph 5.59 above, there would not be any leaseholder in the flat who would be eligible to buy the commonhold unit, and in so doing buy out the freeholder's 999-year lease.[35]

5.92 We therefore recommend that, should Option 1 be adopted, the participating leaseholders should be able to require the freeholder to take the *commonhold unit* of any flats which have not been let to an eligible leaseholder. Additionally, the former freeholder may request that he or she be granted the commonhold unit in respect of such flats (rather than being able to require a 999-year leaseback, as is presently the case). Further, while no consultee commented specifically on this point, we also consider it important to recommend that the former freeholder should always take the commonhold unit over flats let to statutorily-protected tenants and to shared owners

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34 Enfranchisement Report, para 5.152 onwards.

35 We acknowledge that some non-consenting leaseholders in a converted block might also hold very long leases and might therefore be in a similar position. However, the difference is that leasebacks to the former freeholder would be adding to the number of long leases in the building which might not be phased out for a long period of time.

on conversion, in order to protect the tenants' and shared owners' interests. As explained further below, we are recommending that safeguards should be put in place to protect a former freeholder who is required to take a commonhold unit on conversion.

5.93 From the perspective of the participating leaseholders, we note concerns that, on taking a number of commonhold units, the former freeholder might retain control of the development following conversion. The former freeholder would be able to exercise the votes attached to the commonhold units which he or she owns following conversion. However, where the freeholder does not consent to the conversion, leaseholders would need to satisfy the same qualifying criteria as for a CFA claim.[36] It would only be possible to acquire the freehold (and convert to commonhold) without the freeholder's consent where two-thirds of the flats in the building are held by leaseholders who are eligible to participate. There would therefore never be more than a third of the flats in the building which are not held by an eligible leaseholder and in respect of which the freeholder might take the commonhold unit. The freeholder would therefore never be able to exercise votes in respect of more than a third of the flats. Most decisions of the commonhold association need either 50% or 75% of the votes cast to be in favour in order for the decision to be carried.

5.94 Where some or all of the participating leaseholders finance the shares of the freehold attributable to flats in respect of which there is not an eligible leaseholder, and do not require the freeholder to take the commonhold units in respect of such flats (and the freeholder does not elect to take the commonhold units) the commonhold units should be held by the commonhold association in default of any other arrangement between the leaseholders.[37]

**Recommendation 11.**

5.95 We recommend that, if conversion Option 1 is adopted, the participating leaseholders should be able to require the freeholder to take the commonhold unit in respect of any flats which have not been let to a leaseholder who is eligible to participate in the conversion. Additionally, the freeholder should be able to require that he or she be granted the commonhold unit in respect of such flats (rather than being able to require a leaseback, as is presently the case).

5.96 We recommend that the freeholder should automatically become the unit owner in respect of any flats let to statutorily-protected non-qualifying tenants and shared ownership leaseholders on conversion.

5.97 We recommend that, where some or all of the participating leaseholders finance the shares of the freehold value attributable to flats in respect of which there is not an eligible leaseholder (and so do not require the freeholder to take the units and the freeholder does not request the units) the commonhold units should be owned by the commonhold association as a default rule.

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36 The basic qualifying criteria for a CFA claim are set out at para 4.8(1).

37 It would also be possible for the leaseholders to set up a special purpose company to own the units, and share any income deriving from the unit.

### Safeguarding interests on conversion Option 1

5.98 In the Consultation Paper, we expressed our view that Option 1 would sufficiently protect the interests of non-consenting leaseholders on conversion, as they would be permitted to retain their leasehold interests on conversion.[38] However, following consultation we have revised our position. As a result of our recommendations to phase out leases and replace leaseholders' interests with commonhold units (see paragraphs 5.6 to 5.49), non-consenting leaseholders might be required to take a commonhold unit in the future and, at that point, they would be required to comply with the terms of the CCS. It would therefore be necessary to ensure that the terms of the CCS have not been prepared in such a way as to prejudice the interests of the non-consenting leaseholders upon taking a unit.

5.99 Additionally, we are now recommending (see paragraphs 5.82 to 5.97 above) that the participating leaseholders should be able to require the freeholder to take the commonhold unit in respect of flats which have not been let to leaseholders who are eligible to participate. On taking a commonhold unit, the former freeholder would become a member of the commonhold association and would be required to comply with the terms of the CCS which he or she had no role in preparing.

5.100 We are therefore recommending a new regime which will protect all individuals who will or might be required to take a commonhold unit on or following conversion, including non-consenting leaseholders and the former freeholder under both conversion options. The details of this revised scheme are set out from paragraph 5.171 onwards below.

## OPERATION OF OPTION 2

5.101 Under the second conversion option, all leaseholders would be required to take a commonhold unit at the point of conversion. We asked a number of questions about how this conversion option might operate in practice. Again, we have already considered the threshold of support required to convert in Chapter 4 and have concluded that conversion should be possible where eligible leaseholders of at least 50% of the flats in the building support the decision.[39]

### Financing the freehold purchase under Option 2

5.102 As we explain at paragraph 5.57 above, in order to convert to commonhold where the freeholder does not consent to the conversion, eligible leaseholders will be required to acquire the freehold compulsorily and in so doing finance (with or without the help of external funding or investment): (1) their own share of the freehold purchase cost attributable to their own flat; (2) a share of the freehold value attributable to flats let to eligible but non-consenting leaseholders; and (3) a share of the freehold value attributable to flats which have not been let to leaseholders who are eligible to participate.

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38 CP, para 3.103.

39 Para 4.64 onwards.

5.103 We now look at how (2) and (3) might be financed in the context of conversion Option 2.

### Financing Option 2: flats let to non-consenting leaseholders

5.104 On conversion under Option 2, all eligible leaseholders will take a commonhold unit in exchange for their leasehold interest at the point of conversion, including non-consenting leaseholders. No long residential leases over the flats will be permitted to continue.[40] It would therefore not be possible (unlike under Option 1) to grant the former freeholder or an external investor a superior 999-year lease over non-consenting leaseholder's flats in order to reduce the purchase price.

5.105 On conversion to commonhold, all non-consenting leaseholders' property interests would be upgraded from leasehold to freehold. These leaseholders would no longer have an asset which reduces in value as the lease term runs down and would not be required to pay any ground rent. In the Consultation Paper, we explained that it would not be appropriate to require non-consenting leaseholders to pay for their upgraded interest at the point of conversion. Participating leaseholders would therefore need to find a way to finance non-consenting leaseholders' shares of the freehold value. However, it would be unfair for non-consenting leaseholders to obtain their upgraded commonhold interest for free. There would need to be a way for non-consenting leaseholders to pay for the increase in the value of their property which will have changed from leasehold to commonhold on conversion, and to reimburse those who initially financed their share of the freehold purchase.

**Example**

Using the same example of a block of five leasehold flats depicted in figure 3 (paragraph 3.10), leaseholders A, B, C and D wish to convert to commonhold under Option 2 but E does not agree to the conversion. The price payable to acquire the freehold is £15,000 and each flat's contribution is valued at £3,000. In this example, A, B, C and D each pay £3,000 in respect of the value attributed to their own flats. As it would be unfair (and impractical) to require E to pay for his or her own share at the point of conversion, A, B, C and D finance E's contribution between them. On conversion however, E obtains a freehold interest which is worth £3,000 more than his leasehold interest even though he or she has not paid anything towards the freehold purchase. There would therefore need to be a mechanism for E to repay A to D who have provided the necessary finance, at some point in the future.

5.106 As a mechanism for those financing non-consenting leaseholders' shares under Option 2 to recoup their expenditure, we provisionally proposed that non-consenting leaseholders should have a charge placed over their commonhold units on conversion in favour of those who provided their share of the finance. The charge would ensure that, on the subsequent sale of their commonhold units, the non-consenting leaseholders would be required to repay their share of the freehold value to those who

[40] Subject to certain exceptions, such as shared ownership leases: see Ch 11.

provided the necessary finance, although they would have the option to repay their share sooner if they wished.

5.107 We asked a number of questions about how the charge might operate,[41] including the following.

(1) What priority should the charge have in relation to existing mortgages? We said that it might be appropriate for the charge in favour of those providing the finance to take priority over any existing mortgages.[42] Before the conversion, any mortgage lender would only have had a charge over the leasehold interest, rather than the upgraded commonhold interest. We therefore suggested that the best way to maintain the status quo might be to give the new charge priority over existing mortgages. We invited consultees' views on this point.

(2) Who should be able to provide the funding and take the benefit of the charge? We suggested that the finance could be provided by the participating leaseholders, a lending institution or by a third-party investor. We also asked whether the former freeholder might be required to take a charge over the non-consenting leaseholders' units on conversion. The freeholder would not be paid non-consenting leaseholders' shares at the point of conversion. Instead the freeholder would be granted charges over the non-consenting leaseholders' units. As these units come to be sold on, the freeholder would be paid the non-consenting leaseholders' share from the proceeds of sale. Under this option, the former freeholder would not receive periodic payments of ground rent in respect of the non-participating leaseholders' leases, or benefit from the wasting nature of the leases, but would be paid the freehold value of the flat (plus a share in the increase in value, see below) at the point of sale.

(3) How might the charge be set? We explained that the fairness of requiring the freeholder to accept a charge over non-consenting leaseholders' units, and the charge's attractiveness to third-parties as an investment, would depend on whether any interest or "added value" could be attached to the charge. That is, a sum over and above the amount paid on behalf of the non-consenting leaseholder on conversion. If no added value were attached to the charge, there might also not be sufficient incentive for leaseholders to participate in the conversion at the outset, as non-consenting leaseholders would effectively be receiving an interest-free loan to obtain their unit. Such considerations need to be balanced against the fact that non-consenting leaseholders will not have agreed to the charge. The charge should therefore not give rise to onerous obligations or a risk of repossession. We made the following suggestions as to how the charge could be set and we invited consultees' views. The charge could be set:

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41 For discussion of the charge see CP, paras 3.123 to 3.137.

42 In Ch 4 we recommend that it should be possible for charges to transfer automatically from the lease to the commonhold unit on conversion, provided that Government works with lenders to ensure this can be facilitated: see para 4.99.

(a) as a fixed amount representing the non-consenting leaseholder's share of the freehold purchase at the point of conversion (but that would effectively amount to an interest-free loan);

(b) as a fixed amount, with interest;

(c) as a fixed amount, which may increase or decrease in line with house price inflation; or

(d) as a percentage share in the market value of the commonhold unit. This percentage would represent the increase in value of the non-consenting leaseholder's interest which would have changed from leasehold to freehold on conversion.

5.108 To implement the approach in (d) it would be necessary to calculate the percentage increase in value of the non-consenting leaseholder's interest which would have resulted from the conversion to commonhold. In other words, the difference in value between the non-consenting leaseholder's leasehold interest before the conversion, and the commonhold unit he or she would receive following conversion. On the subsequent sale of the commonhold unit, those providing the finance would be paid that same percentage from the proceeds of sale. For example, assume that conversion to commonhold results in a 10% increase in the value of the leaseholder's interest. If the non-consenting leaseholder decided to sell the commonhold unit in the future, he or she would be required to pay 10% of the proceeds of sale to those providing the finance. A mechanism would need to be in place to ensure that the unit could not be sold for less than the unit's open market value.[43] Our view was that this option would strike the best balance between "added value" and protecting the non-consenting leaseholder. It would mean that the person(s) providing the finance would be able to share in any increase in the value of the property. The non-consenting leaseholder would also benefit from the increase in the value of his or her interest, and would no longer be prejudiced by the wasting nature of his or her leasehold interest. Both parties would also share the risk of the property decreasing in value between conversion and the date of sale.

5.109 We also asked consultees whether there might be any alternative way of financing non-consenting leaseholders' shares of the freehold, other than using a charge.

### Consultees' views

5.110 A sizeable majority of consultees agreed with our provisional proposal for a charge to be placed over non-consenting leaseholders' units if Option 2 were to be adopted. In particular, most leaseholders, individuals, residents' associations and leaseholder representative groups were in support. Views amongst other groups were more divided, and the only developer and two commercial freeholders responding were against the proposal.

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43 For example, an independent valuer could determine what the unit is worth on the open market. Those providing the finance could refuse to release the charge unless the property is then sold at market value. A similar mechanism is used in the context of Government's Help to Buy equity loans (see Homes England, *Help to Buy Buyers' Guide* (2018) p 15, at https://www.helptobuy.gov.uk/wp-content/uploads/Help-to-Buy-Buyers-Guide-Feb-2018-FINAL.pdf).

5.111 Most of those who supported the proposal did not provide a substantive comment or they simply said that the proposal was "sensible". A few consultees made the point that the proposal would help leaseholders who wanted to convert to commonhold but who could not afford to contribute at the point of conversion. They said that leaseholders who were unable to participate could still take a commonhold unit at the point of conversion, subject to the charge. Mariyam Zaman (leaseholder) argued that non-consenting leaseholders stand to benefit from taking a commonhold unit, particularly as no ground rent would be payable thereafter.

5.112 Conversely, some consultees argued that the proposal would operate unfairly for non-consenting leaseholders and might contravene leaseholders' property rights under A1P1.[44] In particular, if there were a downturn in the property market and the unit decreased in value, there would be a concern that non-consenting leaseholders would not have sufficient equity in their properties to repay the charge and any mortgage over the property. ARMA argued that the proposal:

> requires that the sale price of the unit is always higher than the purchase price. If it is not then the charge on the cost of commonhold cannot be recovered by the giver. Market fluctuations combined with date of purchase and sale or distressed sales cannot guarantee the required profit to repay the lender based purely upon sale proceeds. To impose a further loss upon the non-consenting converted leaseholder in order to repay the giver would be unreasonable and could significantly harm someone who may already be in a vulnerable position.

5.113 Irwin Mitchell LLP was concerned that non-consenting leaseholders would not have any control over the price paid by the participating leaseholders to purchase the freehold. Non-consenting leaseholders might therefore be required to repay a share of the freehold purchase price on the sale of their units, even if the amount paid to the freeholder was considered by them to be unreasonable. This consultee also asked what impact the proposal might have on the ability of non-consenting leaseholders to obtain additional mortgage finance. In addition, Julia Burgess felt that the proposal added too much complexity to the commonhold model.

### What priority should the charge have in relation to existing mortgages?

5.114 Well over half of the consultees responding to this question were in favour of the charge taking priority over any existing mortgages. Significantly more leaseholders and individuals supported the suggestion. Views amongst other consultees, including law firms and their representative bodies, were more evenly split, and the two housing associations responding disagreed with the charge taking priority.

5.115 Consultees who supported the charge taking priority over existing mortgages generally did so for the reasons set out in the Consultation Paper. They thought the charge should take priority because conversion would have created additional value over and above the leasehold interest, which the mortgage would have been secured against before conversion. Lu Xu said that the charge in favour of those providing the finance should rank:

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[44] Article 1 Protocol 1 to the European Convention on Human Rights ("A1P1"). See para 4.65 above and CP, paras 3.59 to 3.64 for a discussion of A1P1 in the context of conversion.

above mortgages since it is incurred to discharge liabilities and acquire various rights in the previous freehold, which would have superseded the mortgage of the leasehold.

5.116 Some consultees also pointed out that the existing lender would receive improved security over the commonhold unit following conversion to commonhold, particularly as the lender would not be at risk of losing its security through forfeiture or due to the lease term running down (unlike the position in leasehold).

5.117 Berkeley Group Holdings PLC (developer) thought that, if the charge were to take priority, there would be an incentive for lenders, who already have a mortgage secured over non-consenting leaseholder's flats, to provide the additional finance. If the additional finance to cover the non-consenting leaseholder's share were instead provided by the participating leaseholders, or by an investor, these individuals would obtain an interest in the commonhold unit superior to that of the existing mortgage lender.

5.118 The PBA commented that "on balance, the charge should have priority" but thought that the uplift in value resulting from conversion was "unclear". Consequently, this consultee said, "it is possible that lenders secured against leasehold units in negative equity would be unfairly prejudiced by this proposal. That said, we assume this to be comparatively rare".

5.119 Those consultees who were opposed to the charge taking priority over existing mortgages made similar arguments to the PBA. Concerns were raised about the charge eroding the equity available in the property to discharge existing mortgages on the sale of the unit.

5.120 A number of consultees thought that the proposal could result in existing lenders being unwilling to offer further finance in respect of the converted commonhold units, or might result in lenders charging increased rates. Others argued that the proposal would reduce the prospect of lenders accepting commonhold in the first instance. Pamela Hughes, for example, said that the charge would have to come second to existing mortgages "otherwise mortgage companies would not provide funds. Mortgage companies will always insist on having the first charge".

### Who should provide the finance and take the benefit of the charge?

#### Lending institutions and third-party investors

5.121 The most popular selection amongst consultees was for a commercial bank or building society to provide the necessary finance and take the benefit of the charge. However, Tiara Hardy (leaseholder) argued that the finance should only be provided by "ethical firms" which are "heavily regulated in terms of the charge and fees applicable". A few consultees suggested that the existing mortgage lender might provide the additional finance. ARMA said that:

> the simplest mechanism would be for the mortgage [lender] to take the charge against the presumably increased value of the flat. In this scenario there is no complication with regards to a willing commonholder (e.g. B) later selling and hence trying to establish where the charge benefit flows to.

5.122 Lu Xu thought that financing could be provided by “anyone who sees this as an investment opportunity. If people nowadays buy the reversion of leasehold flats, surely they would consider investing in commonhold conversion charge”.

5.123 Conversely, some consultees were sceptical about whether commercial lenders and investors would be interested in providing the finance and taking the benefit of the charge. A. L Hughes & Co (solicitors) argued that, currently, lenders only agree to help fund CFAs on the basis that they will receive premiums when non-participating leaseholders buy lease extensions, and these premiums will increase in value over time (as the lease term decreases). Consensus Business Group (landlord) set out a number of reasons why a commercial lender would likely be uninterested in providing the necessary finance. These reasons included that the “loan would be for an indeterminate period” and “lenders would likely consider such a loan as a bet on the housing market and require a high rate of interest”. While the PBA agreed in principle that it would be possible for a third-party investor to provide the finance, it thought it was “unclear how initial investors would recoup their outlay within a sensible time frame”.

5.124 Additionally, some consultees were generally opposed to external investors playing a role in commonhold. For example, Shira Baram (a leaseholder), said “I do not agree that the purchase of commonhold should be seen as an investment for third-parties”.

### Participating leaseholders

5.125 Slightly fewer consultees provided a comment in support of the participating leaseholders providing the necessary finance between themselves and taking the benefit of the charge. Those that provided a comment generally made similar arguments to those expressed by Shira Baram, that the presence of third-party investors within commonhold should be prevented.

### The freeholder

5.126 A number of leaseholders and individuals supported the suggestion that the freeholder might be provided with a charge over the non-consenting leaseholders’ units, rather than receive non-consenting leaseholders’ shares of the purchase cost at the point of conversion. The freeholder would be paid non-consenting leaseholders’ share of the purchase price when these leaseholders come to sell their units. The National Leasehold Campaign argued that, while the freeholder would not receive any periodic payments of ground rent following conversion, the capital injection from the participating leaseholders would “offset in cash flow terms, the ground rent income they would continue to receive if nothing changes”.

5.127 Other consultees strongly disagreed with the suggestion, saying that it would be unfair and would effectively require freeholders to fund the non-consenting leaseholders’ shares of the initial freehold purchase price. In particular, Consensus Business Group said that the charge would be “a wholly different property asset in the hand of the former freeholder than the investment it made” and that it would replace “an investment which secures a consistent income stream” with “an unsure charge for an indeterminate period”. Berkeley Group Holdings PLC said that requiring the freeholder to take the charge “offends strongly the principles of A1P1”.

### A flexible model

5.128 Additionally, several consultees argued that the funding options available should be flexible. Teresa Velasco said that unit owners should be able to consider how the conversion might best be financed and, accordingly, who should benefit from the charge. And the Chartered Institute of Legal Executives ("CILEx") said "so long as the rules around the creation of the charge are fair to the non-consenting leaseholder it should be immaterial where the finance comes from".

## How might the charge be set?

### A fixed amount

5.129 The option that received the most support from consultees, and particularly leaseholders, was for the charge to be set as a fixed amount, representing the non-consenting leaseholder's share of the initial freehold purchase at the point of conversion. Consultees said that this option would be the least oppressive option for non-consenting leaseholders. Catherine Williams (leaseholder) argued that those financing the conversion should not be able to "take advantage of a non-consenting leaseholder's lack of funds at that time". The Buckingham Court Residents' Association said that conversion to commonhold should not be a "profit-based system". A couple of consultees also argued that this option for setting the charge would be the easiest to administer. However, a few consultees pointed out that this option would amount to an interest-free loan which would not be an attractive investment. As Brenda Fearns (leaseholder) suggested, the non-consenting leaseholder could "wait for inflation to take away the expense of the purchase".

### A fixed amount, plus interest or inflation

5.130 A smaller number of consultees were in favour of setting the charge as a fixed amount, plus interest or inflation. Those in favour of this option said that it would: (1) offer an incentive to provide the financing; (2) encourage leaseholders to participate at the outset as otherwise they would be required to pay an additional amount; and (3) avoid participating leaseholders being "out of pocket". However, a few consultees were concerned that non-consenting leaseholders would be disadvantaged under this option if the value of the commonhold unit were to fall. In this scenario, the leaseholder would remain liable to repay the full amount to those providing the finance, plus interest or inflation (which may have been accruing for a long period of time), but may not have sufficient equity in their unit from which to make the payment.

### As a percentage share in the value of the unit

5.131 This was the second most popular option amongst consultees.[45] Consultees, including two members of our advisory panel, Lu Xu and Mark Chick, argued that this option would provide a return on the investment of those financing non-consenting leaseholders' shares and would therefore offer an incentive to provide this financing. Paul Stevens said that it would be fair for those providing the finance to share in any increase in value of non-consenters' units.

> [When] commonhold becomes widely used, it is highly likely that a commonhold unit will be worth more than a leasehold flat, and it is only fair that whoever pays the

[45] For an explanation of how the charge would be calculated, see discussion at para 5.108 above.

enfranchisement premium should have the benefit (or part of it) of the increase in value. It is less fair that a non-consenting leaseholder should have the full benefit of the increase in value since they have chosen not to take part in the conversion to commonhold.

5.132 On the other hand, some consultees including the Leasehold Knowledge Partnership ("LKP"), expressed concern that if the charge were set as a percentage, those providing the finance might not be repaid in full should the property decrease in value. Further, while the PBA thought that setting the charge as a percentage amount would be "the most principled way to set the charge" it thought the option could lead to valuation disputes at the point of sale.

### What alternatives might there be?

5.133 With regards to whether there might be an alternative way to finance non-consenting leaseholders' shares of the cost of converting, some consultees argued that participating leaseholders should fund the shortfall between themselves, without requiring any form of reimbursement.

5.134 A number of other consultees suggested that, rather than repaying the debt on the sale of the property, non-consenting leaseholders might be able to pay their share of the freehold purchase price in instalments. Graham Webb (leaseholder) argued that "non-consenters will have benefited from the elimination of their ground rent, so a significant regular repayment is entirely justifiable". He argued that regular repayments would benefit those who provided the finance, given that "any sale of the unit (and recouping of the charge) might be decades in the future".

5.135 In addition, many consultees argued that Government support should be available to help finance the cost of converting. Berkeley Group Holdings PLC said that a Government-backed scheme might help "avoid the need to resort to charges". Jo Darbyshire (leaseholder) explained that many leaseholders "will struggle to afford the outright cost of the conversion of their own property without having to also fund the conversion of others". Consultees put forward a number of suggestions as to what Government assistance might look like, including low interest loans, a Help to Buy scheme and a Government fund.

### Discussion and recommendations for reform

5.136 Our view is that, in the vast majority of cases, and even if subject to a charge, non-consenting leaseholders would be in a better position following conversion under Option 2 than if they had remained leaseholders (under Option 1). On conversion, non-consenting leaseholders would obtain an interest which no longer reduces in value as the term runs down and no ground rent would be payable.[46]

5.137 We agree with the view expressed by a number of consultees that it would be important not to put the former non-consenting leaseholders in a position whereby, at the point of sale of the unit, the amount owing under the charge exceeded the property value. We therefore agree with arguments that setting the charge as a fixed amount would be particularly disadvantageous for the former non-consenting

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[46] We provided a worked example in the CP, para 3.126, which compares the financial position of non-consenting leaseholders following conversion Options 1 and 2.

leaseholders if property prices were to go down. In this scenario, the former leaseholders would be required to repay the fixed amount secured by the charge, plus any interest or inflation, regardless of the value of the property at the point of sale.

5.138 Our view is that these concerns could be addressed by setting the charge as a percentage increase in the value of the property which results from the conversion (option (d) at paragraph 5.107(3) above). The commonhold unit and the leasehold interest would be valued as part of the conversion process, and the percentage uplift in value resulting from the conversion to commonhold would be calculated at this point. On conversion, the relative value between the non-consenting leaseholder's leasehold interest and the commonhold unit would be therefore "fixed" or "crystallised". The percentage, once set, would remain constant, regardless of whether the commonhold unit subsequently increased or decreased in value. On the sale of the unit, that same percentage amount would be paid from the proceeds of sale to those financing the non-consenting leaseholder's share. If the charge were set in this way, the amount owing under the charge would never exceed the equity available in the property at the point of sale. If the value of the unit had increased between the point of conversion and sale, those financing the conversion, and the non-consenting leaseholder, would both be able to share in any increase in value of the property. Both parties would also share the risk of there being a downturn in the property market. Any losses which result would be shared in a way that was proportionate to their property interest, again by taking account of the set percentage.

5.139 Setting the charge as a percentage of the value of the property would also address Irwin Mitchell LLP's concern set out in paragraph 5.113 above that non-consenting leaseholders would not have any control over the purchase price paid to acquire the freehold. The percentage figure would represent, on an objective basis, the additional value generated by the conversion to commonhold, rather than the amount of money paid by the participating leaseholders to acquire the freehold.

5.140 That being said, we do, at this stage, have reservations about imposing a charge over the units of non-consenting leaseholders in the manner described in the Consultation Paper.

5.141 Our proposal relies upon the charge being a sufficiently attractive investment for investors. Otherwise, these parties would not be willing to help finance non-consenting leaseholders' shares of the freehold purchase and accept charges over the units in return. While many individuals and leaseholders were sceptical about the involvement of third-party investors, in practice, leaseholders may not be able to raise the necessary funds between themselves. If leaseholders were unable to raise the necessary funds, conversion would be prevented unless external investment became available. Despite our suggestion that the charge could be set as a fixed percentage of the value of the property, which would allow those providing the finance to share in any increase in the unit's value between conversion and sale, some consultees were still not convinced that the charge would be sufficiently attractive to investors. They argued that, unlike the position on CFA claims, investors would not be interested in helping to finance conversion under Option 2, as they would not stand to receive any ground rent or lease extension premiums from non-consenting leaseholders.

5.142 In addition, while it should almost certainly be the case that non-consenting leaseholders, who take a unit subject to a charge, would be in better position financially than if they had remained leaseholders, we are concerned that the charge could have unforeseen financial implications for non-consenting unit owners. In particular, the charge is only likely to be attractive to those providing the finance, if the charge takes priority over any existing mortgages. If, on the subsequent sale of the unit, the mortgage lender were to be paid in advance of those funding the non-consenting leaseholder's share, there may be insufficient equity in the property after paying the mortgage amount to reimburse those providing the finance. However, a number of consultees warned that if the charge were to take priority, lenders might be unwilling to offer additional finance to those taking a commonhold unit, or be unwilling to remortgage on the same terms. Consultees also said that the charge would likely affect lenders' willingness to support commonhold more generally.

5.143 However, we remain of the view, expressed in the Consultation Paper, that non-consenting leaseholders should be required, at some point, to contribute towards the freehold purchase price. These leaseholders will have benefited from improved security in their homes, and will not be required to pay any ground rent following conversion. Given these advantages, we do not agree with the view expressed by some consultees that the participating leaseholders should be required to finance the non-consenting leaseholders' shares of the freehold purchase without obtaining any form of reimbursement. It would be unrealistic to expect participating leaseholders to have the available funds to do so. Further, if non-consenting leaseholders were not required to contribute financially, many leaseholders might hold back their consent in the hope that they would obtain a free commonhold unit. Consequently, unless non-consenting leaseholders are required to repay their share, it would be more difficult for leaseholders to obtain the support necessary to convert and to finance the conversion.

5.144 We note that a number of consultees called for financial assistance from Government in order to help leaseholders meet the costs of converting to commonhold. If Option 2 is to be pursued, our view is that such assistance from Government would be necessary. We suggest that such assistance could take the form of an equity loan which would operate in a similar way to how shared equity loans currently operate under Government's Help to Buy scheme. Under such existing schemes, prospective homeowners are able to obtain loans representing a percentage of the value of the property (typically of up to 20%) in order to buy the property. The Government secures its financing by way of a charge over the property, which ranks after any existing mortgages. If the borrower decided to sell the property, he or she would need to repay Government the percentage of the value of the property, as at the date of sale. The Government scheme does not require the borrower to make up any shortfall if the property drops in value.[47] In this way, the buyer would be able to purchase the property for a lower upfront cost, and Government could share in any increase in the value of the property. Both parties would also share the risk of the property decreasing in value.

5.145 We therefore recommend that, if Option 2 is adopted, Government should provide equity loans to non-consenting leaseholders to cover their share of financing the

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[47] Homes England, *Help to Buy Buyers' Guide* (2018), at https://www.helptobuy.gov.uk/wp-content/uploads/Help-to-Buy-Buyers-Guide-Feb-2018-FINAL.pdf, p 17.

freehold. Non-consenting leaseholders should take their commonhold unit subject to a charge in favour of the Government, which ranks after any existing mortgage, and which would be repayable on the sale of the unit. In order to provide the correct incentive structure, we suggest that Help to Buy loans should also be offered to participating leaseholders on an optional basis.

**Recommendation 12.**

5.146 We recommend that, if conversion Option 2 is adopted, Government should provide equity loans to non-consenting leaseholders to cover their share of purchasing the freehold. Government should also offer such loans to participating leaseholders on a voluntary basis.

### Financing Option 2: Flats which have not been let to eligible leaseholders

5.147 In this scenario, there would be no leaseholder in the flat who would be eligible to take the commonhold unit on conversion. The participating leaseholders would therefore need to find a way to finance the share of the freehold value attributable to these flats. As with Option 1, participating leaseholders may be able to find an investor who would be willing to buy these flats on conversion. Additionally, in the Consultation Paper, we provisionally proposed that the participating leaseholders should be able to require the freeholder to take the commonhold unit of any flats which have not been let to eligible leaseholders, in order to reduce the purchase price.[48]

5.148 Further, in order to safeguard certain statutorily-protected tenancies (such as secure tenancies where the tenant's security would otherwise be lost), we provisionally proposed that freeholders who have granted such tenancies should automatically become the unit owner in respect of these flats on conversion. We also proposed that any freeholder who grants a shared ownership lease should take the commonhold unit on conversion, to ensure that the shared ownership relationship is preserved.[49]

### Consultees' views

5.149 The majority of consultees responding to this question supported the proposal. However, most consultees did not provide a reason for their agreement, other than saying that the proposal "made sense". Of those who did provide a substantive comment, the main argument raised was that the proposal would make conversion easier to achieve.

5.150 Arguments against the proposal mirrored those discussed above in relation to Option 1. Those leaseholders and other individuals who opposed the proposal generally did so because of concerns about the level of control which the freeholder might exert following conversion. Damian Johnson, for example, was concerned that the proposal might result in the former freeholder becoming the "dominant force in the commonhold association". James Taylor (leaseholder) also thought that the proposal

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48 CP, Consultation Question 5, paras 3.111 and 3.142.

49 CP, Consultation Question 5, paras 3.112 and 3.142(2).

was contrary to the aim of commonhold, to give people the "complete right to organise and live in the dwellings which they have purchased, to their own satisfaction".

5.151 Other consultees who opposed the proposal generally argued that it was unfair to require the freeholder to retain an interest in the building, and that it would "force hostile parties into a management structure together".[50] A couple of consultees expressed concern that the proposal might result in the former freeholder, as a unit owner, being required to comply with terms of the CCS which are inconsistent with the terms of any tenancy agreement granted by the freeholder, or becoming liable for commonhold contributions which then cannot be recovered from the tenant.

### Discussion and recommendations for reform

5.152 To facilitate more conversions to commonhold, we consider it necessary to provide leaseholders with a realistic way of financing the freehold purchase of flats which have not been let to a leaseholder who is eligible to participate. We therefore recommend that participating leaseholders should be able to require the freeholder to take the commonhold unit in respect of flats which have not been let to an eligible leaseholder on conversion. The former freeholder should also be able to elect to take the commonhold units of such flats (if not required to do so by the leaseholders) instead of being able to require a leaseback, as is the position currently on a CFA claim. Additionally, for the same reasons as discussed in relation to Option 1 (see paragraph 5.92 above), we recommend that the former freeholder should always take the commonhold unit over flats let to statutorily-protected tenants and to shared owners on conversion.

5.153 We acknowledge concerns that the obligations of the former freeholder, as a unit owner, may conflict with those owed under any tenancy agreement granted by the freeholder before the conversion. We consider this particular difficulty separately below.

5.154 As explained above in the context of Option 1, there is not a significant risk of the former freeholder exerting majority control of the commonhold association following conversion. While the former freeholder would be able to exercise the votes attached to any commonhold units he or she takes on conversion, flats which have not been let to an eligible leaseholder would never make up more than a third of the flats in the building.

5.155 Where some or all of the participating leaseholders finance the shares of the freehold attributable to flats in respect of which there is not an eligible leaseholder, and do not require the freeholder to take the commonhold units in respect of such flats (and the freeholder does not elect to take the commonhold units) the commonhold units should be held by the commonhold association in default of any other arrangement between the leaseholders.[51]

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50 ARMA.

51 It would also be possible for the leaseholders to set up a special purpose company to own the units, and share any income deriving from the unit.

**Recommendation 13.**

5.156 We recommend that, if Option 2 is adopted, the participating leaseholders should be able to require the freeholder to take the commonhold unit in respect of any flats which have not been let to a leaseholder who is eligible to participate in the conversion. Additionally, the freeholder should be able to require that he or she be granted the commonhold unit in respect of such flats (rather than being able to require a leaseback, as is presently the case).

5.157 We recommend that the freeholder should automatically become the unit owner in respect of any flats let to statutorily-protected non-qualifying tenants and shared ownership leaseholders on conversion.

5.158 We also recommend that, where some or all of the participating leaseholders finance the shares of the freehold value attributable to flats in respect of which there is not an eligible leaseholder (and so do not require the freeholder to take the units and the freeholder does not request the units) the commonhold units should be owned by the commonhold association as a default rule.

## SAFEGUARDING INTERESTS UNDER CONVERSION OPTIONS 1 AND 2

5.159 In the Consultation Paper, we explored two potential difficulties which might arise where a non-consenting leaseholder or the former freeholder is required to take a commonhold unit on conversion. We identified these difficulties as relating solely to Option 2. However, as a result of our recommendations above, the issues also need to be considered in the context of Option 1. As explained at paragraph 5.98 above, because of our recommendations to phase out leasehold interests, non-consenting leaseholders under Option 1 might also be required to take a commonhold unit at a later date. Additionally, under Option 1, we recommend that the former freeholder might be required to take the commonhold unit of flats let to leaseholders who are not eligible to participate.

5.160 We consulted on the following potential difficulties in the Consultation Paper.

(1) A potential inability for a non-consenting leaseholder or the former freeholder (now as a unit owner) to pass commonhold costs down to their tenant (or a shared owner). This is a specific difficulty which might arise where an individual, who takes a commonhold unit on conversion, had let out his or her property to an individual who was ineligible to participate in the conversion (for example, a short-term tenant or a shared owner who has not staircased to 100% ownership) and that tenant or shared owner pays a variable service charge in addition to their rent. The issue stems from a potential incompatibility between the regime for the payment of commonhold contributions (payable by the unit owner to the commonhold association) and service charges (payable by the tenant/shared owner to the unit owner).

(2) An inability for a non-consenting leaseholder or the former freeholder (now as a unit owner) to participate in preparing the CCS. This is a broader risk that,

because non-consenting leaseholders and the former freeholder will not have had any say on the preparation of the CCS, the terms of the CCS might be prejudicial to their interests, or might conflict with the terms of any tenancy agreement or shared ownership lease granted before the conversion.

5.161 We now look at each of these issues in more detail.

### Recovering costs from tenants and shared owners following conversion

5.162 In the Consultation Paper we explained that, where the former freeholder (or a non-consenting leaseholder) takes a commonhold unit on conversion, they may face a particular difficulty if, before the conversion, they had let their property to an individual who was not eligible to participate.[52] For example, if they had let their property on a short-term tenancy agreement, or to a shared owner (where the shared owner had not yet staircased to 100%).[53] Such tenancies will continue automatically on conversion to commonhold under our recommendations in Chapter 4. Where the former freeholder or a non-consenting leaseholder takes a commonhold unit on conversion, he or she will be treated in the same way as any other unit owner and will be required to pay commonhold contributions to the commonhold association.

5.163 We explained in the Consultation Paper that the former freeholder, or non-consenting leaseholder, could be placed in a difficult position if his or her tenant or shared owner is required to pay a variable service charge in addition to their rent.[54] Different statutory regimes apply to variable service charges under leasehold legislation, and to commonhold contributions under commonhold legislation. Variable service charges are only recoverable to the extent that they have been reasonably incurred. A tenant or shared owner who pays a variable service charge will therefore be able to challenge the reasonableness of any costs passed down to him or her. Consequently, the former freeholder, or the non-consenting leaseholders (now as unit owners) would only be able to recover from their tenant or shared owner costs which have been reasonably incurred. However, as a unit owner, the former freeholder or non-consenting leaseholder would be required to pay commonhold contributions to the commonhold association without an equivalent right to challenge the reasonableness of costs levied by the association.

5.164 As we discuss in Chapter 13, there is a specific regime attached to the payment of commonhold contributions which has been designed to suit the commonhold context. To help protect the solvency of the commonhold association, any challenges to the costs demanded by the association must be brought before the costs have been incurred. On taking a unit, the former freeholder or non-consenting leaseholder could therefore be placed in the position of paying costs to the commonhold association which are subsequently challenged by the tenant or shared owner and found not to be recoverable. We asked consultees whether this disadvantage might be mitigated either by:

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52 CP, paras 3.113 to 3.119.

53 We consider which individuals will and will not be eligible to participate in more detail at para 3.32.

54 A variable service charge requires a leaseholder or tenant to pay the landlord's actual costs of providing the services, rather than a fixed amount in the tenancy agreement or lease.

(1) placing a restriction on the sums which the commonhold association may recover from the former freeholder or non-consenting leaseholder until the relevant tenancy or lease is brought to an end or expires (or until the shared owner purchases the commonhold unit), to reflect the costs that are recoverable from the tenant or shared owner; or by

(2) modifying the tenant's or shared owner's property interest by removing his or her right to challenge service charge costs in accordance with leasehold legislation and replacing it with a right to make representations about commonhold costs in the same way as unit owners.

### Consultees' views

5.165 More consultees responding were in favour of the second suggestion: exchanging the tenant's or shared owner's existing rights to challenge service charges with new rights under commonhold legislation. Of those who supported this second suggestion, the main argument was that this option would be simpler to administer. The Guinness Partnership commented that the second suggestion "allows for the most simple and streamlined approach and avoids the freeholder or non-consenting leaseholder being trapped between two systems of regulation". Antonia Batty (leaseholder) agreed, saying that "everyone should function under the same rules to make it as easily managed as possible".

5.166 Other consultees said that conversion to commonhold warranted a change to the rights of those within the building "to reflect the fact that the fundamental structure of the building has changed from leasehold to commonhold".[55] A few consultees also argued that it was fair to provide tenants and shared owners with the same rights as unit owners to approve or challenge commonhold costs. CILEx said that "it makes sense that those who are ultimately expected to finance these costs would have a direct means by which to challenge the body responsible for determining what these costs actually are". A couple of consultees argued that the alternative option of a cap on the sums which could be demanded by the commonhold association might leave the association with a shortfall in expenditure.

5.167 Conversely, those consultees who preferred the first option (placing a cap on the recoverable expenditure) argued that it would not be appropriate to alter tenants' and shared owners' rights retrospectively. Damian Greenish for instance, favoured the first suggestion on the basis that "anything else interferes further with existing rights of tenants who have no say in the collective, conversion to commonhold or the subsequent management of that commonhold". Other consultees, including the PBA, thought it would not be satisfactory to provide tenants on short-term agreements with the same say on commonhold expenditure "as those with a longer-term outlook". Further, this consultee argued that if both the tenant and unit owner could challenge the costs levied by the commonhold association, that particular unit will get "two bites at the cherry".

5.168 Some consultees commented that neither of the two suggestions presented were appropriate. As an alternative, Neil Pothecary thought that any difficulties could be

[55] Lu Xu (academic).

resolved by the Tribunal. A few further consultees said that it was not necessary to recommend any reform to address this particular situation.

### Discussion

5.169 Following consultation and further discussion with consultees, it appears that the problem outlined above would not arise frequently for the following reasons.

(1) In many buildings, particularly those in the private rental sector, tenants will pay a fixed, rather than a variable service charge. A fixed service charge means that the amount the tenant is required to pay will not fluctuate in relation to the actual costs of providing services. Instead, the amount the tenant will pay will stay the same from week-to-week or from month-to-month. Only tenants who pay a variable service charge will be able to challenge the reasonableness of costs after they have been incurred.

(2) Our understanding is that variable service charges are more likely to be payable in the social housing sector. However, the risk of the problem occurring in the social sector is also likely to be low, for two main reasons.

(a) Many buildings in the social sector are unlikely to be eligible to convert to commonhold in the first instance. Where a high percentage of the flats in a building are let on shared ownership leases or short-term tenancies (which will often be the case in the social housing sector) conversion to commonhold would be prevented unless the freeholder consents. That is because, if the freeholder does not agree to the conversion, the leaseholders who wish to convert to commonhold would need to satisfy the same qualifying criteria as for a CFA claim. These criteria require at least two-thirds of the flats in the building to be let to leaseholders who are eligible to participate in the claim. And, as noted above, shared ownership leaseholders and tenants on short term tenancies are not eligible for the purposes of this claim.

(b) We are making a specific recommendation in Chapter 11 that would address this particular difficulty in respect of flats let to shared owners. We note that while shared ownership leases can be granted in the private sector, they are far more prevalent in the social housing sector. In Chapter 11 we recommend that providers of shared ownership leases, who become unit owners on conversion, should be able to transfer all commonhold voting rights to the shared owner, including the right to vote on the cost budget. Where votes are transferred in this way, the shared owner would have the same rights as other unit owners to challenge commonhold costs under commonhold legislation, in exchange for their existing rights to challenge costs under leasehold legislation. While we agree with the PBA's point (at paragraph 5.167 above) that it would not be satisfactory to provide short-term tenants with the same say on commonhold decisions as unit owners, a different approach is justified for shared owners. Unlike short-term tenancy arrangements, shared ownership is a method of financing eventual outright ownership. The shared owner will therefore have the same long-term outlook on the management of the building as other owners in the building.

(3) In the rare event that the former freeholder or non-consenting leaseholder does become the landlord of a tenant who pays a variable service charge on conversion, they would only be prejudiced by a shortfall in sums if the costs incurred by the commonhold association are in fact unreasonable and cannot be passed down to the tenant. However, there are clear incentives in the commonhold context for costs to be set at a reasonable level. Leasehold legislation, including the protections available for those who pay a variable service charge, is based on the presumption that an external landlord will decide on the works and services to be carried out in the building. The external landlord will be able to pass on these costs to leaseholders and tenants under the terms of their leases and tenancy agreements, and so will ultimately not be responsible for paying these costs. Without imposing a requirement that leasehold costs must be reasonable, the external landlord might therefore not be provided with any incentive to ensure that the works and services provided are good value for money. Within the commonhold model, there are built-in incentives for owners only to incur reasonable costs. Where the units are owner-occupied, those who agree the cost budget, and pay for the works, will be the same individuals. Where participating leaseholders have granted tenancy agreements before the conversion, they will also want to ensure that the costs incurred by the association are reasonable and can be passed on to their tenants.

(4) In addition, while we consider it unlikely that many short-term tenancy agreements would require the tenant to contribute towards the cost of major works and improvements, we explain in Chapter 13 that it is possible for the CCS to include a threshold on the expenditure that can be incurred on improvements and enhanced services without the risk of challenge. Where the majority of owners wish to incur costs on services or improvements in excess of this threshold, those who are affected by the decision (for example, if the costs would not be recoverable from their tenant) would have a right to challenge these costs before they are incurred.

5.170 At this stage, therefore, we do not consider there to be sufficient evidence to recommend further changes to the commonhold legislation. However, we recommend that this position be kept under review, particularly if the qualifying criteria for conversion should be relaxed in the future. Should differences between the variable service charge regime applicable to tenants and the regime applicable to commonhold contributions become a problem in practice, we recommend that the law should be reformed to address this difficulty.

### Ensuring the terms of the CCS sufficiently protect those who have not consented

5.171 We provisionally proposed in the Consultation Paper that any application to convert to commonhold under Option 2, with less than unanimous agreement, should require the approval of the Tribunal.[56] Our view was that Option 2 represented a more significant interference with non-consenting leaseholders' property rights and that this additional protection was therefore necessary. We suggested that the Tribunal would verify that the necessary consents had been obtained and that the terms of the CCS adequately

[56] CP, Consultation Question 7, paras 3.138 to 3.141 and 3.144.

protected the minority. The Tribunal would not have a general power to overrule the wishes of the majority and prevent the conversion taking place. Rather, the Tribunal would only be able to reject the application if the leaseholders did not provide the necessary evidence of required consents, or if the terms of the CCS did not adequately protect the minority. If the Tribunal suggested amendments to the CCS in order to protect the minority, the participating leaseholders could either accept these amendments and continue with the conversion, or reject the amendments and decide not to convert.

### Consultees' views

5.172 More consultees agreed than disagreed with our provisional proposal. Support for the proposal was especially strong amongst law firms and their representative bodies.

5.173 The main argument made by those consultees who supported the proposal was that a Tribunal application would be necessary to protect non-consenting leaseholders' interests on conversion. FirstPort (managing agents) said "we believe that it is right that the Tribunal play an oversight role in situations where the property rights of an individual are being changed without their express consent". Peter Smith (academic) thought that an application to the Tribunal at the outset of a conversion claim was desirable to prevent challenges later on in the process.

5.174 Those consultees who were opposed to the proposal said that the cost of applying to the Tribunal would likely be prohibitive. They argued that the requirement to apply to the Tribunal would create an additional barrier to conversion and would leave leaseholders reluctant to convert to commonhold. In addition, consultees warned against the freeholder using his or her "financial power" to deter leaseholders from converting to commonhold by threatening legal fees. The National Leasehold Campaign ("NLC") said:

> for many leaseholders going to an organisation such as the Tribunal means two things; legal jargon and cost. I cannot stress enough how off-putting this is for the average person. It will be a deterrent to conversion.

5.175 NLC argued in favour of a new body or organisation "that does not require expensive professionals and is accessible for leaseholders".

5.176 Paul Stevens suggested that, as an alternative, a Tribunal application might be avoided by building adequate safeguards into the CCS. He said:

> if the concern is that the terms of the CCS should adequately protect the interests of non-consenting leaseholders, this should be provided for (so far as possible) by statute and in the standard form of CCS (to apply to all commonholds). In addition, non-consenting leaseholders should have the right to apply to the Tribunal for amendments to the CCS if they feel that their interests are not adequately protected, but it would be hoped that such applications would be rare.

5.177 Stephen Desmond made a similar argument that the "CCS should be based on and compatible with the terms of the existing lease, so far as possible, albeit with powers [for the Tribunal] to make appropriate modifications". LKP, the All-Party Parliamentary Group on Leasehold and Commonhold Reform ("APPG") and A L Hughes & Co

agreed that a Tribunal application should not be required as a matter of course, only where there was an objection from an interested party.

5.178 A few consultees, including Damian Greenish, the Berkeley Group Holdings PLC and the PBA argued that the Tribunal application should also take into account the extent to which the CCS protects the freeholder and individuals who are not eligible to participate, such as commercial and short-term tenants, not only the non-consenting leaseholders.

### Discussion and recommendations for reform

5.179 We note the support for this proposal and agree that it is important to protect the interests of those who have not agreed to the conversion. However, concerns raised by a number of consultees have caused us to reconsider our proposal.

5.180 First, we have reconsidered the scope of the available protection. In the Consultation Paper, we envisaged that safeguards as to the terms of the CCS would only be necessary on conversion under Option 2, and then only to protect the non-consenting leaseholders. However, as we note above, under our recommended conversion regime set out in this chapter, there may be other individuals in the building who might take a commonhold unit, and be required to comply with the CCS, without having consented to the conversion. In particular, non-consenting leaseholders under Option 1 might take a unit in the future as a result of our recommendations to phase out leasehold interests and replace them with commonhold units. The former freeholder, under both conversion options, might also be required to take a commonhold unit on conversion. That is as a result of our recommendations that, in order to reduce the cost of purchasing the freehold, the participating leaseholders should be able to require the freeholder to take the commonhold units in respect of flats which have not been let to a leaseholder who is eligible to participate.[57]

5.181 In addition, participating leaseholders under both conversion options would benefit from safeguards as to the eventual terms of the CCS. To ensure that the process of conversion is quick and cost-effective, it is likely that the participating leaseholders will nominate one or more individuals to prepare the CCS on their behalf, rather than each leaseholder agreeing to every individual term of the CCS. By creating a regime that also protects participating leaseholders, leaseholders will be offered greater certainty as to the eventual terms of the CCS which will encourage participation at the outset.

5.182 In summary, therefore, we recommend a regime that protects: (1) any individual who will take a commonhold unit at the point of conversion; and (2) any individual who might become a unit owner in the future under our recommendations to phase out leasehold interests and replace them with commonhold units. Our regime will therefore cover the former freeholder and the non-consenting leaseholders under both options. Protections will also cover shared owners, as they too might be required to take a commonhold unit in the future after having staircased to 100% ownership (see paragraph 5.55 above).

5.183 We note that some consultees called for additional protections for commercial tenants and other individuals who would not be eligible to participate in the conversion.

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[57] See Recommendations 11 and 13 above.

However, as we explain in Chapter 4, these tenants would not be required to take a commonhold unit on conversion, or at any point in the future under our recommendations. The tenant would continue to be able to enforce the terms of his or her tenancy agreement against his or her landlord on conversion. The unit owner in respect of that flat, would, however, benefit from protection under our regime. In particular, the protections would ensure that the unit owner is not disadvantaged by any inconsistency with the terms of the CCS, and the terms of the business tenancy.[58]

5.184 Second, we have reconsidered whether it ought to be necessary for participating leaseholders to apply to the Tribunal in every case, or whether there might be an alternative way to adequately protect interests on conversion. We are sympathetic to arguments that requiring leaseholders to apply to the Tribunal in every case would create an additional barrier to conversion and might lead leaseholders to carry out a CFA, rather than convert to commonhold. A number of consultees suggested that protections could be built into the terms of the CCS, which would reflect the terms of the existing leases in the building. We were drawn to this suggestion. Following consultation, we have revised the mechanism by which interests in the building will be protected on conversion. We recommend that, under both conversion options, participating leaseholders should be able to elect either:

(1) to comply with certain prescribed conditions when preparing the terms of the CCS; or

(2) to make an application to the Tribunal to approve the terms of the CCS as part of the conversion process.

5.185 We now consider each scenario in more detail.

### Scenario (1): prepare the CCS in accordance with statutory conditions

5.186 We recommend that a list of conditions should be prescribed by Regulations. These conditions should ensure that all leaseholders who will or might take a commonhold unit (see paragraph 5.182):

(1) are not subjected to more extensive obligations in the CCS than those which existed under the terms of their lease (for example, more extensive repairing obligations in respect of their properties);

(2) are not subjected to more extensive restrictions than those which existed under the terms of their lease (for example, a new restriction on keeping pets); and.

(3) possess rights over the building and common parts which are equivalent to their rights under their lease (for example, an exclusive right to use a balcony).

5.187 The prescribed conditions should transpose the main rights and obligations which existed in the leasehold context before conversion (through the lease terms) into the

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[58] We discuss below that, in the future, it may be possible for the unit owners to vote to change the local rules of the CCS. The unit owner would be able to vote in a way which protects his or her interest, and also that of the business tenant. Where the unit owner would be disadvantaged by a change to the local rule (for example, if the change were to put the unit owner in breach of the terms of the business tenancy) the unit owner would be able to invoke the minority protection regime described in Ch 17.

commonhold context (through the CCS). The conditions should take the existing lease terms as a starting point, and ensure that leaseholders' rights under the terms of their lease are not reduced following the conversion, nor their burdens increased.

5.188 As we explain further below, these conditions ought to provide adequate reassurance to all individuals (including non-consenting leaseholders and the former freeholder under both conversion options) who might wish (or be required) to take a commonhold unit on conversion to commonhold that their interests are properly protected. We recommend that the prescribed list should include (but not exhaustively) the following.

(1) A unit should not be allocated a higher percentage of the costs contribution than that currently allocated under the terms of the long lease of that flat. For example, if the lease in respect of a particular flat requires the leaseholder to pay 10% of the service charge, the unit cannot be allocated any more than 10% of the commonhold contributions. If the lease requires the leaseholder to pay a "reasonable share" towards the commonhold's costs, the CCS would only be able to allocate a percentage share that was reasonable in the context of the building. Additional protection is provided for in this respect by our recommendation in Chapter 13 which requires commonhold contributions to be allocated in a way which is reasonably proportionate in relation to the other units.

(2) The CCS should not require a unit owner to pay for a higher level of repairs or improvements than that provided for under the terms of the lease, or for additional services.[59]

(3) The allocation of voting rights must be reasonably proportionate to the service charge allocation.

(4) The CCS should not impose any obligations or restrictions on unit owners by way of local rules which did not exist under the terms of the leases.

(5) Where a leaseholder has rights over the land to become commonhold, he or she must be granted equivalent rights and/or protections over the land in the CCS. In particular, where the leaseholder has been demised part of the building in the lease (for example the roof), which must form part of the common parts on conversion, the unit must be allocated equivalent rights over that part. (Where a building is horizontally divided (ie a block of flats), the structure and exterior of the building *must* form part of the common parts which will be owned by the commonhold association after conversion). If the leaseholder had been demised part of the structure and exterior of the building in the lease, he or she must be given equivalent protections and/or rights over these common parts on conversion. This could be achieved by designating that part of the building as a limited use area (for the sole benefit of the unit) or by providing the unit owner with rights over that part in in the CCS, as appropriate. The unit owner's consent must be obtained before the association can make any changes to limited use areas, or the rights which have been granted in the CCS over

[59] Subject to the minimum standard of repair required by the Commonhold Regulations: see Ch 12.

common parts.[60] The requirement for the unit owner's consent in these circumstances is set out in the commonhold legislation, and cannot be removed by a vote of the unit owners. In respect of areas demised by the lease, which are not required by the commonhold legislation to form part of the common parts on conversion, these areas should form part of the individual commonhold unit on conversion.

5.189 Setting the CCS in accordance with these conditions will protect the non-consenting leaseholders and the former freeholder in the following ways.

(1) Non-consenting leaseholders would be offered a degree of continuity as to their existing rights and obligations, and would be protected against any onerous new obligations.

(2) The former freeholder and non-consenting leaseholders would be protected against the risk of incompatibility between the terms of the CCS and the terms of any tenancy agreement they had granted before conversion. We discuss above (from paragraph 5.169) that inconsistences between the statutory regime for the recovery of costs between the unit owner (regulated by the commonhold legislation) and the tenant (by leasehold legislation) would be unlikely to cause a problem in practice. However, without the above conditions, there is a concern that that there might be an inconsistency between the *terms* of the CCS and the tenancy agreement. For example, rules regarding the use of the particular unit. By preparing the CCS in accordance with the terms of the existing leases in the building, it is highly unlikely that such an inconsistency would arise. That is because, any tenancy agreements in the building would also likely have been drafted in accordance with the terms of the other leases in the building. Leases will often contain a requirement that any other lease or tenancy agreement granted by the landlord in the building must contain the same, or substantially the same, rights and obligations. That is to ensure that all obligations in the building are enforceable against all the occupiers. For example, a rule preventing noise after certain hours in the building would only be effective if everyone were required to adhere to it.[61]

### Scenario (2): Tribunal application

5.190 Alternatively, leaseholders would be able to apply to the Tribunal to approve the terms of the CCS. The Tribunal would ensure that the terms of the CCS adequately protect all individuals who will take a commonhold unit on conversion or who might take a unit in the future under our recommendations to phase out leasehold interests. While the Tribunal may consider the statutory conditions set out above when making its determination, it will not be limited to simply applying these conditions. The Tribunal might suggest alternative ways in which the CCS would adequately protect those individuals who will or might take a commonhold unit. For example, the Tribunal would be able to suggest the creation of sections within the development, such as a

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60 See Ch 10.

61 Additionally, it is highly unlikely that the freeholder would have included terms in the tenancy agreements which place him or her under more extensive obligations than those owed to the leaseholders under the terms of the leases. For the effective management of the building, the freeholder will want to ensure that the duties owed to the occupiers of the building, such as repairing obligations, are consistent.

commercial section, so that only unit owners within the commercial section would be able to vote on decisions affecting that part of the development. In addition, the Tribunal could suggest a cost threshold in the CCS on the expenditure which can be incurred on improvements or enhanced services without challenge.[62] The participating leaseholders would be free either to accept these amendments and proceed with the conversion, or to reject the amendments and not convert. Any individual who will or might be required to take a commonhold unit on conversion (including the former freeholder and non-consenting leaseholders under both options) would be able to make representations at the Tribunal hearing.

### Deciding which route to pursue

5.191 Our revised approach will provide participating leaseholders with a clear basis on which to agree the terms of the CCS. Both routes will adequately protect their own interests, and the interests of others in the building.

5.192 We recommend that guidance should be produced to assist leaseholders when deciding which route to pursue. When deciding which route to pursue, relevant factors for the leaseholders to consider are likely to include the following.

(1) The complexity of the development. The more complex the development, the more likely that participating leaseholders will benefit from the assistance of the Tribunal. In a simple residential block where all leases have been granted on the same terms, it should be relatively straightforward to prepare the CCS in accordance with the statutory conditions set out above. However, in larger developments, where lease terms vary substantially, it may be difficult to work out which lease terms should be carried across, and an application to the Tribunal would be advisable.

(2) The benefits of departing from the prescribed conditions for the participating leaseholders. If the benefits are slight, it may not be worth the time and expense of applying to the Tribunal. Particularly if Option 1 is pursued, there would be advantages in simply adopting the statutory conditions. Carrying over existing lease terms would help simplify the management of the building should conversion Option 1 be adopted. There would be less risk of inconsistency between the terms of the CCS, which bind unit owners, and the terms of the continuing leases.

(3) The impact of departing from the prescribed conditions on those who have not consented. Departures which are prejudicial to owners, and which do not offer equivalent protections, are unlikely to be approved by the Tribunal.

### Consequences of a failure to prepare the CCS in accordance with (1) or (2) above

5.193 We anticipate that, in the vast majority of cases, participating leaseholders will be keen to ensure that the CCS has been prepared correctly in order to avoid future disputes. In the following chapter we recommend that, as part of the application to register the new commonhold, the applicant must sign a statement of truth confirming that the CCS has been prepared in accordance with the statutory conditions, or that a

[62] See Ch 13, para 13.107 onwards.

Tribunal has approved the terms. However, in the rare cases in which the leaseholders do not prepare the CCS in accordance with the above approach, we recommend that the individuals affected should have the following protections.

5.194 If, at the point of conversion, the CCS has not been prepared in accordance with the statutory conditions and the departure has not been approved by the Tribunal:

(1) terms which are inconsistent with the statutory conditions, because they place more extensive obligations or restrictions on a unit owner than those which existed under the terms of their lease, should not be enforceable against that unit owner; and

(2) where a unit owner, who had certain rights over the land to form the commonhold in his or her lease, has not been provided with equivalent protections in the CCS, he or she should have the right to apply to the Tribunal. The Tribunal may order that the terms of the CCS should be amended to protect that owner's right, or may award the payment of compensation for the loss of that right.

5.195 The scenario may also arise in which unit owners seek to vary the CCS at a later date, so that the terms of the CCS are no longer consistent with the statutory conditions, or the terms which have been approved by the Tribunal. Our view is that such changes should bind all those who were unit owners at the time the variation was made, as the unit owners would, at that point, benefit from other protections in the commonhold regime. The primary purpose of the safeguards set out above is to protect those who have not had a say on the terms of the CCS, before they become unit owners. Once a leaseholder or a former freeholder becomes a unit owner, they will then become involved in the democratic process of the commonhold and will be able to vote on any decisions to amend the local rules of the CCS. Under our recommendations in Chapter 10 such decisions will not be made lightly within the commonhold. In order to balance the competing objectives of providing unit owners with certainty as to their rights and obligations in the CCS, and flexibility to amend the local rules CCS, we recommend that a special resolution will be required to vary the local rules. In addition, unit owners will be able to challenge decisions of the commonhold association which might have an impact on them, under our minority protection recommendations in Chapter 17.

5.196 We note that in the Consultation Paper we also suggested that it should be within the Tribunal's remit to check that the necessary consents to conversion had been provided. However, on reflection, we consider that our regime for evidencing consents as set out in the following chapter will be sufficient. Under the current law, there is no requirement for the Tribunal to check that the necessary consents have been obtained, and we see no reason to depart from the current law in this respect.

**Recommendation 14.**

5.197 We recommend that those wishing to convert to commonhold must either:

(1) prepare the CCS in accordance with conditions which should be prescribed by Regulations; or

(2) make an application to the Tribunal as part of the process of converting to commonhold.

5.198 We recommend that, if the participating leaseholders elect to apply to the Tribunal, the Tribunal should authorise the conversion unless the terms of the CCS do not adequately protect the individuals who will take a unit on conversion, and individuals who might take a unit in the future under our recommendations to phase out leasehold interests.

5.199 We recommend that, if the terms of the CCS, as presented to the Tribunal, do not adequately protect these individuals, the Tribunal may suggest revisions to the CCS. Participating leaseholders may choose to accept these revisions and proceed with the conversion, or reject the suggestions and not proceed. Any individual who will or might take a unit should be able to make representations to the Tribunal.

5.200 We recommend that, unless the Tribunal has authorised a departure from the prescribed statutory conditions:

(1) any terms of the CCS which were approved before the individual in question became a unit owner, and which place more extensive obligations or restrictions on the unit owner than those which existed under the lease terms, should not be enforceable against that unit owner; and

(2) a unit owner who had certain rights in his or her lease over the land that will form the commonhold but has not been provided with equivalent protections in the CCS, should have the right to apply to the Tribunal. The Tribunal may order that the terms of the CCS should be amended to protect that owner's right, or may award the payment of compensation for the loss of that right.

# Chapter 6: Which is our preferred conversion option?

## INTRODUCTION

6.1 In the previous chapter, we considered, in detail, two potential models for conversion to commonhold which we named “Option 1” and “Option 2”. Following a brief recap of the recommendations we have made so far in respect of each option, in this chapter we explain which option was preferred by consultees and why. We present the key advantages and disadvantages of both conversion options arising from consultees’ views before recommending Option 2 as our preferred option to Government.

## OVERVIEW OF CONVERSION OPTIONS 1 AND 2

6.2 We begin with an overview of our recommendations so far in respect of conversion Options 1 and 2.

6.3 As explained in Chapter 3, under both conversion options, conversion to commonhold will result in:

(1) each flat in the building being registered as an individual freehold unit with a registered “unit owner”; and

(2) the commonhold association being registered as the freehold owner of the common parts.

6.4 Each flat in the commonhold building must be owned by a commonhold unit owner, who will be a member of the commonhold association.

6.5 In Chapter 4, we recommend that only leaseholders who would be eligible to participate in a CFA claim should be eligible to participate in a decision to convert to commonhold and become the commonhold unit owner. That is because, where the freeholder of the building does not agree to the conversion, leaseholders will need to acquire the freehold through a CFA claim as part of the process of converting to commonhold. As leaseholders will be able to pursue a streamlined process of acquiring the freehold and converting to commonhold, it makes practical sense to adopt the same eligibility criteria. We explain in Chapter 4 that, subject to certain exceptions, residential leaseholders who have been granted leases of over 21 years will be eligible to participate in a decision to convert and will be eligible to take a commonhold unit on conversion.

6.6 Under both conversion options, conversion will be possible where eligible leaseholders of at least 50% of the flats in the building support the decision to convert.

6.7 Eligible leaseholders who decide to participate in the conversion will be able to take a commonhold unit at the point of conversion to commonhold under both options.

6.8 Flats which have not been let to any eligible leaseholder (for example, flats which are empty or which have been let to a short-term or business tenant) will also be treated in the same way under both options. In order to reduce the cost of acquiring the freehold from the freeholder on a CFA claim, the participating leaseholders will be able to require the former freeholder to take the commonhold unit in respect of such flats.[1] But if they do not (and the participating leaseholders finance the purchase between themselves), the commonhold units will be held by the commonhold association in default of any other agreement.

6.9 The key difference between the two conversion options is the treatment of those leaseholders who, while being eligible to participate in the conversion, have not agreed to the process ("non-consenting leaseholders").

### Position of non-consenting leaseholders under Option 1

6.10 Under conversion Option 1, non-consenting leaseholders will retain their leasehold interest at the point of conversion. The commonhold unit owner in respect of such flats will be the commonhold association as a default rule.[2]

6.11 However, we recommend that the continuation of such leases should be a transitional measure under Option 1. At some stage in the future, all non-consenting leaseholders should upgrade their leasehold interest to a commonhold unit. We recommend in Chapter 5 that non-consenting leaseholder's leases should be "phased out" under the following provisions.

(1) All non-consenting leaseholders should have an individual statutory right to purchase the freehold of their unit and become a member of the commonhold association.

(2) This new statutory right to buy the commonhold unit should replace non-consenting leaseholders' existing statutory rights under leasehold legislation to seek a lease extension, and there should be no further CFAs once a building has converted to commonhold; and

(3) When a non-consenting leaseholder decides to sell his or her property in the future, the incoming purchaser should be required to buy the commonhold unit (as opposed to just the leasehold interest) and become a member of the commonhold association.

#### Option 1: worked example

6.12 Taking the block of five leasehold flats depicted in figure 3 (paragraph 3.10 above). Assume that leaseholders A, B, C and D are all eligible to participate in the decision to convert, having residential leases of 99 years. A, B and C wish to convert to commonhold (they are "participating leaseholders"), but D does not. D is therefore an eligible leaseholder who does not agree to the conversion (a "non-consenting

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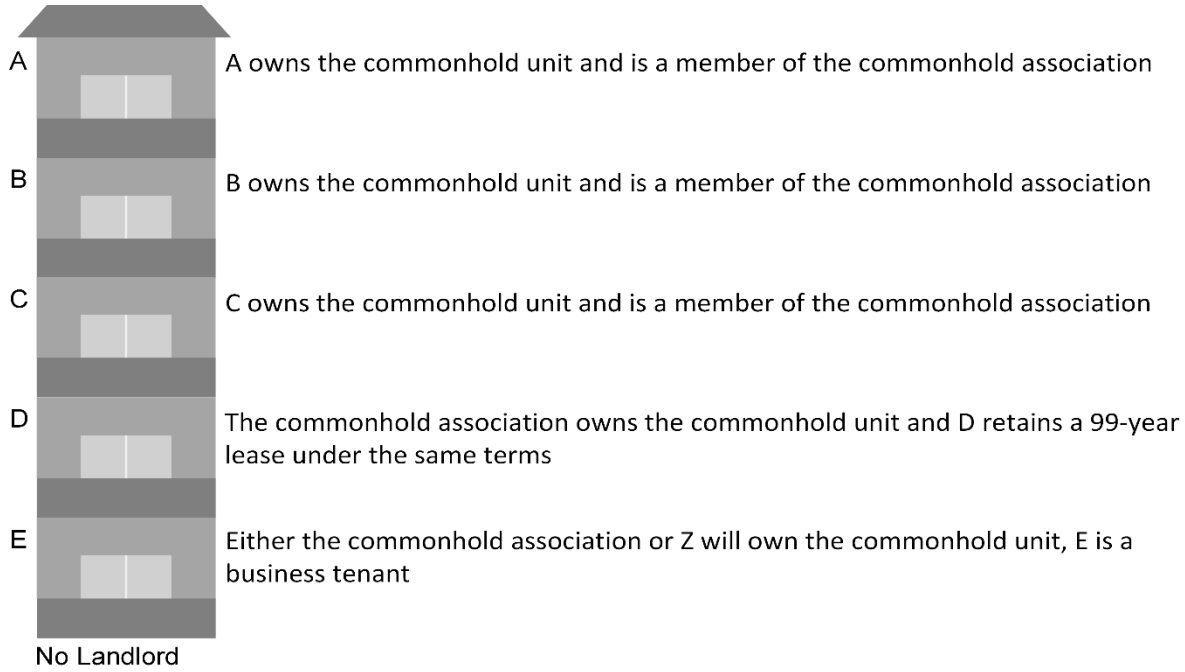
1 The former freeholder will also be able to elect to take the commonhold unit over such flats, if not required to do so by the participating leaseholders.

2 How the unit will be owned will depend on how non-consenting leaseholders' shares of the freehold purchase have been financed. See discussion from para 5.57 onwards.

leaseholder"). E is a business tenant and is not eligible to participate in the decision to convert or take a commonhold unit.

6.13 Following conversion under Option 1, the participating leaseholders A, B, and C will each obtain freehold, commonhold units and will become members of the commonhold association. The non-consenting leaseholder, D would remain on his or her 99-year lease.




### Position of non-consenting leaseholders under Option 2

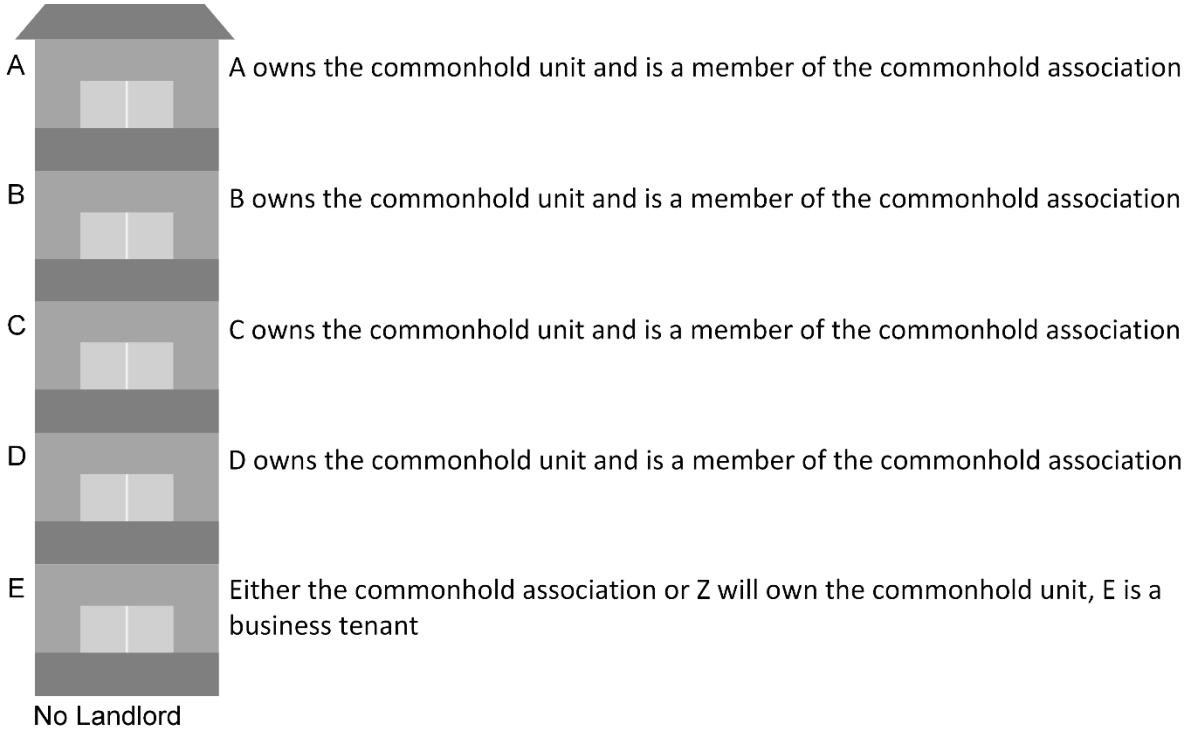
6.14 Under the second conversion option, all non-consenting leaseholders would take a commonhold unit at the point of conversion to commonhold, in exchange for their leasehold interest. No long leases would be permitted to continue.[3] Following conversion, the rights and obligations of the former non-consenting leaseholders would be governed by the commonhold community statement (the "CCS") and by commonhold legislation, rather than by leases and leasehold legislation.

6.15 In the Consultation Paper we expressed our view that, as Option 2 would require all leaseholders to take a commonhold unit at the point of conversion, conversion under Option 2 should require a higher threshold of support than for Option 1, for which we had proposed a threshold of 50%. We provisionally proposed in the Consultation Paper that conversion Option 2 should require the support of 80% of eligible leaseholders in the building. However, several consultees warned that a threshold of 80% would not be achievable in most leasehold blocks. We therefore recommend in Chapter 4 that, in respect of both options, conversion to commonhold should be possible where eligible leaseholders of 50% of the flats support the decision to convert.

[3] Subject to certain exceptions, see Ch 11.

### Option 2: worked example

6.16 The same leasehold block depicted in figure 3 is converting to commonhold, this time under Option 2. Again A, B and C want to convert but D is opposed to the conversion. E is a business tenant and so is not eligible to participate in the decision to convert or take a commonhold unit. Rather than being permitted to retain his or her leasehold interest, D will be required to take a commonhold unit at the point of conversion.




## IS OPTION 1 OR OPTION 2 PREFERABLE?

6.17 We explained in the Consultation Paper that both conversion options have advantages and disadvantages.[4] Our view was that allowing leases to continue automatically on conversion (Option 1) would be less intrusive for non-consenting leaseholders. On the other hand, commonhold was designed to facilitate the freehold ownership of flats and overcome the shortcomings of leasehold ownership. If leases were permitted to continue within commonhold, this may be seen as perpetuating the problems of leasehold ownership within the system designed to overcome its shortcomings. Further, under Option 1, the commonhold association would not be free to run the building by majority vote. Instead, the association would be constrained by the terms of the continuing leases and by the various pieces of leasehold legislation which attach to them.

6.18 If Option 2 were implemented, and all leaseholders were required to take a commonhold unit on conversion to commonhold, the management of the building would be simplified. Commonhold would be able to work as intended with all unit owners having the same type of interest following conversion. However, this option might be viewed as a more significant interference with non-consenting leaseholders'

[4] CP, paras 3.81 to 3.91 (Option 1) and 3.120 to 3.122 (Option 2).

property rights, particularly as they would be required, in one way or another, to pay for their upgraded freehold interest received at the point of conversion.

6.19 After presenting the advantages and disadvantages of both conversion options in the Consultation Paper, we asked consultees which option for conversion they preferred.[5]

### Consultees' views

6.20 The majority of consultees, and particularly leaseholders and individuals, preferred Option 1. However, leaseholders and individuals who supported Option 1 generally did so because we had provisionally proposed a higher threshold of support for Option 2. They argued that a threshold of 80% support would be extremely difficult to achieve. Their support for Option 1 was therefore predominantly based on a desire for a lower threshold, rather a desire to enable leases to continue. A couple of consultees even said that if the threshold of support were the same, they would prefer all leaseholders to take a commonhold unit at the point of conversion. In the Consultation Paper we did not present an option under which non-consenting leaseholders might be required take a commonhold unit with less than 80% support. Therefore, we do not consider that leaseholders and individuals who supported Option 1 necessarily favoured the continued existence of leases following conversion. In response to this question, Paul Stevens said:

> I would prefer Option 2 but only if the threshold remained around 50%, to make conversion as easy and as likely to happen as possible. If Option 2 is not possible on this basis, then Option 1 is to be preferred. I have dealt with leasehold enfranchisement cases in private practice and I therefore know from experience how difficult it can be to get large numbers of leaseholders to agree and to actually sign up to something that might have upfront costs. In the long term though, conversion to commonhold would likely benefit all leaseholders and so it should be as easy as possible to convert.

6.21 Other consultees, particularly law firms and other organisations, who were in favour of leases continuing on conversion (and therefore supported Option 1) argued that it would be unfair to require leaseholders to take a commonhold unit against their wishes (as would be the case under Option 2). They argued that leaseholders may have many reasons for not wanting to take a commonhold unit (for example, not wanting to become involved in managing the building) and that requiring them to do so might constitute a breach of their property rights under the European Convention on Human Rights.[6] The Association of Residential Managing Agents ("ARMA") also argued that taking a unit could affect a leaseholder's existing mortgage agreement over the flat, and subject the non-consenting leaseholder to "onerous mortgage risks and costs".

6.22 Conversely, those in favour of Option 2, and therefore of requiring all leaseholders to take a commonhold unit on conversion, said that this option would create a much simpler system with all the advantages that commonhold offers. Lu Xu (academic) argued that allowing leases to continue would "dilute most of the advantages of

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5 CP, Consultation Question 10, para 3.182.

6 See para 4.65 of this Report and CP, paras 3.59 to 3.64 for a discussion of property rights under the ECHR in the context of conversion.

commonhold". PM Property Lawyers Limited (solicitors) agreed that, while it may be harder to achieve the position where all leaseholders take a commonhold unit on conversion, Option 2 is a more direct attempt at realising the objectives of commonhold. Some consultees, including the National Leasehold Campaign (the "NLC"), called for a more radical approach that would "take bigger steps forward to reduce the footprint of leasehold in England and Wales".

6.23 Several consultees who preferred Option 2 expressed concern about the practical difficulties of managing a building comprising a mix of leasehold flats and commonhold units under the first option, particularly with regards to recovering the commonhold's expenses. Gerald Eve LLP (surveyors) said that the "interaction between leasehold law and commonhold law for units in the same building is completely untried and is likely to increase costs for all concerned for managing the building on a day-to-day basis". And the Guinness Partnership (housing association) argued that "the commonhold association will have enough risks to manage without having to navigate the issues that exist within the leasehold system too".

### Discussion

6.24 We note above that most leaseholders and individuals who preferred Option 1 generally did so due to concerns that the proposed threshold of leaseholder support for Option 2 was unrealistic. Some consultees said that if the threshold to convert were the same under Options 1 and 2, they would prefer all leaseholders to take a commonhold unit at the point of conversion. Concerns about the high threshold of support required to convert under Option 2 however fall away due to our recommendation that conversion under both Options 1 and 2 should be possible with a threshold of 50% support.

6.25 In addition to the threshold, other comments from consultees generally focussed on the following.

(1) The impact of the conversion on non-consenting leaseholders. A number of individuals preferred Option 1 due to concerns that requiring leaseholders to take a unit against their wishes under Option 2 would be unfair, or might subject the leaseholder to unreasonable financial risks.

(2) The management structure created on conversion to commonhold. The main concern with Option 1 was that it would produce a complicated management structure on conversion, given the mix of leasehold and commonhold interests. Consultees said that Option 2 would produce a simplified management structure, which would immediately allow the full advantages of commonhold to be realised.

6.26 Below, we compare the main advantages and disadvantages of both schemes in more detail. We focus on the impact of conversion on non-consenting leaseholders under Options 1 and 2 and the desirability of the management structure that will be in place following conversion. We also compare the practicalities of financing the conversion under both options.

### Impact of the conversion on non-consenting leaseholders

6.27 We note above that one of the reasons why consultees preferred Option 1 was because they considered Option 1 to be less intrusive to non-consenting leaseholders. However, these arguments were predominantly made by professional organisations, rather than leaseholders themselves. Indeed, many leaseholders and other individuals responding to the Consultation Paper referred to the advantages of commonhold over leasehold and called for leasehold to be abolished and replaced with commonhold.

6.28 While we acknowledge that conversion would result in changes to non-consenting leaseholders' property interests, these changes are to the benefit of those leaseholders, by providing them with an improved form of ownership. Conversion to commonhold will offer leaseholders an opportunity to own their homes on a permanent, freehold basis, rather than owning a time-limited interest which will decrease in value as the term runs down. While, as was pointed out by a few consultees, some leaseholders might not want to be involved in the management of the building, whether they do become involved on taking a unit, and the extent of their involvement, will be a decision for them.

6.29 In the Consultation Paper, we drew a clear dividing line between the impact of conversion Options 1 and 2 on non-consenting leaseholders. Our view was that Option 2 was a more intrusive option as it would require all non-consenting leaseholders to change their property interests on conversion. However, in response to the Consultation Paper, a number of consultees pointed out that the difference between Options 1 and 2 is, in reality, more nuanced. These consultees argued that our proposals to phase out leasehold under Option 1 would be requiring leaseholders to take a commonhold unit "by the back door".

6.30 On reflection we have concluded that the distinction between Options 1 and 2 is not as clear cut as we had originally suggested. Our proposals to phase out leasehold within Option 1 would also see leaseholders taking a commonhold unit on the occurrence of certain events.

6.31 The difference between Options 1 and 2 in terms of impact on non-consenting leaseholders is one of scale. Option 2 would see up to 50% of these leaseholders in the building taking a commonhold unit at the point of conversion. Option 1 would be a more gradual route, under which the individual leaseholders would upgrade their leasehold interest to commonhold at a point in the future.

6.32 In the previous chapter, we recommend a system of safeguards that will protect non-consenting leaseholders under both conversion options. Additionally, the regime will protect the former freeholder, if he or she is required to take a commonhold unit.[7] We discuss our recommended regime in detail in the previous chapter, but, in summary, under both options, participating leaseholders will need to either:

(1) prepare the CCS in accordance with certain statutory conditions. These conditions are intended to transpose the main rights and obligations which existed in the leasehold context before conversion (through the lease terms) into the commonhold context (through the CCS). The conditions take the

[7] See discussion from para 5.171 onwards.

existing lease terms as a starting point, and ensure that non-consenting leaseholders are not subject to any new, onerous requirements following conversion, and that they do not risk losing important rights.

(2) apply to the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal") to approve the terms of the CCS. The Tribunal will ensure that the terms of the CCS adequately protect all individuals who will take a commonhold unit at the point of conversion, or who might take a unit in the future under our recommendations to phase out any continuing leasehold interests.[8] This will include, therefore, non-consenting leaseholders and the former freeholder under both options.

6.33 Other concerns about the impact of conversion on non-consenting leaseholders arise from the context of our reforms. Currently there is a lack of awareness about commonhold ownership due to the low number of commonholds in existence. In this respect, our recommendations for conversion need to be considered alongside Government's plans for wider measures to reinvigorate commonhold. While recommendations in this Report will address concerns about the commonhold legislation, Government is also reviewing ways to raise awareness of and confidence in commonhold in the property sector (for example, amongst developers and lenders).

### Management structure

6.34 Consultees' main argument in favour of Option 2, and requiring all leaseholders to take a commonhold unit at the point of conversion, was that it would create a more desirable management structure. We agree with this analysis. Our view is that Option 2 creates a better management structure at the point of conversion to commonhold. Option 2 would enable the commonhold structure to work as intended and would replicate the position in new commonhold developments. The management of the commonhold would be simplified as all owners would have the same type of interest (a commonhold unit), and all unit owners would be governed by the terms of the building's CCS and by commonhold legislation. There would no longer be any long leases in the building,[9] and so leasehold legislation would no longer apply to the owners.

6.35 Conversion under Option 2 would immediately produce all the advantages of commonhold over leasehold.

(1) All leaseholders would become unit owners and would acquire an asset which no longer reduces in value as the lease term runs down. Additionally, as unit owners, no payment of ground rent would be required.

(2) All leaseholders, now as unit owners, would be members of the commonhold association and would be able to participate in decisions about the management of the building.

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8 See paras 5.6 to 5.56.

9 Apart from any leases which are, on an exceptional basis, permitted to exist within commonhold, such as shared ownership leases. See Ch 11.

(3) There would only be one document, the CCS, which sets out the rights and obligations of all the owners in the building. Unit owners would be able to vote on amendments to the local rules of the CCS, providing them with flexibility to respond to changing needs and concerns.

(4) Unit owners would not be at risk of losing their commonhold unit through forfeiture.

(5) As well as many other advantages set out in Chapter 2.

6.36 Where only some leaseholders take a commonhold unit at the point of conversion, the advantages set out above would be diluted. Only those leaseholders who decided to participate in the conversion would become unit owners at that point. Therefore, only these leaseholders would obtain greater security in their homes and take over the management of the building through their membership in the commonhold association.

6.37 If Option 1 were adopted, at the point of conversion the CCS would apply to some, but not all, occupiers of the building. Namely, the CCS would apply to the unit owners and their tenants, but not the continuing leaseholders or their tenants. Many of the key advantages of the CCS would therefore be lost. The CCS is intended to simplify the management of the building by setting out the rights and obligations of all owners (and their tenants) in one document. This benefit will not be realised where there is a mix of commonhold and leasehold ownership in the same building. Additionally, as unit owners, the participating leaseholders would be able to vote to vary the rules which apply to them in the CCS, but they would not be able to impose new rules on the leaseholders in the building, which reduces the benefits of the CCS's flexible nature.

6.38 Further, under Option 1, the participating leaseholders (now as unit owners) would not be free to make any decision they deemed appropriate for the management of the building. Instead, in making decisions, the unit owners would be constrained by the terms of the continuing leases and by leasehold legislation. For example, the unit owners might wish to carry out a programme of refurbishment works to the commonhold but find that the cost of such works cannot be recovered under the terms of the continuing leases. Unit owners might therefore decide only to provide services and carry out works the cost of which can be recovered under the terms of the continuing leases. Alternatively, unit owners might decide to carry out these works or provide these additional services anyway, but fund the cost themselves. The converse situation might also arise whereby the terms of the continuing leases require the building to be maintained to a higher standard than felt desirable by the unit owners. Participating leaseholders (as unit owners) would also need to comply with the various pieces of statutory legislation which attach to leasehold interests, such as the requirement to carry out a specific consultation procedure before incurring costs above a certain amount.[10]

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[10] Before incurring expenditure over a prescribed amount on major works and services, the landlord must follow a consultation process prescribed by legislation. If the landlord fails to carry out this consultation, or obtain dispensation from complying with the procedure, the amount recoverable from leaseholders will be capped. The consultation process is often referred to as "section 20" consultation as it is provided for under s 20 of the Landlord and Tenant Act 1985.

6.39 In many respects, the position following conversion under Option 1 would be similar to that following a CFA where not all leaseholders participate. We explain this scenario in more detail, and provide a worked example, in Chapter 3. In summary, those leaseholders who decided to participate in the CFA claim would acquire the freehold collectively and gain control of the management of the building (although they would retain their leasehold interests). Leaseholders who did not participate in the CFA claim would not gain any say in the management of the building. Their leasehold interests would simply continue on the same terms and, from their point of view, the only change would be the identity of the freeholder. In managing the building, the leaseholders who participated in the CFA claim would still need to comply with the unchanged terms of the non-participating leaseholders' leases. Participating leaseholders would not be able to vary the terms of non-participating leaseholders' leases without their agreement. However, as the participating leaseholders would now own and control the freehold collectively, they would be able to vary the terms of *their own* leases (for example by extending the term of their leases to 999 years and by removing any requirement to pay ground rent).

6.40 While the management structure under Option 1 is not as desirable as that created under Option 2, our view is that, given the similarities between conversion Option 1 and the position following a CFA claim, concerns about the complexities of managing a building under Option 1 may have been overstated by consultees. We suggest in the previous chapter that, if Option 1 is adopted, there would be advantages for the participating leaseholders in preparing the CCS in accordance with the statutory conditions discussed above (at paragraph 6.32(1)). The statutory conditions route takes the existing lease terms as a starting point, which will reduce the risk of inconsistencies between the terms of the CCS and the terms of the continuing leases. We appreciate, however, that there are likely to be additional formalities within the commonhold context. Such formalities arise from the fact that participating leaseholders under Option 1 would need to be familiar both with commonhold legislation (which applies to unit owners) and leasehold legislation (which applies to the continuing leases). For example, when incurring costs, participating leaseholders would need to consult unit owners and leaseholders in different ways.[11] Conversely, leaseholders who participate in a CFA claim will only need to be familiar with leasehold legislation.

6.41 Conversion under Option 1 does, however, have an important advantage over CFA claims. Conversion under Option 1 carries the potential that, at some point in the future, all leaseholders would acquire their commonhold unit and the full, undiluted advantages of commonhold would be realised. Our view is that it would only be worthwhile pursuing Option 1, if our recommendations to phase out leasehold interests and replace them with commonhold units are also adopted.[12] If leases were to continue indefinitely within the commonhold, the full benefits of converting to

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11 Unit owners will be able to make representations about the cost budget to the directors and the unit owners will approve the cost budget of the commonhold each year by way of a vote. Unit owners will be able to challenge the cost of improvements or enhanced services if the cost exceeds a threshold set out in the CCS (see Ch 13). Non-consenting leaseholders will not be involved in this vote on the budget, but would have the right to be consulted if costs for certain works or services exceed a certain amount (under s 20 of the Landlord and Tenant Act 1985).

12 See para 5.6.

commonhold would never be realised. Without measures to phase out leasehold, there would be little advantage in leaseholders converting to commonhold under Option 1, rather than acquiring the freehold collectively.

6.42 While making leasehold a temporary measure would mitigate the long-term consequences of retaining leases in commonhold at the point of conversion, they do not remove the disadvantages of doing so. Therefore, we see Option 2 as the preferable structure, due to immediate benefits it provides at the point of conversion. However, as we now discuss, there are certain difficult practical issues when it comes to financing conversion under Option 2.

### Financing non-consenting leaseholders' share of the freehold purchase

6.43 As considered in more detail in the previous chapter, particular difficulties arise when considering how to finance non-consenting leaseholders' share of the freehold purchase under Option 2.[13]

6.44 On conversion under Option 2, all non-consenting leaseholders' property interests would be upgraded from leasehold to freehold. That is an enhanced interest, and a valuable one. Non-consenting leaseholders would no longer have an asset which reduces in value as the lease term runs down and they would not be required to pay any ground rent. We therefore considered that there ought to be a mechanism for non-consenting leaseholders to pay for their upgraded interest, which will have changed from leasehold to freehold at the point of conversion.

6.45 In the Consultation Paper, we explained that it would not be appropriate to require non-consenting leaseholders to pay for their upgraded, freehold interest at the point of conversion.[14] However, it would be unfair for non-consenting leaseholders to obtain their upgraded commonhold interest for free. There would need to be a way for non-consenting leaseholders to pay for the increase in the value of their property, which will have changed from leasehold to freehold on conversion, and to reimburse those who initially financed the conversion. As a mechanism to achieve this, we provisionally proposed that non-consenting leaseholders should have a charge placed over their units on conversion in favour of those who provided the finance. This charge would take priority over any existing mortgages and would ensure that, on the subsequent sale of the commonhold unit, those providing the finance would be repaid from the proceeds of sale, although the former leaseholders would have the option to repay their share sooner if they wished.

6.46 While a sizeable majority of consultees agreed with our provisional proposal for a charge to be put in place, several consultees expressed reservations about how such

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13 See from para 5.102. These difficulties do not arise under conversion Option 1 as participating leaseholders would have the same methods of financing non-consenting leaseholders' shares of the freehold as are presently available on a CFA claim (see from para 5.57). Participating leaseholders would, for example, be able to grant the former freeholder or an external investor new 999-year leases of the flats which have been let to the non-consenting leaseholders. As no long leases would be permitted to continue following conversion Option 2 (subject to certain exceptions considered in Ch 11), there would be no question of granting a leaseback to the former freeholder or an external investor.

14 CP, para 3.123.

a charge might operate in practice.[15] These concerns are more fully explained in Chapter 5, but the three main concerns were that:

(1) there may be unforeseen negative financial implications for non-consenting leaseholders, particularly as the valuation of commonhold units is currently largely untested;

(2) the charge would not be a sufficiently attractive investment for third-party investors. Unless such parties were willing to help finance non-consenting leaseholders' shares, it is doubtful that many conversions to commonhold would take place; and

(3) if the charge were to take priority over mortgages, lenders would be unwilling to lend on commonhold units more generally.

6.47 As a result of these concerns, we have concluded that, at present, the mechanism we proposed in the Consultation Paper would not offer a viable way of financing non-consenting leaseholders' shares under Option 2. Consequently, if Option 2 were adopted and leaseholders were required to take a commonhold unit on conversion, we consider that financial assistance from Government would be necessary. We suggest in the previous chapter that such assistance could take the form of an equity loan which would operate in a similar way to how shared equity loans currently operate under Government's Help to Buy scheme. The loan could be secured by way of a charge over non-consenting leaseholders' commonhold units on conversion, which would take effect subject to any existing mortgages. To provide the correct incentive structure, we also suggest that financial assistance should be made available to participating leaseholders on an optional basis.

### Existing mortgage finance

6.48 Another potential difficulty with Option 2 relates to non-consenting leaseholders' existing mortgage finance. Most leaseholders will have purchased their flats with the assistance of a mortgage. Leaseholders may find it difficult to convert to commonhold unless there is a way of transferring their mortgage finance from their leasehold flat to the commonhold unit.

6.49 We explain in Chapter 4 that currently, the consent of every mortgage lender who has an interest secured over any of the flats in the building will be required. As lenders will lose their security on conversion, it is inevitable that they will only consent to the conversion if they are prepared to accept a charge over the commonhold unit after conversion.

6.50 Obtaining the consent of every lender would present a significant hurdle to overcome. We therefore recommend in Chapter 4 that it should be possible for mortgages to transfer automatically from the leases to the commonhold units without requiring lender consent. Such an approach can be justified on the basis that commonhold units will provide lenders with an improved security to that available over leasehold flats.

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[15] For a more detailed discussion of consultees' views see Ch 5, para 5.110.

However, in adopting this recommendation, it would be necessary for Government to work with lenders to ensure that such an automatic transfer will be accepted by them.

6.51 In the Consultation Paper, we explained that conversion under Option 1 would be difficult, but not impossible to achieve, without the automatic transfer of mortgages to commonhold units. Conversely, we said that Option 2 would not be workable unless mortgages could transfer automatically from the leasehold interest to the commonhold unit.[16]

6.52 If it were not possible for charges to transfer automatically, and lender consent were instead required:

(1) Under Option 1, only participating leaseholders, who would be taking a commonhold unit on conversion, would be required to seek the consent of their lender. If lender consent were not forthcoming, the participating leaseholder would need to source an alternative lender who would be willing to accept security over the commonhold unit. It would not be necessary, under Option 1, to obtain lender consent in respect of non-consenting leaseholders' leases.[17] Following conversion under Option 1, non-consenting leaseholders' leases would simply continue, as would any charges secured against these leases. We therefore said that lenders, who have an interest secured over a lease which continues on conversion, should not be required to consent to a conversion to commonhold.

(2) Under Option 2, all leaseholders would be required to take a commonhold unit on conversion, including non-consenting leaseholders. All lenders with an interest secured over any of the leases in the building which would become units on conversion would be required to consent to the conversion. While participating leaseholders would be able to seek the consent of their mortgage lender, and source alternative financing if the lender refuses (in the same way as under Option 1), it would not be possible for participating leaseholders to:

(a) seek lender consent on behalf of all the non-consenting leaseholders; or

(b) source alternative financing for the non-consenting leaseholders if their lenders were to refuse consent.

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16 CP, paras 3.167 to 3.169.

17 We note that UK Finance and the Building Society Association argued that lender consent should also be necessary where a leaseholder retains his or her lease on conversion under Option 1. They argued that the possibility of conversion will not have been factored into the credit and risk assessments carried out before lending on the flats, and that a mix of commonhold and leasehold units within a block would bring complexity for buyers, lenders and conveyancers. While we acknowledge these concerns, our view is that the position following a conversion under Option 1 would create a similar position to that following a CFA where not all leaseholders participate. And, currently, lenders do not have any say (under the enfranchisement legislation) on whether leaseholders can participate in such a claim. More generally, lenders with an interest secured over leasehold flats do not have any control over who might buy the freehold and take over management of the building.

To do so would require the participating leaseholders to access personal financial information about the non-consenting leaseholders, and require the non-consenting leaseholders to sign new lending terms against their will.

6.53 Whether Option 2 can be pursued will therefore depend on the success of Government's plans to work with lenders to improve their confidence in commonhold, and ensure charges can transfer automatically from the leases to the commonhold units on conversion.

### Recommendations for reform

6.54 In this chapter, we have presented the main advantages and disadvantages of both options for conversion to commonhold. We have compared the impact of conversion on non-consenting leaseholders, the management structure created on conversion, and the practicalities of financing each option.

6.55 We have concluded that the difference between Options 1 and 2, in terms of impact on non-consenting leaseholders, is not as stark as we originally suggested in the Consultation Paper. While all non-consenting leaseholders will be required to take a commonhold unit at the point of conversion under Option 2, such leaseholders might also take a commonhold unit at a later date under Option 1, due to our recommendations to phase out leases and replace them with commonhold units. The same safeguards need to be available to protect all non-consenting leaseholders who will or might take a commonhold unit on or following conversion to commonhold.

6.56 Our view is that Option 2 creates the preferred management structure on conversion to commonhold. Conversion under Option 2 will immediately produce all the advantages of commonhold over leasehold and will make the building easier to manage, as all owners will hold the same type of interest. We therefore recommend that Option 2 should be adopted. However, implementing Option 2 creates difficult issues in practice, particularly with regards to how the conversion might be financed. As a result of these difficulties, it will only be possible to pursue Option 2 at this present stage if Government is willing to assist leaseholders to finance the conversion, and will work with mortgage lenders to address any reservations about the commonhold model.

**Recommendation 15.**

6.57 We recommend that all eligible leaseholders should be required to take a commonhold unit on conversion (which we call "conversion Option 2"), but only if:

(1) Government provides an equity loan to non-consenting leaseholders to cover their share of purchasing the freehold, and offers such loans to consenting leaseholders on a voluntary basis; and

(2) Government works with lenders to ensure that charges over leasehold flats can transfer automatically to the commonhold units on conversion.

6.58 If the actions listed at (1) and (2) above are not feasible, non-consenting leaseholders should retain their leasehold interests on conversion (which we call "conversion Option 1") but:

(1) non-consenting leaseholders should have the option to buy the commonhold title in respect of their unit at a later date;

(2) the new right to buy the commonhold unit should replace leaseholders' existing rights to a lease extension; and

(3) incoming purchasers should be required to buy the title to the commonhold unit in addition to the leasehold interest.

# Chapter 7: What is the procedure for converting to commonhold?

## INTRODUCTION

7.1 In our Terms of Reference with Government, we were asked to consider whether the procedure for creating and registering commonholds might be simplified. In this chapter, we make a number of recommendations that will make the process of converting to commonhold simpler, quicker and cheaper. Our recommendations will put leaseholders in control of the conversion process, and prevent tactical delays by those opposed to the conversion.

7.2 We illustrate how conversion might take place in two distinct scenarios. First, we consider the procedure for converting where leaseholders need to acquire the freehold compulsorily as part of the conversion process. We explain in Chapter 4, that where the freeholder does not consent to the conversion to commonhold, leaseholders will need to acquire the freehold compulsorily through a collective freehold acquisition ("CFA") claim. In order to make the process of converting as quick and as cost-effective as possible, leaseholders will however be able to follow a streamlined "acquire and convert" procedure. We begin in this chapter by setting out how the streamlined acquire and convert procedure will operate. This procedure will enable leaseholders to acquire the freehold and put the commonhold structure in place at the same time. By following the streamlined procedure, leaseholders will be able to avoid unnecessary delay and costs which might otherwise arise by following a two-stage process of acquiring the freehold through a CFA, and then converting to commonhold.

7.3 Second, we discuss the scenario where leaseholders do not need to acquire the freehold compulsorily in order to convert. Where the freeholder agrees to the conversion, there will not be any need for the leaseholders to carry out a CFA claim as part of the conversion to commonhold. This scenario will most frequently arise where the leaseholders already own the freehold collectively, for example, where the leaseholders have already purchased the freehold through a CFA claim and now want to convert to commonhold.

7.4 When considering both scenarios, we make a number of recommendations that will lighten the administrative burden on those wishing to convert. We reduce the number of forms that must be completed as part of the conversion process and prevent conversion claims being blocked at a late stage in the process. Our recommendations will also enable leaseholders to take control of the process by allowing them (in addition to the freeholder) to register the new commonhold at HM Land Registry. In the words of one consultee responding to the Consultation Paper, the package of reforms:

> places the long leaseholders concerned in the driving seat. It simplifies the procedures and aims to prevent any freeholders minded to do so from blocking the

process as well as limiting the power of originally participating long leaseholders to change their minds on grounds later on.[1]

## THE CURRENT LAW

7.5 Before setting out our recommended procedure for converting to commonhold, we provide a brief overview of the existing conversion process, and the forms that need to be submitted to HM Land Registry. We explain the current procedure in more detail in the Consultation Paper.[2]

7.6 A building can be converted to commonhold by applying to HM Land Registry to register the land as commonhold "with unit holders".[3] At present, the application can only be made by the registered freehold owner of the land.

7.7 The person applying to register the land as commonhold (referred to as "the applicant") must submit the following documents.

(1) Application form "CM1" to register a freehold estate in commonhold land. This form includes a number of tick-boxes that must be completed to demonstrate that the requisite documents have been lodged alongside the application form.

(2) A statement that the applicant is registering "with unit holders".[4] This statement must be in prescribed form COV[5] and must contain a list of individuals who will take a commonhold unit on conversion to commonhold.

(3) The commonhold community statement ("CCS") and a detailed plan of the land to become commonhold. The CCS sets out the rights and obligations of all the unit owners in the commonhold.

(4) The certificate of incorporation of the commonhold association (which demonstrates that the commonhold association has been set up as a company) and its articles of association.[6]

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1 Peter Smith (academic).

2 CP, paras 4.4 to 4.5.

3 We refer to "unit holders" as unit owners in this Report. The "with unit owners" procedure is the procedure intended to be used on conversion to commonhold. It is so-called because the identity of the unit owners will be known (the former leaseholders) at the time of registration. In contrast, where a developer builds a new block of flats which the intention of selling the individual flats as commonhold units, the identity of the new homeowners will not be known at the outset. The developer will therefore apply to register the commonhold "without unit owners". In Ch 9 we recommend removing the "without unit owners" procedure and moving to a single way of registering both new and converted commonholds.

4 CLRA 2002, s 9(1)(b).

5 Commonhold (Land Registration) Rules, r 5(2).

6 CLRA 2002, sch 1 paras 2 to 4. On conversion to commonhold, the commonhold association will own and manage the common parts of the commonhold.

(5) A certificate given by the directors of the commonhold association that the articles of association and CCS comply with the 2002 Act and the Commonhold Regulations 2004.[7]

(6) Evidence that the necessary consents have been obtained. Every individual who is required to consent to the conversion (including each leaseholder and all lenders with an interest secured over their flats, see Chapter 4) must complete a prescribed form CON1.[8] The applicant (which, currently, can only be the freeholder) must provide a statement of truth confirming that the necessary consents have been obtained. This statement is conclusive proof to HM Land Registry that no further consents are required.[9] If any individual has provided consent subject to conditions (that is, their agreement only stands if a particular circumstance does or does not occur), the statement of truth provided to HM Land Registry must confirm that the necessary conditions have been fulfilled at the time of the application.[10]

7.8 Once the necessary information has been provided to HM Land Registry, the Registrar will register the land as a freehold estate in commonhold land. At the same time:

(1) the individuals named as the new unit owners on form COV provided to HM Land Registry (see 7.7(2) above) will be registered as the freehold owners of their particular unit or units under separate title numbers;[11] and

(2) the commonhold association will be registered as the freehold owner of the common parts of the commonhold with a separate title number.[12]

## ACQUIRING THE FREEHOLD AS PART OF THE CONVERSION PROCESS

7.9 We now set out our recommendations for reform in the context of the first scenario discussed above, where leaseholders need to acquire the freehold collectively as part of the conversion process.

7.10 As noted above, in Chapter 4, we recommend that, where the freeholder of the building does not consent to the conversion to commonhold, leaseholders will need to acquire the freehold compulsorily by making a CFA claim. As a result of this recommendation, converting will involve two processes.

(1) Buying the freehold of the building through a CFA claim (determining matters such as the extent of the property to be acquired, and the premium payable for that acquisition); and

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7 CLRA 2002, sch 1 para 7. The certificate must also confirm that the association has not traded and has not incurred any liability which has not been discharged.

8 Commonhold (Land Registration) Rules 2004, r 7.

9 Commonhold (Land Registration) Rules 2004, r 6(6).

10 Commonhold (Land Registration) Rules 2004, r 6(4)(c).

11 CLRA 2002, s 9(3)(b) to (d).

12 CLRA 2002, s 9(3)(a).

(2) Putting in place the commonhold management structure (for example by setting up the commonhold association and preparing the CCS).

7.11 To mitigate the costs and delays that might otherwise be caused by following two distinct processes, we explained in the Consultation Paper that leaseholders would be able to streamline the two processes of buying the freehold collectively and converting to commonhold. Streamlining the two processes would however remain optional. Our intention is to provide leaseholders with as much flexibility as possible when acquiring the freehold and choosing the management structure for their building. Participating leaseholders would have the following options to consider.

(1) Leaseholders could exercise their right of collective freehold acquisition and stop there.

(2) Leaseholders could bring a CFA claim and, at a later date, after having acquired the freehold, decide they want to put in place the commonhold management structure. As certain consultees pointed out, leaseholders may want time to familiarise themselves with the commonhold regime before taking the further step of converting to commonhold. Leaseholders would be able to convert to commonhold by lodging the requisite commonhold documents at HM Land Registry (set out at paragraph 7.81 below).[13]

(3) Leaseholders could bring a CFA claim and, during the process of that claim, decide that they want to put in place the commonhold management structure. These leaseholders would be able to put the commonhold structure in place at the same time as acquiring the freehold, by lodging the requisite commonhold documents at HM Land Registry (set out at paragraph 7.81 below) when registering the freehold transfer.[14]

(4) Leaseholders could commence a bespoke claim to "acquire and convert". This process has been specifically designed to provide the most effective way of acquiring the freehold and converting to commonhold. The acquire and convert procedure incorporates all the steps necessary to acquire the freehold and the additional steps necessary to put in place the commonhold management structure. The Leasehold Knowledge Partnership ("LKP") and the All-Party

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13 This assumes that the same leaseholders who participated in the CFA claim wish to convert. These leaseholders would follow the conversion "without acquiring the freehold" process set out in the second part of this chapter (from para 7.62). It may however be the case that after one group of leaseholders have carried out a CFA claim, a subsequent faction wish to convert to commonhold. If the first group of leaseholders (who now collectively own the freehold) do not consent to the conversion, the second faction would need to carry out an "acquire and convert" claim. In the Enfranchisement Report, we recommend that it should be possible to prevent CFAs for a period of two years after a successful CFA claim, apart from where leaseholders are acquiring the freehold and also converting to commonhold (see Enfranchisement Report from para 5.206). The freeholder (which will now be the leaseholder-controlled company) would be able to refuse to transfer the freehold to any nominee purchaser other than the commonhold association.

14 Although in this scenario, the transfer would likely be from an external freeholder rather than from an FMC as referred to at para 7.81(1). It will necessarily be the case that only the participating leaseholders (as opposed to another faction of leaseholders who are not participating in the CFA claim but who may wish to convert) will be able to make the election to convert. Only the participating leaseholders will be in control of the company that will acquire the freehold, "the nominee purchaser", (see para 7.22 below) and will be able to register the commonhold at HM Land Registry.

Parliamentary Group on Leasehold and Commonhold Reform ("APPG") said that, "if commonhold is shown to work then logically any future collective enfranchisement would look to convert to commonhold at the same time".

7.12 In the Consultation Paper, we suggested that leaseholders might wish to commence a claim to acquire and convert, but decide at a later date that they only wish to acquire the freehold (and not convert).[15] At present, there would be nothing in the legislation that would compel the leaseholders to convert after having commenced an acquire and convert claim.[16] They could, at a later stage, decide that they only want to acquire the freehold, and not put in place the commonhold structure.[17]

7.13 While this remains the case under our recommended regime, on reflection, where leaseholders are uncertain about converting to commonhold at the outset of the claim, it would be preferable for them to commence an ordinary CFA claim, and have the option to convert at a later stage (option (3) above). That would avoid leaseholders having to take any preparatory steps for a conversion which may not in fact proceed. Where leaseholders do commence an ordinary CFA claim, there will be a natural point at which leaseholders should make the election to convert in order to avoid wasting costs. Leaseholders would, for example, be advised to make the election prior to settling the terms of any leasebacks to the former freeholder, who would be required to take a unit on conversion.[18] We consider it far more probable that leaseholders, during the process of the CFA claim, will learn of the benefits of commonhold and wish to convert, rather than, during the acquire and convert claim, decide that they wish to remain leaseholders and not convert.

7.14 Leaseholders who are already familiar with commonhold and make the decision to convert at the outset should use the acquire and convert procedure (option (4)). This process is the quickest and most cost-effective way of converting where the freeholder does not consent. We recommend below that guidance should be produced that will inform leaseholders of their options, and the differences between conversion and

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15 CP, paras 4.16 to 4.17.

16 Although, if a successful CFA claim has already taken place within the previous two years, it would be possible for the freeholder to prevent the further CFA claim, unless leaseholders were also converting (see Enfranchisement Report, from para 5.206). Additionally, if in the future, it becomes possible to convert to commonhold with less stringent qualifying criteria than for a CFA claim, commencing a claim to acquire and convert would need to result in conversion. In these circumstances, it would not be possible for leaseholders to change their minds about converting, and only acquire the freehold, as they would have benefited from the less stringent criteria which should only apply on conversion.

17 Leaseholders would be able to make this election at any point before executing the transfer of the freehold to the commonhold association (which will be named as the nominee purchaser (see paras 7.22 to 7.52). The leaseholders would need to change the nominee purchaser named in the Claim Notice to acquire and convert to a company other than the commonhold association. There is a specific procedure in the enfranchisement legislation that the leaseholders must follow to notify the landlord that the nominee purchaser has been replaced. In reality, it would also be advisable for leaseholders to make an election no longer to proceed with the conversion prior to incurring any costs relating to the conversion process, such as preparing the CCS.

18 We recommend in Ch 5 that under both conversion options, the participating leaseholders will be able to require the former freeholder to take the commonhold unit of any flats which have not been let to a leaseholder eligible to participate in the claim, rather than granting the freeholder a 999-year leaseback. See discussion from para 5.82 regarding Option 1, and para 5.147 regarding Option 2.

acquiring the freehold collectively. The rest of this part of the chapter focusses on the streamlined acquire and convert process.

7.15 While we did not ask consultees a specific question about the acquire and convert procedure, a number of consultees commented that the streamlined procedure would reduce unnecessary cost and complexity. The Chartered Institute of Legal Executives ("CILEx"), for example, identified a number of benefits of the streamlined process, including reducing costs and raising consumer awareness:

> Streamlining of processes is necessary in achieving a workable solution to commonhold which is familiar to consumers, legal practitioners and other relevant parties. In turn, this shall invariably hope to reduce costs by eradicating unnecessary complications and arbitrary distinctions between buying your freehold under enfranchisement laws and buying your freehold under commonhold laws…
>
> This has the added benefit of providing leaseholders with flexibility to change their mind half way through the process should they wish to continue onto a commonhold conversion where they had initially only planned to enfranchise or vice versa.
>
> In addition, having one streamlined process is also likely to improve consumer awareness of leaseholder rights, as the differences in the two ownership models only begin to arise towards the latter stages of the process and are limited to differences in property management. In turn, it shall become easier for practitioners to advise leaseholders on the options available to them…
>
> … the enfranchisement procedure is already well known to practitioners, who would therefore be able to advise more easily on commonhold conversions notwithstanding the lack of these in practice.

### Recommendations for reform

7.16 We agree with consultees that an ability for leaseholders to acquire the freehold and convert to commonhold at the same time would be a very helpful tool. We therefore recommend that a streamlined acquire and convert procedure should be facilitated.

**Recommendation 16.**

7.17 We recommend that it should be possible for leaseholders to acquire the freehold through a collective freehold acquisition claim, and convert to commonhold, by following a streamlined "acquire and convert" procedure.

## THE STREAMLINED ACQUIRE AND CONVERT PROCEDURE

7.18 As explained in the Consultation Paper, facilitating the acquire and convert procedure would require certain changes to be made to the existing commonhold legislation.[19] First, there are certain discrepancies between the CFA process and the conversion process which could make the streamlined process difficult to achieve without

[19] CP, paras 4.39 to 4.44 and para 4.46.

reforming the law. In particular, the way in which leaseholder consent is currently evidenced differs between the two claims. There are also differences between the circumstances in which leaseholder consent, once given, may lapse or be subject to conditions. To accommodate the streamlined procedure, it would be necessary to bring the two processes into alignment. Second, the streamlined procedure would be helped by an ability for leaseholders to control the conversion application themselves, rather than rely on the freeholder to submit the application, as is the position in the current law. In the Consultation Paper we made proposals to address these two issues and sought consultees' views. We also asked consultees whether any further changes could be made to the commonhold legislation to make the streamlined procedure more effective.

7.19 We now set out how the acquire and convert procedure will operate, and, in the light of consultees' responses to our consultation questions, we make a number of recommendations to better facilitate the streamlined process. We consolidate these recommendations at paragraph 7.83 below.

### Initial steps

7.20 Before commencing a claim to acquire and convert, participating leaseholders should take a number of organisational steps. They should:

(1) set up a company to act as the commonhold association. A copy of the commonhold association's certificate of incorporation will need to be provided to HM Land Registry when registering the new commonhold;

(2) agree how the freehold purchase will be financed and decide the circumstances in which the claim to acquire and convert might be withdrawn (see discussion from 7.39 below); and

(3) prepare the CCS, or decide how and when the CCS will be prepared. A copy of the CCS will need to be provided to HM Land Registry when registering the commonhold. In response to the Consultation Paper, a few consultees expressed concern that the preparation of the CCS might be deferred to a later stage of the process, rather than being prepared at the outset. They argued that preparing the CCS at a later stage of the process would not enable the views of those who have not agreed to the conversion (but would be required to take a commonhold unit) to be taken into account. However, in the previous chapter, we explain the basis on which participating leaseholders must prepare the CCS in order to protect the interests of those who have not agreed to the conversion (such as the former freeholder and non-consenting leaseholders). Because protections will be built into the process of preparing the CCS, leaseholders will be able to prepare the CCS at the outset, before bringing a claim to acquire and convert, or defer its preparation to later in the process, while still ensuring the interests of those who have not consented are protected.

7.21 Leaseholders may wish to record any agreement reached about how the claim is to proceed in a "participation agreement". While not a statutory requirement, participation agreements are already commonplace in CFA claims.

### Serving the Claim Notice to acquire and convert and evidence of leaseholder consent

7.22 Once the above preparatory steps have been taken, the leaseholders may serve a "Claim Notice to acquire and convert" (the "Notice") on the freeholder. We recommend that the content of this Notice should be prescribed by law. The leaseholders will name the commonhold association as the "nominee purchaser" who will acquire the freehold from the freeholder.[20]

7.23 The Notice should make clear that if, for any reason, conversion does not take place, the leaseholders still support the collective acquisition of the building. Leaseholders would therefore be able to decide at a later stage only to acquire the freehold and not convert to commonhold.

7.24 We suggested in the Consultation Paper that the Notice could stand as evidence that the requisite leaseholder consents have been obtained for both the CFA and conversion claims.[21] We also suggested that the Notice could stand in place of existing form COV by incorporating the details of individuals who will take a commonhold unit on conversion.

7.25 It is highly likely that the same leaseholders will be supporting the CFA claim and the conversion to commonhold. In Chapter 4, we recommend that the same category of leaseholders should be eligible to participate in a CFA claim and the conversion to commonhold. We also recommend that the same threshold of leaseholder support as is required to bring a CFA claim should be required to convert to commonhold. Namely that eligible leaseholders of 50% of the flats in the building, must support the decision. The result is that if leaseholders are able to acquire the freehold collectively, they will also be able to convert to commonhold.

7.26 Enabling the Notice to act as evidence of leaseholder consent to both claims would, however, require certain changes to the existing law. As we note above, the way in which leaseholder consent is currently evidenced is different in a CFA claim and on conversion to commonhold. In a CFA claim, leaseholders evidence their agreement by signing the CFA claim notice. On conversion to commonhold, each leaseholder must indicate their consent by completing a prescribed form CON1. In addition, there are differences between the circumstances in which consents, once given, may lapse, be withdrawn or be subject to conditions.

(1) Circumstances in which consents may lapse. Agreement to a CFA claim does not lapse. However, consents given in support of a conversion (on forms CON1) automatically lapse after a period of 12 months. In the Consultation Paper, we explained our concern that some claims to acquire and convert may take longer than 12 months to pursue. To align the two processes, we provisionally proposed that leaseholder consent to conversion should not automatically lapse after 12 months.[22]

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20 See para 3.43. The nominee purchaser is a person, either natural or corporate, who will conduct the claim on behalf of the participating leaseholders and acquire the relevant premises on their behalf.

21 CP, 4.35 to 4.36.

22 CP, Consultation Question 12, paras 4.39 to 4.43.

(2) Circumstances in which consents may be withdrawn. Once a CFA claim notice has been served on the freeholder, a decision to withdraw the claim must be made by the nominee purchaser (on behalf of the participating leaseholders). If an individual leaseholder changes his or her mind and no longer supports the CFA claim, this will not affect the validity of the claim notice once served. The circumstances in which leaseholders may decide to withdraw the claim collectively can be set out in a participation agreement prior to bringing the claim. Conversely, under the current conversion procedure, an individual leaseholder may withdraw his or her agreement to the decision to the conversion, which may prevent the conversion from taking place. We invited consultees' views as to whether leaseholders should be able to withdraw their individual consent to the conversion or should be required to withdraw the claim collectively.[23]

(3) Conditional consent. As above, the validity of the CFA claim notice is determined at the point of its service on the freeholder. There is no facility for a leaseholder to provide agreement on a conditional basis, so that if the condition is not met, the validity of the claim notice might be affected. Once the CFA claim notice has been signed by the requisite number of leaseholders (and meets the other formality requirements[24]) the notice will be valid, and will remain valid.[25] Under the existing commonhold legislation, however, any individual whose consent is required can attach conditions to their consent. If these conditions are not met, and the requisite leaseholder support is therefore not obtained, the conversion claim will fail.[26] In the Consultation Paper, we asked consultees a question about a particular difficulty which could arise where a mortgage lender provides its consent subject to conditions discussed at paragraph 7.46 below. However, the ability to give conditional consent creates wider issues, and could frustrate the acquire and convert process. While we did not ask consultees a more general question about removing the ability to give conditional consent, we consider the benefits of doing so below.

### Consultees' views

#### Should leaseholder consent to conversion lapse automatically after 12 months?

7.27 Consultees were almost unanimously in favour of our proposal to prevent consents to conversion lapsing after 12 months.

7.28 Several consultees warned that it will often not be feasible, particularly in larger developments, to obtain the necessary consents and pursue a claim to acquire and convert within a 12-month window. Alice Brown (leaseholder) said that if consents

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23 CP, Consultation Question 12, paras 4.39 to 4.44.

24 See Enfranchisement Report, para 8.109 onwards for a discussion of the information to be included within CFA claim notices, and from 9.39 for discussion of when the validity of the notice may be challenged.

25 Although once a valid notice has been served, the claim notice may be withdrawn by the nominee purchaser. Additionally, a failure to comply with certain procedural deadlines may result in the claim being withdrawn or struck out. See Enfranchisement Report Ch 9, in particular Recommendation 67 at para 3.39

26 We explain in para 7.7(6) above that on applying to register the commonhold under the current law, a statement of truth must be provided to HM Land Registry confirming that the necessary consents have been obtained and that any necessary conditions have been fulfilled.

lapsed after 12 months, it would create "another hurdle to overcome". She said that it is "a logistical challenge to organise multiple parties and removing this barrier will only help more leaseholders to convert to commonhold".

7.29 Consultees also expressed concern that the period of 12 months might lead to stalling tactics by the freeholder, so that the consents might lapse after a year.

7.30 In addition, some consultees acknowledged that, on a practical level, removing the 12-month validity period would be necessary to streamline the procedure with CFA claims.

7.31 On the other side of the argument, Places for People Group Ltd (developer) said that it would be "prejudicial for a party to be bound indefinitely" to conversion. The Association of Residential Managing Agents ("ARMA") argued that "indefinite consent" would not be attractive. Other consultees thought that consents should lapse, but after a longer period than 12 months. Suggestions as to what this longer period should be varied between two and five years.

### Should leaseholders be able to withdraw their consent to the conversion on an individual basis, or should they be required to withdraw the claim collectively?

7.32 With regard to withdrawing consent to the conversion, more consultees were in favour of leaseholders being required to make a collective decision no longer to proceed with the conversion, rather than being permitted to withdraw consent on an individual basis. Consultees argued that the acquire and convert procedure would be prevented if leaseholders could withdraw their consent individually, and risk the validity of the claim. They said that it made sense to adopt the same position as on a CFA claim. A number of consultees agreed with our suggestion that the circumstances in which leaseholders might decide to withdraw the claim collectively could be set out in a participation agreement at the outset.[27]

7.33 Additionally, several consultees argued that the claim should not be blocked by leaseholders withdrawing their consent after the formal legal process had commenced. Tiara Hardy (leaseholder) said that an ability to withdraw individual consent would "cause uncertainty and waste time and resources". The Residential Landlords Association said that allowing individuals to withdraw their consent after the Notice had been served "would be overly bureaucratic, create unnecessary time delays and would create significant barriers to commonhold". Antonia Marjanov and Stephen Collins added that such an ability would be "unfair" to those wanting to convert.

7.34 A few individuals and leaseholders expressed concern that if leaseholders could withdraw individual consent, so that the necessary threshold might not be met, the freeholder might encourage leaseholders to do so. This view was shared by the APPG and LKP who both said that "offering the option of allowing individual leaseholders to withdraw late in the process seems inevitably destined to be exploited by freeholders who might look to frustrate the process".

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[27] The Leasehold Advisory Service ("LEASE") recommended modelling any such agreement upon the precedent contained in the LEASE guidance booklet entitled "Participation Agreement".

7.35 Consultees suggested that leaseholders should carefully consider the implications of signing up to the conversion process at the outset of the claim. Peter Smith (academic) said that an individual right to withdraw consent might create a disincentive for leaseholders properly to consider the consequences of the conversion. A few consultees highlighted the need for accessible information and guidance about the commonhold model. One anonymous consultee said that this information needs to be "freely available, very clear and obtainable, prior to the point where specialists such as surveyors and solicitors' costs come in".

7.36 Peter Smith also made the point that "as the decision to convert is collective, its withdrawal would seem to require a similar type of decision".

7.37 On the other hand, consultees who were in favour of retaining an individual right to withdraw consent to conversion argued that circumstances may alter and that leaseholders should have the flexibility to change their minds. The Guinness Partnership (housing association), for example, said that "as a claim progresses, and as leaseholders develop a more informed view of what they are taking on, it is reasonable that some may change their mind".

7.38 Mark Chick (solicitor) suggested that there should be a vote prior to the conversion taking place to ensure that the decision to convert retains the requisite level of support. ARMA agreed that if the threshold of support were to fall below the requisite level "it would be inequitable to press on regardless as that way now the minority can overcome the wishes of the majority". A few consultees suggested that leaseholders may no longer wish to pursue the claim due to a change in financial circumstances, or because they no longer wish to take a commonhold unit on conversion. Other consultees argued that individual consent should be withdrawn automatically if the consenting leaseholder transfers his or her lease to someone else during the process.

### Discussion and recommendations for reform

#### Withdrawing and lapsing consent

7.39 Our view is that it makes practical sense to replicate the position on a CFA claim. We recommend that consents to conversion should not lapse automatically after 12 months and that leaseholders should not be able to withdraw consent on an individual basis. Rather, a participation agreement entered into at the outset of the claim could set out the circumstances in which leaseholders might decide to withdraw the claim collectively. Leaseholders will be investing time and money into the claim and it would create too much uncertainty if the claim could be blocked at a late stage in the process due to consents lapsing or due to certain leaseholders withdrawing consent.

7.40 Further, if consents could lapse or be withdrawn during the process, there would need to be an additional mechanism (such as a vote, as suggested by some consultees) to check that the requisite threshold of support is still met at the point of conversion. However, such a mechanism is not required in an ordinary CFA claim as the validity of the claim notice will be determined at the point of service. A requirement for a further vote would introduce an unacceptable amount of delay and bureaucracy into the process, and if the requisite level of consent were not met (for example due to leaseholders being abroad or in the process of selling their properties), participating leaseholders will have spent time and money on converting to commonhold for

nothing. Such a risk may deter leaseholders from agreeing to the conversion process in the first place.

7.41 Leaseholders will therefore need to consider carefully whether to support a decision to convert to commonhold before signing the Notice to acquire and convert. As part of its wider measures to encourage the reinvigoration of commonhold, Government should ensure that sufficient information is made available to leaseholders about the commonhold structure and its advantages. The consequences of signing the Notice should also be made clear to leaseholders in guidance and on the Notice itself.

7.42 As mentioned above, some consultees expressed concern that a leaseholder's financial position might change during the course of the claim, so that he or she no longer can afford to contribute. However, the financial consequences of the acquire and convert procedure stem from the process of acquiring the building through the CFA claim, rather than putting in place the commonhold structure. In other words (and as we explain above at paragraph 7.10), determining the purchase price and making a payment to the freeholder fall within the "CFA part" of the acquire and convert process. Not as a result of the conversion. The financial consequences for the participating leaseholders will be the same in an ordinary CFA claim as where the leaseholders are acquiring and also converting. We see no reason to depart from the current position on a CFA claim where leaseholders are acquiring and converting. The CFA legislation does not compel a leaseholder to contribute towards the purchase price if they have signed a claim notice. How the purchase is financed is a matter of agreement between the leaseholders. Consequently (as is the position currently in ordinary CFA claims) if, after signing the Notice to acquire and convert, a leaseholder is no longer able to contribute, there will be a distinction to be drawn between (1) the effect of the inability to contribute on the *validity* of the Notice and (2) *the practical consequences* for the rest of the leaseholders.

(1) The validity of the Notice will be judged at the point at which the Notice is served. So long as the requisite number of leaseholders have signed the Notice at the point of service (and any other validity requirements have been met), the claim may proceed. The validity of the Notice will not be affected if a leaseholder subsequently is unable to contribute towards the cost of buying the freehold. Similarly, if the leaseholder sells his or her unit, this will have no effect on the validity of the Notice.

(2) However, a leaseholder's inability to contribute towards the cost of the freehold purchase could have practical consequences for the other leaseholders. The other leaseholders would need to assess whether they can still afford to purchase the freehold and, if necessary, source additional finance. As discussed above, the leaseholders will likely have entered into a participation agreement at the outset of the claim which will detail how the purchase of the freehold will be financed. The agreement will also often explain the consequences if an individual is no longer able or willing to contribute towards the freehold purchase. It will be a matter for the leaseholders to decide on terms that best protect their interests. A refusal to contribute towards the cost of the freehold purchase will therefore not affect the validity of the claim, but may constitute a breach of any participation agreement entered into before bringing

the claim.[28] Such a breach may result in the participating leaseholders (or the nominee purchaser acting on their behalf) bringing a claim against the leaseholder who is no longer able or willing to contribute.

### Conditional consent

7.43 Since preparing the Consultation Paper, we have also reviewed more generally the ability of leaseholders to attach conditions to their consent. Our recommendations to prevent consents lapsing and being withdrawn on an individual basis are targeted towards simplifying the conversion process and removing uncertainty. Such benefits might be undermined if leaseholders could provide their consent subject to conditions, which might affect the validity of the claim if not fulfilled by the point of registration. Again, there would need to be an additional mechanism to check that the threshold of support remains met at the point of conversion, which would cause complexity, delay and additional costs. We note in this respect that there is no facility on the CFA claim notice to provide agreement subject to conditions. We therefore recommend that it should not be possible for consents to be provided subject to conditions on conversion to commonhold.

7.44 In summary, to simplify the process of conversion to commonhold, to prevent claims being blocked at a late stage in the process, and to streamline the CFA and conversion processes, we recommend that leaseholders should not be able to withdraw their individual consent to the conversion after the Notice has been served, and that consents to conversion should not automatically lapse after 12 months. Additionally, consents to conversion should not be given on a conditional basis.

7.45 Leaseholders who support the conversion will evidence their consent in the same way as on a CFA claim, by signing the prescribed Claim Notice to acquire and convert. The Notice will therefore act as evidence that the requisite number of leaseholders support the CFA claim and the conversion to commonhold. Once served, the Notice will remain valid unless withdrawn by the leaseholders acting collectively.[29] We also recommend that the Claim Notice should stand in place of existing form COV. As we explain above, form COV is currently used to provide details of the leaseholders who will take a commonhold unit on conversion. This information should instead be incorporated into the prescribed acquire and convert Notice.

### Evidence of lender consent

7.46 As alluded to above, the issue of conditional consent currently creates a particular issue in the context of mortgage lenders. Currently each lender must provide their consent to the conversion by completing form “CON1” and may attach conditions to their consent. As, at present, the lender’s security would be lost on conversion see Chapter 4, it is inevitable that a lender would only complete form CON1 on the condition that it would be regranted new security over the commonhold unit after the conversion. HM Land Registry’s practice guide for commonhold advises that, if the

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[28] For this reason, a leaseholder who enters into a participation agreement to pay for a share of the freehold in a CFA claim, and who subsequently decides to sell his or her lease after the claim notice has been served, will often reach an agreement with the incoming purchaser that the incoming purchaser will pay towards the freehold purchase in his or her place.

[29] Or unless and until the Notice is deemed withdrawn or struck out due to a failure to comply with a procedural deadline. Enfranchisement Report Ch 9, in particular Recommendation 67 at para 9.39.

lender is taking a charge on the new commonhold unit, a new charge or a deed of substituted security (transferring the charge from the lease to the new unit) must be lodged with the application to register the commonhold.[30]

7.47 However, as commonhold units will only be created at the point of registering the conversion, it will be impossible to confirm, at the time of applying to HM Land Registry, that the lender had been regranted security over the new commonhold unit and that the condition has been fulfilled. To address this difficulty, we provisionally proposed that a deed of substituted security should act as satisfactory evidence that the condition has been fulfilled.[31]

### Consultees' views

7.48 Almost all consultees responding agreed with this proposal. Only two individuals disagreed. Of those consultees who agreed with the proposal, hardly any provided a substantive comment in support, other than saying that the proposal made practical sense. The two consultees who disagreed with the proposal did so on the basis that lender consent to conversion should not be required in any event.

### Discussion and recommendations for reform

7.49 To a large extent, this question has been overtaken by our recommendation in Chapter 4 that it should be possible for charges to transfer automatically from the lease to the commonhold unit without requiring lender consent.[32] This is provided that Government works with lenders to ensure that such a transfer will be accepted by them. If the automatic transfer of charges is not made possible, and lender consent remains required, our view is that lender consent should be evidenced by way of a deed of substituted security provided to HM Land Registry rather than by requiring each lender to complete form CON1.

7.50 In practice, a lender will only consent to the conversion if it will be regranted security over the new commonhold unit and so a deed of substituted security will be supplied as a matter of course. HM Land Registry guidance indicates that the Registrar requires a deed of substituted security wherever a lender is taking a charge on the commonhold unit. We do not consider that form CON1 offers any additional information to HM Land Registry or protection to the lender. The deed of substituted security will demonstrate that the lender agrees for his or her charge to be transferred from the leasehold interest to the commonhold unit on conversion.

## Response Notice, transfer and registration of the commonhold

7.51 The freeholder must respond to the Notice to acquire and convert within 2 months.[33] The fact that leaseholders are converting to commonhold will not provide the freeholder with any new ground on which to reject the leaseholders' claim. Provided

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30 HM Land Registry, *Practice guide 60: commonhold* (July 2018), at https://www.gov.uk/government/publications/commonhold/practice-guide-60-commonhold.

31 CP, Consultation Question 13, paras 4.47 and 4.50.

32 See para 4.116.

33 This is the time period in which a response is required under our recommended CFA procedure. See Enfranchisement Report, Recommendation 63, para 9.95.

that the qualifying criteria for collective freehold acquisition are made out, the claim should be allowed to proceed.

7.52 Once the terms of the freehold purchase have been determined or agreed, the freeholder and the commonhold association can execute a transfer deed which will transfer the freeholder's land to the commonhold association. An application may then be made to register the commonhold at HM Land Registry. It would be necessary to lodge the following documents alongside application form CM1:

(1) the transfer deed, transferring the freeholder's land to the commonhold association;

(2) the CCS and accompanying plans;

(3) a copy of the Claim Notice to acquire and convert, which provides evidence of leaseholder consents. The Notice will also provide the details of those leaseholders who will be taking a commonhold unit on conversion;

(4) any deeds of substituted security, transferring charges from the leases to the commonhold units (if lender consent is required);

(5) a statement of truth confirming that the necessary consents have been obtained;

(6) the commonhold association's certificate of incorporation and articles of association; and

(7) a certificate by the directors of the association that the CCS and articles comply with the commonhold legislation and regulations. This will include confirmation that the CCS has been prepared in accordance with the recommendations discussed above 7.20(3) which are aimed at protecting those who have not agreed to the conversion.

7.53 On receipt of these documents, HM Land Registry should register the land as a freehold estate in commonhold land. The common parts of the commonhold will be registered in the name of the commonhold association, and the leaseholders who are named as taking a commonhold unit on conversion will be registered as individual freehold owners of their flats.[34]

### Putting leaseholders in control of the registration process

7.54 At present, only the freeholder may make an application to register the conversion to commonhold. One of our objectives when reviewing the conversion procedure has been to provide leaseholders with greater control over the conversion process. In the Consultation Paper, we therefore provisionally proposed that leaseholders, in addition

[34] It is not necessary, under the commonhold legislation, for individual transfers to be made to the commonhold unit owners. Those listed as taking a commonhold unit will be registered as the commonhold unit owners on conversion: CLRA 2002, s9(3).

to the freeholder, should be able to lodge the required documents at HM Land Registry and create the new commonhold.[35]

### Consultees' views

7.55 Our proposal to enable leaseholders to register the new commonhold on conversion received overwhelming support and was endorsed by almost every category of consultee responding.

7.56 Several consultees said that the proposal would help speed up the conversion process and would prevent delaying tactics by the freeholder. The Residential Landlords Association, for example, said:

> We believe that the process to convert to commonhold via collective enfranchisement should be led by individuals and leaseholders. If it was solely incumbent on the freeholder, then there could be unnecessary delays and non-compliance from the freeholder.

7.57 CILEx agreed, saying that the proposal would help "rebalance the current inequality of arms between landlords and leaseholders". In addition, Millbank Residents Company Ltd thought the proposal was a "sensible simplification" and Antonia Batty (leaseholder) said the proposal would help "save fees" which would encourage the uptake of commonhold.

7.58 Arguments against the proposal stemmed from a lack of clarity surrounding the point at which leaseholders might be entitled to register the new commonhold. Consensus Business Group (landlord) said:

> it seems odd that an application could be made to the Land Registry affecting the title rights of a freeholder until the title is actually transferred. It is possible that during the process leaseholders may decide not to proceed, in which case the Land Registry would be required to accept documents that will never enter into force.

### Discussion and recommendations for reform

7.59 In our view, the concerns expressed by Consensus Business Group are satisfactorily addressed by the fact that, under our recommendations, the applicant would be required to submit a transfer deed to HM Land Registry when seeking to register the conversion. The deed would necessarily have been signed by the freeholder once all matters had been agreed or resolved.

7.60 Given the substantial amount of support for our proposal and our desire to simplify the conversion process and prevent delaying tactics, we therefore recommend that our proposal be adopted.

7.61 Our language in the Consultation Paper was however imprecise. In reality, the application to register the new commonhold should be made by the commonhold association (as nominee purchaser) which will be under the control of the participating leaseholders. The commonhold association, rather than the leaseholders, will be a party to the transfer deed transferring the freehold interest. This is consistent with

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[35] CP, Consultation Question 13, paras 4.46 and 4.50.

current practices in CFA claims, where the nominee purchaser will apply to register the transfer deed at HM Land Registry.

## CONVERSION WITHOUT ACQUIRING THE FREEHOLD

7.62 We now consider the second scenario which may arise on conversion, where leaseholders do not need to acquire the freehold compulsorily as part of the conversion process.

7.63 Where the freeholder consents to the conversion to commonhold, there will be no need for the parties to carry out a CFA claim as part of the process of converting. This situation is most likely to arise where the leaseholders already own the freehold collectively. For example, the leaseholders may have exercised their right to collective freehold acquisition some years before. We explain in Chapter 3 that as part of the CFA claim, the participating leaseholders will often set up a company to act as the nominee purchaser that will acquire the freehold on their behalf. We refer to such a company as a "freehold management company" or "FMC". After the CFA claim, this company will therefore be the freeholder of the building. Through their membership of (or shares in) the FMC which owns the freehold, the leaseholders would be able to control the decisions of the freeholder, including the decision to convert to commonhold.[36]

7.64 A number of the steps discussed above in the context of the streamlined acquire and convert procedure will also be relevant where leaseholders are converting to commonhold without acquiring the freehold. We consider the process, and the documents that should be submitted, below.

### Initial steps

7.65 As with the acquire and convert procedure, leaseholders wishing to convert will need to prepare a CCS, or decide how the CCS will be prepared.

7.66 In the Consultation Paper, we also proposed that, prior to the conversion, participating leaseholders should be required to incorporate a new company to act as the commonhold association (in the same way as under the streamlined process).

#### Setting up the commonhold association

7.67 While, prior to the conversion, the freehold may already be owned by a company controlled by the leaseholders (an FMC), we provisionally proposed in the Consultation Paper that the leaseholders should be required to create a new company to act as the commonhold association, rather than change its articles to become a commonhold association.[37] The freehold would need to be transferred from the FMC to the new commonhold association as part of the process of converting. We considered that such a mechanism would be much simpler, and would align with the position where leaseholders are using the "acquire and convert" procedure set out above. Further, we pointed out that many FMCs are set up as companies limited by shares. A commonhold association is a company limited by guarantee and it is not

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36 How the decision would be carried would depend on that FMC's articles of association.

37 CP, Consultation Question 14, paras 4.54 to 4.59.

possible, as a matter of company law, for a company limited by shares to become a company limited by guarantee.

### Consultees' views

7.68 The vast majority of consultees agreed with our proposal.

7.69 Most consultees supporting the proposal did so for the reasons set out in the Consultation Paper. In particular, consultees acknowledged that the proposal provided a "practical solution to a change from a company limited by shares to a company limited by guarantee".[38] The British Property Federation agreed that setting up a new company would be "the simplest solution in these circumstances" and CILEx welcomed the approach "in adopting a simpler and more pragmatic approach to dealing with commonhold conversion".

7.70 Those consultees who disagreed with the proposal were concerned that the proposal would result in two companies existing in tandem, the FMC and the commonhold association, adding cost and complexity to the process. Neil Ryan argued that "the more entities or ownership structures, the more complicated matters become". He suggested that "model articles could be drafted for a hybrid commonhold association which is also a FMC limited company so that adoption of new articles is straightforward".

7.71 A few consultees neither agreed nor disagreed with the proposal but queried why the association could not simply change its articles of association to become a commonhold association. Matt Ashley said "I see nothing wrong in a company changing its articles. It is the easiest route to convert if the freehold is already owned by an FMC".

### Discussion and recommendations for reform

7.72 We appreciate consultees' concerns about the possibility of two leaseholder-controlled companies co-existing. However, in practice, the FMC will have no role to fulfil following the transfer of the freehold to the commonhold association. The FMC will not own any assets and will not have any responsibilities to fulfil in respect of the commonhold land. The FMC can therefore simply be wound up.[39]

7.73 We also understand that, at first glance, it may appear preferable for the FMC to change its articles to become a commonhold association. However, it will only be possible to do so where the FMC is a company limited by guarantee and, even then, there would be practical difficulties. Changing the FMC's articles is unlikely to be simpler than creating a new company. The articles of a commonhold association are prescribed, and have limited scope for amendment. Any provision inconsistent with the prescribed articles will have no effect. Leaseholders would need to consider which of the FMC's articles should be removed or varied and which articles should be added. Our view is that it would be much "cleaner" and cost-effective to abandon the FMC's existing articles and adopt the model articles of the commonhold association.

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38 Buckingham Court Residents' Association.

39 Alternatively, if the FMC is not wound up, and the members fail to comply with company law requirements in respect of the FMC, the FMC would likely be struck off at Companies House.

7.74 Further, to assist with consumer awareness and to simplify conveyancing processes, we see advantages in requiring all conversions to commonhold to proceed in the same way, rather than some FMCs changing articles, and others transferring its common parts to a new company.

7.75 We therefore remain of the view, as supported by the majority of consultees, that setting up a new company to act as the commonhold association, will be the most practical way to proceed, rather than attempting to alter the FMC's articles. We make a recommendation to this effect below.[40]

### Evidence of leaseholder consent

7.76 We explain in Chapter 4 that even where the freeholder *does consent* to the conversion, eligible leaseholders of at least 50% of the flats in the building must still support the decision to convert.[41] However, they would not need to satisfy any additional qualifying criteria that would be necessary to bring a CFA claim.

7.77 At present, each leaseholder would need to complete and submit form CON1 as evidence of their consent. We consider that it would be more efficient for one prescribed form to be produced which demonstrates that the threshold of leaseholder support has been met. We refer to this form as the "Conversion Notice". Each leaseholder would confirm their agreement to the conversion by signing this notice. Additionally, to reduce the number of forms that need to be completed, we recommend that the Conversion Notice should stand in place of form COV, by incorporating the details of leaseholders who will take a unit on conversion.

7.78 For similar reasons to those outlined above from paragraph 7.39 our view is that leaseholders should not be able to withdraw their consent to the conversion on an individual basis once they have signed the Conversion Notice and their consent to the conversion should not lapse after a certain period of time. Nor should consent be given on a conditional basis. Leaseholders will be investing time and money into the conversion process and the conversion should not be prevented at a late stage due to consents lapsing or being withdrawn, or due to conditions not being satisfied. Leaseholders should therefore carefully consider whether they wish to convert before signing the notice. As with the streamlined procedure, we recommend that guidance should be produced which will inform leaseholders about the commonhold structure and the consequences of signing a Conversion Notice. Similar guidance could be included on the prescribed form itself.

7.79 Under our recommendations, there will therefore be two prescribed forms that may be used to convert to commonhold, a Claim Notice to acquire and convert (where the freeholder does not consent to the conversion), and a Conversion Notice (where the freeholder does consent to the conversion). Both will provide evidence that the

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40 The requirement (see para 7.81(6)below) that the applicant lodge the commonhold association's certificate of incorporation on registering the commonhold at HM Land Registry would prevent the FMC from seeking to change its articles, rather than setting up a new company to act as the commonhold association.

41 See para 4.88. That is because, while the freeholder's interest would not be affected in this scenario, the interests of the other leaseholders in the building would be. These leaseholders might be required to take a commonhold unit at the point of conversion, or at some stage in the future: see Ch 5. In practice, however, it is likely that the same leaseholders who control the freehold, and consent on behalf of the freeholder, will also meet the threshold of leaseholder consent required to convert.

requisite number of leaseholders support the claim, and will include details of those leaseholders who will take a unit on conversion. However, the “acquire and convert” form will also include the additional information necessary to bring a CFA claim.

### Evidence of lender consent

7.80 We recommend above (in the context of the acquire and convert procedure) that, should lender consent be required to convert, it should not be necessary for each mortgage lender to complete form CON1 as evidence of their consent. Instead, a deed of substituted security transferring the mortgage from the leasehold interest to the commonhold unit will act as satisfactory evidence to HM Land Registry that the lender agrees to the conversion. We recommend that the same position should apply both where leaseholders follow the acquire and convert procedure, and where leaseholders are converting to commonhold without also acquiring the freehold.

### Registration of the commonhold

7.81 The applicant (which in this scenario is likely to be the leaseholder-controlled company, or a representative acting on its behalf), will need to submit the following documents to HM Land Registry:

(1) the transfer deed, transferring the freehold title to the commonhold association. We explain above that the transfer to the association will likely be from a FMC;

(2) the CCS and accompanying plans;

(3) the Conversion Notice, evidencing that the necessary leaseholder consents have been obtained. The Notice will also provide the details of those leaseholders who will be taking a commonhold unit on conversion;

(4) if lender consent is required, any deeds of substituted security, transferring charges from the leases to the commonhold units;

(5) a statement of truth confirming that the necessary consents have been obtained;

(6) the commonhold association’s certificate of incorporation and articles; and

(7) a certificate by the directors of the association that the CCS and the articles comply with the commonhold legislation and regulations, including confirmation that the CCS has been prepared in accordance with the recommendations discussed above (at paragraph 7.20(3)) which are aimed at protecting those who have not agreed to the conversion.

7.82 On receipt of these documents, the Registrar should register the land as a freehold estate in commonhold land. The Registrar should also register the commonhold association as the freehold owner of the common parts and each leaseholder named as taking a commonhold unit on the Notice should be registered as the freehold owners of their unit(s) under separate title numbers.

## OUR RECOMMENDATIONS AND CONCLUSION

7.83 In this chapter, we have considered the process of converting to commonhold in two scenarios (1) where leaseholders need to acquire the freehold compulsorily as part of the conversion process, and (2) where leaseholders are converting without acquiring the freehold. When considering each scenario, we have made numerous recommendations that will improve the process of converting to commonhold. Our recommendations will make it simpler, quicker and more cost-effective for leaseholders to convert to commonhold. Below, we draw together our recommendations in this chapter, covering both conversion scenarios. Together with our other recommendations in this Part, which will remove the requirement for unanimous agreement to convert, we are confident that our recommended reforms will make it much easier for existing leaseholders to convert to commonhold and benefit from an improved model of home ownership.

### Recommendation 17.

7.84 We recommend that a prescribed Claim Notice to "acquire and convert" should be produced for leaseholders who need to acquire the freehold compulsorily as part of the process of converting to commonhold. We further recommend that a prescribed "Conversion Notice" should be produced for leaseholders who do not need to acquire the freehold as part of the conversion to commonhold. In this recommendation, "the Notice" refers either to the Claim Notice to acquire and convert or the Conversion Notice as appropriate.

7.85 We recommend that leaseholders should indicate their consent to the conversion to commonhold (and the collective freehold acquisition claim, where leaseholders are also acquiring the freehold compulsorily) by signing the Notice.

7.86 We recommend that once the Notice has been signed, leaseholders should not be able to withdraw their individual consent to the conversion. Leaseholders should make a collective decision no longer to pursue the claim.

7.87 We recommend that leaseholder consents to the conversion should not lapse automatically after a certain period of time and that it should not be possible for leaseholders to provide their consent to the conversion on a conditional basis.

7.88 We recommend that, should mortgage lender consent be required to the conversion, lenders should evidence their consent by completing a deed of substituted security to transfer their charge to the commonhold unit.

7.89 We recommend that, in addition to the freeholder, it should be possible for the commonhold association (as nominee purchaser) to apply to HM Land Registry to create a new commonhold. Those applying to HM Land Registry (whether the freeholder or the nominee purchaser) should submit the following documents alongside application form CM1:

(1) the transfer deed, transferring the freeholder's land to the commonhold association;

(2) the CCS and accompanying plans;

(3) a copy of the Notice (which provides evidence of leaseholder consents and lists the individuals who will take a unit on conversion);

(4) any deeds of substituted security;

(5) a statement of truth confirming that the necessary consents have been obtained;

(6) the commonhold association's certificate of incorporation and articles of association; and

(7) a certificate by the directors of the association that the CCS and articles of association comply with the commonhold legislation and regulations. The certificate should also confirm that the CCS satisfies the statutory conditions which are aimed at protecting those who have not agreed to the conversion, unless a copy of the Tribunal order approving the terms of the CCS is supplied.

7.90 We recommend that, where the freehold of the building is controlled by the leaseholders through a freehold management company (an "FMC"), the freehold should be transferred to a new commonhold association as part of the process of conversion to commonhold (rather than the FMC changing its articles to become a commonhold association, where this is possible).

7.91 On receipt of the documents above, HM Land Registry should register the land as a freehold estate in commonhold land. HM Land Registry should also register the commonhold association as the freehold owner of the common parts and those leaseholders identified as taking a unit on conversion should be registered as the freehold owners of their unit or units under separate title numbers.

# Part III: New commonhold developments

# Chapter 8: Mixed-use and multi-block developments

## INTRODUCTION

8.1 If commonhold is to be a viable alternative to leasehold beyond simple residential developments, it must be usable for mixed-use and multi-block developments. There is an increasing nationwide trend for developers to build larger, more complex developments.[1] These developments may contain a mixture of different uses, such as commercial elements alongside residential properties. A single development will now often combine:

(1) multiple types of residential properties; for instance, a mix of modern blocks and converted listed buildings, or a mix of flats and terraced houses;

(2) commercial properties such as shops, hotels and offices; and

(3) a number of other facilities; for instance, leisure facilities, open spaces, and power plants.

8.2 Additionally, the properties within the development may be owned and occupied in a variety of ways; there may be a mix of commonhold units, shared ownership leases,[2] social tenancies and commercial leases.

8.3 Under the current law, it is virtually impossible to use commonhold for anything other than the simplest of developments. In this chapter, we recommend the introduction of "sections" to unlock the ability to use commonhold for mixed-use and multi-block developments. Sections can be used to separate out the management of different types of interest within the commonhold, such as residential and commercial interests. They ensure that only owners within a particular section are able to vote on matters affecting that section, and that only those who benefit from a particular service are responsible for paying towards it.

8.4 We make recommendations concerning the way in which sections should operate, covering:

(1) how new sections can be created;

(2) how two or more sections can be combined;

(3) how unit owners can apply to the First-tier Tribunal (Property Chamber) in England and the Leasehold Valuation Tribunal in Wales (the "Tribunal") if they are adversely affected by the creation or combining of sections; and

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1 See further, CP, paras 5.1 to 5.6.

2 There is a general ban on residential leases of over seven years within commonhold. In Chapter 11 we make an exception to this ban to accommodate shared ownership leases.

(4) how committees of the main board of directors can be used to give more decision-making responsibility to individual sections.

## PROBLEMS WITH THE CURRENT LAW

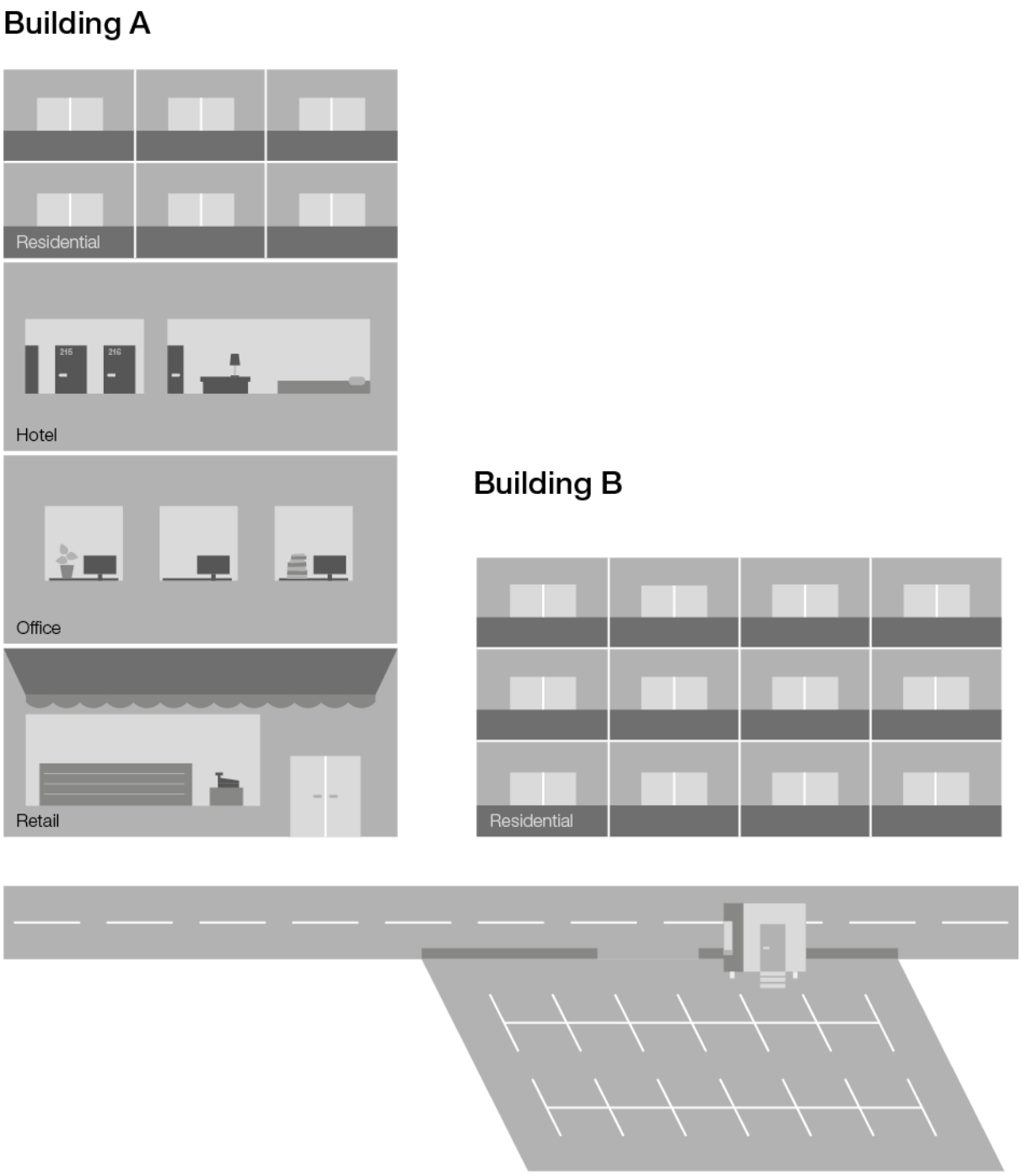
8.5 Respondents to the Call for Evidence told us that the current commonhold model does not offer sufficient flexibility to cater for mixed-use or multi-block developments.[3] This view was reinforced by consultees in response to the Consultation Paper.

8.6 Commonhold currently assumes that all the unit owners in the development have similar types of property and the same, or similar, interests. Every unit owner is entitled to take part in the votes of the commonhold association, regardless of the extent to which a particular decision affects him or her.

8.7 Figure 11 depicts a development comprising two buildings. One is a tower block with three large, non-residential units on the first three floors and six modern flats over the top two floors (Building A). There is also a separate, listed building on the estate which has been converted into 12 residential units (Building B). There is a concierge service and a small gym inside Building B which can only be used by the residents of Building B. There is also a driveway and a car park shared by the unit owners in both buildings.

[3] See Commonhold: A Call for Evidence – Analysis of Responses, question 5; CP, para 5.11.

**Figure 11: Example commonhold development**




8.8 Under the current law, if the commercial unit owners in Building A wanted to upgrade the building's security system, then all unit owners in both Buildings A and B would be able to vote on that decision in accordance with their percentage voting rights as allocated in the commonhold community statement (the "CCS"). Additionally, all owners would be required to contribute towards the cost of the new security system, in the percentage allocated to them in the CCS. At present, every owner is required to contribute towards all a commonhold's costs, in the percentage set out in the CCS,

regardless of the extent to which the owner benefits from particular works or services. There is no flexibility to allow different percentage contributions in respect of different categories of cost. So, if a unit owner in Building B were required to pay 10% of the costs of the commonhold, he or she would need to pay 10% towards every cost within the commonhold, including the cost of the new security system.

8.9 While it may be possible under the current law to separate out the management of different interests within a development by creating separate commonholds (for example, Buildings A and B could be set up as separate commonholds), there would not be any effective way to manage the facilities which are shared between the commonholds. Solutions could potentially be found to create the necessary financial obligations, but these solutions would not create voting rights to accompany the financial responsibility. For example, if the driveway formed part of Building B's commonhold, then the unit owners in the commonhold comprising Building A could be required to contribute towards the cost of maintaining the driveway through existing legal mechanisms. However, there would not be any mechanism to enable unit owners in Building A to have a say over how that driveway should be maintained.

8.10 In addition, while there are other tools which offer a degree of flexibility within commonhold, these tools are not, by themselves, sufficient for more complex developments. Some flexibility is provided by:

(1) limited use areas: the existing law allows areas of the common parts to be designated as "limited use areas". Limited use areas allow common parts to be limited to specific persons (called "authorised users") who are entitled to use those common parts. For example, the gym in Building B could be designated as a limited use area to which only unit owners in Building B are given access;

(2) CCS terms giving rights to specific units: although not expressly stated in the 2002 Act or the Commonhold Regulations, it is likely that the CCS could already be used to vary the services different units are entitled to.[4] For example, the CCS might specify that only unit owners in Building B are to benefit from the attached concierge service; and

(3) varied commonhold contributions: we make a recommendation in Chapter 13 that it should be possible for individual units to be allocated a percentage contribution to different "heads" of cost. For example, the CCS could specify that only authorised users of the car park contribute towards its cost.

8.11 While these three provisions go some way to enabling developers to adapt commonhold to each specific development, none of them enable voting rights to be differentiated so that only those affected by a decision are entitled to participate in making that decision. In any of the examples presented above, unit owners in Building A would be able to participate in decision-making over the services that are enjoyed exclusively by unit owners in Building B and vice versa in accordance with the percentage voting rights that were allocated to their respective units in the CCS. For example, even if the gym were designated as a limited use area for those in Building B, and a separate head of cost was created so that only those in Building B were

[4] By specifying such rights in Annex 2 to the CCS, under "Rights for Commonhold Units".

made to contribute towards it, at present all the owners in Building A would be able to vote in decisions affecting the gym.

8.12 In order for commonhold to work effectively for mixed-use and multi-block developments, a solution is needed which, by itself, can: limit certain common parts to specific unit owners; specify services which only some units are entitled to use; vary the contributions of different units towards different costs; and differentiate voting rights.

## OBJECTIVES FOR A NEW FRAMEWORK

8.13 In the Consultation Paper, we explained that our proposed reforms for mixed-use and multi-block developments should meet the following objectives.[5]

(1) The framework should provide the ability to separate out the management of a variety of different types of interest, in particular by:

(a) differentiating voting rights, so that only those affected by a decision are entitled to participate in making that decision; and

(b) allowing shared costs to be allocated in different ways to ensure that only those benefitting from a service pay for it.

(2) The framework needs to be able to regulate the relationship between multiple buildings that access the same shared areas.

(3) The framework needs to strike an appropriate balance between standardisation across commonhold developments and flexibility to suit the needs of a particular development.

(4) The framework should facilitate consumer protection and ensure that, so far as possible, abuses that have arisen in the residential leasehold context cannot be transposed into commonhold.

8.14 We asked consultees whether they agreed that we had identified the correct objectives, or whether there were any other objectives that should be added to the above list.[6]

### Consultees' views and discussion

8.15 The vast majority of consultees said that they agreed with our proposed objectives for a revised management structure. However, three consultees suggested that commonhold should not be trying to accommodate mixed-use developments at this stage.

8.16 Our Terms of Reference with Government require us to reinvigorate commonhold as a workable alternative to leasehold. As explained above, we believe that, in order for commonhold to be a workable alternative, it must be made to accommodate mixed-

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5 CP, para 5.14.

6 CP, Consultation Question 16, para 5.15 to 5.16.

use and multi-block developments to the same degree that leasehold can.[7] Our view, supported by consultees, is that the objectives outlined above will provide the correct basis on which to create a new management framework for mixed-use and multi-block developments.

## SECTIONS AS A FRAMEWORK FOR MIXED-USE AND MULTI-BLOCK COMMONHOLDS

8.17 In the Consultation Paper, we presented three different frameworks that could enable commonhold to work for mixed-use developments.[8] Two of these frameworks are used in other jurisdictions: "flying commonholds", and "layered commonholds".[9] However, we concluded that both of these options were unsuitable for use in England and Wales, and did not satisfactorily meet the objectives above.

8.18 Instead, we provisionally proposed a third option – the use of "sections" to separate out interests within the same commonhold. We thought that this third option addressed the problems with flying and layered commonholds, and better met the above objectives.[10]

8.19 Under the sections model, different interests within a commonhold are separated out without the need for additional corporate bodies (as would be the case in "layered commonholds"), by creating different membership classes within a single commonhold association.

8.20 Once membership classes have been set up, the CCS will then set out the matters which are only paid for, and therefore can only be voted on, by members who are part of a certain section. Some decisions would be open to multiple sections; some to just one; and some to all. This framework allows one part of a development to be responsible for specific costs, and allows that part to take the corresponding decisions independently of the rest of the development.

8.21 To make it clear which rights and responsibilities each section has, some of the common parts can be designated to specific sections by the CCS. Doing so will help to ensure the costs of upkeep and decision-making powers are allocated correctly. Sections will also allow shared services to be allocated to a specific part of the commonhold, if they are only for the benefit of a certain group of units.[11]

8.22 If sections were applied in the development depicted at Figure 11, the developer could, for example, set up three sections:

(1) Section 1 could include the top two floors of Building A which comprises the six residential flats;

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7 At paras 8.1 to 8.4.

8 CP, Ch 5.

9 CP, paras 5.17 to 5.38.

10 CP, paras 5.39 to 5.57.

11 More detail on the sections model can be found in the CP, paras 5.39 to 5.57.

(2) Section 2 could comprise the three non-residential units in Building A;[12] and

(3) Section 3 could comprise Building B.

8.23 The CCS could then designate responsibility for certain common parts to each section. For example:[13]

(1) the common areas internal to the top two floors of Building A are designated to Section 1 only (for instance, any hallways, lifts or stairwells used by the residential units only). Only unit owners in Section 1 are able to vote on matters relating to these areas and are responsible for the associated costs;

(2) the common areas internal to the bottom three floors of Building A are designated to Section 2 only (for instance, any lifts or stairwells used by all of the commercial units, but not the residential units). Only unit owners in Section 2 are able to vote on matters relating to these areas and are responsible for the associated costs;

(3) the common areas that form the exterior of Building A, and any other structural elements of Building A, are designated to Sections 1 and 2 only. Only unit owners in Sections 1 and 2 are able to vote on matters relating to these areas and are responsible for the associated costs;

(4) the common areas that form Building B, both the exterior and interior, are designated to Section 3 only. Only unit owners in Section 3 are able to vote on matters relating to these areas and are responsible for the associated costs; and

(5) the non-designated common parts of the development, such as the driveway, remain the responsibility of all sections, through the commonhold association. All unit owners can vote on decisions affecting the driveway and will be responsible for paying towards its upkeep.

8.24 We recommend in Chapter 10 that where sections are used, it should be possible to add schedules to the CCS that set out the rights and obligations which are specific to the unit owners in that section. For example, it could set out unit owners' voting allocations in decisions which are specific to that section, and their share of the costs relative to that section. Alternatively, the CCS may simply provide that percentage allocations towards all of the commonholds costs and votes are scaled up on a pro rata basis to total 100% when decisions are being taken by a smaller number of owners within a section.

### Consultees' views

8.25 A significant majority of consultees agreed with our provisional proposal to introduce sections, including several developers and their representatives. For example, the

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12 Alternatively, the developer could create separate sections for each of the three commercial units, rather than group all three together into one section.

13 In practice this would be more complex and detailed, and would have to be accompanied by plans carefully demarcating each designated area. For example, a floor plan of Building B would be required, showing the gym, and any stairwells or lifts.

British Property Federation said "a commonhold with sections … is likely to prove the simplest and most workable structure for more complex developments".

8.26 Those consultees who disagreed with the proposal did so either because they took the view that we should not be trying to accommodate mixed-use commonhold developments at this stage, or on points of detail, rather than because of a fundamental objection to the use of sections. For instance, FirstPort (managing agents), and Wallace Partnership Group Ltd (landlord), raised concerns that sections might not be compatible with company law.

8.27 Additionally, a couple of consultees suggested introducing flying commonholds, layered commonholds, and sections to give developers and their lawyers as much flexibility as possible when setting up a development.

### Discussion and recommendations for reform

8.28 We do not share the concern, expressed by a couple of consultees, that sections would be incompatible with company law. The sections model is in fact directly based on class-membership principles from company law.[14] In addition, we do not consider it appropriate to introduce three different mechanisms to accommodate larger, mixed-use developments. We expressed concern in the Consultation Paper about the inability to build a measure of standardisation and consumer protection into flying commonholds, and about the complexity of the layered commonholds model.[15] The sections model by itself provides a significant degree of flexibility. Sections will enable a developer to build any development, from a simple commonhold with two residential flats above a shop, through to a highly complex commonhold with several buildings, offices, shops, restaurants and more.

8.29 In the light of consultees' views, we are of the view that sections are the best method of making commonhold workable for mixed-use and multi-block developments. Sections will provide a significant degree of flexibility for developers to create a wide range of commonholds, while also ensuring a measure of standardisation is maintained. Sections necessitate some degree of complexity, but the sections framework is far less complex than the layered model used overseas, and sections are no more complex than mixed-use or multi-block leasehold developments. The sections model also allows a certain degree of consumer protection to be built in through the mandatory terms of the CCS and commonhold's model articles of association.[16]

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14 Different classes of membership within a single company are provided for by the Companies Act 2006, ss 629 to 640. For more discussion of class rights within companies limited by guarantee, see M Mullen and J Lewison, *Companies Limited by Guarantee* (4th ed 2014), paras 4.11.1 to 4.11.3.

15 See CP, paras 5.22 to 5.35 and 5.36 to 5.38.

16 See Glossary.

**Recommendation 18.**

8.30 We recommend that commonholds with sections (which are not individual corporate bodies) should be introduced as a management structure, to make commonhold workable for more complex developments.

8.31 The diagram below demonstrates what creating sections will offer to a development over and above the existing tools described at para 8.10. Whether it is sufficient to rely on the existing tools, or create one or more sections, will depend on the particular features of a commonhold. However, as we discuss later in this chapter, to help promote standardisation across commonholds, and so as not to risk fragmenting commonholds unnecessarily, sections should only be created where there is good reason to, and the tools below are not sufficient.

**Figure 12: Methods of obtaining greater flexibility in mixed-use and multi-block developments**

| | | Differentiates voting rights | Differentiates contributions to shared costs | Permits only certain units to use certain common parts | Permits only certain units to access certain services |
|---|---|---|---|---|---|
| **Sections** | | **Yes** | **Yes** | **Yes** | **Yes** |
| **Other tools** | **Limited use areas** | No | No | **Yes** | No |
| | **CCS provisions giving particular rights to certain units only** | No | No | **Yes** | **Yes** |
| | **Varying commonhold contributions (following our recommendations in Chapter 13)**[17] | No | **Yes** | No | No |

[17] See paras 13.44 to 13.58.

8.32 The rest of this chapter looks at how sections operate, including: how sections can be set up; how sections can be combined; and how committees created by a commonhold's directors could be used to help manage sections.

## SETTING UP SECTIONS

### Who can set up a section?

8.33 In the Consultation Paper, we provisionally proposed that it should be possible to create sections at the outset by the developer, and by the commonhold association later on. We explained that this approach would give flexibility for developers, and would also allow the unit owners, after having experienced living in the commonhold, collectively to restructure the commonhold should they wish.[18]

#### Consultees' views

8.34 The vast majority of consultees agreed with our provisional proposal.[19] Mark Chick (solicitor) said:

> The developer will no doubt want to identify and create sections on day one. The commonhold association should be allowed to create new ones and or add to these if required in the lifetime of the development.

8.35 Buckingham Court Residents' Association suggested that it should also be possible to create new sections "on conversion, at the outset", and similar points were raised by a few other consultees.

8.36 A small number of consultees disagreed with our proposal, and raised concerns that developers may use the ability to create sections in an abusive manner. Tiara Hardy (leaseholder) said the ability to create sections by the developer should be regulated.

#### Discussion and recommendations for reform

8.37 We have considered carefully how sections will operate. We do not think that sections will provide avenues that can be exploited by unscrupulous developers. However, if abuses do emerge over time, secondary legislation could look to address the issue through amendment of the prescribed terms of the CCS.

8.38 Given the support for our proposal, we recommend that it should be possible to set up sections by the developer at the outset, and subsequently by the unit owners. We note the helpful suggestion by Buckingham Court Residents' Association that it should also be possible to create sections when a development is converted from leasehold to commonhold. We agree that allowing sections to be set up on conversion will help make conversions workable for more varied developments, and we make a recommendation accordingly.

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18 See CP, para 5.84.

19 CP, Consultation Question 21, para 5.88.

**Recommendation 19.**

8.39 We recommend that it should be possible for sections to be created:

(1) at the outset, by the developer;

(2) at the outset, on conversion from leasehold to commonhold; or

(3) at a later date, by the commonhold association.

### Setting up a section at a later date

8.40 Under our recommendation above, it will be possible for a commonhold association to create new sections during the life of a commonhold, once the benefits of creating a section have become apparent. It is therefore necessary to determine how a section might be set up. We are of the view that creating a new section should require a vote of the commonhold association. We therefore turn to consider what majority is needed for a commonhold association to approve the creation of a section.[20] In the Consultation Paper we provisionally proposed that in order to create a new section, a special resolution of the commonhold association should be required. Additionally, at least 75% of the total votes held by the unit owners who would be part of the new section should be cast in favour of creating the section.[21]

8.41 The voting threshold for setting up a section has two limbs.

(1) Limb 1: a special resolution of the commonhold association is required – at least 75% of the *votes cast by those present and voting* must be in favour of the decision. 20% of the total votes in the commonhold must have been cast for the vote to be quorate.

(2) Limb 2: 75% of all of the *votes held by all of the units* which will be in the new section must be cast in favour of creating the section. Limb 2 is effectively a separate vote, although it could be conducted at the same time as the vote in limb 1. It is not a requirement that 75% of those turning up to vote must vote in favour, but rather a requirement that unit owners holding 75% of the total votes in the new section must vote in favour.

8.42 The two voting limbs ensure that both the members of a commonhold association as a whole, and the members of a proposed new section, are given an appropriate say in the decision: see figure 13.

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20 See CP, paras 5.85 and 5.86.

21 CP, Consultation Question 21, para 5.89.

**Figure 13: Operation of voting thresholds for creating a new section**

**Example 1**

In a commonhold of 100 units with one vote each, it is proposed to create a section containing 40 of the 100 units.

Limb 1 is satisfied if 20 votes have been cast (to make the meeting quorate), and at least 15 of those votes are in favour (representing 75% of those turning up to vote).

Limb 2 is satisfied if 30 out of the 40 units which will be in the new section have voted in favour of creating the section (representing 75% of all the total votes in the new section).

If 20 votes had been cast, of which 15 were cast in favour, limb 1 would be satisfied but limb 2 would not be.

**Example 2**

In a commonhold of 100 units with one vote each, it is proposed to create a section containing four of the 100 units.

Limb 1 is satisfied if 20 votes have been cast (to make the meeting quorate) and 15 of those votes are in favour (representing 75% of those turning up to vote).

Limb 2 is satisfied if three of the four units which will be in the new section have voted in favour of creating the section (representing 75% of all the votes in the new section).

### Consultees' views

8.43 The majority of consultees agreed with our provisional proposal. Berkeley Group Holdings PLC (developer) suggested that the creation or combination of sections "could result in additional financial obligations being imposed so should require a higher threshold".

8.44 A significant minority of consultees disagreed with the proposal, suggesting different voting requirements that should instead apply, but there was no consensus among these consultees over what the threshold should be. Some consultees argued that our proposed threshold would be difficult to meet and that the threshold should therefore be lower. The National Leasehold Campaign, for example, said "we all know that to get high percentages of unit owners (and current day leaseholders) is difficult, and we should be looking for ways to make these processes easier and lowering barriers and difficulties". On the other hand, some consultees called for a larger majority, noting that the creation of a section could alter unit owners' voting rights and financial obligations, and so should only happen with a very high level of support. Irwin Mitchell LLP (solicitors) suggested that "unanimity should be required".

### Discussion and recommendations for reform

8.45 We are of the view that our proposed voting threshold achieves an appropriately balanced position. Creating a new section will restructure voting rights and financial obligations within a commonhold, and the required majority needs to be sufficiently high to prevent such a restructuring from happening without careful thought and widespread support. At the same time, we are also mindful of not setting a threshold that is so high that creating a new section is almost impossible.

**Recommendation 20.**

8.46 We recommend that for a commonhold association to create sections at a point after the commonhold has been set up:

(1) the decision should be approved by a special resolution of the commonhold association; and

(2) separately, 75% of all the votes held by unit owners who would be part of the new section should be cast in favour of creating the section.

## A right to apply to the Tribunal

8.47 Creating a new section will, in most cases, result in an alteration of unit owners' financial obligations and corresponding voting rights. That is the reason why we recommend above that unit owners owning at least 75% of the total votes in the part to form the new section must vote in favour for the section to be created. Nevertheless, we recognise that situations may arise in which a unit owner who was outvoted may be adversely affected by the decision to create a section.[22] We therefore provisionally proposed introducing rights for adversely affected unit owners to apply to the Tribunal.[23]

### Consultees' views

8.48 The vast majority of consultees agreed with our provisional proposal to allow a unit owner who is negatively affected by the creation of a section to apply to the Tribunal. The Residential Landlords Association agreed that "an additional layer of protection should be applied to allow unit owners adversely impacted to have the opportunity to contest decisions".

8.49 A few consultees also pointed out that the converse situation could arise: that is, that the required majority for the creation of a new section cannot be attained, and one or more unit owners are adversely affected by the failure to set up a new section.

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22 See CP, paras 5.68 and 5.67.

23 CP, Consultation Question 21, para 5.90.

8.50 Other consultees suggested that there should be some additional threshold that must be met before an application can be made to the Tribunal in order to reduce the number of trivial or vexatious claims.

8.51 Amongst those consultees who disagreed with our proposal, the main concerns raised focussed on aspects of the Tribunal's operation which fall outside the scope of our project. A few consultees also suggested that the Tribunal should not be able to overrule decisions taken by a majority in the commonhold.

### Discussion and recommendations for reform

8.52 As discussed further in Chapter 17, while commonhold is intended to operate as a democracy, we are of the view that there are instances in which the Tribunal should be able to step in and provide protection for a minority against the decisions of the majority. We think that creating a new section is one of those instances, given the potential impact of creating the section on unit owners.

8.53 We therefore recommend that unit owners, who are adversely affected by a decision to create a new section, should be able to apply to the Tribunal under the minority protection provisions we recommend in Chapter 17. In Chapter 17, we make recommendations about the circumstances in which applications might be made to the Tribunal and how trivial and vexation claims might be prevented.

8.54 We have carefully considered whether it should also be possible to apply to the Tribunal to push through decisions where the requisite majority has not been met. However, we have concluded that to do so would undermine the policy reasons behind setting a high threshold. We believe that if the threshold cannot be reached, the current position should be maintained. Furthermore, unit owners may take other steps to achieve some, but not all, of the advantages provided by a section. For example, unit owners would be free to amend the CCS to set up different "heads of cost", or new limited use areas, or to apply to the Tribunal to challenge the percentage allocation of commonhold contributions set out in the CCS if they are not "reasonably proportionate".[24]

**Recommendation 21.**

8.55 We recommend that unit owners should have a right to apply to the Tribunal under our recommended minority protection provisions.

## Criteria which must be met for a section to be created

8.56 We explained in the Consultation Paper that there are several advantages to introducing criteria which must be satisfied before a new section can be created.[25] In particular, such criteria would ensure:

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24 See paras 13.75 to 13.106 below.

25 CP, paras 5.91 and 5.92.

(1) a measure of standardisation across developments as to what may constitute a section; and

(2) that sections are only created where there is a good reason, meaning that the central "ethos" of commonhold (the idea of collective democratic responsibility) is not unnecessarily diluted. In many scenarios, it may be sufficient to rely on the other tools described above 8.10.

8.57 Considering the examples of complex, mixed-use and mixed-tenure developments that stakeholders shared with us, we provisionally proposed that criteria should be introduced so that sections can only be created to give separate classes of vote to:

(1) residential and non-residential units; or

(2) non-residential units, which use their units for significantly different purposes (such as a hotel, restaurants and shops); or

(3) different types of residential units (such as flats and terraced houses); or

(4) separate buildings in the same development;[26] or

(5) other premises falling within the commonhold which, in the interests of practicality and fairness, the Tribunal decides should form a separate section.

### Consultees' views

8.58 The vast majority of consultees agreed with our provisional proposals. The Chartered Institute of Legal Executives ("CILEx") agreed that it should not be possible for a commonhold association to subdivide itself for any other reason as doing so "would run the risk of overcomplicating the commonhold structure unnecessarily as well as undermining collective interest and exacerbating tensions between neighbours". A number of consultees suggested adding criteria which would allow separate sections to be created for two further reasons: for units which have access to different services or common parts; and where there are different tenures or different types of owner within a development.

8.59 Some consultees queried the Tribunal's role in determining whether a section should be established. Irwin Mitchell LLP suggested that requiring the Tribunal to decide in every instance whether a proposed section satisfies criterion (5) would be

[26] Enfranchisement law currently includes the concepts of a "self-contained building" and a "self-contained part of a building" to deal with the concept of separation (see Enfranchisement CP, paras 7.70 to 7.73). A "self-contained part of a building" must constitute a vertical division of a building: no overhang or underhang is allowed, so as to prevent flying freeholds arising. If two blocks of flats are built above an underground car park, it is unlikely that one of the blocks could be subject to a collective freehold acquisition ("CFA") claim, as it would not meet the vertical division test (though the two blocks of flats and the car park might together be a "building" and therefore be subject to a CFA claim). In the Enfranchisement Report (at paras 6.206 to 6.215), we are recommending that these concepts be carried forward into our new scheme, subject to a relaxation of this vertical division criterion. However, we think that the approach taken in commonhold will need to be broader than that taken in enfranchisement. In the example above, it should be possible to create a section in respect of one of the blocks alone.

undesirable, and instead it “should be a matter for the lawyers setting up the scheme at the outset to establish”.

8.60 In addition, some consultees voiced concerns over how the criteria would be enforced, and what the consequences might be if a section had been set up where it should not have been.

### Discussion and recommendations for reform

8.61 We acknowledge that introducing criteria before a section might be set up would limit flexibility to some extent. Notwithstanding, we think that the benefits of setting criteria, as noted above, outweigh that limitation.

8.62 We have considered whether additional criteria should be introduced, covering access to different services and to enable different tenure types to be separated out. However, we have concluded that neither is an appropriate additional criterion for the following reasons.

### Access to different services

8.63 To ensure that sections are only created where there is a good reason, our existing criteria focus on situations where the different interests at play could always justify the creation of a separate section. These different interests arise as a result of something in the nature of the commonhold units themselves: their use, physical characteristics or location – for instance, whether the unit is residential or commercial, or where units are in a separate block.

8.64 The main advantage of allowing sections to be created on the basis of access to common parts, or shared services, would be that only those unit owners who had the right to use a particular common part or service would be entitled to vote on matters relating to that part or service. However, allowing sections to be created in these circumstances introduces the potential for a significant degree of complexity, and risks sections being introduced where there is very little reason for doing so. In some developments, this could lead to every single unit comprising its own section because each unit had a slightly different combination of access to common parts and services: for instance, whether or not the unit had a balcony, whether the unit had an allocated car parking space, whether the unit had access to an internal courtyard garden, and so on. We do not think that access to different services will generally be a sufficient justification to create a separate section. In the vast majority of cases, limited use areas, provisions of the CCS specifying certain units have access to certain services, and varied commonhold contributions can be used to give units access to different common parts or services, and to allocate the financial obligations accordingly. Where unit owners have the right to vote on something which they do not use or do not pay for, we think it unlikely that they will have sufficient incentive to exercise that vote in a way that seeks to damage other interests. Even if they do exercise that vote, it is unlikely to change the overall result.

8.65 However, we can see that there may be some situations where different units have substantially different access to services, and it would then be much more practical to separate the units into separate sections. Rather than create an additional criterion, which would always permit separate sections to be created where there is differential access to services, we instead think that the few situations where a separate section

is desirable can be dealt with under criterion (5). This criterion would allow the Tribunal to decide that in these particular circumstances, the different access to services means that it is in the interests of practicality and fairness to create a new section.

### Different tenures and owners

8.66 Some consultees suggested that sections should be created on the basis of different types of owner (for example, distinguishing between owner-occupiers, buy-to-let investors and social landlords) or on how the property is being occupied (for example, it may be owner occupied, let to a shared ownership leaseholder or let to a short-term tenant).

8.67 Allowing a section to be created for these reasons would focus on the identity of the unit owner, or the use to which the unit is put, rather than on the nature of the unit itself. We do not think the characteristic of the tenure, or of the owner or occupier, as opposed to the unit, provides a sufficient basis for the creation of a section, particularly as the characteristic in question may be temporary or transient in nature. For instance, a buy-to-let unit may be sold on to an owner-occupier and vice versa; a shared owner may staircase to 100%; and a tenant of a registered provider of social housing may exercise the right to buy and become a unit owner. We therefore do not think that a separate criterion should be added allowing sections to be set up on the basis of the identity of the unit owner or the use to which the unit is put. Additionally, we do not think the Tribunal should be able to decide to set up a section under criterion (5) on the basis of tenure, or any other characteristic focussing on the identity of the unit owner, alone.

8.68 However, in practice, sections may be created for other reasons where it so happens that the units in one section are all of one tenure, and the units in another section are all of another tenure. For instance, social-rented flats are often built in a separate block to privately owned flats. In this scenario, separate sections could be created for each of the two blocks. At the present time, we think it should be permissible to create such sections so long as one of the other criteria, based on the nature of the unit itself, is satisfied. We are aware that Government is considering restricting the ability to create developments where social-rented flats are in a separate part of the development or have access to different facilities to privately-owned flats.[27] Such a policy would prevent housing segregation. Should Government decide to pursue this policy, restrictions could be introduced into commonhold to prevent sections (or limited-use areas) being used to separate out social-rented and privately-owned units.

### Role of the Tribunal in applying criterion (5)

8.69 We note Irwin Mitchell LLP's view that the creation of sections should be left to those establishing the commonhold. However, we think that it is helpful for the Tribunal to hold the reins on what will and will not be capable of becoming a section under criterion (5). As noted above, the purpose of introducing criteria is to ensure that sections are only created where there is a good reason, meaning that the central "ethos" of commonhold is not unnecessarily diluted. We have also explained above

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[27] Press Release, *Brokenshire unveils new measures to stamp out 'poor doors'* (20 July 2019), at https://www.gov.uk/government/news/brokenshire-unveils-new-measures-to-stamp-out-poor-doors.

that we do not think that the mere fact that different services are provided, or that different tenures exist, provides sufficient justification to create a section. We think that requiring the Tribunal to determine whether a proposed section satisfies criterion (5) will prevent this criterion being used in an overly-expansive manner. Some of the factors that it may be desirable for the Tribunal to consider include:

(1) what common parts and services will be the responsibility of the proposed section;

(2) whether the units in the new section would be grouped together or are interspersed within the commonhold (such a distribution will not necessarily prevent a section being created, but may indicate that it is not in the interests of practicality to create a section);

(3) whether there are other ways to separate out the interests without creating a section (for example by creating a limited-use area or by creating separate heads of cost);

(4) whether creating a section is the most effective way to achieve the desired result;

(5) whether it is in the interests of the effective management of the commonhold to create the section; and

(6) whether the section is being proposed on account of something in the nature of the units themselves, or something about the identity of the unit owners or their occupancy (we say above that sections should never be set up on the basis of unit owners' identities or how they use the property).[28]

### Enforcement and consequences of inappropriate sections

8.70 We are of the view that, so long as the criteria are clear, there will be a sufficient degree of certainty as to the validity of a section. We suggest that guidance be produced which specifies examples of what will, and will not, satisfy each of the five criteria. Additionally, if there are concerns over whether a proposed section would be lawful under criteria (1) to (4), a pre-emptive application to the Tribunal could be made to determine whether the section will be legitimate.[29] Under our recommendations, an application to the Tribunal would always be necessary to set up a section under criterion (5).

8.71 Any decision of the Tribunal that a section has been set up where none of the criteria have been met will require a change in the structure of the commonhold from that date, but will not render the section void from the outset.

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[28] See para 8.67 above.

[29] If a commonhold regulator is created, the regulator could deal with such questions instead.

**Recommendation 22.**

8.72 We recommend that qualifying criteria for sections should be introduced, so that sections can only be created to separate out the interests of:

(1) residential and non-residential units; or

(2) different non-residential units, which are used for significantly different purposes; or

(3) different types of residential units; or

(4) separate buildings in the same development; or

(5) other premises falling within the commonhold which, on an application by the developer or commonhold association, and in the interests of practicality and fairness, the Tribunal decides should form a separate section.

8.73 We recommend that the Tribunal should not be able to decide that a separate section should be set up on the basis of differences in the identity of unit owners or different tenure types. New sections should instead be justified by some difference in the nature of the units.

8.74 We recommend that any decision of the Tribunal that a section has been set up where none of the criteria have been met will require a change in the structure of the commonhold from that date, but will not render the section void from the outset.

## Single-unit sections

8.75 Although a *commonhold* cannot, by definition, contain a single unit, we provisionally proposed that a *section* should be able to contain only one unit. This provision would allow, for example, sections to be used where there is a block of three residential flats above one commercial unit.[30] The commercial unit could comprise its own section which would enable the separation of the residential and commercial interests in the building.

### Consultees' views and recommendations for reform

8.76 The vast majority of consultees agreed with our conclusion, although a couple of consultees raised concerns over whether it would permit every unit in a commonhold to become its own section because unit owners could not agree on particular issues. However, our recommendations above will prevent this scenario from arising. Sections will only be possible where certain defined criteria can be made out.

30 See CP, para 5.95.

**Recommendation 23.**

8.77 We recommend that it should be possible for sections to consist of a single unit.

## COMBINING TWO OR MORE SECTIONS

### Voting requirements and the right to apply to the Tribunal

8.78 There may be situations where a commonhold association wants to combine two or more sections. In the Consultation Paper, we explained how restructuring a commonhold by combining two or more sections has parallels with the restructuring of a commonhold by creating a new section. Either creating a new section, or combining two or more existing sections, will affect which decisions unit owners are entitled to vote on, and the costs they have to contribute towards. In addition, unit owners may be adversely affected by the combining of sections, as they might be by the creation of sections.

8.79 We therefore provisionally proposed that the voting majority required to combine two or more sections should be set at the same level as the required majority for creating a section.[31] Additionally, we proposed that the same right to apply to the Tribunal as set out in Recommendation 21 above should be given to a unit owner affected by a decision to combine two or more sections.

#### Consultees' views

8.80 The vast majority of consultees were in favour of our proposals to set the same voting threshold, and give the same right to apply to the Tribunal, for combining sections as for creating sections. CILEx was in favour of "the streamlining of processes where possible to help simplify conveyancing procedures" and therefore noted "the decision to adopt the same framework for combining sections, as with creating sections, is thereby welcome".

8.81 Those opposing our proposals raised similar concerns over the voting threshold as were raised in response to the proposed threshold for creating sections.[32] Similarly, there was no consensus over an alternative voting threshold.

8.82 A few consultees suggested that our provisional proposal to provide unit owners affected by a decision to combine two or more sections with a right to apply to the Tribunal should be extended to cover unit owners affected by a decision not to combine sections.

8.83 Some consultees requested clarity on whether the second element of the voting majority (75% of all the votes held by unit owners in the sections to be combined must be cast in favour) applied to each affected section individually, or the group of affected unit owners as a whole.

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31 See para 8.41 above for details of the two limbs of the voting threshold.

32 See para 8.44 above.

### Discussion and recommendations for reform

8.84 We are of the view that each section which is to be combined must separately satisfy the voting requirement, so that 75% of all the votes held by unit owners in each affected section must be cast in favour of creating or of combining the section(s). That ensures that the interests of each section affected have an appropriate say in the decision.

8.85 For the same reasons set out above, we think our recommendation strikes a balanced position, and we see significant benefits in requiring the same voting majority to combine existing sections as to create new sections. We do not recommend extending the right to apply to the Tribunal where unit owners have not been able to meet the requisite voting threshold, for the same reasons as set out at paragraph 8.54 above. To provide such a right would be to undermine the reasons behind setting the high threshold. The voting threshold is set purposefully high in order to protect unit owners' expectations.

**Recommendation 24.**

8.86 We recommend that to combine two or more sections:

(1) the decision should be approved by a special resolution of the commonhold association; and

(2) separately, each of the sections which will be combined should individually meet the requirement that 75% of all the votes held by all the unit owners in that section must be cast in favour of combining the sections.

8.87 We recommend that unit owners should have a right to apply to the Tribunal under our recommended minority protection provisions if a decision to combine two or more sections is approved.

## Criteria which must be met for combining sections

8.88 We recommend above that certain criteria must be met in order for a new section to be created, to ensure sections are only created where there is good reason to do so.[33] However, different considerations apply when two or more sections are combined. There is no expectation or presumption that a section will be created even when the criteria for doing so are met. The presumption is that sections will not exist within a commonhold unless there is clear justification. That being the case, we think that it should be possible for a commonhold with sections to adapt to a structure with fewer (or without) sections should it wish to do so, without the need to meet specific criteria.[34]

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[33] See Recommendation 22.

[34] See CP, para 5.100.

### Consultees' views and recommendations for reform

8.89 The majority of consultees agreed with our conclusion. The main argument raised by consultees who disagreed was that good reasons should have to be established before sections can be combined. We agree that unit owners should have good reasons to combine sections. However, we do not consider that it is necessary to require them to specify what those reasons are or for those reasons to fit within prescribed criteria. As we have explained above, the default position is that a commonhold will not have sections, rather than that sections will exist. It is consistent with this presumption that specific criteria should not need to be fulfilled to reduce or remove sections from a commonhold. The high voting threshold that we recommend in order for two or more sections to be combined will make it highly likely that such a vote will only be passed where there are sensible and well-supported reasons for wanting to combine the sections.

**Recommendation 25.**

8.90 We recommend that there should not be any criteria which must be met before two or more sections in a commonhold can be combined.

## SECTION COMMITTEES

8.91 A commonhold divided into sections remains under the control of a single commonhold association. One board of directors is therefore responsible for the whole development. Under the current law, directors can set up a committee, and delegate some of their powers to that committee ("section committees"). In the Consultation Paper, we explored in more detail how different committees could be set up and given responsibility for managing different sections in a commonhold. We set out various options and invited consultees' views.[35]

### Setting up a section committee: mandatory or optional?

8.92 We provisionally proposed that it should be optional, rather than compulsory, for a commonhold to set up section committees. It would therefore be possible for sections to be created within a commonhold, but for no committees to be set up.[36]

### Consultees' views

8.93 The vast majority of consultees agreed with our provisional proposal that it should be optional, rather than mandatory, for a committee to be set up for a section within a commonhold. The Leasehold Knowledge Partnership ("LKP") added:

> The fiduciary duty of the directors under company law is to act in the best overall interests of the site as a whole. It should only be by extreme exception that an

35 CP, paras 5.58 to 5.80.

36 CP, Consultation Question 18, para 5.71.

individual ‘section’ might consider its interests so diverse from the rest of the site that it wished to act in a unilateral way.

8.94 CILEx also agreed, commenting that leaving the creation of section committees optional would allow unit owners to “determine the extent of involvement or separation that they prefer, in line with their own needs and the nature of their commonhold”.

8.95 The main argument made by consultees who thought the creation of section committees should be mandatory was summarised by the view of Jean Breakey (leaseholder) that “somebody must step up and take responsibility” for each section in a commonhold.

8.96 A small number of consultees suggested that it should be mandatory for the directors to set up a section committee if enough unit owners in the relevant section vote in favour. Damian Greenish (solicitor) said “it is important to establish […] that a commonhold association cannot seek to control say a commercial unit by simply refusing to establish a section or section committee”.

### Discussion and recommendations for reform

8.97 We agree that it is necessary for responsibility to be borne by someone, and that in many cases it would be preferable for unit owners in a particular section to take on the responsibility for their section. However, we do not think that requiring a committee to be set up for every section will necessarily lead to this result. If unit owners in a section have no desire to take responsibility, then there will be no members on the committee for that section. We think that it is preferable for section committees only to be set up where a committee is desired by the unit owners in a particular section. In situations where no committee is set up, or there are no members on the committee, the board of directors for the commonhold as a whole will retain responsibility for taking decisions regarding that particular section, thereby ensuring that there is always someone with responsibility for each section.[37]

8.98 We note the comments made by Damian Greenish and others that owners should be able to compel the directors to create section committees. However, in our view, the decision to create committees, and what powers delegate powers to it, should remain with the directors. As we explained in the Consultation Paper, making section committees and the delegation of specific powers mandatory may place the commonhold association in a vulnerable position. As the section committee does not have its own legal identity, the common parts of a commonhold will remain the responsibility of the commonhold association. A failure of the section committee to carry out certain obligations might therefore result in the association (and its directors) being put in breach of the CCS. Directors therefore need to be free to decide whether or not it is appropriate and in the best interests of the commonhold association for a section committee to be created. Much of the benefit of using sections to separate out voting rights and financial obligations for different interests in a development can be gained without having a section committee in place.

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[37] In legal terms, responsibility ultimately remains with the directors of the commonhold association, regardless of whether a section committee has been set up or not.

**Recommendation 26.**

8.99 We recommend that it should be optional for a section to have a section committee.

### Delegating powers to a section committee: collateral or exclusive delegation?

8.100 There are two different ways that powers can be delegated by the directors to a section committee:

(1) collateral delegation, which means that the directors retain their power to make the delegated decisions, so both the committee and the directors have power to make delegated decisions; or

(2) exclusive delegation, which means that the directors give up their power to make certain decisions, so only the committee has the power to make those decisions.

8.101 We explained in the Consultation Paper that exclusive delegation would give the committee complete control over the delegated matter. However, exclusive delegation would make it difficult for the directors to step in if the committee failed to carry out its obligations. We invited consultees to share their views as to whether delegation to section committees should be collateral or exclusive.

#### Consultees' views

8.102 The majority of consultees thought that it should be for a commonhold association to decide in each case whether a power should be delegated collaterally or exclusively. However, a large number of consultees argued that delegation to a section committee should always be collateral. The main points raised by these consultees were that collateral delegation would encourage good practice, by providing oversight of section committees by the directors. Collateral delegation would give the directors the ability to step in where a section committee was not complying with the CCS, or was operating poorly. Concerns were also raised that exclusive delegation could "result in the directors retaining liability for a decision (or lack of one) but without the power to enact it".

8.103 Comparatively few consultees made arguments in favour of exclusive delegation. The Consensus Business Group (landlord) said:

> If collateral delegation will enable directors of the commonhold association to step in to override the decisions of the section committee, which is what the proposals appear to allow, this will undermine the wishes of the section members and give cause for conflict, opportunity for abuse of less powerful commonhold unit holders and potentially deter owners from joining a section committee.

#### Discussion and recommendations for reform

8.104 While there may be instances where exclusive delegation is needed for one reason or another, we are persuaded by arguments that, in the vast majority of cases, collateral delegation is preferable to exclusive delegation. We therefore recommend that, although it should be for a commonhold association to decide how powers are

delegated, the default position should be that powers are delegated collaterally. We also recommend that guidance should be created, alerting directors to the advantages and disadvantages of exclusive delegation, and recommending collateral delegation is used in most circumstances.

8.105 Further, we are of the view that regardless of the wording of a delegated power, the directors should retain the ability to exercise a delegated power if it is reasonable to do so. For example, where a section committee's exercise of (or failure to exercise) that power causes the commonhold association to be in breach of its duties in the CCS. The ability to step in will help to protect the commonhold association and unit owners in other sections where powers have been delegated exclusively. However, to ensure that this power is exercised fairly, the directors will first be required to serve a notice on a section committee. The notice should identify the reasons why the directors wish to exercise the delegated powers and provide the section committee with 14 days to rectify the problem identified by the directors, before the directors can step in to exercise the delegated power.

8.106 If the directors are seeking to step in and exercise a delegated power due to an emergency, they will not need to wait 14 days to act in the section committee's stead. In such circumstances the directors should be able to give notice of their intention to exercise the delegated power, provide reasons, and step-in as soon as notice is given. This will ensure that a commonhold association is not placed at risk due to the exclusive delegation of any powers. Any disputes arising over this can be resolved using the dispute resolution mechanism.[38]

**Recommendation 27.**

8.107 We recommend that it should be for the directors of a commonhold association to decide whether powers are delegated collaterally or exclusively to a section committee.

(1) We recommend that if a delegated power does not state how it has been delegated, it should be presumed to have been delegated collaterally.

(2) We recommend that the CCS should provide that, regardless of the wording of a delegated power, the directors retain the ability to exercise that delegated power if it is reasonable to do so. The provision should require the directors to serve a notice on the section committee which identifies the reason(s) why the directors intend to exercise the delegated power, and confirms the directors' intention to exercise the power unless the committee remedies the problem(s) identified by the directors within 14 days. If the directors are seeking to exercise the delegated power because an emergency has arisen, they should be able to step in immediately upon serving notice of their intention.

[38] See para 16.1.

(3) We recommend that guidance should be created which explains the advantages and disadvantages of collateral and exclusive delegation and recommending that collateral delegation be used in most circumstances.

### Revoking the powers of a section committee

8.108 In the Consultation Paper, we considered how the powers delegated to a section committee could be revoked by the commonhold association. We invited consultees' views on whether:

(1) the directors should be able to revoke or alter the powers delegated to a section committee as they wish;

(2) section committees affected by a decision to revoke or alter the delegated powers should be given the ability to apply to the Tribunal; or

(3) the directors should have to apply to the Tribunal in order to alter or revoke a delegation.

#### Consultees' views

8.109 The majority of consultees were in favour of adopting both (1) and (2): allowing the directors to revoke or alter powers as they wish, but also giving section committees affected by a decision to revoke or alter powers the ability to apply to the Tribunal. The main arguments raised by consultees in favour of this position were that, as the directors retain overall responsibility for the commonhold association, then they need to be free to revoke delegated powers where it becomes apparent that it would be in the best interests of the commonhold association to do so. However, consultees also argued that in order to protect the interests of unit owners in the affected section, there should be some opportunity for them to object to the revocation or alteration of powers. A few consultees preferred option (3), stating that this option gave greater certainty and protection to unit owners.

#### Discussion and recommendations for reform

8.110 Consultees' views highlight the need, on one hand, to ensure that the directors are able to revoke delegated powers where it would be in the interests of the commonhold to do so and, on the other hand, to protect unit owners' expectations. Unit owners may have purchased their commonhold unit on the expectation that their committee would be able to exercise certain powers. We agree with consultees that, as the directors retain overall responsibility for the commonhold association, they should be able to alter or revoke powers delegated to any section committee. However, to protect unit owners in a section, we think that the directors should only be able to alter or revoke the powers where it is reasonable to do so. For example, where a section committee has repeatedly failed to comply with its obligations, or otherwise where the alteration or revocation would be in the best interests of the commonhold association.

8.111 We also recommend that the directors should be required to provide the committee with 14 days' notice of its intention to revoke the delegation or to alter the power. If a

section committee considers the alteration or revocation of the power to be unreasonable, or if they were not provided with 14 days' notice to address any concerns, unit owners within that committee may invoke the dispute resolution procedure against the directors. Where the directors wish to permanently alter or revoke the powers delegated to a committee in emergency circumstances, they should not have to provide 14 days' notice.

8.112 We are of the view that applying the same reasonableness criterion to both the directors stepping-in to exercise delegated powers on a one-off basis and to a permanent alteration or revocation of those powers is not problematic, as making a permanent change to the powers that were delegated will require stronger evidence to show that doing so is reasonable.

**Recommendation 28.**

8.113 We recommend that the directors of a commonhold association should be able to revoke or alter the powers delegated to a section committee as they wish, subject to the following requirements:

(1) the directors should only be able to revoke or alter the delegated powers where reasonable to do so; and

(2) the directors should be required to give 14 days' notice to the section committee that they intend to revoke or alter a power delegated to that section committee, unless the directors are seeking to revoke or alter the delegated power in an emergency.

## CONCLUSION

8.114 Our recommendations above will make commonhold workable for mixed-use and multi-block developments. Where there are different interests in a single commonhold, these can be separated out using sections, and section committees can be set up to assist with managing these different interests. These sections can be used by developers to help structure the new commonholds that they build, but can also be created or combined by a commonhold association at a later date should it transpire that a different structure is preferable.

8.115 Our recommendations give developers a range of options to adapt commonhold to each specific development, giving them significant flexibility to use commonhold to set up mixed-use and multi-block developments. Sections are the most comprehensive and effective tool, but there may also be instances where developers prefer to use one of the other provisions available.

# Chapter 9: Development rights

## INTRODUCTION

9.1 "Development rights" are the mechanism by which a developer will be able to ensure completion of a commonhold development after some, but not all, of the commonhold units have been sold.

9.2 Developers often plan the construction of sites in phases, so that construction takes place at different times across a development. Where a development is completed in phases, developers often need to be able to retain rights over the completed parts of the development that have been sold on to buyers, in order to facilitate later phases of construction. In respect of new build commonhold developments, the way in which developers would be able to retain rights over completed parts of the development, would be by retaining "development rights" in the commonhold community statement ("CCS").

9.3 In leasehold, developers have a significant degree of freedom to reserve rights in the lease to complete the development. In commonhold, while the Commonhold and Leasehold Reform Act 2002 (the "2002 Act") makes provision for development rights to be reserved in the CCS, only rights falling within an exhaustive list may be reserved. This is likely to be seen as a limiting factor when compared with leasehold. At the same time, there is little to protect unit owners against the developer employing "work arounds" to try and retain a significant degree of control over the development.[1]

9.4 This chapter sets out recommendations that aim to strike a better balance between the interests of the developer and unit owners in new commonhold developments. The recommendations will provide developers with sufficient flexibility to meet their legitimate needs in completing the development, while providing enhanced safeguards and certainty for unit owners who buy before the development is complete.[2] In summary, we recommend that the developer should be able to reserve the rights necessary to complete the development in the CCS. However, we recommend that there should be limitations on the exercise of these rights in order to protect unit owners who buy before the development is complete.

## THE CURRENT LAW

9.5 Before considering our recommended scheme, we provide a brief overview of the current process of registering new commonhold developments and reserving development rights.

9.6 In order to create a new commonhold development, the developer will apply to HM Land Registry to register the commonhold land "without unit owners".[3] The developer

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1 See further CP, paras 6.27 to 6.39.

2 See further, Commonhold CP, para 6.2.

3 See para 9.84 below.

will be required to submit a number of documents to HM Land Registry including the CCS, the commonhold association's certificate of incorporation and its articles. On receipt of these documents, HM Land Registry should register the land as a freehold estate in commonhold land. However, the CCS and commonhold legislation will not apply to that development from the point of registration. Nor will the commonhold association become the registered owner of the common parts at that stage.[4] Instead there will be a "transitional period". During the transitional period, the developer will be the registered owner of the common parts and also the registered owner of each of the commonhold units. The rights and duties set out in the CCS will not yet be in force.

9.7 Once the first unit has been sold, however, the transitional period will come to an end. The purchaser will be registered as the freehold owner of that unit and will become a member of the commonhold association. The commonhold association will be registered as the freehold owner of the common parts of the commonhold, and the CCS will come into force.[5]

9.8 After the transitional period has ended, the flexibility available to developers can be significantly limited by virtue of the fact that the common parts now belong to the commonhold association. The developer may therefore wish to reserve development rights over the common parts and any sold units to facilitate the completion of the development and to vary the extent of the commonhold land after the transitional period has ended. Where development rights are reserved, they must be set out expressly in a separate annex to the CCS.

### Rights which may be reserved

9.9 As noted above, there is an exhaustive list of rights which may be reserved in the CCS. These rights are listed in the 2002 Act.[6] They permit or facilitate the developer to:

(1) complete or execute works on the commonhold land (or land which may have been added to the commonhold under the separate development right below);

(2) advertise and carry out other activities designed to market the commonhold units;

(3) add commonhold land;

(4) remove commonhold land;

(5) amend the CCS; and

(6) appoint and remove the commonhold association's directors.

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4 There are bespoke rules that cover the membership of the commonhold association during the transitional period: Commonhold Regulations 2004 (as amended by the Commonhold Amendment Regulations 2009), sch 2, art 7.

5 CLRA 2002, s 7(3)(c).

6 CLRA 2002, sch 4.

9.10 The CCS may also include obligations on unit owners to co-operate with the developer in exercising these development rights and can specify the consequences of failing to do so.[7]

## PROBLEMS WITH THE CURRENT LAW

9.11 As explained in the Consultation Paper, our concern is that the current system of development rights does not fit the purpose for which it was intended. Consultees have explained that developers are too constrained by the current law, as they can only reserve rights which permit or facilitate activities falling within an exhaustive list. In leasehold, there are few limitations on what rights the developer can reserve in the lease. At the same time, certainty for unit owners is not guaranteed. There is no guarantee that the developer would not be able to add to or vary the rights reserved in the CCS at a later date.[8] There is also no restriction on the purpose for which development rights may be exercised. For instance, a right to make amendments to the CCS could be used to make changes which benefit the developer but are unrelated to the completion of the subsequent phases of development (such as re-allocating car parking from existing unit owners to attract future purchasers).

## OBJECTIVES FOR REFORM

9.12 We consider that a reformed system of development rights should meet the following objectives:

(1) provide developers with sufficient flexibility to build in phases, without being required to commit themselves at the outset to what the final extent of the development will be. We appreciate that developers will often not know the full extent of the development at the time building commences and will need to respond to changing circumstances;

(2) allow for a commonhold development to grow, incorporating the use of sections;[9]

(3) provide for the developer to determine any necessary reallocation of contributions or votes when subsequent phases of the development are added to the commonhold, but with protections for unit owners built-in, so as to prevent unfairness.

(4) ensure unit owners' enjoyment of their units is not unduly affected by the exercise of development rights.

## BUILDING COMMONHOLDS IN PHASES

9.13 Where a development is built up in phases, a developer will usually want to sell units in a completed phase while works continue on the remainder of the site. If a developer

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7 CLRA 2002, s 58. Prof Clarke suggests that potential penalties could include the imposition of a financial penalty.

8 Either by relying on a reserved right to amend the CCS, or by controlling the votes of the commonhold association and its appointed directors.

9 See further Ch 8.

were to register the whole development as commonhold at the outset, then, on the sale of units in the first phase of the development, the commonhold association would become the owner of all the common parts of the whole development. Provisions of the 2002 Act and the CCS would come into effect in respect of the development and would restrict the changes the developer could make to the land registered as commonhold (which would include changes to the units, the common parts, and the extent of the commonhold). The developer would therefore be required to reserve extensive development rights in the CCS to facilitate the completion of any further phases.

9.14 In the Consultation Paper we suggested that, under the current law, the developer would not need to register the whole development as commonhold at the outset. Instead, in order to retain the maximum degree of flexibility, the developer could register the commonhold at HM Land Registry in phases. When the developer had completed the first phase, the developer would only need to register as commonhold the land falling within that first phase, before selling units within that phase. On the sale of the first unit in that registered phase, the commonhold association would become the owner of the common parts within the completed phase only, and the 2002 Act and the rules of the CCS would only apply to this phase. The remaining land would be retained by the developer outside of the commonhold structure. The developer would therefore remain free to deal with the land outside of the commonhold as he or she wishes.[10]

9.15 Where appropriate, the developer can grant rights of access to the unit owners over the retained land and require financial contributions for the maintenance of such means of access (and any other facilities made available to the unit owners) until the development is completed and transferred to the commonhold association. Such arrangements can be dealt with in the same way as where one part of a freehold is sold and rights are required to be granted and retained over both plots to allow each to function.[11] Commonhold is, after all, freehold ownership.

9.16 At paragraph 9.99 below, we provide a worked example which demonstrates the benefits of registering in phases when building up a new commonhold.

## A NEW REGIME FOR THE RESERVATION OF DEVELOPMENT RIGHTS

9.17 Even though, by completing the development in phases, the developer would retain control over parts of the development which have not been registered as

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10 CP, para 6.46 onwards.

11 Under the current law, there are a number of mechanisms available to provide individuals with rights over freehold land and to require freehold owners to contribute towards the costs associated with exercising these rights. For further details, see Making Land Work: easements, covenants and profits a prendre, (2011) Law Com No 327, para 5.21 onwards. Our recommendations in that Report will also will also enable the creation of payment obligations on landowners, subject to controls to prevent abuse. Additionally, in England, Government is planning to introduce measures which will protect freehold owners who are required to pay towards the maintenance of shared facilities which are owned by a different freeholder. Such protections should extend to freehold owners within commonhold. See Ministry of Housing, Communities and Local Government, *Implementing reforms to the leasehold system in England: government response* (June 2019), para 4.1 to 4.18.

commonhold, the developer may still need to exercise certain rights over the registered commonhold land, such as to add land or amend completed phases.

9.18 As we have already noted, under the current law, development rights need to be reserved expressly in the CCS. The Consultation Paper discussed an alternative approach to exercising development rights over commonhold land. Rather than needing to reserve rights expressly in the CCS, we asked whether, when building new commonhold developments, developers might automatically be given a wide range of statutory development rights, into which safeguards could be built. We explained that these rights would be drawn widely to assist the developer to build up in phases, for example, to add a new phase to a completed phase, make consequential variations to commonhold contributions and voting rights, and to facilitate access rights. We envisaged that such rights would be sufficient to enable developers to complete the remaining works over the commonhold and that developers should be prevented from retaining control over the development through alternative means.

9.19 We invited views on this alternative approach, but we did not put forward a provisional proposal for reform.

### Consultees' views

9.20 The vast majority of consultees said that development rights should apply automatically and should be placed on a statutory footing, although few consultees gave substantive reasons for their view. The Property Litigation Association (the "PLA") said that putting development rights on a statutory footing would "provide clarity, simplicity and consistency, provided that the automatic statutory development rights are clearly defined and not too far-reaching".

9.21 However, two main concerns were raised by consultees who disagreed with the alternative approach.

(1) Several consultees argued that statutory development rights might limit developers' flexibility to the point where they are unable to complete more complex developments with multiple phases. In particular, stakeholders argued that, even if drawn extremely widely, it would be difficult for statute to anticipate all rights which a developer may require in order to complete the development.

As Boodle Hatfield LLP (solicitors) explained, "we believe that there will be too much variation from one development to the next to be able to have a standard 'one size fits all' set of rights".

A further consultee, responding confidentially, said that applying development rights automatically would simplify the process, but expressed concern that developments can be so different from one another that doing so might not be practical.

(2) Some consultees were concerned that statutory development rights would not provide certainty or protection for unit owners. Shira Baram (leaseholder) was concerned that our provisional proposal "might create a loophole for developers…to add things to the commonhold that those who purchased at the beginning might not have agreed to".

### Discussion and recommendations for reform

9.22 We note consultees' support for the alternative scheme outlined in the Consultation Paper. However, while putting rights on a statutory footing is superficially attractive, as it would offer standardisation and avoid the need to reserve rights expressly in the CCS, consultees highlighted some significant drawbacks with this approach.

9.23 We agree with consultees that it would be difficult in practice for statute to draw up a list of development rights which the developer should be able to exercise in all cases. Commonhold developments will vary widely in size and character, making it hard to anticipate all rights a developer may legitimately want to exercise.

9.24 We were originally concerned that requiring a developer to reserve rights expressly in the CCS might be viewed as cumbersome. However, on reflection, and following subsequent discussions with consultees, we think that requiring the developer to reserve development rights expressly in the CCS would more closely align with leasehold practice, with which developers are already familiar. Developers often expressly reserve rights in leases over land which has been sold to ensure they can complete the development and market any unsold properties.

9.25 Requiring developers to set out development rights in the CCS should also provide greater clarity for unit owners. Unit owners will be provided with a list of all the rights that may be exercised over their specific development.

9.26 We have concluded, therefore, that the needs of developers and unit owners are better provided by a non-statutory system of development rights. In other words, our view is that development rights should continue to be reserved in an annex to the CCS.

9.27 However, the developer should not be given complete freedom with regards to the use of development rights. When considering which rights might be reserved by the developer, two issues are brought into tension. Currently, a developer may only reserve rights from an exhaustive list, and this is seen as unduly restrictive. As we note above, it would be difficult to draw up a list that covers all rights a developer may legitimately need to exercise. On the other hand, if developers were given free reign with regard to the use of development rights, unit owners may not be sufficiently protected. One of the problems with the current law is that development rights might be used in an unfair way. In particular, there is a risk that the developer might use development rights for a purpose unconnected with the development in order to benefit at the expense of unit owners.

9.28 In considering what rights might legitimately be needed to complete a development, it has become apparent that, for almost every instance where developers may need a right to do something, the same rights could – in theory – be used in a way which exposes unit owners to abuse. Rather than controlling what rights can be reserved in the CCS, therefore, it is the *purpose* for which a developer is acting, or the effect of the action taken, that determine whether the developer should or should not be allowed to take the action in question.

9.29 The table below illustrates this point. It sets out the rights a developer may seek to reserve in the CCS and shows that each right might be exercised by the developer for

a legitimate purpose which should be permitted, and an illegitimate purpose, which should not be permitted.

**Figure 14: Potential uses of development rights which should and should not be permitted**

| Scenarios which should be permitted | Scenarios which should not be permitted |
|---|---|
| Adding new units to the commonhold | |
| Once a new phase has been completed, the developer will want to add the units in the new phase to the commonhold. | When adding a new phase to an existing commonhold, if voting or contribution percentages are not allocated fairly to the new units added, this could create a disproportionate burden on the existing units – see “Altering the voting and commonhold contributions allocated to each unit” below. |
| Adding new common parts to the commonhold | |
| A newly completed phase may include common parts such as a gym, business lounge or roof terrace that the developer wishes to add to the existing commonhold. | The developer may decide to add a significant number of expensive new facilities to the commonhold in order to attract purchasers to the new phase. This change may lead to the commonhold contributions being set at a much higher level than originally envisaged, placing an unreasonable burden on existing unit owners. |
| Altering the voting rights and commonhold contributions allocated to each unit | |
| When a developer adds units from a new phase to the commonhold, the voting rights and commonhold contributions allocated will have to be altered to incorporate the new units.<br><br>This could be done in a fair and proportionate way. | When a developer adds units from a new phase to the commonhold, the voting rights and commonhold contributions allocated will have to be altered to incorporate the new units.<br><br>This could also be done in a disproportionate way, that may significantly benefit commercial units, or units retained by the developer, while putting an unreasonable and disproportionate burden on existing residential units. |

| Scenarios which should be permitted | Scenarios which should not be permitted |
|---|---|
| Making physical changes to the common parts | |
| In order to complete works on the rest of the land, the developer might need to make physical changes to the common parts in the existing commonhold, for instance to connect a new phase to the combined heat and power unit in the complete phase. | The developer may decide that residential units in this development have become so lucrative, that he or she decides to build a new block of flats on the garden area which had been incorporated into the commonhold already. |
| Changing the use of common parts | |
| The developer may have provided a gym in the first phase, with the intention of replacing it with a larger gym in a future phase. Once that larger gym has been built, the developer may then want to change the smaller gym in the first phase to a residential unit or other use. | A communal car park might have been included in the commonhold as part of a completed phase. In order to help sell the units in a subsequent phase, the developer might then allocate all of the spaces in the car park as limited use areas for each of the units in the subsequent phase, which would then prevent the existing unit owners being able to use the car park. |
| Enforcing rules in the CCS | |
| The developer may want to enforce the maintenance and repairing obligations in the CCS to ensure that buildings in completed phases are kept in a good standard of repair while the developer is continuing to build and sell units in subsequent phases. | The developer may try to use enforcement of rules in the CCS as a bargaining tool, or to exert an unreasonable degree of control over the unit owners and commonhold association. This is of particular concern where there are rules in the CCS in which the developer has no interest, such as specific hours during which a laundry room can be used. |

9.30 As demonstrated, it is very hard to draw up an exhaustive list of all the actions a developer may need to take when completing a phased commonhold. Additionally, it is near impossible to identify separate lists of actions which developers should always be permitted to undertake, or never permitted to undertake.

9.31 We have found it useful to distinguish between:

(1) the *actions* a developer may want to take (for instance, to add land to a commonhold, make changes to CCS terms, or have access rights over commonhold units or common parts);

(2) the *purpose* for which the developer wishes to take that action; and

(3) the *effect* of the actions taken by the developer.

9.32 We have concluded that the best way to balance flexibility for developers and protection for unit owners is not to create a list of actions a developer may take, but to prevent the developer from exercising rights that they reserve in the CCS if (1) they are not connected with a particular permitted purpose or (2) they have an unacceptable effect on the unit owners. We recommend that the developer should be free to reserve such rights in the CCS as he or she considers appropriate, taking into account the particular development, but there will be statutory limitations on the exercise and effect of these rights. We consider that this distinction between the action, the underlying purpose and the effect is key to ensuring:

(1) developers are free to reserve the rights which are best suited to the size and needs of their particular development;

(2) unit owners are adequately protected, because developers are only permitted to make changes to or exercise control over a commonhold when doing so is for a specific purpose, and does not have an unreasonable effect; and

(3) that it is clear how, and for what reason, development rights can be challenged.

9.33 We appreciate that, within leasehold, there are no equivalent limitations on the actions a developer may take to complete the development, regardless of the purpose or effect on leaseholders. While developers will want to ensure commonhold offers a comparable level of flexibility to leasehold, this flexibility should not extend to the point at which developers are able to use their powers abusively. Our commonhold project provides an opportunity to improve how new developments are set up and provide a better balance between developers and unit owners' interests.

**Recommendation 29.**

9.34 We recommend that developers should be able to reserve such rights in the CCS as they consider appropriate for the particular development. However, a developer should only be able to exercise development rights:

(1) for a permitted statutory purpose; and

(2) in accordance with certain statutory limitations which protect unit owners against unreasonable effects of development rights.

## Limitations on the exercise of development rights

9.35 We now discuss the purpose for which rights must be exercised and the effects that might be considered unreasonable.

### The purpose for which development rights can be exercised

9.36 Developers, in contrast to any other third-parties, are permitted to reserve rights in the CCS because such rights are necessary to enable developments to be completed. The purpose for which developers exercise development rights should therefore be linked to this underlying justification. Consequently, we think that developers should only be permitted to exercise reserved development rights where, in that particular instance, the right is being exercised in the pursuit of the "development business" of the developer.

9.37 As to what should constitute "development business", we recognise that a developer's interest continues beyond the completion of building works until the point at which all the units have been sold. We therefore recommend that development business should be defined as including the completion of a development and the marketing and sale of units within a development.

9.38 We recommend that guidance should be produced which will provide examples of when an exercise of development rights will or will not be in line with this purpose.

**Recommendation 30.**

9.39 We recommend that a developer should only be able to exercise any development rights reserved in the CCS for a purpose which is the pursuit of the development business of the developer.

9.40 We recommend that "development business" should be defined as including:

(1) the completion of a development; and

(2) the marketing and sale of units within a development.

### Effect of the development rights on unit owners

9.41 We recommend above that the developer should only be able to exercise development rights in accordance with certain statutory limitations which protect unit owners against unreasonable effects of development rights. The current law contains three limitations, which prevent the developer's actions unreasonably affecting unit owners. These limitations are:

(1) the developer must not exercise rights in a way which would interfere unreasonably with unit owners' enjoyment of their units or their ability to exercise rights granted by the CCS;

(2) the developer may not remove land from the commonhold which has already been transferred to a unit owner unless the owner of that unit provides written consent; and

(3) any damage caused to the commonhold land by the developer should be remedied as soon as reasonably practicable.[12]

9.42 In the Consultation Paper, we invited views on whether any further restrictions should be introduced. We also asked consultees whether a time limit should be imposed on the exercise of development rights. This is discussed separately at paragraph 9.63 onwards.

### Consultees' views

9.43 Consultees were divided on the question of whether any further limitations are necessary. Of those providing a substantive comment on the relevant issues, half thought that there should be no change to the existing law. Generally, developers and law firms opposed additional restrictions, whereas leaseholders and other individuals were in favour.

9.44 A couple of consultees suggested that some of the existing limitations were unnecessary or unclear. The PLA, for example, suggested that the first requirement (not to exercise development rights in a way that would interfere unreasonably with unit owners' enjoyment of their units) "is uncertain and so could lead to disputes". One anonymous consultee suggested that any restrictions on development rights should be negotiated with unit owners.

9.45 Consultees opposed to additional restrictions cited developers' need for flexibility. Berkeley Group Holdings PLC (developer) stressed that developers need flexibility to complete developments, and that additional restrictions should therefore not be introduced. The Leasehold Advisory Service ("LEASE") argued that developers need to be encouraged to take up commonhold and that additional restrictions would act as a disincentive. A L Hughes & Co (solicitors) did not offer a view either way, but said that developers need flexibility "if they are to have confidence in commonhold".

9.46 A few consultees argued in favour of additional restrictions.[13] Katie Kendrick (leaseholder) suggested that any additional restrictions should only be for the purpose of increasing consumer protection. A couple of consultees suggested that there should be some restriction preventing excessive or large payments being demanded from unit owners. For example, an anonymous consultee argued that "developers must be restricted from demanding excessive payments from unit buyers".

9.47 Shira Baram suggested that developers should be unable to change the use of unsold units at a later date, and should not be able to change the use of common parts, for instance by building a new block of flats on an area which was originally intended to be a garden.

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12 Commonhold Regulations 2004, reg 18.

13 The remaining consultees who argued in favour of change raised concerns regarding changes to the time limit – see para 9.65 onwards.

## Discussion and recommendations for reform

9.48 While we appreciate developers' need for flexibility, we believe that it is appropriate that some limitations on the exercise of development rights are prescribed. Under our recommendations, the developer is given wide scope to include whatever rights he or she considers appropriate in the CCS. Limitations are required as to the effect of these rights in order to protect and provide certainty to unit owners. Our view is that the existing restrictions set out above provide a basic level of protection to purchasers and that these restrictions should be carried across into our revised regime. However, there should be greater clarity about how these restrictions are intended to operate.

9.49 We note the PLA's concern that the "unreasonable interference" test within the first limitation is unclear. To address this concern, we recommend that guidance should be produced which details the types of action that would normally constitute an unreasonable interference with unit owners' enjoyment of their units, or their rights granted in the CCS. Guidance should also make clear that interference with enjoyment extends to the exercise of development rights which place an unreasonable financial burden on the unit owners. For example, if the developer were to add a significant number of expensive facilities to the development in order to attract new purchasers. Further, in Chapter 13 we provide an additional protection for unit owners against costs being allocated disproportionately between the commonhold units.[14]

9.50 The second existing limitation, that the developer may not remove land from the commonhold which has been transferred to a unit owner without that unit owner's consent, is slightly ambiguous in effect. As we explain in Chapter 10, there is already a requirement in the CCS to obtain a unit owner's consent before changing the boundaries or his or her unit. This is a prescribed term of the CCS which cannot be removed or amended. It appears, therefore, that the terms of the prescribed CCS would already prevent the developer from changing the boundaries of the commonhold unit without the unit owner's consent. There are also other circumstances in which a unit owner's consent would be required by the terms of the prescribed CCS, but which are not currently listed as a limitation on the developer's exercise of development rights. The unit owner's consent is also required before:

(1) changing the use of a commonhold unit (for example, changing the use of a unit from residential to business use);

(2) removing a unit owner from the list of authorised users of a limited use area (for example, removing a unit owner's right to use a car park or balcony). We also recommend in Chapter 10 that, where there is only one authorised owner of a limited use area, that owner's consent should be required before reducing the extent of that area, or adding in more users. For instance, if a unit had a garden area which was for that owner's exclusive use, that unit owner's consent would be required in order to reduce the size of that garden. Additionally, if a unit had been given exclusive use of a car parking space, that owner's consent would be required before adding additional users to that space;

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14 See para 13.93 onwards.

(3) altering rights over a commonhold unit (for example, rights of access over a unit); and

(4) Altering rights provided for a commonhold unit over the common parts (for example, rights to use a shared driveway or for the unit owner to use a particular facility).[15]

9.51 We consider it inconsistent that the second limitation only refers to a requirement for the developer to obtain a unit owner's consent before changing the boundaries of a unit, and not any of the other scenarios listed above. In our view, it would never be justifiable for the developer to alter the boundaries of a unit, change the rights over that unit, the use of that unit, remove that unit's access to a limited use area, or alter the use of the limited use area in the ways discussed above, without that owner's consent. In each of these circumstances, the developer should be required to obtain the consent of the affected unit owner.

9.52 However, the final scenario listed above (altering a unit owner's rights over common parts) warrants a different approach. Unlike the other scenarios, altering rights over common parts would likely require the consent of numerous, rather than individual, unit owners. And unlike the other scenarios, we can foresee circumstances in which it might be justifiable for the developer to make changes to the common parts in order to respond to changing needs. For example, it may be the case that the developer needs to re-designate part of the common parts in order to install a larger heating system than previously envisaged. Or, the developer may want to add to the rights which owners already have to cover newly completed parts of the development. The developer would be too restricted if he or she could never make such a change without obtaining the consent of every owner who had a right over that part in the CCS. If specific consent were required, and could in no circumstances be overridden by the developer, the developer would likely seek to avoid the need for consent in the first place by not providing unit owners with any specific rights over the common parts in the CCS. We do not want to encourage such a practice, as it would provide unit owners with less certainty. We therefore consider it preferable for the developer to be able to make changes to the common parts, without requiring the consent of each person with a right over that area. However, such changes will only be possible if they are in accordance with the general statutory limitations on the exercise of development rights. Namely, the developer would only be able to make changes to the common parts if the change was in pursuit of development business and did not interfere unreasonably with unit owners' enjoyment of their units and their rights granted in the CCS.

9.53 With regard to changing the use of any unsold units, we understand the concern expressed by Shira Baram that, to provide certainty, changes to unsold units should be restricted. At the same time, we can see that there may be legitimate reasons why a developer wishes to make these changes. For instance, a developer may have retained a unit in the first phase to act as a marketing suite, and later wishes to move the marketing suite to a subsequent phase which is closer to the units being marketed. It would make sense for the developer to then be able to covert the original marketing suite into a flat or shop. In order to strike a balance between giving certainty

[15] Commonhold Regulations 2004, sch 3, paras 4.8.5 to 4.8.10.

to unit owners and flexibility to meet developers' needs, an absolute limitation cannot be placed on all changes to the use of units or common parts. Instead, we think that the requirement for the developer to reserve expressly any rights to make such changes in the CCS will help to alert unit owners to the possibility of such changes being made, so that they can take that into account in their decision whether to buy a unit. Unit owners will also be protected by our recommendation that developers should only exercise rights in pursuit of development business and should not be able to interfere unreasonably with unit owners' enjoyment of their units or rights granted in the CCS.

**Recommendation 31.**

9.54 We recommend that the exercise of development rights should be subject to the following limitations:

(1) A developer must not exercise rights in a way which would interfere unreasonably with unit owners' enjoyment of their units or their ability to exercise rights granted by the CCS.

(2) A developer must not make any of the following changes without first obtaining the written consent of the unit owner affected:

(a) changing the boundaries of a unit;

(b) removing a unit from the list of authorised users of a limited use area;

(c) where a unit owner is the only authorised owner of a limited use area, reducing the extent of that limited use area, or adding in more users; or

(d) altering rights over a commonhold unit.

(3) Any damage caused to the commonhold land by the developer should be remedied as soon as reasonably practicable.

### Challenging the exercise of development rights

9.55 Although the developer is not limited in what rights can be reserved in the CCS, the developer will be limited in the exercise of these rights. Unit owners should be entitled to apply to the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal") where the developer is exercising a development right for a purpose which is not the pursuit of the development business of the developer, or where the developer is in breach of any of the statutory restrictions set out in Recommendation 31 above regarding the effect of the right.

9.56 The Tribunal should be able to determine that a particular exercise of development rights was or was not permissible (or, for a pre-emptive application, would or would not be permissible). The Tribunal could then either award damages, or transfer the application to the court for the award of an injunction.

9.57 It is important to note that a unit owner will not be able to challenge the validity of a right on the basis that it should never have been reserved in the CCS in first place. A unit owner would only be able to challenge the exercise of a development right if it is not exercised for a permitted purpose or is in breach of the statutory limitations in Recommendation 31.

**Recommendation 32.**

9.58 We recommend that unit owners should have the right to apply to the Tribunal where a development right is being exercised:

(1) for a purpose which is not the pursuit of the development business of the developer, or

(2) in a way which contravenes the limitations set out in Recommendation 31.

### Adding to and varying the development rights in the CCS

9.59 The next question which arises is whether, once they have been expressly reserved in the CCS, the development rights might be added to or varied.

9.60 In leasehold developments, a developer cannot unilaterally change or add to the rights which have been reserved in the lease. In commonhold, while there may be an expectation that the developer will not add to the list of development rights in the CCS after the first unit had been sold, there is no express provision which would prevent this. The position in commonhold is complicated by the fact that unit owners may vote to amend the local rules of the CCS. As development rights are a form of local rule, the developer, while owning a majority of units within the commonhold (and therefore the majority of votes), might vote to add to or amend the existing rights reserved in the CCS. The other side to this position is that, once the majority of units have been sold, unit owners may try to frustrate the exercise of development rights by voting to add to or remove these rights from the CCS.

9.61 To provide greater certainty to the developer and unit owners, and to replicate the position in leasehold developments, we recommend that development rights reserved in the CCS should not be amended or added to without the unanimous agreement of the developer and unit owners.

**Recommendation 33.**

9.62 We recommend that the development rights reserved in the CCS should not be added to or amended without the unanimous agreement of the developer and the unit owners.

### Period for which development rights may be exercised

9.63 Under the current law, the developer may not exercise development rights if the works for which the right was granted have been completed (excluding the developer's right to market units). The developer may also decide to end any development right on a voluntary basis, by sending a notice to HM Land Registry surrendering this right. In addition, the developer may attach certain conditions to the exercise of development rights, perhaps to reassure potential purchasers. This may include setting a time limit on the ability to exercise development rights.

9.64 We invited consultees' views as to whether a time limit should be introduced into the commonhold legislation, so that the developer would not be able to exercise development rights after a certain period had elapsed.

#### Consultees' views

9.65 Of those consultees providing substantive comments in response to this question, the majority were in favour of introducing a statutory time limit.

9.66 Heather Keates (conveyancer) suggested that a time limit would give "certainty to the commonhold owners as to a final point when matters fully crystallise". Among those consultees who said that a time limit should be introduced, there was no consensus as to what that time limit should be. Various fixed periods from six months to three years were suggested.

9.67 While not opposing a time limit, some consultees expressed concern that setting a statutory time limit would be near impossible, as every development is different and will need development rights for a different time period. The Federation of Private Residents' Associations (the "FPRA") and Christopher Jessel (solicitor) suggested that any time limit should vary according to the size of the development. The Association of Residential Managing Agents ("ARMA") observed that a time limit should provide developers with "sufficient flexibility to amend the scheme to accommodate changes over what may be a multi-year development".

9.68 Several consultees were against setting a time limit. LEASE argued that "market forces and planning law should dictate any time limits. There seems little need to add additional regulations in this regard". Berkeley Group Holdings PLC (developer) considered that "there are sufficient protections already built in or proposed to protect unit owners as to the exercise of those rights".

9.69 The joint response of some members of the London Property Support Lawyers Group (the "joint response") opposed a time limit, suggesting that "on a large multi-phase development it can be impossible to gauge and there may be instances where unavoidable delays occur". Boodle Hatfield LLP suggested that "each development will differ from the next, and therefore flexibility is required".

#### Discussion

9.70 We are persuaded by arguments that it would be too difficult to set a time limit on the exercise of development rights that would work appropriately in every case. Consultees have provided us with examples of existing developments that are likely to take over 20 years to complete. It would be detrimental to the reinvigoration of

commonhold if it were not possible to build such complex developments on a commonhold basis. However, if a long statutory time limit were set to accommodate larger sites, this time limit would not serve a useful purpose in smaller, straightforward sites.

9.71 We are therefore not recommending the introduction of a statutory time limit on the exercise of development rights. Instead, the limitations we recommend above on the exercise of development rights will provide a more effective way of protecting unit owners who buy before the development is complete. The developer will only be able to use development rights for as long as he or she has a legitimate reason to do so in order to complete the development and market the commonhold units.

9.72 That being said, we recommend the position be kept under review. There is a risk that a developer might fail to surrender his or her rights on completion of the development. Development rights might therefore be listed in the CCS for much longer than necessary. Although the developer may have no intention of using these rights, the inclusion of development rights in the CCS might cause uncertainty for unit owners and have an impact on the value of the units within the development. Best practice will be for developers to surrender all development rights at HM Land Registry on completion of the development, and we recommend stating this best practice in guidance. Rather than setting a time limit on the exercise of development rights (which we have concluded is impractical), it may be possible, if deemed necessary in the future, to provide unit owners with a right to seek the removal of development rights from the CCS after it has become clear that the developer no longer intends to use the reserved rights. For example, after a certain period of non-use. However, at present, there is not sufficient evidence to justify providing unit owners with such a right and we would expect developers to adhere to the best practice in this regard. As no time limit on the exercise of development rights is given in the current law, our conclusion means that no change is required in this respect. Therefore, we do not make a formal recommendation.

## DEVELOPERS' ABILITY TO APPOINT DIRECTORS

9.73 Under the current law, the developer may reserve the right to appoint directors as a development right in the CCS. Where the developer elects to do so, there are detailed rules governing the number of directors that he or she may appoint.[16] We explained in the Consultation Paper that we do not believe that developers should be given a statutory right to appoint directors. Instead, we provisionally proposed that developers' ability to appoint directors should depend on the number of units, and consequently the number of votes, which the developer retains. This will be closely linked to the number of units which remain unsold. So long as the developer retains more than 50% of all the votes allocated to the units, the developer would be able to nominate all the directors. Once the purchasers control more than 50% of the votes, then they would be able to control the election of the directors.[17]

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16 CP, para 6.14.

17 CP, para 6.61. That is of course provided that a sufficient number of purchasers vote in favour of their nominated director, in order to outvote the developer.

### Consultees' views

9.74 A sizeable majority of consultees agreed with our provisional proposal that a developer's ability to appoint directors should depend on the number of votes they have in the commonhold association. However, few provided substantive comments in support of the proposal.

9.75 Consultees who disagreed with our proposal raised a number of common concerns. These concerns highlighted two contrasting themes. On the one hand, a few individuals and leaseholders were concerned that the proposal may allow the developer to exert too much control over the development. Teresa Velasco suggested that:

> a developer could end up controlling the appointment of directors and, therefore, services and expenditure, by renting instead of selling a higher number of units in a development. This would give it general control over the commonhold.

9.76 A few consultees felt that the developer should never have a say on the appointment of directors. For example, Collette Boughton argued that "developers are only builders – their role should not extend beyond that", and Gail Nelson suggested that "once development is completed then all matters should be left with the owners to decide".

9.77 On the other hand, a few consultees argued that developers need to be able to control the appointment of directors for the duration of development in order to be able to complete the planned development. Julia Burgess suggested that the proposal "is impractical as handover of the common parts has a time lag. The developer needs to retain control during this period". Places for People Group (developer) said that:

> It would be usual for developers to control the management vehicle until the development has been completed and then hand over to the dwelling holders. We do not see the case to change this model.

9.78 Damian Greenish (solicitor) argued that our provisional proposal is unsatisfactory and "appears to go from one extreme to the other; less than 50% of units, the developer appoints the directors; 50% or more of the units and the developer has no power to appoint any directors".

### Discussion and recommendations for reform

9.79 In response to Damian Greenish's point, in reality there will not be a clear cut off point at which the developer can no longer appoint directors. Simply, the more units that are sold, the more votes the occupiers will have in commonhold decisions. The unit owners, once in the majority, might wish to appoint a different director, or may be content with the director appointed by the developer.

9.80 We note consultees' concerns that the developer may retain unsold units in order to exert control. However, we do not think that it will be in the developer's interest to retain a large number of unsold, vacant units for a significant period of time. This is because the developer will need to pay the percentage share of commonhold contributions allocated to any unsold units. A developer may, on the other hand, decide to retain a number of units in order to rent them out. However, selling and renting units are different business models, and we question whether a desire to retain

control will, in itself, lead to developers choosing to rent units, as doing so will not generate a capital sum for reinvestment. While there may be instances where a developer does retain a number of voting rights, we do not think this is any different to the situation where any other unit owner owns more than one unit, and so is able to exercise a larger proportion of votes. Outside the scope of control provided by the statutory development rights, we think that the developer should be treated as any other unit owner.

9.81 At the same time, we disagree with consultees that the developer should retain absolute control over the appointment of directors. Such a level of control is not possible under the existing commonhold legislation. The ability to reserve and exercise development rights under our recommendations above will give developers sufficient flexibility to make any necessary changes to, and exercise the necessary control over, the commonhold, where there is a legitimate reason for doing so. Additionally, under our suggested approach to phasing, the developer would only be transferring control to unit owners in respect of completed phases of the development, and then only once more than half of the units in that phase have been sold. Our recommendations draw a careful balance between the needs of developers on the one hand, and protecting owners of units on the other. That balance could not be maintained by handing complete control of the commonhold to developers.

9.82 We therefore recommend that developers should not have a specific statutory right to appoint commonhold association directors. Instead, a developer's ability to appoint directors should depend on the number of votes it retains in the commonhold association.

**Recommendation 34.**

9.83 We recommend that there should not be any specific statutory provisions for the appointment of developers' directors. Instead, a developer's ability to appoint directors will depend on the number of votes it owns in the commonhold association.

## THE "WITHOUT UNIT OWNERS" REGISTRATION PROCEDURE

9.84 In the Consultation Paper, we outlined that commonholds can be registered in two different ways: registration with unit owners; and registration without unit owners.[18] The former was intended to be used where existing leasehold developments are converted to commonhold, and the latter for new commonhold developments. The main difference is that the procedure for new developments (without unit owners) contains a transitional period, whereas the procedure for conversion (with unit owners) does not.

9.85 As explained above, the transitional period in the without unit owners procedure, commences once the land is registered as commonhold and ends on the sale of the first unit. Once the first unit is sold to a purchaser, all of the common parts of the

[18] CP, paras 6.4 to 6.20 and 6.36 to 6.38.

estate will be transferred to the commonhold association and the CCS will bind the developer and any other unit owners.[19]

9.86 The transitional period assumes that there is a usefulness in the developer leaving a period of time between registering the land as commonhold and selling the first unit to a purchaser. In most cases, however, we anticipate that a developer will only register the land as commonhold when he or she is ready to sell units in the commonhold. We invited consultees' views on whether the transitional period has any advantages, or whether it would be preferable to have only one procedure for creating both new and converting commonholds.

### Consultees' views

9.87 Consultees' views were evenly split as to whether or not the transitional period had any advantages. On the one hand, some consultees argued that the transitional period provided flexibility for developers during the construction of new developments. On the other hand, some consultees argued that, with sufficient development rights, and by adopting the phasing procedure outlined in the Consultation Paper (and above at paragraph 9.13), developers would have sufficient flexibility.

### Discussion and recommendations for reform

9.88 We consider that a transitional period will no longer be necessary under the recommended scheme set out in this chapter.

9.89 We understand that removing the transitional period may be viewed as reducing flexibility. However, in realty, the transitional period was designed to fit within a regime that requires registration of the whole commonhold development at the outset, rather than being built up in phases. As the current law only refers to one transitional period being available, it necessarily implies that the developer would be required to register the whole development at the outset in order to benefit from the transitional period. Our recommendations in this chapter are designed to replace the current scheme with a new regime that will offer developers much greater flexibility by registering the commonhold in phases.

9.90 Under our recommended scheme, the developer would not need to know the full extent of the development at the time building commences. The developer would only register phases of the development once they are complete, and a unit within that phase is ready to be sold. While it may be possible to provide for multiple "transitional periods" across the development which would apply on the registration of each separate phase, such a reform would, in our view, add unnecessary complexity. In practice, we consider it unlikely (under the current law and under our recommended scheme) that a developer would register the development or any part of it as commonhold unless a unit was ready to be transferred to a unit owner. By not registering the development or part of it until a unit is ready to be sold, the developer will remain completely in control of development, and will not need to be concerned with complying with the company law requirements of the commonhold association that will apply following registration.

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[19] CP, paras 6.6 to 6.9, and 6.52.

9.91 We are therefore of the view that our recommended scheme offers improved flexibility and that the transitional period is unnecessary and should not be a feature of our revised regime. Removing the transitional period has the advantage of simplifying commonhold's registration process. It will allow one registration process to be used for conversion and for new developments (albeit that different documents will need to be submitted alongside the application form). If the transitional period is removed, the "without unit owners" registration procedure is no longer needed. We recommend that the law should be simplified by removing the "without unit owners" registration procedure, and moving to a single way of registering a commonhold for existing and new developments.

**Recommendation 35.**

9.92 We recommend that the "without unit owners" registration procedure should be removed and there should be a single process for registering commonholds at HM Land Registry for existing and new developments.

## DEVELOPERS' VOTING RIGHTS

9.93 We explained in the Consultation Paper that it is currently unclear whether, under the "without unit owners" registration procedure, the developer will be able to exercise the votes attached to all units of which it is the registered owner. On one interpretation of the 2002 Act, developers would only own one vote altogether, and not the total number of votes allocated to the units that they retain. Following our recommendation above to remove the "without unit owners" registration procedure, this concern falls away. Under the single registration procedure that will remain, it will be clear that the developer will be able to exercise all the votes allocated to the units that they retain.

9.94 We also expressed the view in the Consultation Paper that the developer should only be able to exercise the votes which are attached to his or her commonhold units, and should not be able to exercise the votes of other unit owners. We proposed the introduction of "anti-avoidance" provisions to ensure that the developer does not attempt to secure a greater degree of control than that given by the legislation.

### Consultees' views and recommendations for reform

9.95 Almost all consultees agreed with our proposal to introduce anti-avoidance provisions which would prevent developers from requiring unit owners to allocate their votes to the developer. The only consultees who disagreed with our proposal to introduce anti-avoidance provisions did so for the reason that developers need to be able to control voting rights and directors for the duration of development in order to be able to complete the planned development.

9.96 For the reasons set out above, we disagree with this argument. Our regime has been carefully considered to balance the legitimate needs of the developer with protections for unit owners. We think this balance would be undermined if anti-avoidance provisions were not in place. We are concerned that some developers would seek to obtain a greater degree of control than that afforded by our scheme.

9.97 We therefore recommend that anti-avoidance provisions should be introduced to prevent developers from securing a greater degree of control over the commonhold than is provided by our revised regime.

**Recommendation 36.**

9.98 We recommend that "anti-avoidance" provisions should be introduced to ensure that a developer does not attempt to secure a greater degree of control by:

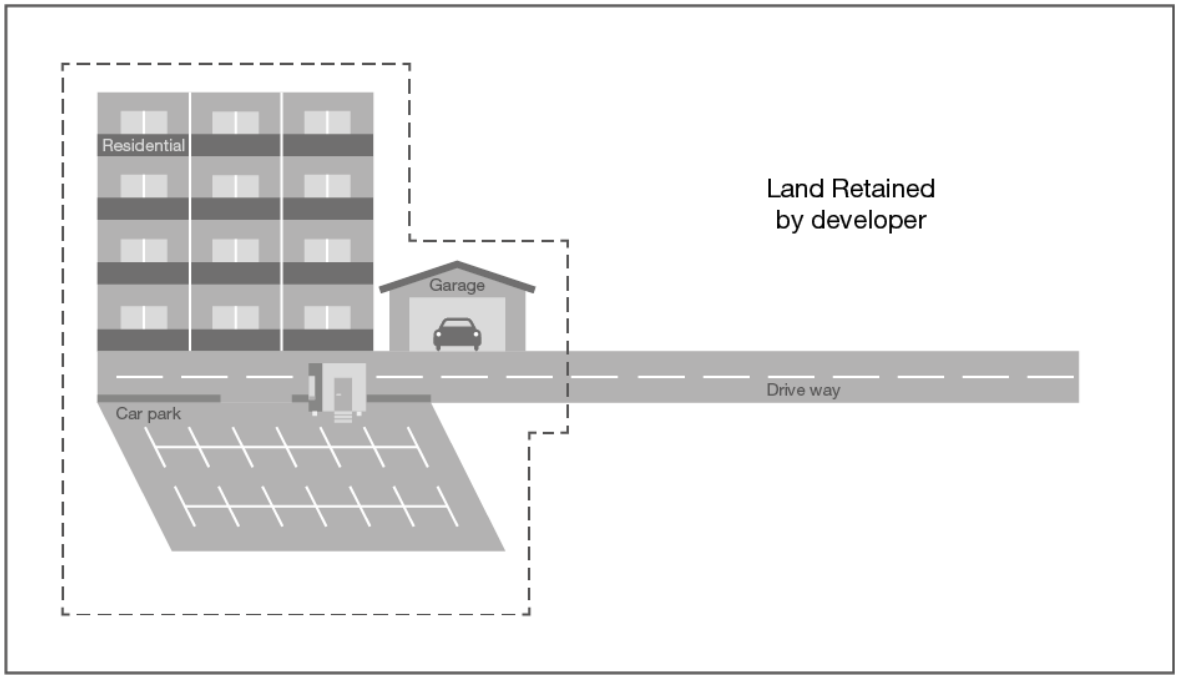
(1) taking powers of attorney from the purchasers of commonhold units (or seeking to control votes in any other way); or

(2) attempting to control how unit owners vote by inserting terms in the purchase contracts.

## WORKED EXAMPLE OF OUR REVISED SCHEME

9.99 Below we provide a simple worked example to demonstrate how our revised scheme would enable the developer to build a commonhold development in phases.

**Phase 1**




In this example, the developer wishes to build a residential development in two phases. The first phase, depicted above, includes a block of 12 flats with access to a garage and a car park.

After building phase 1, the developer registers phase 1 as a commonhold. The area of land comprised within the commonhold (shown outlined above) includes the outline of the building, the garage and car park.

On the sale of the first unit in phase 1 (flat 1), the common parts within phase 1 (that is, the common parts falling within the outlined area), are registered in the name of the commonhold association. The purchaser becomes the unit owner in respect of flat 1. In decisions of the commonhold association, the owner of flat 1 can exercise 8% of the votes of the association.[20] The developer remains the registered unit owner in respect of the other 11 flats and can exercise the remaining votes of the association. The developer would therefore, at this stage, retain control over the association and could, for example, appoint his or her own directors. The developer could not require the owner of flat 1 to sign a power of attorney allowing the developer to exercise the owner's voting rights.

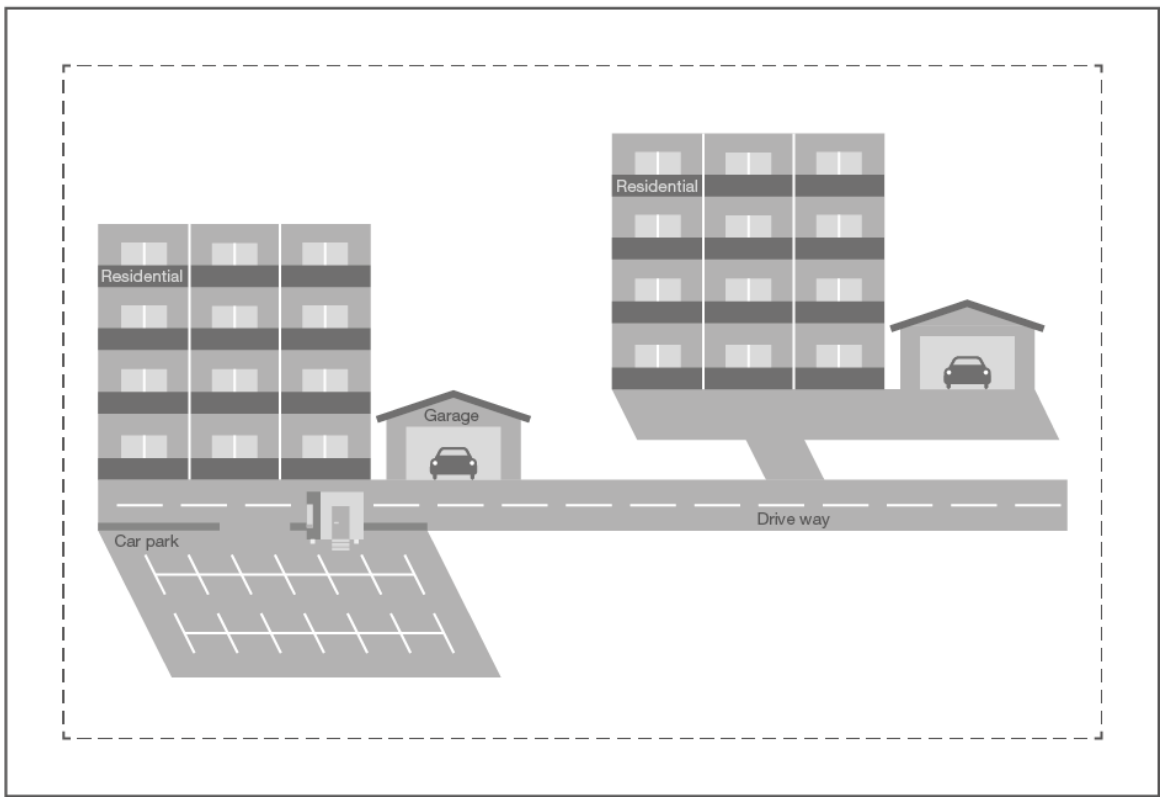
The developer would retain all the land falling outside of the commonhold which he or she would be free to develop. The developer grants the owner of flat 1 access rights over the driveway in order to access flat 1. The developer could require the commonhold association to pay towards the costs of maintaining the driveway, and these costs can be passed down to any unit owners in the building.

The developer may also decide to reserve certain rights to make changes to the commonhold in phase 1 to facilitate subsequent development. For example, the right to add subsequent phases to the commonhold and to make any necessary changes to the CCS. However, the developer would only be able to exercise these rights for a purpose related to the completion of the development or the marketing and sale of units.

The developer then sells six more flats. The seven new homeowners would now collectively own around 60% of the votes of the association, sufficient for most decisions of the commonhold to be carried. The homeowners could decide to replace the directors put in place by the developer.

[20] On the assumption that votes are shared equally in the development, which they may not be in practice (eg to take into account floor space).

## Phase 2




The developer completes phase 2 of the development. The developer applies to extend the area of land falling within the commonhold to include phase 2 (shown outlined above).

The developer may need to make certain changes to the existing commonhold to incorporate the subsequent phase. However, in exercising any rights to make changes, the developer must not interfere unreasonably with phase 1 unit owners' enjoyment of their properties or their rights granted in the CCS. For example, where a unit owner in phase 1 has been granted a right to use the car park in the CCS, he or she may challenge a decision to reassign all car parking spaces to the unit owners in the second phase, in order to make the subsequent phases more attractive.

All the common parts within the development will fall within the ownership of one commonhold association. The developer could create separate sections (see Chapter 8) for phases 1 and 2 so that only decisions which affect the particular phase can be voted on and paid for by those within the particular phase.

### CONCLUSION

9.100 Our recommendations in this chapter will enable commonhold to be used for developments which are constructed in phases. The improved system of non-statutory development rights will enable developers to reserve the rights they need, while protecting unit owners against abuse. Our recommendations will also give greater certainty to both developers and unit owners over when the exercise of a development right can be challenged, and on what basis.

# Part IV: The commonhold community

# Chapter 10: The commonhold community statement

## INTRODUCTION

10.1 The commonhold community statement (the "CCS") plays a central role in every commonhold. It is the commonhold's "rule book", governing the rights and obligations of the commonhold association and the unit owners. The CCS sets out the values and ideas that govern a particular commonhold. The CCS also defines the extent of the commonhold land and describes the boundaries between the commonhold units and the common parts.

10.2 The CCS performs a similar function to a lease, but enjoys several advantages.

(1) To a large extent the CCS is a standardised document. Legislation prescribes both the format of the CCS and the rules that must be contained within it. This high level of standardisation simplifies the conveyancing process and improves consumer understanding of commonhold. As the main terms of the CCS are prescribed in legislation, it can easily be updated to accommodate changing needs.

(2) There is flexibility to include rules in a CCS which are tailored to the community. These bespoke provisions are referred to as the "local rules". It is the local rules that give a commonhold its unique character. Through local rules a developer, or commonhold association, can codify the ethos of a particular commonhold. For example, a commonhold might style itself as an environmentally sustainable block of flats.

(3) The main rights and obligations of all parties in a commonhold are set out in one document. This differs from the position in leasehold. Leaseholder's rights and obligations are set out in their own lease, and the terms of the leases in the block might be contradictory to one another.

10.3 Given the important role played by the CCS, the document needs to function as effectively as possible. In this chapter, we make recommendations that will make the CCS a more transparent and easy to navigate document. Our recommendations will also ensure that the CCS provides unit owners and other occupants with certainty as to their rights and obligations, while retaining sufficient flexibility to meet their needs.

## PROBLEMS WITH THE CURRENT LAW

10.4 Within commonhold, the advantages of standardisation and flexibility are in competition. A standardised CCS provides unit owners with certainty and will simplify the conveyancing process. However, at the same time, the CCS needs to be sufficiently flexible to both give unit owners the ability to effectively self-govern and to cater for the needs of all commonholds, which may vary substantially in size or character.

10.5 The current commonhold legislation has been criticised for failing to strike the correct balance between standardisation and flexibility in two respects.

10.6 First, as to the content of the local rules that can be included within a CCS. Local rules can only be added where they do not contradict the prescribed rules. However, in certain areas, it is unclear whether a local rule is permitted or not. In particular, it is currently unclear whether unit owners can include a local rule prohibiting short-term letting or a local rule requiring the payment of an event fee.[1]

10.7 Second, as to how the local rules may be varied by unit owners in the future. Currently most local rules in the CCS can be added or amended by an ordinary resolution, meaning that over 50% of the votes cast must be in favour of the amendment.[2] In response to the Call for Evidence, several consultees said that it was currently too easy to make changes to the local rules contained in the CCS, which may have a significant impact on the unit owners.

10.8 Additionally, we have identified problems with the transparency of the CCS. Currently, aa CCS is capable of binding both unit owners and their tenants. However, as not all provisions in the CCS do in fact bind tenants, it is not always clear when, and by what rules, tenants are bound. This lack of clarity introduces uncertainty for tenants, their landlords, the commonhold association and any other interested unit owner who would seek to enforce rules against a tenant.

10.9 A fourth issue that we identified with the CCS is cosmetic, but still of some importance. Because of the mixture of standard provisions and local rules in the CCS, it is not always easy for consumers to navigate the CCS and work out what content is most relevant to them.

10.10 We make recommendations to strike a better balance between flexibility and standardisation (both in respect of the terms that may be included in the CCS at the outset and how it may be amended subsequently), to improve transparency for tenants and other occupants, their landlords and the commonhold association and to reform the layout and presentation of the CCS to improve consumer understanding. We begin with considering the terms that may be included in the CCS.

## THE CONTENT OF THE CCS

10.11 The CCS contains three kinds of provision.

(1) Provisions prescribed by legislation.[3] These provisions are standardised across all commonholds and cannot be amended. The prescribed provisions are provided for in the form of a "model CCS" annexed to the Commonhold Regulations 2004 (the "Commonhold Regulations").

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1 Event fees are fees that are payable on the occurrence of a specified event, such as on the sale of a unit or the grant of a tenancy.

2 In Ch 11 we make recommendations in respect of permissible leases in commonhold. Where appropriate, references to unit owners voting should be taken to include leaseholders that we recommend should be given voting rights in commonhold. See Recommendations 48 and 51.

3 Commonhold Regulations 2004, sch 3.

(2) Provisions which are specific to a particular commonhold and which must be inserted into the CCS in order for the commonhold to operate. The model CCS prescribes the format in which this information must be provided. For example, Annex 3 of the CCS requires those establishing a commonhold to insert the percentage votes allocated to each unit owner into a table.

(3) Other provisions which are unique to the particular commonhold, over and above those which must be inserted into the CCS. These rules can cover a wide range of subjects or issues. For example, a commonhold might have a rule preventing washing from being hung outside or might prescribe the colour that doors should be painted.

10.12 Together, the second and third category of provision are known as a commonhold's "local rules".

10.13 Unlike the prescribed rules (category one above), local rules can be amended, and therefore provide a commonhold with flexibility. There is wide scope for those drafting the CCS to include different local rules tailored to a community's specific needs. However, the drafters of the CCS do not have complete freedom when choosing local rules. Currently, local rules are restricted in three respects.[4]

(1) Local rules cannot conflict with the prescribed terms of the model CCS, with the Commonhold and Leasehold Reform Act 2002 (the "2002 Act"), the Commonhold Regulations, or with the commonhold's articles of association.[5]

(2) Local rules cannot provide for the transfer or loss of an interest in land on the occurrence or non-occurrence of a specified event.

(3) Local rules cannot place any limit on the ability of a unit owner to create, transfer or grant an interest in his or her unit.

10.14 While it is evident that the third restriction means that a local rule could not prevent a unit owner from selling his or her property, or granting a mortgage over his or her unit, other effects of this restriction are less clear. In particular, it is unclear whether the third restriction prevents the inclusion of a local rule banning short-term letting or requiring the payment of event fees on the sale of a commonhold unit.

10.15 In the Consultation Paper, we asked consultees how these two points of uncertainty might be resolved.[6] We also asked consultees whether any further restrictions on the content of local rules might usefully be introduced or whether any more prescribed terms should be included within the model CCS.

### Prohibiting short-term letting

10.16 Under the current law, it is unclear whether unit owners can choose to restrict certain types of lettings, such as short-term or holiday lets (including Airbnb), in the CCS. In

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4 See CP, para 8.12.

5 See Glossary.

6 CP, Consultation Question 35, paras 8.35 to 8.36.

the Consultation Paper, we explored whether the law should be clarified either to permit or to prevent such a restriction being included in a commonhold's CCS.[7]

10.17 On the one hand, preventing a unit owner from granting a tenancy of their property might seem inconsistent with freehold ownership. On the other hand, many commonholds will be blocks of flats where individuals are living in close proximity to one another. Short-term lets granted by unit owners in such commonholds can become a source of friction with other owners. Short-term lets may cause nuisance, create security risks, impact the value of other units or lead to damage of the common areas. On balance, our view in the Consultation Paper was that unit owners should be given the flexibility to decide whether or not to restrict short-term letting within their particular commonhold.

10.18 However, as the focus of concern appears to lie with short-term letting rather than other types of tenancy (such as assured shorthold tenancies), we wished to ensure that any restriction would not impact on unit owners' ability to let their homes in the private rented sector. In the Consultation Paper we took the view that, due to the important role rental accommodation plays in meeting housing demand in England and Wales, the private rented sector should be protected so far as possible. Additionally, a unit owner, may, for example, buy a commonhold unit as a home, but for an unexpected reason might wish to let out his or her unit for a period of time. As a way of addressing this difficulty, we suggested that the ability to impose restrictions might be confined to lettings of less than six months. The vast majority of assured shorthold tenancies are granted for periods of six months or more, and would therefore fall outside the scope of any restriction.

10.19 We also asked consultees to consider if the social rented sector should be excluded from the proposed ability to prevent lets of less than six months.[8] Many social housing providers provide emergency accommodation to vulnerable people on a short-term basis and we were concerned that such valuable practices should not be frustrated.

### Consultees' views

10.20 The vast majority of consultees agreed with our provisional proposal that it should be possible for a commonhold to impose restrictions on the short-term letting of units in their CCS. Consultees agreed that short-term lettings can be a major source of friction between neighbours. Some consultees provided evidence of the types of problem that short-term tenants have been known to cause. David Silverman (leaseholder) said:

> In the past there has been people being sick on others' doors, one time some group of guys rented an Airbnb and smashed the lift up, other times rubbish was left in the communal hall and outside on the street. Someone urinated from a balcony down on to one of the residents' balconies!

10.21 The Property Litigation Association (the "PLA") confirmed that short-term lettings are a major source of disputes within leasehold blocks and agreed that it should be open to unit owners to prevent such lettings in commonhold.

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7 CP, para 8.28 to 8.36.

8 CP, Consultation Question 35, para 8.36(2).

> Short-term lettings, empty residential properties and liability for the cost of shared areas can together be a major source of disputes between landlords and tenants (and by analogy) between unit owners and a commonhold association. It should therefore be in the power of the commonhold association by its members to impose such restrictions in their discretion.

10.22 Martin Wood (solicitor) noted that it is not uncommon to find restrictions on short-term letting in leasehold developments and that it is a legitimate issue for unit owners to wish to control.

10.23 Some consultees disagreed with our provisional proposal and maintained that it should never be possible for a CCS to restrict unit owners' ability to let out their units. Consultees pointed out the benefits of short term letting and argued that restrictions of any kind erode basic principles of freehold ownership. Thomas Bygott commented:

> Renting is by its nature a short-term form of housing. Lettings of less than six month have a valid place in the economy, for example where people are working temporarily far from home, or are in the process of purchasing a property.

10.24 A few other consultees disagreed with our provisional proposal on the basis that issues stem from how tenants use the property, rather than from the length of a letting. Of those consultees, many argued that it would be more effective to either regulate the holiday rental market or to allow commonhold associations to only target holiday lets in any restriction, rather than lettings of less than six months. As Trowers & Hamlins LLP (solicitors) explained:

> The difficulties often do not seem to arise from the length of letting but from the nature of the user. Constraints should perhaps be as to user rather than length of letting.

### Length of tenancies which may be restricted

10.25 With regards to the period for which it should be possible to restrict short-term lettings, we suggested that it should only be possible to restrict lettings of less than six months to ensure that any potential restriction on letting within a commonhold does not unduly interfere with the private rental sector. Many consultees supported the six-month limit. The Leasehold Advisory Service ("LEASE") said:

> As an assured shorthold tenancy is, normally, for a minimum of 6 months, this would seem an appropriate length to stipulate. Accordingly, the CCS restriction should be confined to lettings of less than 6 months.

10.26 Several consultees said that enabling unit owners to restrict lettings of less than six months was too severe because lettings of less than six months "are encountered not infrequently". These consultees considered that allowing the CCS to restrict lettings of up to 90 days would be more proportionate.

10.27 Many consultees referred to the Deregulation Act 2015 (the "Deregulation Act") as a basis for a 90-day restriction. The Deregulation Act provides that a person who wants to use residential premises in Greater London to offer temporary sleeping accommodation for less than 90 days in a year will not need planning permission to do so. The City of London Law Society suggested:

> Rather than outlaw short-term lets it might be preferable to preserve the flexibility and benefits of being able to grant short term lets but at the same time tackle the negative impacts by increasing the regulation of the holiday let market […]. Measures are already in place in London which means that the total number of nights that a residential property is used for short term letting cannot exceed 90.

### An exception for the social rented sector

10.28 Several consultees commented that registered providers of social housing should not be restricted in their ability to let units for the short term. The All-Party Parliamentary Group on Leasehold and Commonhold Reform (the "APPG") emphasised the importance of preserving social landlords' ability to deal with their units freely. Irwin Mitchell LLP (solicitors) said:

> It would not be acceptable to a registered provider taking space in part of the scheme to be told in future that the CCS had been amended to prevent them from renting out their units, or that rules had been introduced or amended to address actual or perceived behaviour of the social housing tenants […].

10.29 The Guinness Partnership (housing association) commented that registered providers of social housing should be exempt insofar as short-term tenants are placed in a unit for the purposes of providing them with affordable accommodation:

> Registered providers of social housing and housing associations should be exempt from any restrictions, so long as the use of the unit is in accordance with the provision of affordable housing and not any separate commercial activity (i.e. private renting) that the provider may engage in.

10.30 Consultees who did not think that registered providers of social housing should be exempt from any restrictions did so because of concerns over the behaviour of social housing tenants or because of concerns with social housing more generally.

### Discussion and recommendations for reform

10.31 Consultees who provided anecdotal evidence of their experiences with short-term lets highlighted how contentious they can become. Recent experiences in New South Wales further demonstrates the tension that short-term letting can foster in blocks of flats, as well as the desire of many unit owners to control this type of letting.[9] In New South Wales, feedback from unit owners have led to reforms that once commenced will make it possible to restrict non-resident unit owners' ability to use their units for short-term rental accommodation.[10]

10.32 The vast majority of consultees agreed with our provisional proposal that legislation should not impose a blanket ban on short-term lettings in all commonholds. We consider that commonhold associations should have the choice to restrict short-term lettings by inserting a local rule in the CCS to that effect. If a restriction on short-term

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9 In 2017 the New South Wales' Department of Customer Service and Department of Planning, Industry and Environment published an options paper requesting feedback on proposed reforms to the New South Wales strata title scheme dealing with short-term holiday lets. The options paper and related feedback are available online (http://planspolicies.planning.nsw.gov.au/index.pl?action=view_job&job_id=8525).

10 Fair Trading Amendment (Short-term Rental Accommodation) Act 2018 No 41.

letting is included in the CCS from the outset by the developer, then unit owners buying into the commonhold will purchase their unit on the understanding that holiday lets are restricted. For many unit owners this will be an advantage, rather than a detriment. Furthermore, if problems emerge in the future, a vote of the commonhold association can lift (or impose) a restriction.

10.33 It would also be open to the drafters of the CCS to frame a local rule limiting short-term lettings in a way that works for that particular commonhold. For instance, the commonhold would be free to attach conditions or include exceptions to any rule restricting short-term letting.

10.34 A direct consequence of unit owners living in close proximity with one another is that unit owners have a legitimate interest in choosing to impose local rules that might impact on their own freedoms as freehold owners. For example, it is sensible for unit owners seeking to minimise nuisances to make rules stipulating the hours within which noise should be kept at a minimum. Additionally, unit owners must contribute to the costs incurred by the commonhold association in it fulfilling its obligations to repair and maintain common areas.[11] Short-term lettings can increase the pressure placed on common areas, increasing the cost of repairs. We understand that some unit owners will want to be able to take steps to minimise pressure placed on shared facilities and the risk of nuisances associated with short-term tenants. Giving unit owners the choice to restrict short-term lettings would provide unit owners with greater flexibility to achieve these goals.

10.35 We note consultees' comments that we should focus on the conduct of the occupants, rather than the length of the letting. While we agree that disruptive behaviour should be targeted in the CCS, regardless of the type of occupancy, we think that specific issues arise out of the short-term letting of units. For instance, frequent changes of occupant impact on the security of a building. Moreover, enforcing restrictions against short-term occupants will be difficult for the commonhold association. It is more effective in these cases to give the commonhold association the power to simply restrict short-term lettings.

### Length of tenancies which may be restricted

10.36 We turn now to consider the maximum length of letting that it should be possible for the CCS to restrict.

10.37 Several consultees suggested it should only be possible to restrict tenancies of up to 90 days, citing the Deregulation Act. However, in our view, the Deregulation Act does not address what developers, or commonhold associations, will want to achieve by a restriction on short-term letting. The effect of the Deregulation Act was to relax the rules on short-term letting in Greater London, by removing the need for planning permission for very short-term letting. Rather than banning lets of fewer than 90 days, the Act permits them, so long as the total number of days for which the property is let in a calendar year does not exceed 90. By contrast, if a commonhold wanted to restrict letting, it is likely to want the freedom to restrict all short-term letting, rather than permitting short-term lettings for a specified period every year.

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11 See para 13.1.

10.38 In any event, by reforming the current law to allow the CCS to restrict lettings for up to (but not including) six months, commonholds would have the flexibility to set their own limits. It will then be up to individual commonholds to choose where to draw the line, if a restriction is imposed at all. A commonhold association could impose a limit of up to 90 days, if appropriate. The majority of consultees supported giving unit owners the flexibility to choose where to draw the line, so long as it was shorter than six months.

10.39 By enabling commonholds to prohibit only lettings made for a period of less than six months, our recommendation ensures that the vast majority of assured shorthold tenancies, commonly used in the private rental sector, are not captured by the restriction. Our recommendation will therefore ensure that the private rental sector is not unduly impacted by any commonholds choosing to restrict short-term lettings.

### An exception for the social rented sector

10.40 In the Consultation Paper, we took the view that our recommendations should not prevent or restrict registered providers of social housing from providing vulnerable people with emergency accommodation. To this end, we sought consultees views on whether registered providers should benefit from a statutory exemption from any restrictions placed on short-term letting by a commonhold association, should our provisional proposal, set out at paragraph 10.19, be taken forward.[12]

10.41 Most of the consultees who responded thought that it should not be possible to restrict the activities of registered providers of social housing for this precise reason. In contrast, consultees who did not think an exemption should be made for social landlords did so because of concerns with social housing more generally or because of concerns over the behaviour of social tenants.

10.42 For the reasons set out from paragraph 10.28 above, we recommend that any restriction placed on short-term lettings in a particular commonhold should not extend to those bodies who are performing housing functions by or on behalf of a local authority, which include registered providers of social housing when letting units for the purposes of providing affordable and/or emergency housing.

10.43 Consultees did not provide much commentary on whether any additional class of unit owner should be exempt from any restrictions placed on short-term letting in a CCS. However, we are of the view that it may be necessary to expand this category in the future. For example, it might be necessary to widen the scope of protection to cover certain charities providing shelter to vulnerable groups. For this reason, we recommend that the Secretary of State should be given a rule-making power to provide for additional exceptions to any restriction on short-term lettings in a CCS.

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12 CP, Consultation Question 35, para 8.36(2).

**Recommendation 37.**

10.44 We recommend that it should be possible for a CCS to impose restrictions on the use or occupation of units and on lettings of less than six months.

10.45 We recommend that it should not be possible for a CCS to restrict the short-term letting of units by certain bodies who are responsible for the provision of temporary or emergency accommodation and that the Secretary of State be given the power to determine whether additional categories of unit owner should benefit from such an exemption in future.

## Restricting event fees

10.46 "Event fees" are sums which become payable on the occurrence of certain events, such as on the sale of a property or when a property is let.[13] In the leasehold context, event fees might be payable to the freeholder, the developer or the managing agents. Of the commonholds already in existence, one has included an event fee in its CCS which requires unit owners to pay 0.75% of the proceeds of sale of the unit into the commonhold's reserve fund. However, as we explained in the Consultation Paper, it is not clear whether event fees are actually permitted in commonhold under the current law.[14] A requirement to pay a fee out of the proceeds of sale of a unit might be viewed as a restriction on a unit owner's ability to sell his or her property and, as we have explained in paragraph 10.13(3) above, such restrictions are prohibited by the 2002 Act.

10.47 We considered it necessary to resolve this lack of certainty within the current legislation, causing us to review whether event fees have any place within the commonhold model. As explained in our report on event fees in retirement properties, event fees have proven highly controversial within leasehold.[15] In particular, they have been criticised for not being transparent, as leaseholders are not always fully aware of the existence or implications of an event fee when buying a leasehold property. One of our aims in reforming the commonhold legislation has been to prevent, so far as possible, abuses which have arisen within the leasehold sector from arising within commonhold. We were particularly concerned that a developer might include a requirement in the CCS for fees to be paid to him or her, despite having no ongoing role in respect of the commonhold.

10.48 Additionally, in the majority of commonholds, we did not think that there would be an incentive or need for event fees, because we recommend the introduction of mandatory reserve funds in Chapter 14. However, we acknowledged that event fees might serve a useful purpose in the retirement housing sector as a way of making accommodation and specialist services affordable for older people who are often "asset rich but cash poor". Our report on event fees in retirement properties explored how event fees should be regulated in order to preserve the benefits that these fees

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13 Event Fees in Retirement Properties (2017) Law Com No 373, para 3.10 to 3.12.

14 CP, para 8.38.

15 Event Fees in Retirement Properties (2017) Law Com No 373, paras 1.8 to 1.13 and 2.2 to 2.10.

can offer consumers in the retirement context while mitigating the risks posed by event fees.[16]

10.49 In the Consultation Paper we therefore provisionally proposed that event fees should not be permissible in commonhold, except in specific circumstances expressly provided for in statute. We then asked consultees to consider whether, if we were to recommend a ban on event fees, an exception should be made for specialist retirement properties or in any other circumstance.[17]

### Consultees' views

10.50 The vast majority of consultees agreed with our provisional proposal to ban event fees in commonhold.

10.51 Several consultees were particularly concerned that event fees could be used unfairly to generate an income for third-parties, such as the former freeholder following a conversion to commonhold or a commonhold's developer.

10.52 Some consultees said that event fees are often poorly understood by consumers in leasehold properties and that this lack of transparency should not be carried over into the commonhold model. In a joint response some members of the London Property Support Group (the "joint response") said:

> Such fees would introduce a further layer of complexity for unit holders and mean that unit holders do not have full transparency as regards the costs they will incur.

10.53 Other consultees agreed with our view that event fees were unlikely ever to become necessary in commonhold if unit owners were required to make contributions to a mandatory reserve fund.

10.54 The very few consultees who disagreed with the proposal argued that event fees could be useful in commonhold, because such fees can be used to subsidise the cost of major works programmes or the provision of expensive services.

10.55 As to whether there should be an exception to any potential ban on event fees, several consultees argued in favour of permitting an exception for specialist retirement properties. Associated Retirement Community Operators ("ARCO") emphasised that event fees were crucial to its ability to care for its residents.

> Event fees are however vital for the financial viability of long-term business models such as ours and help to make it viable for such communities to offer care and other services in an integrated manner in a way which is convenient for our residents.

10.56 Irwin Mitchell LLP and FirstPort (managing agents) highlighted that specialist retirement homes are different from many other residential communities in that they often provide additional services and specialist facilities, such as communal living spaces or nursing care. The Residential Landlords Association said that event fees

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16 Event Fees in Retirement Properties (2017) Law Com No 373.

17 CP, Consultation Question 36, para 8.43.

were also an important source of income for properties catering for those who are disabled or vulnerable.

10.57 However, some consultees thought event fees should be banned in all commonholds. The National Leasehold Campaign said:

> By continuing to give [specialist retirement homes] exemptions you give credibility to a business model that is used to exploit vulnerable consumers. Specialist retirement developers have proved time and again that they are incapable of doing the right thing unless put under considerable pressure.

### Discussion and recommendations for reform

10.58 Event fees provide scope for abuse that should be avoided within the commonhold model. Given the strong support for our provisional proposal, we recommend that event fees should be prevented within commonhold, save for any specific exceptions set out in statute. It will therefore not be possible to include a local rule in the CCS which requires the payment of an event fee unless it falls within the scope of any exception.

10.59 We note that some consultees argued that event fees could be used as a way of subsidising the costs of running a commonhold. However, in most cases, it will not be practicable for the commonhold association to finance its costs in this way. The payment of event fees will, by their nature, be unpredictable. The association will not know, for example, when a unit owner is planning to sell his or her property and will not be able to factor the receipt of event fees into the association's annual budget. The commonhold model assumes that there will not be an external party who is able to cover the commonhold's costs while awaiting the payment of any event fees. A commonhold association should not operate on a deficit in the hope of recouping monies spent on projects through event fees at a later point. Instead, regular payments into a reserve fund will help the commonhold association afford larger items of expenditure or projects over time, and we recommend that the use of reserve funds should be made mandatory in Chapter 14.

10.60 In our report on event fees we highlighted the role that event fees play in the specialist retirement sector.[18] Event fees in the retirement sector can provide an additional source of funding for specialist services, while making retirement homes more affordable for their occupants. Our report on event fees noted that event fees both facilitate the supply of specialist retirement housing and can enable consumers to enjoy a better standard of living in the retirement sector, and consultees' views echoed that view. We therefore recommend that event fees in the retirement sector should be exempt from any prohibition of event fees in commonhold. Consideration would need to be given as to the most appropriate mechanism for facilitating the use of event fees in commonhold, in light of the questions that retirement housing providers have raised in relation to how retirement properties will be accommodated within commonhold. The recommendations made in our separate report on event fees, which aim to make event fees more transparent and fair for consumers, should extend to event fees granted in the retirement sector.

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[18] Event fees in retirement properties (2017) Law Com No 373, para 2.11 onwards.

**Recommendation 38.**

10.61 We recommend that event fees should be prohibited within commonhold, subject to an exemption for specialist retirement properties.

### Additional restrictions on the contents of local rules

10.62 We asked consultees whether there should be any additional restrictions on the contents of local rules that can be included in the CCS.[19]

#### Consultees' views and discussion

10.63 Most consultees responded that no further restrictions on the contents of local rules that can be included in the CCS should be imposed. Those in favour of imposing further restrictions did not provide substantive suggestions. We therefore do not consider there to be sufficient grounds on which to impose any further restrictions on the local rules that may be included in the CCS. If, in the future, it becomes apparent that further restrictions would be desirable, it will be possible for Government to amend the model CCS through secondary legislation.

### Additional mandatory terms of the CCS

10.64 We also sought consultees' views on whether any additional mandatory terms should be included in the standardised provisions of the CCS and therefore apply to all commonholds.[20]

#### Consultees' views and discussion

10.65 Of the few consultees who suggested additional prescribed terms, most suggested terms falling into one of the following categories:

(1) terms governing noise controls or nuisance;

(2) terms requiring an independent regulator to attend board meetings of the commonhold association; or

(3) terms prescribing rights of access for the commonhold association over individual units.

10.66 Having considered each of the above suggestions, we have concluded that it is preferable not to add any further prescribed terms to the CCS.

10.67 Most modern leases contain restrictions on noise within certain hours or address other nuisances. It is currently open to developers, or commonhold associations, to set their own rules on noise or nuisance in the CCS. These bespoke rules are more likely to be suited to a commonhold's circumstances than a general prohibition. We consider it

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19 CP, Consultation Question 37, para 8.47.

20 CP, Consultation Question 41, para 8.83.

preferable, for example, to provide unit owners with the freedom to select noise controls that work for them, rather than imposing a certain minimum standard.

10.68 The APPG suggested that an independent regulator should attend board meetings of commonhold associations to ensure that meetings proceed in compliance with company law. We think this would place a disproportionate administrative burden on smaller commonholds. There is currently no such requirement for resident-owned management companies and the imposition of greater regulatory burdens on the directors of a commonhold association could make commonhold a less attractive option for prospective purchasers and for leaseholders looking to convert to commonhold.

10.69 The subject of access rights is discussed in more depth in Chapter 12 from paragraph 12.209. On balance we have concluded that developers, or commonhold associations, are best placed to draft bespoke access rights if they are needed for the commonhold association to carry out its repairing and maintenance obligations.

## VARYING THE CCS

10.70 We now consider how the local rules of the CCS might be varied. We make recommendations in respect of:

(1) the voting threshold required to vary the local rules of the commonhold;

(2) the rights of unit owners to challenge a variation; and

(3) the circumstances in which a unit owner's specific consent should be required before the CCS may be varied.

### The voting threshold to vary local rules

10.71 Commonhold is intended to operate as a democracy and most local rules of the CCS can be changed with the support of a simple majority of votes cast by unit owners. In response to our Call for Evidence, a number of consultees argued that it is currently too easy to change the local rules of the CCS. While some changes might not have a significant impact on owners, other amendments to the CCS could affect how owners are able to use their own freehold properties.

10.72 In the Consultation Paper, we therefore provisionally proposed that the voting majority to amend local rules in the CCS should be raised from an ordinary resolution to a higher threshold.[21] We explained how a relatively small proportion of unit owners can currently impact the entire commonhold by approving an amendment to the CCS.[22] We considered that raising the voting threshold for amendments would protect the certainty of purchasers, who buy into a commonhold on the basis of the local rules in place at the point of purchase.

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21 CP, para 8.68.

22 CP, figs 21 and 22. That is because only 20% of the unit owners need to attend the meeting in order for the meeting to be quorate, and only 50% of votes cast at that meeting would need to be cast in favour for the decision to be carried.

10.73 We asked consultees whether the threshold should be raised, and asked what higher voting threshold should apply to amendments to the local rules of the CCS. A range of options were presented to consultees, reflecting the thresholds required elsewhere in the commonhold legislation. These were:

(1) a special resolution;[23]

(2) the agreement of 80% of all unit owners; or

(3) a unanimous resolution.[24]

We also asked consultees whether the threshold should be the same for amending all local rules, or whether some local rules should require a higher level of support to amend than others.[25]

### Consultees' views

10.74 Well over half of the consultees responding said that it is currently too easy to make changes to the CCS. Consultees agreed that, given the CCS plays a key role in defining the character of a commonhold, and can affect how a person uses his or her unit, changes to local rules should not be made without strong support. Consultees thought a higher threshold of support was necessary to protect unit owners' expectations on buying a commonhold unit. The Association of Residential Managing Agents ("ARMA") said:

> People will be buying into a commonhold on the basis of the CCS and local rules at the point of sale. There needs to be some certainty that those rules will not be changed lightly […] The emphasis should be on getting the rules right in the CCS upon formation of the commonhold. Later changes could have a material effect on people (banning pets for example) and should require a special written resolution to ensure that non-resident owners are heard.

10.75 Damian Greenish (solicitor) pointed out that rules should not be varied lightly, because rules in the CCS can impact the value of individual units. Consensus Business Group (landlord) commented that unit owners should be advised to obtain external advice on the effect of an amendment on the future marketability of their units. Consensus Business Group also suggested that a high voting threshold might protect unit owners from internal conflict.

> We are concerned that amendments could be made to the detriment of a minority of unit holders. As stewards of a substantial portfolio of freeholds we frequently encounter problems where leaseholders complain of bullying by assertive and domineering individuals.

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[23] For a special resolution to be approved by the commonhold association, either (a) 75% of all unit owners must vote in favour using a written voting procedure or (b) 75% of votes of those attending a meeting must be cast in favour, and least 20% of all unit owners must attend the meeting for it to be quorate.

[24] For a unanimous resolution to be approved by the commonhold association, either (a) all unit owners in the commonhold must vote in favour using a written voting procedure or (b) all unit owners present at a meeting, attended by at least 20% of unit owners, must vote in favour of that resolution.

[25] CP, Consultation Question 38, paras 8.68 to 8.69.

10.76 Those who disagreed with the proposal thought that the requirement for an ordinary resolution worked well, as amendments to the CCS can be undone as easily as they can be made. Other consultees were concerned that a higher voting threshold would make it very challenging for the commonhold association to amend the CCS. The Guinness Partnership (housing association) suggested that "the biggest barrier many commonhold associations may face will be lack of engagement". ARMA, although in agreement with our proposal, voiced concern over our survey of existing unit owners, from which we ascertained that, even with the existing threshold of a simple majority of votes cast, no commonhold surveyed had succeeded in amending its CCS.

### Setting a higher threshold

10.77 In respect of what higher threshold might apply, the most popular selection was a special resolution. For example, the PLA said:

> We consider that it would be reasonable to adopt a regime under which the equivalent of a special resolution has to be passed in order for specific categories of local rule to be amended by the commonhold association.

10.78 Three consultees went further. They said that it should not be possible to change any local rules without the unanimous support of unit owners. Martin Wood felt strongly that any threshold falling short of unanimity would be an unacceptable interference with a unit owner's freehold title. He said:

> I profoundly disagree with the basic premise underpinning these ideas: that because getting unanimous consent may be difficult, there must be some lower threshold. Why? You can't amend a lease without the lessee's consent, and these rules are essentially the equivalent of lease terms. People should not have the terms of their tenure altered without their consent.

### Differentiating between local rules

10.79 Most consultees said that the same voting threshold should apply to all local rules.

10.80 Of these, several consultees argued strongly that differentiating between local rules would make commonhold overly complicated for consumers. ARMA commented that differentiation introduces complexity at two levels: at the drafting stage and again during the management of the commonhold.

10.81 The Chartered Institute of Legal Executives ("CILEx") agreed with ARMA:

> CILEx is conscious that creating subdivisions in local rules, with different voting thresholds applied for different categories of rule, would overcomplicate the system making it harder and more inaccessible for the average homeowner to navigate. This could have the inverse effect of what commonhold is trying to achieve: stifling rather than liberating the ability for homeowners to have a say over their properties and how they are managed.

10.82 The Federation of Private Residents Associations (the "FPRA") added that recommending a right to apply to the Tribunal would obviate the need for any rules to be entrenched.

### Discussion and recommendations for reform

10.83 We understand consultees' concerns that a threshold above a simple majority could make it practically difficult to vary the CCS, particularly where unit owners are not engaged with decision making. However, we think that decisions to change the local rules should not be made easily. The ethos of a commonhold is codified in its CCS. Purchasers, when buying in to a commonhold, do so on the basis of the local rules at the point of purchase. It is also at the point of purchase that unit owners receive legal advice on the contents of the CCS. All of these factors support the view that amendments, if they are to be implemented, should be approved by a significant majority of unit owners.

10.84 We have noted ARMA's concerns about the results of our survey of existing commonholds above. In response to that survey, seven commonhold associations told us that they had tried and failed to amend their CCS. This raised a concern that even a simple majority might be a difficult threshold to meet. However, it is not clear from the survey whether the amendments in these seven cases failed to pass because the threshold was too high (and it was too difficult to ensure sufficient numbers turned up to vote) or because unit owners did turn up to vote and a majority were opposed to the variation. In either case, we do not share the concern that apathy will prevent many decisions from being carried. A special resolution only requires 75% of those attending a quorate meeting to vote in favour of the proposed amendment.

10.85 We are also of the view that concerns around voter apathy can be tackled in a number of other ways. For example, participation could be increased by individual commonholds making it easier to vote remotely. Several consultees suggested that modern voting procedures could increase unit owner engagement.

10.86 In addition, we do not agree that an ability to reverse commonhold decisions as easily as they are made is an advantage of the current law. We think that encouraging unit owners who are unhappy with an amendment to simply try and overturn it at the earliest opportunity is not an effective way of protecting unit owner expectations. If amendments end up being repeatedly carried then reversed, this will place an administrative burden on the directors and in turn increase uncertainty amongst unit owners as to what rules apply to them.

10.87 In light of the very strong support from consultees for the adoption of our provisional proposal, we think that the best way forward to protect the expectations of unit owners (particularly on purchasing their property) is to raise the voting threshold required to vary the local rules in the CCS.

10.88 When selecting a new voting threshold, a balance has to be struck between protecting unit owner certainty and ensuring that it is not impossible to make changes to the CCS. Setting a very high threshold, or requiring unanimity, is overly restrictive and inflexible. Even in the leasehold context, it is possible to vary lease terms without unanimous agreement.[26] Commonhold is intended to operate as a democracy, and this ensures a degree of flexibility throughout the life of a commonhold. Flexibility brings with significant advantages, as it provides unit owners with the ability to respond effectively to changing needs. While raising the voting threshold to make

[26] Landlord and Tenant Act 1987, s 35 and s 37. See para 1.28 of the CP.

amendments to the CCS is an inroad into commonhold's flexibility, we do not think this flexibility should be removed completely.

10.89 The threshold that is selected should also be easy for the directors of the commonhold association to apply and to understand. Our view, which is supported by consultees, is that it would add too much complexity to the commonhold model, and to conveyancing processes, if the higher threshold were to apply to some but not all local rules. Additionally, we think that applying the same threshold to all local rules ensures that there is no confusion for the directors when working out the required threshold to add a new rule where the CCS had previously been silent on the subject. For these reasons we will not be recommending a hierarchy of rules.[27] Our recommendation for the introduction of a special resolution to amend the CCS where there is not already a specific voting threshold in the CCS circumstances will help to eliminate some of the complexity found in the current law, simplifying the task of the directors.

10.90 We recommend that wherever an ordinary resolution is required to make an amendment to the CCS under the current law, this should be raised to a special resolution. A special resolution can be approved in either a meeting of unit owners or using a written voting procedure of the entire commonhold. This should provide commonhold associations with the flexibility that they need to pass resolutions in a way that best works for them. Our view is that a special resolution strikes the correct balance between providing greater certainty to unit owners while maintaining a degree of flexibility.

**Recommendation 39.**

10.91 We recommend that wherever the model CCS requires an ordinary resolution to approve an amendment to the local rules in a CCS under the current law, this voting majority should be raised to a special resolution.

### A right to apply to the Tribunal

10.92 In the Consultation Paper we invited consultees to comment on whether the First-tier Tribunal (Property Chamber) in England or a Leasehold Valuation Tribunal in Wales (the "Tribunal") should play a role in protecting unit owners from amendments to the CCS that have a particular impact on them.[28] We noted in the Consultation Paper that a right to apply to the Tribunal could help in striking the correct balance between flexibility and certainty, and could prevent unit owners from being unfairly singled out by the majority when changes are made to the CCS.[29]

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27 One exception will persist, however. It is currently only possible to add land to a commonhold with a unanimous resolution. We do not recommend a change to that particular voting threshold.

28 CP, Consultation Question 38, para 8.69(2).

29 See CP, para 8.61.

### Consultees' views

10.93 The vast majority of consultees responding to this question said that a right to apply to the Tribunal would be an important safeguard and should be introduced. Consultees felt that unit owners should be protected from abuses by the majority. Trowers & Hamlins LLP (solicitors) suggested that:

> Opponents to amendments should have the right to apply to the Tribunal to prevent the change when they think that it is of great importance to them (eg a unit holder with a guide dog on an amendment to ban pets/animals).

10.94 Several consultees went further than what was suggested in the Consultation Paper and said that it should be possible for a majority of unit owners to apply to the Tribunal to push through an amendment where a special resolution cannot be obtained. Irwin Mitchell LLP suggested that:

> If there are more than 50% of unit holders seeking a change for a good policy or safety reason but there are not sufficient numbers to allow a change to be made then it may be appropriate to have the right for those unit holders to apply to the Tribunal.

10.95 A small minority of consultees said that disputes over amendments to the CCS did not warrant the involvement of the Tribunal, or commented that the Tribunal itself was not fit for purpose to decide in such cases.

### Discussion and recommendations for reform

10.96 In light of concerns over the protection of minority interests expressed above, and consultees' support for our proposal, we recommend that it should be possible for unit owners to challenge amendments to the CCS in the Tribunal. Changes to the CCS are capable of affecting individual unit owners in a disproportionate manner and unit owners should have the opportunity to apply to the Tribunal to protect their interests. Chapter 17 of this Report concerns how a right to apply to the Tribunal in those circumstances would operate. In particular, it outlines the test to be applied by the Tribunal and the remedies that should be available to applicants.

10.97 Several consultees felt that it should also be possible for unit owners to apply to the Tribunal to amend the CCS where the commonhold association has blocked a resolution to this effect. We carefully considered whether such a right should be recommended. However, in our view, enabling unit owners to push through a decision of the commonhold association, where the necessary level of support has not been met, would undermine the policy reasons for increasing the threshold discussed above.

10.98 We acknowledge Irwin Mitchell LLP's argument that important decisions, such as matters relating to health and safety or to rectify mistakes in the CCS, need to be able to be made. We also note that, in the leasehold context, it is possible for leaseholders and landlords to apply to the Tribunal to vary a lease. In leasehold this right to apply to the Tribunal is limited to remedying specific defects in a lease, such as insurance,

repair or safety.[30] However, in commonhold, two distinct mechanisms are available in such circumstances.

(1) As explained above, a large proportion of the CCS is prescribed by legislation. These standardised sections of the CCS deal with many essential issues. For example, the prescribed terms of the CCS place a repairing obligation on the commonhold association. If there were any concerns about the standards of health and safety within commonhold in future, these concerns would be best addressed by altering the prescribed terms of the CCS through secondary legislation. The important changes would then be incorporated into the CCSs of all, and not some, commonholds.

(2) Many other key policy issues are addressed in the second category of local rules of the CCS, as set out at paragraph 10.11(2) above. If there are mistakes in these rules in a CCS, it is currently possible for a unit owner to apply to the court rectify those mistakes. For example, if the total voting allocations in the CCS do not equal 100%,[31] then a unit owner can apply to the court for a declaration that the CCS does not comply with the Commonhold Regulations.[32] If the rule is found not to be compliant, the court can make an order to fix the mistake in the CCS. Under our recommendations in Chapter 16, jurisdiction would be transferred to the Tribunal.[33]

**Recommendation 40.**

10.99 We recommend that unit owners should have a right to challenge amendments to a CCS in the Tribunal.

### Changes to limited use areas

10.100 As an additional layer of protection for unit owners, the consent of individual owners is currently required before certain important changes can be made to the CCS that affect their property interests. In some instances, as the value of the unit may be affected by the change, the consent of that owner's mortgage lender is also required. For example, if the commonhold association wanted to make a change that affected the use or the boundaries of an individual unit, the consent of the affected unit owner and his or her lender would need to be obtained.[34]

10.101 The consent of an individual unit owner and his or her mortgage lender will also be required before removing that owner from the list of authorised users of a limited use area. A limited use area is an area within the common parts of a commonhold (and

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30 The Landlord and Tenant Act 1985, s 35.

31 It is a requirement for the allocations of voting contributions in a commonhold to equal 100% when added together.

32 CLRA 2002, s 40(2).

33 See 16.65 to 16.73.

34 For a full breakdown of the specific circumstances in which unit owner, and lender, consent is currently required see fig 20, Ch 8 of the CP.

therefore managed by the commonhold association), which has been designated for the exclusive use or one or more unit owners.[35] Common examples of limited use areas include balconies or car parking spaces, which are owned and maintained by the commonhold association, but which only certain unit owners are entitled to use. In Annex 4 of the model CCS, those preparing the CCS must insert details of any limited use area within the commonhold and the corresponding unit owners who are entitled to use these areas.[36] If the association wanted to remove a unit owner from this list of authorised users, it would need the consent of that unit owner and his or her lender.

10.102 While not raised directly by any consultee, we are concerned that the wording of the current legislation does not go far enough to protect unit owners against changes that could be made to limited use areas. There are some instances in which making changes to limited use areas will not affect the value of a particular unit. For example, if there is a leisure centre which half of all unit owners in a commonhold are entitled to use, adding an additional number of authorised users should not affect the value of those units. In contrast, where there is only one authorised user, changes to the limited use area are likely to have a significant impact on the original authorised user. We think there are two circumstances, not addressed by the current law, where changes to a limited use area might affect the value of a commonhold unit.

(1) Reducing the extent of the limited use area where there is currently only one authorised user: for instance, if a unit had a garden area which was for its exclusive use only, if the CCS were varied to reduce the size of that garden, that could have the effect of reducing the value of the unit.

(2) Adding additional authorised users where there is currently only one authorised user: for instance, a unit might have been given exclusive use of a car parking space. If additional users were added to the car parking space, the value of having an allocated space would be lost.

10.103 We therefore recommend that it should not be possible, where there is currently only one authorised user of a limited use area, to:

(1) reduce the extent of the limited use area; or

(2) add additional authorised users;

without the written consent of the existing sole authorised user and his or her lender.

**Recommendation 41.**

10.104 We recommend that a commonhold association may only:

(1) add additional authorised users to a limited use area that previously had only one authorised user; or

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35 See Glossary.

36 Commonhold Regulations 2004, sch 3.

(2) reduce the extent of such a limited use area

with the express written consent of the sole authorised user and his or her lender.

## APPLICATION OF THE CCS TO TENANTS, LICENSEES AND OTHER OCCUPIERS

10.105 The successful functioning of commonhold depends upon the commonhold association's ability to enforce the obligations in the CCS against the occupiers of commonhold units. As we note above, in addition to the prescribed terms of the CCS, there is wide scope for the commonhold association to create a range of local rules regulating the use of units and the common parts. However, if a commonhold association could only take enforcement action against unit owners, and not their tenants (or any other occupier), the effectiveness of local rules is undermined, and instead a patchwork of enforceability would exist. Particular difficulties may arise where a unit owner is absent from a unit for long periods of time, or cannot be contacted. The private rental sector continues to grow, and other forms of occupation, such as Airbnb, are increasingly common. Commonhold therefore needs to adapt to accommodate these changes.

10.106 In the Consultation Paper we explained that, in addition to imposing rights and obligations on unit owners and the commonhold association, the CCS also imposes certain obligations on tenants of unit owners.[37] While we did not ask a consultation question on this topic, we have become aware of a number of problems in the drafting and effect of the CCS in respect of tenants, licensees and other occupiers[38] which were not raised in the Call for Evidence or the Consultation Paper.

10.107 First, there are ambiguities as to what provisions of the CCS apply to tenants. It is also unclear whether amendments of the CCS take affect against tenancies which were created prior to the amendment.

10.108 Second, the obligations set out in the CCS are not stated to apply to other occupiers such as licensees, and a commonhold would therefore face difficulty taking enforcement action in these circumstances. In this section, we make a number of recommendations to address these issues and clarify the current law.

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37 CP, para 8.19. The term "tenant" is used here in its broadest sense, and will also cover shared ownership leaseholders. See Ch 11.

38 A licensee is an occupier of land who is present with the permission of the owner. This could be oral permission, or under the terms of a contract. A licence does not confer any property interest to the licensee. In practical terms, a unit owner's family member or friend who occupies his or her property may do so as a licensee. Similarly, an occupier who has paid to use a property through "Airbnb" or a similar platform occupies the property as a licensee. "Other occupiers" refers to a class of occupier who are neither owners nor licensees. This includes a mortgage lender (or their agents) who takes possession of the property, as well as a receiver appointed by a mortgage lender under the Law of Property Act 1925.

### The position of tenants

10.109 The model CCS provides that "where stated, rules also bind tenants".[39] Accordingly, if a provision in the CCS states that it binds tenants it can be enforced against tenants. However, it is unclear whether this provision refers only to prescribed rules in the CCS, or whether it encompasses local rules added to the CCS. It is also unclear whether changes to the local rules made after a tenancy agreement was created would bind that tenant. As noted above, the successful functioning of commonhold depends upon the enforceability of the CCS against whoever is in occupation of the unit.[40] Given the growth of the private rental sector, it is likely that tenants will constitute a proportion of occupiers in most commonholds. The efficacy of many local rules depends on their enforceability against tenants (and as we note below, other occupiers). For example, a local rule preventing music after 10pm is ineffective if tenants can continue to play loud music after 10pm, but unit owners cannot. Similarly, a rule preventing the storing of bicycles in the common parts is ineffective if it prevents unit owners from doing so but not their tenants.

10.110 Local rules are therefore ineffective if tenants cannot be bound by them. From the perspective of a landlord or owner-occupier, leasehold property may be viewed as more desirable, as it is possible for a lease to include regulations affecting tenants and other occupiers. Amendment of such regulations takes effect against any pre-existing tenancies. We therefore recommend that the law is clarified to confirm that, in addition to the prescribed terms of the CCS which are expressed to bind tenants, any local rules that are drafted to apply to tenants should also bind tenants. We further recommend that any amendment to these local rules should take effect against existing tenants.

10.111 However, we are conscious that the model CCS makes a distinction between obligations imposed on unit owners and obligations imposed on tenants. It should not be possible to impose an obligation on tenants in the local rules which the prescribed CCS limits to unit owners. For example, the model CCS prevents unit owners from passing their obligation to pay commonhold contributions on to their tenants. It should not then be possible for this distinction to be undermined by a commonhold association requiring tenants to pay the commonhold contributions in the local rules. In our view, it must be possible for certain prescribed provisions of the CCS to bind only unit owners, and the local rules should not undermine this distinction. If and when prescribed provisions are added in the future, it will be possible to decide whether the new rule should apply to only unit owners, only tenants, or both. We therefore recommend that it should not be possible to add a local rule to the CCS which is expressed to bind tenants if there is already an equivalent prescribed obligation in the model CCS that is not expressed to bind tenants.

10.112 We are also conscious that tenants should be aware of the obligations with which they may be required to comply, and that it is possible that these obligations may change over time. Under the current law, a prospective landlord of a commonhold unit must provide a prospective tenant with a prescribed notice (known as form 13)

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39 Commonhold Regulations 2004, sch 3, para 4.1.2.

40 Para 10.105, above.

informing the tenant that he or she will be subject to obligations in the CCS.[41] We recommend that the prescribed notice is updated to better inform tenants that they are subject to the terms of the CCS as it stands, and any subsequent amendments.

**Recommendation 42.**

10.113 We recommend that it be clarified that tenants of commonhold units are bound by all rules in Part 4 of the model CCS and by any local rules that are drafted to bind tenants. We recommend that it be further clarified that any amendment to these provisions bind existing tenants of commonhold units.

10.114 We recommend that local rules that are expressed to bind tenants of commonhold units should not be capable of being added to a CCS if there is already an equivalent prescribed obligation in the model CCS that is not expressed to bind tenants.

10.115 We recommend that form 13 is updated to better inform prospective tenants that they are subject to the terms of a CCS as it stands, and any subsequent amendments.

### Licensees and other occupiers

10.116 Under the current law, obligations in the CCS can be enforced against unit owners and tenants, but not against other occupiers such as a licensee.[42] A commonhold association would therefore face difficulties in taking action against a licensee or other occupier who failed to comply with the local rules or the provisions in the CCS concerning use. As noted above, the efficacy of local rules requires that they bind the occupiers of units – whether they be owners, tenants, licensees or other occupiers. In contrast to commonhold, certain obligations can be enforced against licensees and other occupiers of leasehold properties.[43] This distinction may prove problematic in commonhold, and therefore act as a disincentive to its take up.

10.117 For these reasons, we believe that, in addition to unit owners and tenants, other occupiers of commonhold units should be bound by obligations in the CCS. However, given that a licensee holds no property interest in a commonhold unit and will generally be in occupation for a short period of time, we recommend that any obligations imposed on licensees and other occupiers should be limited. We believe that the appropriate balance is compliance with prescribed provisions in the CCS relating to use of the unit and of the common parts, and to any to any local rule expressed to apply to licensees and other occupiers.[44] It would not be appropriate or necessary for a person granting a license to be bound by the provisions in the CCS relating to the prescribed notice procedure when creating a tenancy, for example, or to

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41 Commonhold Regulations 2004, sch 3, para 4.7.12. Form 13 is found in sch 3 of the Commonhold Regulations 2004.

42 See n 38 above for discussion of “other occupiers”.

43 *Clarke on Commonhold*, para 19[17].

44 See n 38 above for further information on the nature of a licence.

take action against a unit owner or tenant under the dispute resolution procedure. We believe that this approach would provide the commonhold association with effective tools to regulate community life and draft local rules in a manner that bind all occupiers of commonhold units – whether owners, tenants, licensees or other occupiers.

**Recommendation 43.**

10.118 We recommend that any provision in the model CCS relating to use should be enforceable against a licensee or other occupier.

10.119 We recommend that a local rule in a CCS drafted so as to apply to licensees should be enforceable against licensees and other occupiers.

## THE LAYOUT OF THE CCS

10.120 The format of every CCS is standardised. The layout is prescribed by the "model CCS" in the Commonhold Regulations, and is structured in four parts. Each part links to a corresponding annex.

(1) The parts comprise standardised provisions that can only be amended by legislative intervention. However, it is possible to add to them by including local rules. Local rules can be added to the ends of any part or section (within the part), if prefaced with prescribed wording to draw attention to the fact they are local, not prescribed, rules.[45]

(2) The annexes contain the majority of a commonhold's local rules. These are completed by the developer or by the commonhold association and can be amended. Additional annexes containing more local rules can also be added to the CCS. Any development rights reserved over a commonhold are currently contained in an optional, but heavily standardised, sixth annex.[46]

10.121 One issue with the current model CCS is that it is difficult to navigate. In particular we are concerned that it is difficult for the reader to understand what their rights and obligations are at first glance. This is compounded when local rules are scattered throughout the CCS. In this section, we make recommendations for reform of the model CCS that will ensure greater transparency for consumers.

### Removing mandatory provisions from the CCS

10.122 As explained, under the current law, the CCS contains both standard provisions and a commonhold's local rules.

10.123 In the Consultation Paper we provisionally proposed that the mandatory provisions applicable to all commonholds should not be reproduced in the CCS. Rather, the CCS

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45 Commonhold Regulations 2004, reg 15(11) and (12).

46 Development rights are covered in Ch 9 of this Report.

would only set out the local rules which are tailored to the particular commonhold. The effect of this change would be twofold.

(1) The administrative burden borne by the directors and HM Land Registry will be reduced. Every time the CCS is amended, either by a vote of the commonhold association or because of legislative intervention, the revised CCS has to be registered with HM Land Registry. Removing the standardised provisions from the body of the CCS would obviate the need to register the CCS again if the prescribed rules are updated by legislation. The directors would only be under an obligation to register a revised CCS where the local rules have been amended by the unit owners.

(2) Removing the mandatory provisions will increase transparency. The current model CCS frontloads the prescribed rules and provides space for local rules at the back. As noted, some local rules can also be added to the end of a part or section containing prescribed terms, making it even more difficult to determine where relevant rules are found. By removing the mandatory provisions from the CCS, a commonhold's local rules will be placed at the forefront. This will make it easier for unit owners or prospective purchasers to look at the terms of the CCS and recognise both what their own rights and duties are and whether any terms are onerous. Consumers would still be given the mandatory provisions with the CCS, but as a standalone document.

10.124 We asked consultees whether they agreed that the CCS should only contain the local rules specific to the particular commonhold. We also asked consultees whether directors should be under a duty to provide (1) copies of the most up-to-date standard provisions, along with a copy of the CCS, to any new purchasers and (2) provide copies of the mandatory provisions to all unit owner as and when they are updated following a legislative change.[47]

### Consultees' views

10.125 A sizeable majority of consultees agreed with our provisional proposal to remove standard provisions from the CCS. Most consultees agreed with the arguments presented in the Consultation Paper that removing the mandatory provisions from the CCS would reduce both costs and administration time. Buckingham Court Residents' Association said that removing the mandatory provisions "would make sense and create standardisation and in fact make the operation of commonhold straightforward in practice". CILEX agreed, saying:

> A clearer layout is not only beneficial for conveyancers when advising their clients on the impacts of the CCS, but also for homeowners when referring back to the CCS in future. The time spent navigating the CCS would undoubtedly be shortened by removed duplication of terms already prescribed for in regulations, provided that those prescribed terms are collated together for ease of access.

10.126 A couple of consultees argued that removing the mandatory provisions would make it easier for unit owners to access the rules that were specific to their commonhold. Consultees were also persuaded by the positive experience in New South Wales,

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47 CP, Consultation Question 39, paras 8.77 to 8.78.

referred to in the Consultation Paper, where mandatory provisions are kept separate. The National Leasehold Campaign commented that the New South Wales model "works […] and keeps costs and administration time down".

10.127 Other consultees disagreed with our provisional proposal. They said that it would be difficult for unit owners to understand what provisions applied to them if mandatory provisions and local rules were not all collated in one place and available at HM Land Registry together.

### Duty to provide prescribed terms

10.128 Many consultees who responded argued that directors should be under a duty to provide up-to-date copies of the mandatory terms to unit owners and to prospective purchasers. CILEx said:

> Accordingly, in the interests of improving transparency and consumer awareness, CILEx fully supports the proposals requiring a commonhold association's director to provide copies of these provisions, along with a copy of the CCS, to all relevant persons.

10.129 Christopher Jessel (solicitor) did not think that the directors should be under an obligation to seek out purchasers and provide them with a copy of the CCS. Instead, he said that a copy of the CCS should be "supplied to new unit owners (whether purchasers or not, such as a devisee under a will […]) on request". He added that larger commonholds may have their own internet site and could make the relevant documents available online.

10.130 However, the Property Bar Association said that "the standard provisions in the regulations can be provided by the conveyancing solicitor when advising on the purchase".

### Discussion and recommendations for reform

10.131 In our view, local rules should be separated from the mandatory provisions. First, it reduces the administrative burden that the directors of the commonhold association must bear. If the standard terms of the CCS are amended by legislation, the directors will not be under a duty to register the new CCS with HM Land Registry. This reduces the risk that a unit owner misunderstands his or her rights and obligations, because the directors have failed to update and register a revised CCS.

10.132 Second, removing the mandatory provisions of the CCS will make the document easier to navigate as the rules that a unit owner or purchaser will be most interested in examining will be placed at the forefront. While separating the mandatory provisions from local rules will require unit owners to read across the document, we are of the view that this is not materially different from what is required under the current law. The current CCS requires unit owners to read across from the mandatory provisions at the front of the document to the local rules in the Annexes at the back. This difficulty is outweighed by the administrative benefit of maintaining standard provisions and local rules in separate documents.

10.133 Third, it will simplify the conveyancing process. Providing purchasers with the mandatory terms as a standalone document will help to improve familiarity with these

terms. These terms will remain the same in every commonhold and, when moving to a different commonhold, the unit owner will already have a basic understanding of their rights and obligations. In addition, it will ensure that purchasers can be confident that all of a commonhold's local rules are collected in the same place, and not scattered in amongst a commonhold's prescribed rules.

10.134 The vast majority of consultees went on to say that the directors should be under a duty to make updated copies of the mandatory provisions available to unit owners if the Commonhold Regulations are amended. We agree that the directors are best placed to ensure that all unit owners are able to access updated rules. We do not think this will be too onerous a duty, as the Commonhold Regulations are not likely to change often, and if they do, the additional cost of applying to HM Land Registry is removed.

10.135 We also asked consultees who should supply prospective purchasers with the mandatory provisions. A few consultees argued that it should be the vendor or their solicitor who supplies a copy of the prescribed terms to purchasers, rather than the directors. We agree that this is the most workable solution. The directors should not bear a legal responsibility of this kind to an incoming purchaser before they have become a unit owner.

**Recommendation 44.**

10.136 We recommend that the mandatory provisions applicable to all commonholds contained in the Commonhold Regulations should not be reproduced in a CCS.

10.137 We recommend that the directors of commonhold associations should be under a duty to make updated copies of the mandatory provisions available to unit owners, in print or electronic form, if the Commonhold Regulations are amended. Any unit owner selling his or her unit should provide a copy of the most up-to-date mandatory provisions to prospective purchasers along with a copy of the CCS.

### Introducing schedules to separate out rules applicable to sections

10.138 The current "one size fits all" CCS does not work effectively for complex modern developments. We recommend the introduction of sections in Chapter 8 of this Report to increase flexibility in commonhold. Sections are designed to ensure that only those unit owners affected by a decision are able to vote on it and that only those unit owners who benefit from a service are responsible for paying for it.

10.139 To make the CCS easier to navigate where sections are established, we provisionally proposed that it should be possible to add schedules to the CCS, in which rules specific to that section would be collated.[48] We considered that schedules in the CCS would allow unit owners and prospective purchasers to quickly identify what rules apply within their specific section and what rules apply across the commonhold.

[48] CP, Consultation Question 40, para 8.80.

### Consultees' views and recommendations for reform

10.140 The vast majority of consultees agreed that it should be possible to add schedules to the CCS to collate the local rules applicable to specific sections. They agreed that schedules would make it easier for unit owners to recognise what rules applied to them because of the section they are part of and what rules applied to every unit owner in the commonhold.

10.141 None of the consultees who opposed the proposal provided a substantive reason for their opposition.

10.142 We think that the use of schedules would make the CCS much more accessible to unit owners who buy a property in a large mixed-use development. Such owners would only need to read one schedule to understand the rights and obligations which apply to their section, plus the main body of the CCS. The use of schedules also replicates current practices in leasehold developments, where schedules are often used to differentiate the rights and obligations of particular groups of leaseholders who might use their property in a particular way or have access to particular services.

**Recommendation 45.**

10.143 We recommend that it should be possible to add schedules to a CCS to collate the rights and obligations applicable to different sections.

# Chapter 11: Permissible residential leases in commonhold

## INTRODUCTION

11.1 In commonhold, unit owners are prohibited from granting residential leases for a term of longer than seven years, or for a premium.[1] This prohibition was justified to "avoid the possibility of repeating the difficulties which exist in leasehold blocks".[2] In this chapter we recommend limited exceptions to this prohibition to ensure that shared ownership leases and lease-based home purchase plans can be accommodated in commonhold.

11.2 Shared ownership is a key component of the Government's programme to create affordable housing. It is therefore important to ensure that the shared ownership model can fit into the commonhold structure. Home purchase plans are used to finance property purchases. They have arisen in response to the traditional prohibition of interest (or "usury") in Islamic law. Home purchase plans are regulated by the Financial Conduct Authority and take a variety of forms. It is important to ensure that commonhold ownership can be financed in a way that is compatible with religious beliefs.

11.3 We also look at the consultation responses received on other forms of affordable housing within commonhold, including community land trusts and co-operative housing. We conclude that no specific exceptions are necessary for these forms of affordable housing to operate within commonhold.

## AN EXCEPTION FOR SHARED OWNERSHIP LEASES

11.4 Shared ownership enables a person to buy a percentage share in the ownership of a house or a flat and pay rent on the share owned by the shared ownership provider.[3] Additional shares can be purchased in the future through a process known as "staircasing", up to the point at which the property is fully owned. Shared ownership therefore enables people to get onto the housing ladder with a potentially lower upfront cost and plays a key role in Government strategies to provide more affordable housing.

11.5 Homes England and the Welsh Government support shared ownership through grant funding. Grant funding of shared ownership, of both houses and flats, is only available in respect of shared ownership *leases*. Presently, no other model of shared ownership

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1 We refer to the term "residential lease" in this chapter for simplicity. The current commonhold legislation prevents "residential unit owners" from granting leases over their units: Commonhold Regulations 2004, reg 11(1).

2 Explanatory notes to CLRA 2002, s 17, para 65. We explored the reasons for this further in the CP at paras 12.6 to 12.10.

3 We refer, in this chapter, to an organisation (whether from the private or social sector) that provides shared ownership as a "Provider".

is funded. As residential leases of over seven years are currently prevented within commonhold, grant funding for shared ownership will not, at present, be available within commonhold. That is because shared ownership leases are long leases.

11.6 Homes England and the Welsh Government require, as a minimum, certain fundamental clauses to be included in leases granted with funding in order to provide a level of protection for leaseholders. These include a set formula to review the rent payable on the unowned share and provisions to enable the shared owner to staircase. Homes England produce model shared ownership leases, which incorporate the fundamental terms and which Providers can choose to adopt. Providers may however prefer to use their own form of lease, provided that, if they wish to receive Government funding, that lease includes the fundamental terms.

11.7 Although, historically, shared ownership has often been associated with social landlords, it can also be provided by private landlords, with or without grant funding. From late 2018 to early 2019, Government ran a call for proposals on private shared homeownership, seeking to leverage private sector funding and capacity to deliver more affordable homes.[4]

11.8 In the Consultation Paper we provisionally proposed a limited exception to the ban on residential leases of over seven years, and leases granted for a premium, to enable shared ownership within commonhold.[5] In order to provide a certain level of protection for shared owners, we proposed limiting this exception to leases which, as a minimum, contain the fundamental clauses set by Homes England, in England, and the Welsh Government in Wales.

### Consultees' Views

11.9 A sizeable majority of consultees agreed that an exception should be made to enable shared ownership within commonhold. Consultees also agreed that this exception should be limited to leases which contain the fundamental clauses specified by Homes England or the Welsh Government.

11.10 Consultees described the ability to include shared ownership in commonhold as essential and vital, stating that it was of particular importance in new developments, for housing associations and community land trusts.

11.11 Lucy Shepherd (solicitor) commented that shared ownership provided a valuable route into home ownership while Millbank Residents Company Ltd described the proposal as "socially responsible".

11.12 A number of consultees however raised objections to the proposal. Several consultees were concerned that permitting shared ownership leases in commonhold had potential for abuse. For instance, J Brown (leaseholder) stated:

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4 Ministry of Housing, Communities and Local Government, *Innovation in affordable home ownership: a call for proposals for private shared ownership* (October 2018), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/751981/call_for_proposals_for_Private_Shared_Ownership.pdf.

5 CP, Consultation Question 65, para 12.30.

this would be tantamount to eroding the founding principle of commonhold, namely to eradicate the third-party absent landlord and the associated problems of leasehold.

11.13 A few consultees were concerned that mixing leasehold and commonhold would result in complexity and a two-tier system.

11.14 No specific objections were received to our provisional proposal that shared ownership leases should only be permitted if they include the fundamental clauses prescribed by Homes England or the Welsh Government. One consultee, Heather Keates (conveyancer), did raise concerns over conveyancers' current understanding of the fundamental clauses and referred to associated failures to properly incorporate them when drafting leases.

11.15 There was support from several consultees for promoting shared ownership in commonhold without the use of a lease, through co-ownership trusts or similar arrangements.[6]

### Discussion and recommendations for reform

11.16 We note the strong support from consultees for our provisional proposal to permit shared ownership leases within commonhold and the benefits of the provision of affordable housing within commonhold. We therefore recommend that an exception should be made to the ban on residential leases to permit shared ownership within commonhold. While consultees did not make substantive comments about our proposal to limit this exception to shared ownership leases containing the fundamental clauses, our view is that this will be a necessary safeguard for shared ownership leaseholders ("shared owners"). The clauses provide a level of protection, such as standardised rent review provisions, and should prevent the same abuses which have been witnessed in the leasehold context being carried over to commonhold.

11.17 Regarding concerns about complexity, we make recommendations later in this chapter to ensure that shared ownership leases can be successfully integrated into the commonhold structure. Regarding concerns about creating a two-tier system, we make further recommendations in this chapter, and elsewhere in this Report, to ensure that, as far as possible, shared owners gain the same advantages and protections of living in a commonhold that are enjoyed by unit owners, such as having a say in how the commonhold is run.

11.18 As set out in the Consultation Paper, while it may be possible, in time, to move to an alternative model of shared ownership that does not depend upon a lease, such as a co-ownership trust, our Terms of Reference with Government require us to accommodate shared ownership in its present form.[7] And as we note above, currently, the only form of shared ownership for which Homes England and the Welsh Government provide funding is the leasehold model.

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6 See CP, paras 12.24 to 12.26.

7 CP, para 12.28.

**Recommendation 46.**

11.19 We recommend that there should be an exception to the prohibition of residential leases exceeding seven years, and leases granted at a premium, for shared ownership leases which contain the fundamental clauses prescribed by Homes England in England or the Welsh Government in Wales.

## OPERATION OF SHARED OWNERSHIP IN COMMONHOLD

11.20 We consider the operation of shared ownership leases in commonhold in two parts. The first part looks at the operation of a shared ownership lease granted in an existing commonhold (where either the shared ownership lease has been granted in a new commonhold development or after the building has converted to commonhold). The second examines the position where a shared ownership lease was granted before the building converted to commonhold.

## PART 1 – SHARED OWNERSHIP LEASES GRANTED IN EXISTING COMMONHOLDS

11.21 Where a shared ownership lease is granted in an existing commonhold, the Provider will always be the registered owner of the commonhold unit it leases to the shared owner.

11.22 We now consider the various components of the relationship between the shared owner and the Provider, and how those components can be best integrated with commonholds. We look at, in particular, the shared owner's compliance with the commonhold community statement ("CCS"), who will exercise the commonhold voting rights, the shared owner's enfranchisement rights, and his or her position on final staircasing.

### Shared owner's compliance with the CCS

11.23 In the Consultation Paper we noted that, although shared owners do not initially own the property outright, they will take on the usual responsibilities of a full owner-occupier.[8]

11.24 Under the current law, any provision in the CCS which states that it applies to a unit owner's tenant will also bind shared owners.[9] However, we are conscious that in addition to the CCS, the relationship between the shared owner and Provider is one of landlord and tenant, and is also governed by the terms of the shared ownership lease. To ensure consistency between the terms of the CCS and the terms included within the lease, we provisionally proposed that any model shared ownership lease used in commonhold should require the shared owner to comply with all the terms of CCS.[10] Including such a term in the shared ownership lease will improve the enforcement

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8 CP, para 12.34.

9 Commonhold Regulations 2004, sch 3 para 4.1.2. We discuss how the obligations in the CCS affect tenants of commonhold units in Ch 10.

10 CP, Consultation Question 66, para 12.44.

options available to the Provider where the shared owner breaches a term of the CCS. Not only would the Provider be able to take action against the shared owner under the commonhold's dispute resolution process (which would involve including the commonhold association),[11] but also the Provider would be able to take direct action against the shared owner under the terms of the lease.

### Consultees' views

11.25 The vast majority of consultees agreed with our provisional proposal. The Leasehold Advisory Service ("LEASE") described the proposal as "essential to the smooth operation of the Commonhold Building".

11.26 There were very few responses against the proposal. Colette Boughton (consultee), Denise Clark (leaseholder) and Jeanette Allen (leaseholder) disagreed with the proposal on that basis that they opposed an exception for shared ownership more generally.

### Discussion and recommendations for reform

11.27 We think that it is essential that shared ownership leases are drafted in a manner that reflects the shared owner's obligations under the terms of the CCS. Including a term in the lease which requires the shared owner to comply with the terms of CCS will not only provide shared owners with greater certainty as to their rights and obligations, but will also protect the Provider in the following ways.

(1) As a unit owner, the Provider will remain ultimately responsible for ensuring that all the terms of the CCS are complied with. However, as noted above, only the terms of the CCS which are expressed stated to apply to tenants (in its broadest sense, see above) will bind the shared owner. It is therefore particularly important to ensure consistency between the terms of the CCS and the shared ownership lease. For example, if the CCS prohibits pets, but this provision were not expressly stated to bind tenants, it would be important for the Provider to ensure that an equivalent prohibition appeared in the shared ownership lease. Otherwise the Provider would be in breach of the CCS without any enforcement action being possible against the shared owner (either directly under the terms of the lease or under the commonhold's dispute resolution procedure).

(2) Where the right or obligation is expressed to bind the shared owner in the CCS (for example, a rule in the CCS which prevented unit owners and their tenants from keeping pets), requiring the shared owner to comply with all terms of the CCS in the lease would increase the enforcement options available to the Provider. The Provider may only take enforcement action under the terms of the shared ownership lease if the lease required the shared owner to comply with the terms of the CCS. In the absence of a provision in the lease requiring the shared owner to comply with the CCS, the Provider would not be able to take direct action against its tenant. It would only be able to ask the commonhold association to take action against the shared owner for breaching the CCS

[11] See Ch 16, para 16.10 onwards.

under commonhold's dispute resolution procedure.[12] Such an approach would be cumbersome, and Providers are likely to be in a better position to understand the most appropriate way of addressing the particular breach. If the association refused to take action, the Provider would have no further course of action against the shared owner.[13]

11.28 We think the simplest way of ensuring that a Provider may take enforcement action under the terms of the lease is for any model shared ownership lease which is produced (or adapted) for the commonhold context, to require the shared owner to comply with all terms of the CCS. If the shared owner breaches the CCS and the model lease is used, the Provider may treat the breach of the CCS as a breach of a term of the lease and take enforcement action directly against the tenant. The Provider could apply for a court order requiring the shared owner to comply with the CCS ("an injunction") or in appropriate circumstances, take action to terminate the lease. The Provider could also seek to recover any losses caused by the shared owner's breach.

11.29 If the Provider decides not to use the model lease and instead elects to use its own form of lease, it would be advisable for the Provider to include provisions to the same effect to ensure that it can take action to enforce any breaches of the CCS.

11.30 For these reasons, and given the high level of support for our provisional proposal, we recommend that any model shared ownership lease for commonhold should include a term expressly requiring the shared owner not to breach the terms of the CCS.

**Recommendation 47.**

11.31 We recommend that it should be a term of any model shared ownership lease designed or adapted for use in commonhold to require the shared ownership leaseholder to comply with all the terms of the CCS.

### Voting rights

11.32 In the Consultation Paper we provisionally proposed that as the shared owner takes on the responsibilities of an owner-occupier, in commonhold he or she should, as far as possible, take on the rights of a unit owner.[14] Since unit owners are able to exercise control over the management of the commonhold through their voting rights, we provisionally proposed that the shared owner should acquire the voting rights

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12 We discuss the dispute resolution procedure in detail in Ch 16. There are three different procedures which may be followed, depending on the parties to the dispute, including a procedure to be used as between unit owners and/or any tenants in the building. Under the unit owner/tenant v unit owner/tenant procedure, the unit owner/tenant would be required to give notice to the commonhold association under the dispute resolution procedure asking it to take action to enforce the relevant duty: CCS, para 4.11.20.

13 The Provider could however challenge the association's refusal to take action against the tenant under commonhold dispute resolution procedure.

14 CP, paras 12.34, 12.37.

which are held by the Provider as unit owner. We refer to the transfer of voting rights as "delegation".

11.33 In the Consultation Paper we provisionally proposed that the shared owner should acquire all the voting rights of the Provider. This would mean that the shared owner would be able to vote on matters including:

(1) appointing and removing directors;

(2) approving the draft costs budget for the following year;

(3) alterations to the common parts;

(4) changes to the local rules of the CCS; and

(5) decisions to grant a charge over the common parts.

11.34 In the Consultation Paper, we noted that our provisional proposal would not extend to a vote on termination.[15] In these circumstances we suggested that the vote should be exercised jointly with the Provider. If either party were opposed to termination, the vote would be cast negatively.

11.35 Membership of the commonhold association is limited to unit owners.[16] Therefore the Provider's membership would not be lost following delegation of its voting rights to the shared owner. Instead, the Provider would remain a member of the commonhold association until the shared owner staircased to 100% ownership and acquired the freehold of the unit. At this point, the shared owner would become the unit owner and a member of the commonhold association.

### Consultees' Views

11.36 The vast majority of those who responded supported our provisional proposal. Consultees stated that shared owners are already often treated as full owners in many respects, and that as they are the occupiers and ultimately pay for the services, they should be able to vote on those services.

11.37 For instance, the Guinness Partnership (housing association), stated "as shared owners are the ultimate beneficiaries of services and the performance of the commonhold association, they should have full access to participation".

11.38 Notting Hill Genesis (housing association) also agreed with our provisional proposal and additionally noted "it is right that the decision to terminate should be a joint decision with the Registered Provider landlord as their interest is affected".

11.39 Of those who opposed the proposal, the main concerns were in relation to the impact on the Provider. Berkeley Group Holdings PLC (developer) stated:

> the Provider remains the unit owner with the obligations and risks that status brings. It remains in law primarily responsible to the association to pay its contributions to

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15 CP, Consultation Question 66, para 12.45.

16 CLRA 2002, sch 3 paras 7, 10.

the shared costs so it should have a choice, at least to "opt out" of such automatic delegation.

11.40 The Leasehold Knowledge Partnership (the "LKP") and the All-Party Parliamentary Group on Leasehold & Commonhold Reform (the "APPG") said that except for votes on termination, the votes should be cast in proportion to the percentage of the service charge paid. They maintained that in future shared owners may not always be responsible for 100% of the service charge costs.

### Discussion and recommendations for reform

11.41 We acknowledge that the Provider will retain an interest in the shared ownership property until the shared owner becomes a member of the commonhold association. However, we consider that, when a person buys into a shared ownership unit, they should be treated as the owner of that unit from the start in respect of voting rights, for the following reasons.

11.42 First, the current law treats shared owners in the same way as outright owners in the sense that a shared owner will always be responsible for 100% of the service charge costs, regardless of the size of his or her ownership share. Moreover, the shared owner, and not the Provider, will be the ultimate beneficiary of the services provided. It follows that the shared owner should be entitled to vote on how commonhold budgets are set and on how the commonhold is managed and maintained.

11.43 We accept that the Provider also has a legitimate interest in how the commonhold is governed and that mandatory delegation removes its influence over decision-making. However, it is unlikely that the shared owner would vote in a manner that undermines the value or marketability of his or her unit. Even with the minimum ownership share, the shared owner will have a significant financial stake in the unit, and it is unlikely that he or she would vote in a manner that diminished the value of his or her interest. This alignment of interests offers a level of protection for the Provider. As we note below, we do not consider that delegation should extend to termination. In the case of termination, the Provider is entitled to exercise the vote jointly with the shared owner.

11.44 Second, many aspects of the CCS govern how the commonhold is occupied and used. It is the shared owner, and not the Provider, who is affected by these provisions, and we believe the shared owner is the appropriate party to vote on such matters.

11.45 Third, shared ownership is a product designed to facilitate home ownership and lead to full/outright ownership of the property. We noted in the Consultation Paper that Government expects shared owners to take on "the usual responsibilities of a full owner-occupier".[17] Providing shared owners with voting rights from the outset will make them more likely to take an active role and interest in the management of the commonhold. Additionally, the proposal discourages shared owners from being viewed as inferior to unit owners. Their voice will carry equal weight, regardless of whether they have the minimum 25% share, or are close to reaching 100%.

11.46 We are not persuaded by the suggestion that votes should be cast in proportion to the percentage of the service charge paid. As we note above, under the current law, the

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[17] CP, para 12.34, quoting the Government's guidance on shared ownership for England.

shared owner is responsible for 100% of the service charge regardless of the size of his or her stake. If in future the extent of shared owners' service charge liability were altered, calibrating voting rights in accordance with that liability would create considerable complexity for a commonhold association to manage in practice.

11.47 We particularly note that Providers of shared ownership leases were amongst those consultees in support of the proposal. We therefore recommend that for shared ownership leases granted in commonhold, shared owners should be able to exercise all the votes of the commonhold association in place of the Provider, with the exception of termination, which will be exercised jointly with the Provider. A vote will only be counted in favour of termination if both the Provider and shared owner support it. The Provider has a significant financial stake in the unit, and we do not believe that the shared owner should exercise the vote exclusively.

11.48 LEASE suggested that the shared owner should be entitled to exercise the vote in respect of termination exclusively once he or she owns more than 50% of the property. We do not agree. Even if the shared owner staircases and owns the majority share, the Provider remains the freeholder of the unit, and it would not be appropriate for freehold ownership to be extinguished without an opportunity for the freeholder to object.

11.49 Our recommendation treats shared owners as conventional unit owners who are entitled to vote on the full range of issues in the commonhold. We believe that a necessary implication of this is that shared owners should be able to exercise the minority protection provisions in the same manner as other unit owners.[18] Regardless of their share, decisions of the commonhold association may negatively impact a shared owner in the same manner as any other unit owner. It would therefore be anomalous if shared owners could not benefit from the minority protection provisions.[19]

**Recommendation 48.**

11.50 We recommend that, where shared ownership leases are granted in new commonholds or in buildings which have converted to commonhold, shared ownership leaseholders should be able to exercise:

(1) all the voting rights associated with the unit in place of the shared ownership provider (the "Provider"), apart from a decision to terminate the commonhold, which should be exercised jointly with the Provider. If either party is opposed to termination, the vote should be cast negatively; and

(2) the minority protection rights available to unit owners, in place of the Provider.

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18 Our recommendations for minority protection are set out in Ch 17.

19 Following our recommendations in Ch 12, shared owners would also enjoy the right to apply to the Tribunal for the appointment of professional directors where unit owners are unwilling to serve as directors, and the right to apply for the appointment of directors where the current directors fail to comply with their duties.

### Rights to challenge contributions to costs

11.51 Residential leaseholders have certain statutory protections, such as a right to challenge the reasonableness of service charges.[20] These protections reflect the fact that leaseholders with a third-party landlord have little control over how the service charge monies are spent. However, commonhold unit owners control the commonhold association and therefore do not need the same protections. There is therefore no right for unit owners to challenge the commonhold contributions once they have been incurred. Instead, unit owners have the right to vote on budgets in advance and, under our recommendations, may have minority protection rights in respect of costs exceeding a certain amount, enabling the unit owner to refer the question of whether the expenditure should be permitted to the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal").[21]

11.52 As a unit owner, the Provider will be bound to pay the commonhold contributions and will pass these costs on to the shared owner as a service charge. However, using the statutory protections available to residential leaseholders, the shared owner would have the right to challenge these service charges after the costs have been incurred. If the shared owner is successful in challenging a service charge, the Provider would still be required to pay the commonhold contributions, but would not be able to recover this charge in full from the shared owner. This potentially makes commonhold unattractive for shared ownership as a Provider would be at risk of liability for commonhold contributions with no way of recovering these from the shared owner.

11.53 We therefore provisionally proposed that shared owners should not have the statutory rights in sections 18 to 30 of the Landlord and Tenant Act 1985 to challenge service charge costs or to be consulted on works and contracts exceeding a certain amount.[22]

#### Consultees' views

11.54 Roughly half of the consultees who answered this question agreed with our provisional proposal. These consultees noted that there would otherwise be a discrepancy in the relationship between the commonhold association and the Provider and the relationship of the Provider and the shared owner. For instance, Notting Hill Genesis stated that otherwise "there would be different incompatible rights of challenge. The protection due to a commonhold unit should be sufficient".

11.55 The Guinness Partnership noted that the proposal "puts the onus on the shared owner to participate in the running of the commonhold association".

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20 Landlord and Tenant Act 1985, ss 19 and 27A. These protections apply where the leaseholder pays a variable, as opposed to a fixed service charge. A variable service charge means that the amount of service charge payable fluctuates in accordance with the landlord's actual costs of providing the service, rather than remaining the same from week-to-week or from month-to-month (s 18(1)(b)).

21 We note in Ch 13 that the CCS may contain an index-linked threshold on the amount of expenditure which can be incurred on the cost of alterations and improvements without challenge. We recommend that if costs within a budget exceed this threshold, any unit owner who objects may refer the matter to the Tribunal as a minority protection issue to decide whether the expenditure should be permitted. See the discussion of minority protection in Ch 17 of this Report and the discussion of approving the budget and challenging commonhold contributions in Ch 13.

22 CP, Consultation Question 66, para 12.46.

11.56 On the other hand, a number of consultees raised concerns over shared owners not being able to challenge costs in the same way as residential leaseholders. For instance, Chin Li (leaseholder) stated:

> Shared ownership leaseholders are least likely to be able to afford expensive works. They are also paying both service charge as well as rent, so should have rights to query what they pay.

11.57 Antonia Marjanov said "shared ownership is a form of affordable housing that should not be made unaffordable by service charges".

### Discussion and recommendations for reform

11.58 As explained at paragraph 11.51 above, commonhold unit owners do not have rights to challenge the reasonableness of service charges. Unlike a traditional landlord and tenant relationship, it is the unit owners who themselves set these charges. We agree with consultees that if shared owners enjoyed a right under leasehold law to challenge the reasonableness of the commonhold assessment but also enjoyed the right to take part in setting the level of that charge these rights would be incompatible. We recommend that the statutory rights associated with leasehold, including the rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount, should not apply to service charges in shared ownership leases granted in commonhold.

11.59 We acknowledge that there is a risk that the costs incurred by Providers may be more than the commonhold contributions the Provider is required to pay to the commonhold association. For instance, Providers may seek to pass costs additionally incurred in managing the unit onto the shared owner. If the right to challenge service charges is removed completely, the shared owner would be powerless to challenge these additional charges. We therefore recommend that the statutory right to challenge service charges should remain for any charges demanded by a Provider which do not represent a straight transfer of the commonhold contributions it is required to pay to the commonhold association for that unit. The shared owner would therefore still be able to challenge the reasonableness of any service charge payments which exceeded the commonhold contributions.

11.60 We note the concerns raised by consultees that shared owners may not be able to afford expensive works and should therefore retain the right to challenge commonhold contributions. Elsewhere in this Report, we have made provision to allow shared owners and unit owners to challenge expenditure that exceeds a certain amount specified in the CCS (which we describe as a "costs threshold").[23] The inclusion of a costs threshold in the CCS offers substantive protection to shared owners and other unit owners against excessive expenditure.

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[23] See Ch 13, para 13.120 onwards.

**Recommendation 49.**

11.61 We recommend that the statutory rights associated with leasehold, including the rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount, should not apply to service charges in shared ownership leases granted in new commonholds or in buildings which have converted to commonhold. The shared ownership leaseholder will instead have the same rights to vote on the costs budget and challenge commonhold contributions as unit owners.

11.62 We recommend that the right to challenge service charge costs should remain in respect of any service charge costs which are incurred by the Provider in excess of the costs demanded by the commonhold association.

### Enfranchisement rights prior to staircasing to 100% ownership

11.63 In Chapter 1, we explain that, subject to meeting certain eligibility requirements, leaseholders are able to exercise "enfranchisement rights" which enable them to obtain greater security in their properties. In particular, leaseholders have rights to purchase a lease extension and to buy the freehold of their property from their landlord (either individually in the context of a house, or collectively with the other leaseholders in the context of a block of flats). These rights are considered in our Enfranchisement Report.

11.64 In the context of shared ownership, Government has decided that, as a matter of policy, shared owners should have a statutory right to a lease extension (in the same way as other long leaseholders). However, Government's policy is that, prior to final staircasing, shared owners should not have a statutory right to buy the freehold of their properties (either individually or collectively with the other leaseholders in the building). This is because the shared ownership lease has been specifically designed to enable those who cannot afford to purchase outright to do so in stages, via the staircasing provisions which form part of all shared ownership leases. It would be incompatible with the operation of shared ownership if leaseholders were able to circumvent these provisions by relying on statutory enfranchisement rights to acquire the freehold of their home or building.

11.65 To that end, we consider it correct that, prior to final staircasing, shared owners should not have a statutory right to buy the freehold of their commonhold unit. To provide otherwise would be to circumvent the staircasing provisions in the shared ownership lease. However, shared owners would retain their right to a lease extension in order to obtain greater security in their homes.

### Position of shared owners on staircasing to 100% ownership

11.66 In the Consultation Paper we provisionally proposed that, in respect of shared ownership leases granted in existing commonholds, the shared owner should be transferred the commonhold unit upon purchasing 100% of the value of the commonhold unit and should become a member of the commonhold association.

### Consultees' views

11.67 The vast majority of consultees who responded to this question agreed with our provisional proposal. For instance, the British Property Federation (trade association) stated that "when they have staircased to 100% it is equally right that they should become members of the commonhold association".

11.68 Some concerns were raised over how this proposal would work where, for example, the developer has entered into planning agreements requiring the property to be retained as affordable housing for applicants with local connections.[24]

### Discussion and recommendations for reform

11.69 We note the high level of support for our provisional proposal. Consultees generally considered that the correct approach was that once shared owners had purchased the full value of the commonhold unit, they should become full unit owners. Once this occurs, there is no reason for them to be treated differently from any other unit owner.

11.70 We are not persuaded that conditions imposed through planning law are likely to have a significant bearing on the proposal. If the concern is to retain affordable housing stock, a shared ownership lease could only have been granted in compliance with planning conditions, and the possibility of staircasing to 100% would have been a foreseeable consequence of that grant. Likewise, if local connection conditions existed, the shared owner would have had to satisfy those conditions in order to acquire the lease.

11.71 We also note that planning restrictions on staircasing to 100% ownership might exist for properties in designated protected areas and for retirement properties. We acknowledge that such restrictions will have an impact on our recommendation for this limited category. Our recommendation is not intended as a comment on the desirability of these types of properties.

11.72 For these reasons, we recommend that the shared owner should receive the freehold title of the unit and become a member of the commonhold association upon purchasing 100% of the unit.

**Recommendation 50.**

11.73 We recommend that, if a shared ownership lease is granted in a new commonhold or in a building which has converted to commonhold, the shared ownership leaseholder should acquire the freehold title of the unit and become a member of the commonhold association on staircasing to 100%.

[24] Under ss 70 to 72 of the Town and Country Planning Act 1990 it is possible for planning authorities to impose conditions on planning permission which, for example, restrict the occupation of property to local people or which limits the value at which the property can be sold.

## PART 2 – SHARED OWNERSHIP LEASES GRANTED BEFORE A BUILDING CONVERTS TO COMMONHOLD

11.74 In this part of the chapter, we consider the position of a shared owner whose lease was granted before the building converted to commonhold.

11.75 We discuss the consequences of conversion to commonhold in more detail in Chapter 5. In Chapter 5, we consider two potential options for how the conversion to commonhold might operate. Either, leaseholders who are eligible to participate in the conversion (which will not include shared owners prior to having staircased to 100% ownership)[25] will retain their lease at the point of conversion (which we call "Option 1"), or all eligible leaseholders will be required to take a commonhold unit on conversion ("Option 2"). Depending on the option pursued, following conversion, the Provider will either own a commonhold unit, or will own a leasehold interest superior to that of the shared owner. However, irrespective of the option pursued, the shared owners' leasehold interest will continue following the conversion (see discussion from paragraph 4.91). Our recommendations in Chapter 5 also ensure that the relationship between the Provider and the shared owner is preserved following the conversion, and that the staircasing provisions will remain intact.

11.76 We turn now to consider at the relationship between the shared owner, the Provider and the commonhold association.

### Shared owner's compliance with the CCS

11.77 We recommend above that any shared ownership lease used in commonhold should require the shared owner to comply with the terms of the CCS.[26] However, following conversion, it will not be possible to alter the terms of the lease retrospectively, or to compel the parties to adopt any new model of shared ownership lease which has been specifically designed for the commonhold context. However, the parties may elect to adopt any new model lease on a voluntary basis.

11.78 In Chapter 5 we set out recommendations to ensure that, so far as possible, the terms of the CCS do not contradict the terms of any tenancies or shared ownership leases that may continue following the conversion to commonhold.

### The delegation of voting rights and challenging contributions to costs

11.79 In the Consultation Paper, we asked questions about how voting rights should be exercised following conversion and what interest the shared owner should receive when he or she has staircased to 100%.

11.80 We provisionally proposed that, where the Provider is a unit owner following conversion, it should be able, but not required, to delegate any of its voting rights to the shared owner.[27]

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25 See paras 3.32 to 3.35 and 4.54.

26 Para 11.31, above.

27 CP, Consultation Question 67, para 12.49.

### Consultees' views

11.81 Well over half of the consultees who answered this question agreed with our provisional proposal.

11.82 Consultees who disagreed with the proposal doubted why there should be a distinction between the position of shared owners in new developments and conversions to commonhold. Consultees noted that the proposal would also mean that different shared owners in the same building may have different rights depending on whether they entered into the shared ownership lease before or after conversion to commonhold. Some consultees also stated that, as the person ultimately responsible for paying the commonhold contributions, shared owners should have a say on the budget regardless of the point at which the lease was granted.

### Discussion and recommendations for reform

11.83 We acknowledge consultees' concerns that our provisional proposal may result in discrepancies between the position of shared owners who were granted leases before conversion to commonhold, and those who have been granted leases after conversion. Under our recommended approach, in respect of shared ownership leases granted before conversion, the Provider *may* elect to delegate voting rights to the shared owner. In respect of shared ownership leases granted after conversion (and in new commonhold developments) Providers *must* delegate their voting rights in full (with the exception of termination, where the vote will be exercised jointly).[28]

11.84 We believe that this distinction is necessary. Where the Provider grants a new shared ownership lease following conversion, the Provider will be aware of the basis on which that lease will be granted, and will understand the requirement for all rights to be delegated to the shared owner. Where the lease was granted prior to the conversion, however, it would not be appropriate for the Provider's decision-making powers to be taken away as an automatic consequence of the conversion. Instead, we think the workable solution is to provide that delegation of voting rights should be optional for the Provider. The Provider will therefore be able to choose whether, and the extent to which, it will delegate its voting rights to the shared owner following conversion. However, we consider that the Provider's decision to delegate all of its voting rights should carry particular consequences for the shared owner in order to address the following difficulty.

11.85 We noted in the Consultation Paper that tenancies which make provision for a variable service charge to be payable may prove problematic for a landlord who is required to take a commonhold unit on conversion.[29] On taking a commonhold unit, the landlord would become liable to pay towards the costs of running the commonhold. The regime applicable to financial contributions in commonhold has been designed specifically for the commonhold context. Under our recommendations, unit owners therefore have the right to participate in how commonhold expenditure is set (by voting on the cost budget), and to challenge costs pre-emptively in certain scenarios, but will not have a

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28 See para 11.50.

29 CP, para 3.113.

right to challenge the reasonableness of the commonhold assessment after the costs have been incurred

11.86 That creates a difficulty in the context of the landlord and tenant relationship. The tenant of a unit owner would retain his or her right to challenge the reasonableness of a variable service charge under leasehold legislation after the particular cost had been incurred. The unit owner would therefore become responsible for paying costs to the commonhold association which may not be recoverable under the tenancy agreement.

11.87 The incompatibility between the regime for challenging costs could cause a particular difficulty for Providers who have granted shared ownership leases prior to conversion. If Providers are to have confidence in commonhold, we believe that Providers must be able to address the risk of non-recoverable service charges. To resolve this difficulty, we recommend that, where the Provider delegates its voting rights in full, the shared owners' rights to challenge costs should fall away. Instead, the shared owners' rights should be brought into alignment with that of a unit owner. We turn now to explain this in more detail.

### Delegation of voting rights in full

11.88 If the Provider delegates its voting rights in full to the shared owner following conversion to commonhold, the shared owner would be placed in the same position as shared owners in new commonhold developments and shared owners whose leases were granted after the conversion. Following the full delegation of voting rights, the shared owner would enjoy the same voting rights and protections as a unit owner, and would be able to challenge commonhold contributions in the same way. Consequently, for the same reasons as discussed above in the context of new commonholds, we recommend that, on the full delegation of voting rights, a shared owners' rights to challenge the reasonableness of service charges should fall away.[30] Otherwise, the shared owner would receive double protection under two different, and incompatible, regimes. First the shared owner would enjoy the same rights as unit owners in controlling the commonhold expenditure that is set. Second, the shared owner would enjoy additional rights to challenge the decisions of the association under leasehold legislation.

11.89 We note that for the purpose of this recommendation, "full voting rights" means all voting rights except the right to vote on termination, which may be exercised jointly with the Provider. We acknowledge that termination is a matter which will affect the Provider and consider that it should have a say on this matter.

11.90 We recognised above when discussing shared ownership leases granted in new commonhold developments or following conversion to commonhold that the loss of the shared owner's right to challenge service charges creates a potential for the Provider to impose additional charges over and above the commonhold assessment which cannot be challenged.[31] We therefore recommend that the statutory right to challenge service charges should remain for any charges demanded by a Provider

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30 See para 11.61.

31 See para 11.59.

which do not represent a straight transfer of the commonhold contributions it is required to pay to the commonhold association for that unit.

11.91 We would expect Providers to communicate their intentions clearly with shared owners and agree upon the terms of the delegation wherever possible. However, we anticipate that, in the majority of cases, shared owners are likely to be willing to exercise the Provider's voting rights and participate in decision making about how their development is run. Many consultees responding felt that shared ownership does not offer shared owners a sufficient say in the management of their homes, and thought that shared owners following conversion should be put in the same position as owners in new commonholds.

11.92 The effect of our recommendations can be summarised as follows:

(1) Where a shared ownership lease is granted before a building converts to commonhold, the Provider may delegate some or all of its voting rights to the shared owner following conversion.

(2) Where a Provider delegates its voting rights in full following conversion, the statutory rights available under leasehold legislation to be consulted on contracts exceeding a certain amount and to challenge service charges are lost, except to the extent that the charge represents an amount over and above the commonhold contribution. The shared owner will have the same rights to vote on the costs budget and challenge commonhold contributions as unit owners.

**Recommendation 51.**

11.93 We recommend that where a shared ownership provider (the "Provider") takes a commonhold unit on conversion to commonhold, the Provider may delegate some or all of its voting rights associated with the unit to a shared ownership leaseholder of the unit.

11.94 We recommend that where a Provider's voting rights associated with a unit have been delegated in full to a shared ownership leaseholder following conversion to commonhold:

(1) the shared ownership leaseholder's statutory rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount should no longer apply; and

(2) the minority protection rights available to unit owners will be available to the shared ownership leaseholder, in place of the Provider.

11.95 We recommend that the voting rights associated with a unit should be considered to be delegated "in full" only if the shared ownership leaseholder may exercise all the votes associated with the unit in place of the Provider, apart from a decision to terminate the commonhold, which should be exercised jointly with the Provider. If either party were opposed to termination, the vote should be cast negatively.

11.96 We recommend that, where a Provider delegates its voting rights associated with a unit in full to a shared ownership leaseholder following conversion to commonhold, the shared ownership leaseholder's right to challenge service charges should remain in respect of any service charge costs which are incurred by the Provider in excess of the costs demanded by the commonhold association.

### Enfranchisement rights prior to staircasing to 100% ownership

11.97 For the same reasons as set out at paragraph 11.64 above, prior to final staircasing, the shared owner will be entitled to seek a lease extension, but will not be eligible to purchase the freehold of their commonhold unit, as to do so would bypass the staircasing provisions in the shared ownership lease.

### Position of shared owners on staircasing to 100% ownership

11.98 In the Consultation Paper, we considered the position of shared owners following 100% staircasing in a building which had converted to commonhold after the shared ownership lease had been granted.[32]

11.99 Under the current law, when a shared owner of a flat staircases to 100%, he or she continues to be a leaseholder, but the provisions relating to shared ownership cease to have any effect.

11.100 We provisionally proposed that this position should continue to apply following conversion to commonhold: upon 100% staircasing, a shared ownership leaseholder of a commonhold unit will remain a leaseholder, but the provisions in the lease related to shared ownership will cease to have any effect. We further provisionally proposed that after having staircased to 100% ownership, a shared owner should have a statutory right to purchase the commonhold unit and become a member of the commonhold association.[33]

#### Consultees' views

11.101 Most consultees who responded to our provisional proposal agreed that the lease should continue but that there should be a right for the shared owner to purchase the commonhold unit following 100% staircasing.

11.102 Of those who opposed the proposal, several consultees raised concerns that the proposal could lead to residential leasehold interests continuing indefinitely in commonhold.

11.103 A couple of consultees questioned the costs of purchasing the commonhold unit, stating that there should be no cost to purchase the unit following 100% staircasing. For instance, Michael Tsoi stated "this doesn't seem right, they've paid the staircasing and own 100% of their home, they should then be freeholder".

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32 CP, para 12.48(2).

33 CP, Consultation Questions 67, paras 12.50 to 12.51.

### Discussion and recommendations for reform

11.104 An automatic transfer of the freehold estate to the shared owner upon staircasing to 100%, without requiring any further payment to the Provider, presents difficulties. Because shared ownership leases of flats do not provide for the automatic transfer of the freehold estate to the shared owner upon staircasing to 100%, recommending such a provision would retrospectively alter the terms upon which shared ownership leases were granted prior to a conversion to commonhold. This alteration would not properly compensate the Provider. The amount payable on final staircasing would have been calculated on the basis that the shared owner is paying for the acquisition of the remaining term of the lease, not the acquisition of the freehold. In staircasing to 100%, the shared owner will therefore have only paid towards full ownership of the remaining term of his or her lease, but not the costs of acquiring the freehold.

11.105 In contrast, where the lease is granted in a new commonhold, or after the building has converted, the shared owner and the Provider will enter into that lease, knowing that on 100% staircasing, the shared owner will become a commonhold unit owner. The Provider will already be a unit owner and the cost of acquiring the freehold on 100% staircasing can be factored in. This will not be the case where a shared ownership lease is granted prior to a decision to convert.

11.106 We therefore consider that a shared owner of a lease granted before conversion to commonhold should not have the freehold automatically transferred to them on staircasing to 100%. On final staircasing, the shared owner will therefore remain a leaseholder but the provisions specific to shared ownership will fall away.

11.107 We note concerns that this recommendation could perpetuate the existence of leases within commonhold, a system designed to replace leasehold ownership of flats. Following final staircasing, our view is that the former shared ownership leaseholder (now an ordinary long leaseholder) should be treated as any other long leaseholder in a converted building. In Chapter 5, we explain that, if leaseholders, who are eligible to participate in the conversion, but who do not agree to the conversion, are permitted to retain their leases following conversion (conversion Option 1), they should be required to upgrade their leasehold interest to a commonhold unit at some stage in the future.[34] Given the shortcomings of leasehold ownership, and the fact that commonhold was designed to overcome these shortcomings and facilitate the freehold ownership of flats, we wish to ensure that, wherever possible, the existence of residential leasehold within commonhold is minimised. We therefore recommend the following position should apply on final staircasing:

(1) The former shared owner should have a statutory right to buy their commonhold unit.

(2) The former shared owner's new statutory right to buy the commonhold unit should replace their existing enfranchisement rights (including the right to a lease extension) as an improved way of obtaining greater security in their homes; and

[34] See para 5.6.

(3) Where the former shared owner wishes to sell his or her interest, the incoming purchaser should be required to buy the commonhold unit, rather than the leasehold interest.

11.108 This recommendation will help ensure that all long leases are gradually phased out within the commonhold block, so that commonhold can work as intended, with all owners holding the same type of interest. In Chapter 5 we make recommendations to ensure that, on conversion to commonhold, the terms of the CCS will adequately protect all individuals who will or might take a unit in the future, including shared owners.

**Recommendation 52.**

11.109 We recommend that, where a shared ownership lease is granted before a conversion to commonhold, the shared ownership leaseholder of a commonhold unit should remain a leaseholder after staircasing to 100%, but the provisions relating to shared ownership should fall away. After staircasing to 100%:

(1) the shared ownership leaseholder should have a statutory right to buy the commonhold title to his or her unit;

(2) the shared ownership leaseholder's new statutory right to buy the commonhold title to the unit should replace his or her existing enfranchisement rights; and

(3) where the shared ownership leaseholder wishes to sell his or her interest, the incoming purchaser should be required to buy the commonhold title, rather than the leasehold interest.

### Summary of recommendations for shared owners

11.110 In the table below, we summarise the position of shared owners whose leases were granted in existing commonhold developments, and those who were granted leases before the conversion to commonhold took place.

**Figure 15: The position of shared owners in new and converted commonholds**

| | Shared ownership lease granted after conversion, or in new commonhold developments | Shared ownership lease granted before the conversion |
|---|---|---|
| **Compliance with the CCS** | Any model CCS designed or adapted for commonhold should include a requirement for the shared owner to comply with the CCS. | The terms of the shared ownership lease cannot be altered, but the parties may elect to move to any model lease which has been designed for commonhold. |
| **Voting rights** | The shared owner exercises all the voting rights of the Provider, apart from the vote to terminate which is exercised jointly with the Provider. | The Provider may elect to delegate its voting rights to the shared owner. |
| **Rights to challenge costs** | The shared owner will be able to vote on the cost budget and challenge costs in the same way as unit owners. | The shared owner will be able to challenge costs under leasehold legislation, unless the Provider delegates full voting rights to the shared owner. If the Provider delegates voting rights in full, the shared owner will be able to challenge costs in the same way as unit owners. |
| **Enfranchisement rights prior to 100% staircasing** | The shared owner will have a statutory right to a lease extension but will not have a right to buy their commonhold unit. | The shared owner will have a statutory right to a lease extension but will not have a right to buy their commonhold unit. |
| **Position following 100% staircasing** | The shared owner will be transferred the commonhold unit and will become a member of the commonhold association. | The shared owner will remain a leaseholder but provisions in the lease relating to shared ownership will fall away. The shared owner will have a statutory right to buy the freehold of their unit. This new right will replace their right to a lease extension and an incoming purchaser must but the commonhold unit, rather than the lease. |

## COMMUNITY LAND TRUSTS AND CO-OPERATIVES

11.111 In the Consultation Paper, we discussed the position of community land trusts ("CLTs") and co-operatives within commonhold. CLTs and co-operatives are forms of community-led housing which aim to ensure housing is kept permanently affordable.[35] We noted some of the ways in which these forms of housing could be accommodated within commonhold without requiring the grant of long leases, such as providing affordable homes through periodic rental tenancies. We invited views on whether an exception to the ban on residential leases over seven years was needed to better accommodate community land trusts and co-operatives.[36]

### Consultees' views

11.112 The responses we received were fairly evenly split, with a very slight majority against making an exception to the ban on long residential leases.

11.113 A few consultees who were against making an exception to the ban on long residential leases told us that an exception was unnecessary, noting that community land trusts and co-operatives are already able to use commonhold without the use of long residential leasehold. Aside from providing affordable rental tenancies, the use of co-ownership trusts, restrictive covenants and limitations placed in the CCS were suggested as potential ways to keep units affordable in perpetuity and to have some control over who could occupy the unit. For instance, J Brown (leaseholder) stated:

> Ownership is ownership and is achievable via a Co-ownership model. Renting is renting and is achievable via a short-term tenancy. There is no place for leasehold in commonhold.

11.114 A couple of consultees who favoured making an exception stated that many of the concerns that have been raised about leasehold in general would not apply to community land trusts and co-operative housing. These consultees noted that community land trusts are not-for-profit organisations in which residents can already participate in governance and the setting of rents.

11.115 Other consultees argued that the ability to grant leases was an important feature of community land trusts and co-operatives and that, without an exception, co-operatives and community land trusts may be prevented from using the commonhold model. Examples were provided by consultees of community land trusts using long-term residential leasehold, including an example in which the terms of the lease linked the resale value to the average household income in the area.

11.116 A few consultees also stated that community land trusts and co-operatives need the ability to retain the title to the land themselves (rather than, for example, granting ownership over the individual commonhold units) in order to ensure that it remains available in perpetuity for the provision of affordable housing.

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35 CP, paras 12.52 to 12.67.

36 CP, Consultation Question 68, para 12.58.

### Discussion and recommendations for reform

11.117 We do not consider that an exception is needed to accommodate community land trusts and co-operatives within the commonhold model. As noted in the Consultation Paper, our general view is that long residential leases should continue to be prohibited in commonhold. As commonhold was designed to overcome the problems of residential leasehold ownership, exceptions to the ban on residential leases should only be made where necessary. While we recommend that an exception should be made for shared ownership and (below) home purchase plans, there are key differences between those products and community land trusts and co-operatives which justify an exception.

11.118 First, the majority of consultees opposed an exception for community land trusts and co-operatives. In contrast, consultees strongly supported our provisional proposal to provide an exception for both shared ownership leases and home purchase plans.

11.119 Second, we do not consider that long leases are a necessary means of ensuring affordable housing is available within community land trusts and co-operatives. There are other viable techniques available to achieve the aims of community land trusts and co-operatives when using the commonhold model. As noted by consultees, affordability can be "locked in" to commonhold units through the use of restrictive covenants and bespoke terms of the CCS. It is also open to a co-operative or community land trust to create shared ownership leases. Alternatively, co-operatives and community land trusts could use leases of less than seven years to provide affordable housing.

11.120 In contrast, we do not consider there to be any viable alternatives to the provision of shared ownership and home purchase plans which do not depend on the grant of a lease. Government has prioritised shared ownership leases as the standard. Our Terms of Reference require us to consider how to accommodate shared ownership in its current form, and we consider that an exception is essential to achieve that.

11.121 In respect of home purchase plans, non-lease-based products are increasingly rare within other forms of tenure, and as we noted in the Consultation Paper, are not offered by many providers.[37] As we explain below, the lack of alternatives suggests that not to make an exception would disproportionately impact the Muslim population and therefore exclude people from commonhold on the basis of their religious beliefs.[38]

11.122 Given that consultees did not support an exception and that there are other viable options available to accommodate community land trusts and co-operatives within the commonhold model, we do not believe a further exception to the ban on long leases is necessary.

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37 CP, paras 12.70 to 12.75.

38 Para 11.143, below.

## OTHER FORMS OF AFFORDABLE HOUSING

11.123 In the Consultation Paper, we invited consultees to inform us of any other types of affordable housing which require an exception to the prohibition on long leases.[39]

### Consultees' views

11.124 Few specific concerns with the current commonhold legislation were identified in response to this question. Most responses mentioned general areas that the Law Commission may wish to consider further. Some responses related to concerns about affordable housing provision generally, rather than issues with its compatibility with commonhold.

11.125 The main areas which consultees suggested for further consideration were retirement communities and equity release products.[40]

11.126 One anonymous consultee suggested making provision for discounted market sale – a scheme whereby housing associations or local authorities sell property at a discount. The discount binds the property, and the home can only ever be sold on with the same initial discount. For example, if a home were sold under a discounted market sale scheme at 70% of its market value, when re-selling the property, the owner would be required to offer it at 70% of its market value.

11.127 Stephen Desmond questioned the compatibility of affordability requirements imposed via planning permission with commonhold.

11.128 Trowers & Hamlins LLP (solicitors) questioned whether shared equity mortgages can be accommodated in commonhold.[41]

11.129 A few consultees noted the general compatibility of commonhold with affordable housing. For instance, Colette Boughton stated "any form of affordable housing can be compatible with commonhold if well thought through".

11.130 Some consultees cautioned against creating further exceptions to the ban on long residential leasehold, considering this to be unnecessary and creating risks of misuse. For instance, the National Leasehold Campaign stated, "you need to ensure commonhold is the default and keep any exceptions to an absolute minimum (if there need to be any at all)".

### Discussion and recommendations for reform

11.131 From the responses received we are not persuaded that further exceptions to the ban on residential leasehold over seven years in commonhold are necessary to

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39 CP, Consultation Question 69, para 12.67.

40 Equity release products may be either lifetime mortgages, or lease-based home reversion plans. Under these products, individuals can receive a payment related to the value of their home and are permitted to remain living there.

41 Shared equity mortgages can reduce the amount needed for a deposit. The scheme requires the buyer committing to a conventional mortgage for large amount of the property (e.g. 75%), coupled with a loan to buy a part of the property (eg 20%), reducing the amount needed for a deposit.

accommodate other forms of affordable housing. The products mentioned by consultees can already be accommodated in commonhold.

11.132 In response to consultees' concerns over retirement communities and equity release products, we note that both are currently commonly provided without the use of long residential leasehold. Equity release, for instance, can be provided through lifetime mortgages which do not involve a lease. Consultees did not raise any specific difficulties for the provision of these non-lease-based arrangements in commonhold.

11.133 As set out in the Consultation Paper,[42] shared equity arrangements, such as those offered under Homes England's and the Welsh Government's respective Help to Buy schemes, involve a charge secured against the home and, unlike shared ownership, which is discussed earlier in this chapter, do not rely on the use of a lease.[43] Since shared equity arrangements do not typically rely on the use of a lease (as set out in the Consultation Paper), they could already be offered in commonhold without further changes to the system.

11.134 Stephen Desmond questioned the position of planning conditions which require property to be sold at a discount. Conditions may be attached to planning permission that require property to be sold at less than the market rate. As noted above, planning conditions relating to affordability will take effect against whoever owns the freehold title to the land and do not require the use of long leases.[44]

11.135 Discounted market sale could operate in commonhold without difficulty. We understand that this scheme relies on the use of a restriction entered on the freehold title, requiring the owner to sell the property below its full market value. This restriction would bind anyone who owned the property. There is no obstacle inherent in commonhold that would prevent this restriction from being placed on the freehold title of a commonhold unit.

## HOME PURCHASE PLANS

11.136 Home purchase plans can be used to finance property purchases. They have arisen in response to the traditional prohibition of interest (or "usury") in Islamic law. Home purchase plans are regulated by the Financial Conduct Authority and take a variety of forms. The main forms, ijara wa iqtina and diminishing musharaka, use residential leases which would usually be for more than seven years.

11.137 In the Consultation Paper we noted that not permitting an exception for home purchase plans could make commonhold ownership less accessible for people whose faith prevents the use of interest-based mortgages. We therefore asked consultees whether an exception to the ban on the grant of residential leases over seven years,

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42 CP, paras 12.62 to 12.65.

43 The distinction between shared equity which uses a charge against the property, and shared ownership, which typically involves a lease, is discussed at para 12.65 of the CP.

44 See para 11.70.

and leases granted for a premium, should be created for providers of home purchase plans.[45]

### Consultees' views

11.138 A sizeable majority of those who responded to this question were in favour of an exception being created.

11.139 Concerns over not creating an exception were raised. For instance, CILEx stated that the exception would help to ensure that the commonhold legislation did not breach human rights legislation, or the Equality Act 2010. It stated, "the exception is necessary in order to provide equal access to a commonhold purchase in accordance with Islamic Law".

11.140 Consultees who were in favour of the exception also noted that, since these are regulated products, there would be a level of oversight by the Financial Conduct Authority.

11.141 Consultees who were against an exception to the ban on residential leases over seven years raised concerns, including potential misuse, and questioned how the exception would work in practice. Suggestions were also made that alternatives which did not involve a lease may be preferable.

### Discussion and recommendations for reform

11.142 We consider that an exception should be made to permit lease-based home purchase plans in commonhold. First, as set out in the Consultation Paper, we note the relative scarcity of alternatives which do not use leases.[46] Murabaha is one such alternative, and involves a bank buying the property and then immediately selling it on to its customer at an increased price, with the payments being made to the bank in instalments over the term of the arrangement. No leaseback is created. However, this is not a complete alternative: a number of providers of home purchase plans in England and Wales do not offer murabaha type arrangements.

11.143 Second, given that the dominant form of home purchase plan is lease-based, not providing an exception to the ban on long leases for home purchase plans would disproportionately impact the Muslim population and therefore exclude people from commonhold on the basis of their religious beliefs.

11.144 While consultees raised concerns over abusive practice in the leasehold sector, as other consultees pointed out, home purchase plans are regulated by the Financial Conduct Authority, reducing the risk of abuses seen in other areas of the leasehold sector. For these reasons, and in view of the large amount of support for our provisional proposal, we consider that an exception should be created.

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45 CP, Consultation Question 70, para 12.79.

46 CP, para 12.75.

**Recommendation 53.**

11.145 We recommend that an exception to the prohibition of residential leases exceeding seven years, and those granted at a premium, should be made for lease-based home purchase plans regulated by the Financial Conduct Authority.

## Operation of lease-based home purchase plans in new commonhold developments

11.146 In the Consultation Paper we noted that many of the considerations which arose in relation to permitting shared ownership leases in commonhold also arise with the use of lease-based home purchase plans in commonhold.

11.147 In new commonhold developments, the home purchase plan provider would be able to purchase the commonhold unit and grant a lease to the customer in the usual way.

11.148 We noted, however, the difficulties that the statutory rights in leasehold to challenge service charges could pose for providers of home purchase plans in commonhold. As a unit owner, the home purchase plan provider would be liable for the commonhold contributions raised by the commonhold association. Since unit owners control the management of a commonhold, and to protect the solvency of the commonhold association, there is no right to challenge the commonhold contributions after they have been incurred by the commonhold association.[47] Home purchase plan providers recover the costs they pay towards the management of the building (in commonhold this would be the commonhold contributions) from their customers as a service charge.

11.149 Since home purchase plan customers will be leaseholders and will be able to challenge the reasonableness of service charges under leasehold legislation, home purchase plan providers could find that they are liable for the commonhold contributions, but unable to reclaim these from their customers. As with shared ownership,[48] there was a concern that this would make commonhold unattractive for home purchase plan providers.

11.150 We therefore provisionally proposed that customers of lease-based home purchase plans should not have the same statutory rights to challenge service charges as other leaseholders outside of commonhold.[49]

### Consultees' views

11.151 A majority of consultees agreed with the proposal for the reasons set out in the Consultation Paper.

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47 See further CP, Consultation Question 57, para 10.44.

48 CP, para 12.41.

49 CP, Consultation Question 71, para 12.84.

11.152 For instance, CILEx provisionally agreed with the proposal, adding that home purchase plan customers should be given "the same right as unit owners to challenge commonhold costs before they have even been incurred".

11.153 Several consultees cautioned that home purchase plan customers should not be at a disadvantage due to the removal of their rights to challenge service charges, and made the case for equal rights with unit owners, such as an equal vote with other unit owners on commonhold decisions. For instance, the Conveyancing Association stated that home purchase plan customers "should retain the same rights as other comparable unit holders delegated to them by the lessor".

11.154 A few consultees objected to the proposal on the basis that leaseholders in commonhold should have the same rights as leaseholders outside of commonhold. A few consultees also raised concerns about the potential for misuse of the exception.

11.155 One consultee cautioned that the proposal could create differences in ownership and lead to discrimination. Another consultee raised concerns that, if the home purchase plan provider had retained the right to vote on commonhold budgets, it would have no interest in objecting to these since it could just pass the charges on to its customer, however unreasonable.

### Discussion and recommendations for reform

11.156 Consultees raised similar concerns to those raised in relation to shared ownership, which we consider above at paragraphs 11.21 to 11.110. In particular, we note consultees' concerns that home purchase plan customers should, so far as possible, have the same rights as unit owners. We agree with this position. We are therefore recommending that home purchase plan customers should be able to participate in decisions of the commonhold as equals with other unit owners, and will have the vote on these decisions in place of the home purchase plan provider. This mirrors our recommendation in respect of shared owners in new commonhold developments.[50]

11.157 Since the home purchase plan customer will be treated, so far as possible, as a full unit owner, the considerations regarding the rights associated with leasehold, such as the ability to challenge service charges, mirror those discussed above at paragraphs 11.58 to 11.62.

11.158 We therefore recommend that, for home purchase plans created in existing commonholds, the rights usually associated with leasehold, such as the ability to challenge service charges, are replaced with the rights enjoyed by unit owners in commonhold. This would include minority protections,[51] and the right to vote and participate in commonhold decisions. This would not extend to a vote on termination, in which case the vote would be exercised jointly by the home purchase plan customer and the provider.

11.159 In order to protect against additional unreasonable charges being raised by the home purchase plan provider, we recommend that the statutory rights to challenge service charges are removed only to the extent that the service charge is a direct transfer of

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50 See above, para 11.50.

51 See Ch 17 for further discussion of protection of minorities in commonhold.

the commonhold contributions. Where charges are raised which exceed these, the leasehold rights would remain in respect of the excess charges. As with shared ownership, we consider that decisions on termination of the commonhold should be taken jointly with the home purchase plan provider.

**Recommendation 54.**

11.160 We recommend that where home purchase plan leases are granted in new commonholds or in buildings which have converted to commonhold, home purchase plan customers should be able to exercise:

(1) all the voting rights associated with the unit in place of the home purchase plan provider, apart from a decision to terminate the commonhold, which should be exercised jointly with the home purchase plan provider. If either party is opposed to termination, the vote should be cast negatively; and

(2) the minority protection rights available to unit owners, in place of the home purchase plan provider.

**Recommendation 55.**

11.161 We recommend that the statutory rights associated with leasehold, including the rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount, should not apply to service charges in home purchase plan leases granted in in new commonholds or in buildings which have converted to commonhold. The home purchase plan customer will instead have the same rights to vote on the costs budget and challenge commonhold contributions as unit owners.

11.162 We recommend that the right to challenge service charge costs should remain in respect of any service charge costs which are incurred by the home purchase plan provider in excess of the costs demanded by the commonhold association.

11.163 We consider that once a home purchase plan customer has met its obligations under the home purchase plan, he or she should become a full unit owner. The parallel situation for shared owners following 100% staircasing is discussed further at paragraphs 11.69 to 11.73 above.

**Recommendation 56.**

11.164 We recommend that, for home purchase plan leases granted in in new commonholds or in buildings which have converted to commonhold, once the home purchase plan customer has met his or her obligations to the home purchase plan provider, he or she should be transferred the commonhold title of the unit and become a member of the commonhold association.

### Conversion of existing buildings to commonhold and home purchase plans

11.165 We explained in the Consultation Paper that the position of home purchase plans on conversion to commonhold is currently unclear, particularly with regards to who will take the commonhold unit, and become a member of the commonhold association, at the point of conversion.

11.166 Following our recommendations in Chapter 4, only certain leaseholders will be eligible (or required, if conversion Option 2 is adopted: see paragraph 11.75 above) to take a commonhold unit on conversion to commonhold. We recommend there that only leaseholders who would be eligible to participate in a collective freehold acquisition ("CFA") should be eligible (or required) to take a commonhold unit. We explain CFAs in more detail in Chapter 3, but in summary, CFAs provide leaseholders with a right to act together to acquire the freehold of their building compulsorily where their freeholder does not agree to sell the freehold to them. As conversion to commonhold would result in the freeholder losing his or her interest in the property, we recommend at paragraph 4.39 that, where the freeholder does not consent to the conversion, leaseholders will need to acquire the freehold compulsorily through a CFA claim as part of the conversion process (although leaseholders will be able to streamline the two processes under our recommendations in Chapter 7). We therefore adopt the same eligibility requirements to convert as are required to bring a CFA claim.

11.167 We set out the eligibility requirements to participate in a CFA claim (and therefore take a commonhold unit) in Chapter 3. In summary, leaseholders of flats who have been granted leases of longer than 21 years will generally be able to participate in the CFA claim, and therefore take a commonhold unit. We understand that many lease-based home purchase plans are granted for longer than 21 years, and so the customer would be eligible to participate in the CFA claim and take a commonhold unit on conversion. If the customer decided, or was required (if Option 2 were adopted), to take the commonhold unit on conversion, the provider's interest would need to be purchased as part of the process, and could frustrate the financial agreement.

11.168 As this difficulty might already arise during CFA claims, in the Consultation Paper we invited consultees' views on how this difficulty is currently addressed in CFA claims and whether there is a way to ensure the relationship between the home purchase plan provider and the customer can be reserved on conversion to commonhold.

11.169 Because the question creates issues of the customer's eligibility to participate in a CFA claim (on which we are basing the eligibility to take a commonhold unit) we consider the responses received, and outline our suggested approach, in the Enfranchisement Report.[52] We acknowledge in the Enfranchisement Report that it would be undesirable if an enfranchisement claim were to disrupt these financial agreements. However, few consultation responses were received in response to this question, and we were not made aware that customers' enfranchisement rights are causing an issue in practice. While customers are not presently excluded from enfranchisement rights, we are not aware of customers exercising these rights in practice, and it is unlikely to be in their interests to do so.

11.170 Given the lack of evidence available, we suggest in our Enfranchisement Report that Government should examine further the interaction between such leases and the current enfranchisement regime, with the assistance of appropriate evidence from the Islamic finance sector, and consider whether there is a case for their exclusion from enfranchisement rights in the future. We also suggest that, when deciding whether or not to make an exception, Government should consider the implications of their decision on the regime for converting to commonhold, particularly if conversion Option 2 is adopted. As noted above, Option 2 would require all eligible leaseholders to take the commonhold unit on conversion. This would necessarily frustrate the financial arrangement between the customer and the finance provider. Consequently, if Government does not exclude customers from enfranchisement rights, it would be necessary to ensure that the finance provider, rather than the customer takes the commonhold unit on conversion, so as not to undermine the financial agreement.

11.171 We are unable to make recommendations governing the relationship between the home purchase plan customer and home purchase plan provider on conversion until it is clear whether home purchase plan customers will be eligible to participate in a CFA claim (and therefore take a unit), and whether Government wishes to adopt conversion Option 1 or Option 2.

[52] See Enfranchisement Report, para 7.211.

# Part V: Managing and financing the commonhold

# Chapter 12: Management and maintenance

## INTRODUCTION

12.1 Under the Commonhold and Leasehold Reform Act 2002 (the "2002 Act"), the commonhold association takes the legal form of a company limited by guarantee. In this chapter we make recommendations to assist with the management of the commonhold association as a company, and to help the commonhold association to carry out its responsibilities in maintaining the commonhold.

12.2 Our recommendations are designed to achieve the following:

(1) simplify the procedure for the appointment of directors;

(2) enable a court, the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal") to appoint directors where the existing directors persistently fail to comply with the commonhold community statement ("CCS");

(3) ensure that the commonhold association is able to take out buildings insurance over parts of the building owned by unit owners, and directors' and officers' insurance;

(4) make existing obligations to repair that are imposed on the commonhold association and unit owners more effective, and enable commonholds to impose a higher standard of repair than is required by prescribed rules;

(5) make it easier for unit owners to carry out certain minor alternations; and

(6) prevent potential abuse of long-term contracts by developers.

## APPOINTMENT OF DIRECTORS

12.3 The current procedures for appointing directors are complex.[1] These requirements might overcomplicate the commonhold structure, particularly with respect to smaller commonholds. Furthermore, the ability of directors to recommend the appointment of directors without an election appears un-democratic and could be used to confine control of the commonhold to a minority.[2]

12.4 We provisionally proposed a simplified procedure, under which directors should be elected at a general meeting, but could also be co-opted by existing directors.[3] Our provisional proposal was designed to replicate in commonhold the provisions for the

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1 CP, paras 9.4 to 9.10.

2 CP, paras 9.14 and 9.15.

3 CP, Consultation Question 42, para 9.32.

election of directions in RTM Companies and companies limited by guarantee generally.[4]

### Consultees' views

12.5 The vast majority of consultees were in favour of our proposal. In particular, the proposal drew almost universal support from bodies representing leaseholders, legal professionals, managing agents, and landlords, and from individual professionals. Consultees generally echoed the arguments made in the Consultation Paper. Graham Webb (leaseholder) noted, for example, that from his experience "the ability to co-opt directors is essential, as there are always more vacancies than candidates".

12.6 Other consultees just thought that the election procedure should be kept as simple as possible. Those who opposed it were particularly concerned at the possibility for abuse of the ability of existing directors to co-opt new directors.

### Discussion and recommendations for reform

12.7 In the light of consultees' support, we recommend a simplified procedure for the election of directors.

(1) Directors may be elected by ordinary resolution. This would generally be passed at a general meeting, but it could be passed by the written resolution procedure.

(2) Directors may be co-opted by the existing directors.

(3) The whole board of directors is subject to annual elections.

12.8 We acknowledge that co-option creates the potential to preserve the dominance of a clique. However, we consider that it is necessary to retain the possibility of co-option for the good running of commonhold associations. We agree with consultees' suggestion that it is a useful tool to fill vacancies.

12.9 We have addressed the potential for abuse by requiring the board of directors to be subject to annual elections. A co-opted director could therefore be removed at the next annual election if unit owners saw fit. As a commonhold association must hold at least one general meeting per year, this is not an onerous requirement. Alternatively, as noted in point (1) above, the requirement for an annual election could be satisfied in writing.

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4 CP, para 9.9.

**Recommendation 57.**

12.10 We recommend that the procedure for the election of directors of a commonhold association should be simplified, so that the prescribed articles of association provide that directors should be elected by an ordinary resolution, which should generally be passed at a general meeting, but which might be passed by the written resolution procedure. We further recommend that directors may also be co-opted by the existing directors.

12.11 We recommend that a commonhold association's board of directors should be subject to an annual election.

## ENSURING THAT THERE ARE DIRECTORS WHEN UNIT OWNERS FAIL TO APPOINT THEM

12.12 The current law does not address the scenario in which unit owners are unwilling to serve as directors and refuse to appoint professional directors. In this scenario, management of a commonhold will likely stall. Lack of management is detrimental to unit owners and mortgage lenders, as the value of the units will likely suffer if the commonhold is not properly maintained. Perhaps most significantly, it may result in the commonhold association being struck off.

12.13 As noted in the Consultation Paper, we hope that the seriousness of this possibility would lead to unit owners serving as directors.[5] However, to address the possibility that no unit owners are willing to stand as directors, and agreement cannot be reached to appoint professional directors, we provisionally proposed that any member of a commonhold association, or anyone with a mortgage or other charge over a unit, should be able to apply to the court or Tribunal for professional directors to be appointed, who would then be paid by the commonhold association.[6]

### Consultees' views

12.14 The vast majority of consultees were in favour of our proposal. Those who supported the proposal tended to share our concerns as to the consequences if a commonhold association was left without directors. A couple of consultees who supported our provisional proposal acknowledged concern at the idea of a person who has not been nominated by members of the commonhold association being appointed as a director. For example, PM Property Lawyers Ltd (solicitors) said that it "fell foul" of the commonhold ethos for directors to be appointed in this way.

12.15 Those who opposed the proposal tended to think that for a court or Tribunal to have to appoint directors undermined the principles of democracy and self-governance that are integral to commonhold. One consultee said that if directors could not be

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5 CP, para 9.28.

6 CP, Consultation Question 43, para 9.36.

appointed, then the unit owners should consider terminating the commonhold, while another suggested that unit owners should be required to act as directors in rotation.

12.16 A few consultees were against lenders having standing to apply to the court or Tribunal. Their view was that lenders, with possibly only a small stake in the property, should not be treated as having equal standing with unit owners.

12.17 Some consultees thought that the appointment should be made by a court rather than the Tribunal. Some consultees also considered that the costs of making the application should automatically be reimbursed by the commonhold, and that a conflict of interests could arise if managing agents are appointed as directors.

12.18 Several consultees suggested that those with interests in units other than owners and lenders should also be eligible to apply to the court or Tribunal. The Property Bar Association (the "PBA") suggested that those holding leases of units following a conversion to commonhold should have standing to apply.

### Discussion and recommendations for reform

12.19 The potential implications of unit owners failing to appoint directors are extremely serious. An absence of directors will result in lacuna in management. Urgent repairs, for example, may not be able to proceed. It may also result in the commonhold association being struck off. If that occurred, the commonhold structure would dissolve, and no positive obligations could be enforced between unit owners. Such an outcome would significantly reduce the value and marketability of a commonhold's units. This is an outcome we have sought to prevent as much as possible.[7]

12.20 The fact that commonhold is controlled by unit owners provides a significant degree of protection against an absence of directors. If no directors were in post, it is likely that unit owners would agree to serve as directors, or appoint professional directors, in order to protect the value of their units. Nonetheless, we believe it is necessary to provide a safeguard to protect unit owners and all parties with a stake in the commonhold where unit owners are unwilling to serve and no agreement is reached on appointing professional directors. We consider that providing a right to apply to the court or Tribunal for the appointment of professional directors is a proportionate means of doing so. We address consultees' concerns in turn.

#### Jurisdiction

12.21 Consultees suggested that the application should be made to the court rather than the Tribunal. We believe that the Tribunal is the appropriate forum. The Tribunal is experienced in appoining recievers and manageres of leasehold property and is therefore well-placed to appoint directors of commonhold associations. More broadly, our general view is that disputes relating to commonhold should be heard by the Tribunal, as the specialist body, rather than the court, unless there is a compelling reason to require an application to the court. We do not see any reason to require an application to the court in this instance.

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7 See Ch 19 of this Report.

### Who should be able to apply

12.22 A few consultees opposed the suggestion that mortgage lenders should be able to apply for the appointment of a professional director where no unit owner is willing to serve and there is no agreement on the appointment of professional directors. We maintain the view that lenders should have standing to apply for the appointment of a director in these circumstances. An absence of directors has the potential to significantly reduce the value of the units, and any decrease in value will also impact the value of the lender's security. Providing lenders with standing therefore offers a proportionate method of protecting their interest.

12.23 Consultees suggested that our provisional proposal would enable lenders to exercise control over a commonhold. We do not agree with this suggestion. First, the circumstances in which a lender may apply are narrowly defined. A lender may only apply for the appointment of a professional director where no unit owner is willing to serve and there is no agreement on the appointment of professional directors. So long as unit owners either serve as directors or appoint professional directors, lenders have no standing to apply for the appointment of professional directors.

12.24 Second, if a lender does apply, this does not allow them to nominate their own director. It would therefore not be possible for the commonhold to come under the control of a lender's agent.

12.25 Third, our provisional proposal does not change the basic position that a lender does not enjoy voting rights in a commonhold. In any case, as we have noted elsewhere, we doubt that lenders have any wish to be involved in the day-to-day management of a commonhold. We therefore recommend that lenders have standing to apply for the appointment of a director where unit owners refuse to serve and fail to appoint professional directors.

12.26 We agree with consultees who suggested that a wider range of interested parties should be able to apply for directors to be appointed than unit owners and lenders. The PBA suggested that any leaseholders who have to contribute to the commonhold expenditure should be entitled to apply. As these leaseholders have a substantial stake in their unit, we agree that they should be entitled to apply. Those who fall within this category would include non-consenting leaseholders (under conversion Option 1), and "permitted leaseholders" (that is, those who hold units under shared ownership leases, or a home purchase plan).[8]

12.27 Berkeley Homes Group PLC suggested that a developer should also be entitled to apply during the development period. We also agree with this suggestion. We therefore recommend that in addition to unit owners and mortgage lenders, permitted leaseholders, non-consenting leaseholders under conversion Option 1 and developers exercising development rights may all apply for the appointment of directors where unit owners are unwilling to serve and unwilling to appoint professional directors.

12.28 However, extending standing to non-consenting leaseholders and permitted leaseholders creates a parallel right to a protection that leaseholders would ordinarily enjoy under current leasehold law. Under Part II of the Landlord and Tenant Act 1987

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8 See Ch 5 and Ch 11.

(the "1987 Act"), non-consenting leaseholders and permitted leaseholders could apply to the Tribunal for a receiver and manager to be appointed if a commonhold association, as their landlord, was in breach of its obligations under the lease. Having this right alongside the right to apply for directors to be appointed if there are none could prove inconvenient and confusing. We therefore recommend that, if non-consenting leaseholders and permitted leaseholders can apply for directors to be appointed, this should replace their rights under Part II of the 1987 Act.

### Costs

12.29 We are taking the view that the Tribunal should generally deal with commonhold disputes on a "no costs" basis. This means that applicants and respondents pay their own legal costs, if they incur them, and, if they are successful, do not have the right to be reimbursed by the other side. We think, however, that an exception to this principle would be appropriate here. A unit owner, or any other applicant, who makes an application to the Tribunal for professional directors to be appointed, is acting in the interests of all unit owners, and indeed everyone with a stake in the commonhold. Allowing them to claim their legal costs from the commonhold ensures that the costs are borne fairly by all.

### Ethos of commonhold

12.30 We note consultees' concerns that the appointment of a director by the Tribunal runs contrary to the democratic principles of a commonhold. However, we do not think that there is a viable alternative to address an unwillingness of unit owners to serve as directors or appoint professional directors. It would be unduly drastic for a commonhold to terminate in these circumstances. Further, the position of lenders might be prejudiced so long as there were no directors, and they would not be able to initiate a termination. Nor do we think that it is practical or desirable for the unit owners to be required to serve as directors in rotation. We note that such a requirement would also run contrary to the general requirement in company law that directors have to confirm their acceptance of office.

### Managing agents

12.31 We note concerns around conflicts of interest if managing agents are appointed as directors. Notwithstanding, we think that the ability to appoint managing agents as directors is likely to be useful. An alternative approach, whereby the Tribunal appoints directors to appoint managing agents, seems unnecessarily complex and would incur additional expense. If the unit owners wished to take back responsibility for electing directors, the new directors would then be able to choose who should be the managing agent.

**Recommendation 58.**

12.32 We recommend that, if a commonhold association cannot find unit owners able and willing to serve as directors, and is also unwilling to appoint professional directors, it should be possible to make an application to the Tribunal for professional directors to be appointed, who would then be paid by the association.

12.33 We recommend that the following parties should be entitled to apply for directors to be appointed:

(1) unit owners;

(2) permitted leaseholders;

(3) non-consenting leaseholders, under conversion Option 1;

(4) mortgage lenders and other secured lenders; and

(5) developers exercising development rights.

12.34 We recommend that the rights of permitted leaseholders and non-consenting leaseholders under this provision should replace their right to apply for a receiver and manager to be appointed under Part II of the Landlord and Tenant Act 1987.

12.35 We recommend that anyone who makes an application to the Tribunal under this provision should normally be paid their reasonable costs by the commonhold association.

## THE DUTIES OWED BY DIRECTORS, AND ENSURING COMPLIANCE

12.36 The directors of a commonhold association owe the same duties as any other company directors.[9] Additionally, a commonhold association owes duties to unit owners under the terms of the CCS.[10] However, there may be instances when directors fail to comply with their obligations set out in the CCS. This scenario has the potential to compromise the management of commonholds and therefore diminish the value of commonhold units. However, there is currently no satisfactory method of ensuring that the directors comply with their duties in the CCS. A unit owner could apply for an injunction requiring the commonhold association to comply with its obligations, but it is very difficult to enforce such an injunction.[11]

12.37 We invited consultees' views as to whether a problem is likely to arise whereby a single investor, or a group of investors, who own a majority of units, run a block in their own interests in order to "squeeze out" other owners.[12] If so, we then asked whether a unit owner should be able to make an application to the court or Tribunal to appoint directors where there is a "persistent failure to comply with the CCS in a material respect".[13]

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9 CP, para 9.39.

10 CP, para 9.41.

11 CP, para 9.44.

12 CP, Consultation Question 44, para 9.51.

13 CP, Consultation Question 44, para 9.52(1).

12.38 We also asked whether the court or Tribunal should have supervisory powers over the directors appointed.[14] We suggested that the court or Tribunal would need to have supplemental powers to ensure that the majority unit owners did not use their voting strength to appoint further directors to outnumber those it had appointed, or to pass a special resolution requiring the directors to act, or not to act, in a specified way. We also asked if the court or Tribunal would need to exercise supervision over the directors it had appointed.[15]

12.39 Finally, we invited views as to whether other solutions were possible.[16]

### Consultees' views

#### Potential for investor(s) to "squeeze out" other unit owners

12.40 A sizeable majority of consultees thought that it was possible that an individual or group might seek to take control of a commonhold and force the minority to sell, and expressed concern over this scenario. The Association of Residential Managing Agents ("ARMA") thought it was possible, but unlikely, in view of the considerable capital expenditure that it would require. Some consultees, however, offered examples of where the scenario had occurred in leasehold blocks following a collective freehold acquisition. Some consultees who felt the scenario was unlikely to arise nonetheless considered it desirable to have a means in place to deal with it.

12.41 A substantial majority of consultees drawn from a wide range of categories supported our proposed solution that unit owners should have the right to apply to the court or Tribunal for the appointment of directors to replace the elected directors.

12.42 A significant minority of leaseholders and other individual consultees put forward suggestions which took a different approach to the problem. They proposed either restricting the number of units that any individual owner might own, or restricting the voting rights that the owners of more than one unit might exercise.

#### The threshold at which the court or Tribunal may appoint a director

12.43 Several consultees, including the PBA and the Property Litigation Association (the "PLA") thought that our suggested threshold for intervention might need to be lower. The PLA specifically suggested that a "material breach of the CCS" rather than "persistent failure" should be the test. The PBA thought that our suggested test would be unlikely to "cover the full ambit of potential problems that may arise" but did not suggest an alternative formulation.

#### Jurisdiction

12.44 Most consultees thought that the Tribunal should deal with the appointment of directors. A small number of leaseholder consultees here and elsewhere expressed concerns over the competence and impartiality of the Tribunal, and generally preferred that all disputes should go to the court.

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14 CP, Consultation Question 44, para 9.52(3).

15 CP, Consultation Question 44, para 9.52(4).

16 CP, Consultation Question 44, para 9.52(5).

12.45 A few consultees – who generally favoured giving jurisdiction over commonhold matters to the Tribunal – thought that in this particular instance it should be possible for the dispute to be heard in court. The PBA thought that the court would be the more appropriate forum, as the context in which applications will be made may involve allegations of fraud. Other consultees favoured the court on the basis that the allegations made are likely to be contentious, or because they felt that the court would more appropriately deal with the appointment and possible removal of directors.

### Supplemental powers and supervision

12.46 Consultees generally did not raise objections to our proposal that additional directors be appointed by the court or Tribunal. Serious reservations as to the practicalities of this approach were, however, expressed to us by some Tribunal judges. The Tribunal judges were concerned that the result of our proposal might be that the Tribunal would need to repeatedly appoint additional directors to outnumber those elected by unit owners, and that contested issues would need to continually be referred back to the Tribunal. The judges preferred to emulate Part II of the 1987 Act, by which the Tribunal appoints a single receiver and manager, who takes the place of the landlord (and of the landlord's agents).

12.47 Consultees tended to conflate the issues of supervision, and the facility to refer back to the court or Tribunal for rulings on points of contention, and were uncertain as to the nature of the supervision that might be undertaken.

## Discussion and recommendations for reform

12.48 We do not think that it is likely that unit owners will be "squeezed out" frequently. Nonetheless, we are of the view that the risk is sufficiently serious to warrant the introduction of a scheme to protect the minority.

12.49 The first solution consultees suggested was to limit the number of units that any one individual unit owner might own. This conflicts with a principle in commonhold that unit owners, as freeholders, should have freedom to transfer their units. The second solution consultees proposed was to restrict the voting rights of unit owners who own more than one unit. This proposal conflicts with the principle that voting power within a commonhold should correlate with unit owners' economic stake in the commonhold. In any event, such restrictions might be circumvented if units are owned by associates or by subsidiary companies.

12.50 In the absence of a workable alternative, and of the wide support of consultees, we consider that giving the court or the Tribunal a power to appoint a sole director to replace any existing directors, if there is a persistent failure to comply with the CCS in some material respect, offers the most effective solution. We turn now to outline how this power should operate.

### Appointing a sole director

12.51 We provisionally proposed that the court or Tribunal appoint multiple directors to take control of the association.[17] We acknowledge the concerns raised by the Tribunal judges that this may result in the Tribunal needing to repeatedly appoint additional

[17] CP, para 9.49.

directors to outnumber those elected by unit owners, and that contested issues would likely result in repeated applications back to the Tribunal.[18] We agree that our provisional proposal should be revised to better reflect the approach taken in Part II of the 1987 Act. We therefore recommend that the Tribunal should have the power to remove a commonhold's existing directors and to appoint a sole professional director to replace them. The appointed director would be accountable to the Tribunal, broadly to the same extent as a receiver and manager under the 1987 Act.

12.52 We recognise that this makes an exception to the general rule of having at least two directors for each commonhold.[19] In these exceptional circumstances, we think the balance of convenience tilts in favour of there being a sole director.

12.53 We also note that that this right should apply in respect of professional directors appointed by the Tribunal under our recommendation above.[20] While we think it is highly unlikely that appointed professional directors would fail to comply with the CCS, the directors' failure to comply may arise because of an unwillingness on the part of the owners to co-operate with the directors.

### The threshold at which the court or Tribunal may appoint a director

12.54 We provisionally proposed that the Tribunal may appoint directors where there has been "persistent failure to comply with the CCS in some material respect". The PLA suggested that a "material breach" of the CCS is preferable. We consider that our original approach should be adopted. The PLA's formulation would enable the appointment of directors upon a single breach of the CCS. We think that would be a disproportionate response. If the directors breach the CCS a unit owner may apply to the court for a mandatory injunction to require the directors to comply with the CCS.[21] That should continue to be the case.

12.55 In contrast, the power to appoint directors offers a safeguard where an injunction has not been complied with, or has to be remade because of repeated breaches of the CCS. In these circumstances of persistent failure to comply with the CCS, we consider that the replacement of the commonhold's directors is a proportionate response. We therefore that persistent failure to comply with the CCS is the threshold at which a court or Tribunal may appoint a director.

### Jurisdiction

12.56 We are not persuaded that the application should need to be made to the court in all cases. The Tribunal's experience of appointing receivers and managers in leasehold makes it well-placed to appoint directors. However, we acknowledge that there will be cases which the Tribunal considers need to be referred to a court. When that happens, the court should be able to deal with all aspects of the dispute by appointing directors. Therefore, while we remain of the view that the application should initially be

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18 See above, para 12.46.

19 Commonhold Amendment Regulations 2009, sch, art 39.

20 Para 12.32.

21 Or to the Tribunal, if it had been given an extended jurisdiction.

made to the Tribunal, the power of appointment should lie both with the court and Tribunal.

### The supervisory role of the Tribunal

12.57 We do not consider that the Tribunal should take on an active supervisory role in overseeing an appointed director. We do not anticipate that an appointed director will need to report back to the Tribunal as a matter of course, nor do we envisage that an appointed director would need to furnish annual reports or accounts to the Tribunal. We consider that the Tribunal's supervisory role is engaged upon the application of a director or unit owners. For example:

(1) the appointed director may need to go back to the Tribunal by an application in the original proceedings (rather than a fresh application) if the director feels that his or her decisions are being undermined by a majority of unit owners and that he or she therefore needs additional powers; or

(2) as suggested by consultees, a unit owner may, for good cause, apply to the Tribunal for the replacement or removal of a director that it has appointed.

12.58 Most managerial functions within the commonhold lie with the directors rather than the unit owners as members. Unit owners may, however, pass resolutions to frustrate the ability of the appointed director to manage the commonhold effectively. For example, unit owners might:

(1) pass an ordinary resolution to remove the appointed director;

(2) resolve to elect further directors with a view to their outvoting the appointed director;

(3) pass a special resolution requiring the appointed director to take, or not to take, a specified course of action; or

(4) fail to approve a budget, and contributions to shared costs, which were intended to remedy any disrepair, or to cover necessary expenditure.[22]

12.59 We take the view that (1) and (2) can best be avoided by providing that a resolution to achieve either result should be of no effect while an appointed director was in post. If the unit owners thought that an appointed director was acting improperly and should be replaced, they would be able to apply to the Tribunal for his or her removal.[23]

12.60 In the case of (3), if the unit owners passed any such resolution then the appointed director would have the power to annul it. The resolution would then be of no effect, but a unit owner, or someone else who has standing to make an original application for the appointment of a director, would have the right to apply to the Tribunal for it to confirm the resolution. We recommend that the Tribunal would then have the power to

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22 See our recommendations in Ch 13 at paras 13.32 to 13.38 which deal with this situation.

23 We deal with how unit owners may resume control at para 12.63 below.

let the annulment stand, to confirm the resolution, or to make such other order and on such terms as it saw fit.

12.61 We would want to achieve broadly the same outcome for case (4) above as for case (3). We cannot, however, simply replicate the procedure. Our recommendation for (3) depends on there being a resolution which the appointed director can annul, and which can then be referred to the Tribunal for consideration. If the owners fail to approve the commonhold contributions, there is no resolution to annul or to refer. The owners in the majority might even attempt to frustrate the attempts of the appointed director to fund necessary works at the commonhold simply by ensuring that any general meeting called to approve the level was not quorate.

12.62 We believe that a different approach is necessary for the approval of commonhold contributions when an appointed director is in place. While the appointed director should consult with unit owners before setting the level of contributions, we consider that there should be no need for unit owners to vote to approve them.[24] If, however, unit owners pass a resolution objecting to the proposed contributions, then any owner who objected to the proposed contributions should be entitled to apply to the Tribunal. The Tribunal could then determine the appropriate level of contributions.

### Resumption of control by unit owners

12.63 A number of consultees noted that the Consultation Paper did not explain how, following the appointment of directors by the court or Tribunal, the powers to manage the commonhold would be returned to unit owners. The appointment of a director by the court or Tribunal should be temporary. We therefore consider that it should be possible to apply for the removal of the appointed director when appropriate. We recommend that any person who had standing to apply to the court or Tribunal for the appointment of a director, and the appointed director themselves, should be able to make an application for his or her removal. Rescinding the appointment would be appropriate, for example, if the membership of the commonhold association has changed such that there is no longer a danger that the elected directors will fail to carry out their duties.

**Recommendation 59.**

12.64 We recommend that, if there is a persistent failure by the directors of a commonhold association to comply with the CCS in some material respect, the Tribunal or the court should have the power to appoint a director who would replace any existing directors. Upon the appointment of a director, unit owners would be unable to resolve to remove that director, or to elect further directors.

12.65 We recommend that the following parties should have standing to make an application for the appointment of a director:

(1) unit owners;

[24] See Ch 13, para 13.4 to 13.31 for an overview of our recommended approach for the approval of commonhold contributions.

(2) permitted leaseholders;

(3) non-consenting leaseholders, under conversion Option 1;

(4) mortgage lenders and other secured lenders; and

(5) developers exercising development rights.

12.66 We recommend that applications for the appointment of a director should be made initially to the Tribunal, but that, if the application should require remedies which are beyond the scope of the Tribunal to grant, the Tribunal should have power to transfer the application to the court.

12.67 We recommend that the director appointed by the court or the Tribunal should remain in place until the court or Tribunal granted an application to remove or replace the appointed director. Anyone who might have applied originally for the appointment of a director, and additionally the appointed director, should have standing to make the relevant application

12.68 We recommend that the Tribunal or the court should have power to make supplementary orders so as to ensure that the powers of the appointed director cannot be frustrated by the unit owners.

12.69 We recommend that, if the unit owners passed a special resolution requiring the appointed director to take, or not to take, any specified action, the appointed director should have the power to annul it.

12.70 We recommend that, if the appointed director annuls a resolution of the commonhold association, a unit owner, or any other party with standing to make an application for the appointment of a director, may apply to the Tribunal to confirm the resolution. The Tribunal should then have the power to let the annulment stand, to confirm the resolution, or to make such other order and on such terms as it sees fit.

12.71 We recommend that so long as there is a director appointed by the court or the Tribunal, the director should consult with the unit owners before setting the contributions to shared costs and reserve fund(s), but there should be no requirement that the unit owners approve the level of contributions. Instead, if the owners voted to reject the proposed level of contributions, anyone who had voted in favour of the rejection should be entitled to apply to the court or the Tribunal to determine the appropriate level of contributions.

## USE OF PROXY VOTING

12.72 As with any limited company, unit owners as members of a commonhold association may vote “by proxy”. Voting by proxy enables a unit owner to appoint another person to vote and express views on his or her behalf at a company meeting. The ability to vote by proxy is useful where, for example, a unit owner is unable to attend a meeting.

However, proxy voting is potentially open to abuse if the incumbent directors (or the managing agents) collect a large number of proxy votes from unit owners, enabling them to control the commonhold. It is also possible that a developer may insist that purchasers sign a proxy so that the developer can maintain control of the commonhold. There is also a risk that lenders will seek a proxy as a means of protecting their security (although we acknowledged that it is unlikely that a mortgage lender would wish to be actively involved in the running of the commonhold).[25]

12.73 We asked consultees about their experience of proxy voting in leaseholder-controlled companies.[26] We also asked if abuse could be prevented by restricting the number of proxies any individual can hold or by other means.[27]

### Consultees' views

#### The risk of abuse

12.74 Consultation responses were equivocal as to the possible risk of abuse. Some consultees, particularly leaseholders and individual consultees, linked the problem with non-resident leaseholders. The Leasehold Advisory Service ("LEASE") thought that there was a link:

> Based on our experience, abuse of proxy voting is more likely to happen with buy-to-let properties. Flat owners may not be aware of the management issues and may be more likely to lean on management advice and consequently to accept proxy voting. This way, errant management can influence the tactical way such votes are to be cast.

12.75 A few consultees suggested that voting should be restricted to resident unit owners, or that those who owned more than one flat should enjoy only one vote.

12.76 A few consultees had encountered abuse in practice, while a slightly larger number thought that abuse was possible.

#### Preventing and mitigating abuse

12.77 To prevent and mitigate abuse, the vast majority of consultees thought that there should be a restriction on the number of proxy votes that any individual might hold. Most of the remainder favoured some form of restriction on the voting rights of non-resident leaseholders.

12.78 The Federation of Private Residents' Associations (the "FPRA") did not favour any restriction on the number of proxies that any individual leaseholder might hold. They thought that proxies should be allowed commonhold in order to take into account the views of those who are unable to be present at a general meeting. They pointed out that a standard proxy form allowed the member to direct how his or her vote should be cast. Trowers & Hamlins LLP (solicitors) also preferred the use of "closed" rather than

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25 CP, para 9.53 to 9.59.

26 CP, Consultation Question 45, para 9.58.

27 CP, Consultation Question 45, para 9.59.

"open" proxies. They also favoured proxies being limited to the next meeting, which would be unavoidable with "closed" proxies.

12.79 Several consultees suggested that greater use could be made of postal or digital voting. One individual consultee thought that the need to use proxy voting would be mitigated by the greater use of the written resolution procedure.

### Discussion

12.80 Although a few consultees had experience of abuse of proxy voting in leaseholder-controlled companies, we have not been presented with evidence of wide spread abuse. We therefore do not consider that there is a convincing reason to restrict the use of proxy voting in commonhold. It is fundamental to the operation of a commonhold that all unit owners, as members of the commonhold association, are entitled to the votes allocated to their units. However, unless there is legitimate reason to do so, unit owners should not be prevented from delegating control over decision making where they wish to do so.

12.81 Criticism of the possible misuse of proxy voting is largely confined to "open" or "general" proxies, which enable the person nominated to exercise discretion as to how to vote. We agree that there is potential for abuse. There are, however, safeguards to prevent this persisting. First, a unit owner may revoke the proxy if he or she was dissatisfied in how the vote was exercised. Second, the proxy holder should vote in accordance with what he or she considers in their best judgment to be the principal's wishes.[28] In the light of consultees' concerns, we recommend that use of open-proxy votes in commonhold is kept under review.

12.82 One consultee suggested that the need to use proxy voting would be mitigated by the greater use of the written resolution procedure. Although under company law most resolutions can be passed as written resolutions, we are reluctant to suggest that written resolutions should generally replace the procedure of passing resolutions at meetings. Bringing people together for a meeting encourages discussion, which the written resolution procedure does not. Voting by "show of hands" at a meeting is a convenient way of passing formal and non-contentious business. Making greater use of the written procedure has some attractions. It does, however, suffer from the disadvantage that it does not provide an opportunity for unit owners to discuss matters relating to the commonhold. It is also difficult to provide for a resolution to be amended.

12.83 Consultees also suggested greater use of digital voting. We agree that digital voting has the potential to simplify the voting process in commonholds. We do not, however, consider that it is desirable to recommend bespoke voting mechanisms in commonhold. This would create an undesirably distinction between the law governing commonhold and company law more generally. Company law is in the process of modernising voting processes in light of new technology. Commonhold will likely to adapt to these changes over time.

12.84 We do not think that it would be generally acceptable or right in principle for "buy-to-let" unit owners to be deprived of their voting rights in the way that a few consultees

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[28] *Shackleton on the Law and Practice of Meetings* (14th ed), para 14-28.

suggested. Nor do we consider that owners of more than one unit should be deprived of the voting rights connected allocated to their units.

## REQUIREMENTS FOR INSURANCE

12.85 In the Consultation Paper we raised four separate issues on insuring commonholds:

(1) the ability of the commonhold association to take out buildings insurance;

(2) the provision of information on insurance to unit owners and their mortgage lenders;

(3) whether the commonhold association should be required to take out public liability insurance; and

(4) the ability of the commonhold association to take out directors' and officers' insurance.

12.86 As each issue raises discrete points we discuss them in turn.

### Buildings insurance

12.87 The CCS imposes duties to insure a commonhold. In respect of the common parts, the commonhold association must insure the common parts against loss or damage caused by fire and any other risks specified by unit owners in the CCS.[29] In contrast, the obligation to insure the units may be placed on the association or on the unit owners.[30]

12.88 This provision provides flexibility for different types of commonholds. In a development comprised of houses, it may be appropriate for individual unit owners to take responsibility for the insurance of their homes. On the other hand, in the case of flats and other horizontally-divided buildings,[31] the obligation can be placed on the commonhold association so that the whole commonhold can be insured under a single policy.

12.89 Where a commonhold is comprised of flats and other horizontally-divided buildings it is essential to have the whole of the building covered by one buildings insurance policy. This avoids having a multiplicity of policies, which would be inconvenient in the case of damage affecting numerous units and the common parts. It is also highly unlikely that unit owners could procure buildings policies for individual flats.

12.90 The current law presents difficulties for insuring the whole of a commonhold under a single buildings policy. First, a valid insurance policy requires that the insured has an "insurable interest" in the subject matter of the insurance policy. An insurable interest requires that the party taking out the insurance must gain a benefit from the preservation of the subject matter of the insurance or suffer a disadvantage should it

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29 Commonhold Regulations 2004, sch 3, para 4.4.1. See also CP, paras 9.65 to 9.69.

30 Commonhold Regulations 2004, sch 3, annex 4, para 6.

31 "Horizontally-divided buildings" would also include divisions of, for example, stable blocks or other buildings which would not generally be described in that way.

be lost.[32] It is generally satisfied if the insured party owns, or has a legal right arising out of a contract in respect of, the subject-matter of the policy.[33] However, the fact that the commonhold association owns the common parts but not the individual units may prevent the commonhold association from validly insuring the entire building.

12.91 To satisfy this requirement, we provisionally proposed that legislation should deem the commonhold association to have an insurable interest in parts of the building that are owned by unit owners.[34]

12.92 Second, as insurance policies are contracts of indemnity, the policyholder can recover only the amount of his or her actual loss.[35] The current law requires the commonhold association to reinstate the common parts. However, as the commonhold association is not required to reinstate the units, it might be argued that it has not suffered a loss and is therefore not entitled to claim the costs of reinstating or rebuilding the whole commonhold. We therefore provisionally proposed that the commonhold association should be required to reinstate or rebuild (as appropriate) the whole of a horizontally-divided building – including the parts owned by the unit owners – in order to satisfy the indemnity principle within insurance law.[36]

12.93 Finally, we asked consultees if they considered there to be any other legal difficulties with the ability of the commonhold association to obtain buildings insurance.[37]

### Consultees' views

#### Commonhold association having an insurable interest

12.94 There was almost universal approval from consultees to the proposal that the commonhold association should be deemed to have an insurable interest in parts of a building that are owned by unit owners.

12.95 Other consultees wished to raise other insurance-related issues, such as the taking of commissions on insurance policies.[38]

12.96 J Brown (leaseholder) suggested that:

> In Australia there is a clear delineation between responsibility for insurance of the common parts by the commonhold associaiton and responsibility for insurance of the Unit by the Unit Holder.

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32 Insurance Contract Law: Post Contract Duties and Other Issues (2011) Law Commission Consultation Paper No 201; Scottish Law Commission Discussion Paper No 152, para 10.1.

33 The classic test is that the policyholder has a right in the property which is the subject of the insurance, or a right arising out of a contract in respect of it: *Lucena v Craufurd* (1806) 2 Bos & PNR 269.

34 CP, Consultation Question 46, para 9.87.

35 CP, para 9.76.

36 CP, Consultation Question 46, para 9.88.

37 CP, Consultation Question 46, para 9.89.

38 Although this has been a controversial topic within residential leaseholds, it is difficult to see how it would be an issue within commonholds, as any commission would be paid to the association. Long-term insurance policies arranged by developers would fall within recommendations made later in this chapter.

### Imposing a requirement to rebuild

12.97 Similarly, our provisional proposal that the commonhold association should be under an obligation to reinstate or rebuild the whole of a horizontally-divided building attracted almost universal approval.

12.98 Four consultees raised concerns that imposing a requirement to rebuild on the commonhold association might have undesirable consequences. They all suggested that it would be inconvenient to impose an obligation on the association to reinstate and rebuild if it would in fact be more economic to rebuild to some entirely different and more modern specifications, which might involve the unit owners opting to terminate the commonhold. They would then sell the site, and divide up the proceeds of sale and any insurance claim.

### Any other legal difficulties in obtaining buildings insurance

12.99 Some consultees, including Stephen Desmond and Trowers & Hamlins LLP, raised the question of what should happen if a commonhold proved to be uninsured or underinsured. Nick Wilkins (leaseholder) proposed that if an insurer failed to pay out on a Government-approved insurance policy, then Government should itself bear the loss.

12.100 Consultees referred to various risks which they thought a commonhold should consider insuring against. ARMA, for example, thought that attention should be paid to the need for insurance to cover the cost of alternative accommodation for residents if a commonhold building was damaged or destroyed.

12.101 The Conveyancing Association and Clutton Cox Conveyancing proposed that statutory requirements for insurance should require comprehensive insurance such as would satisfy the requirements of the Lenders' Handbooks issued by UK Finance (association representing mortgage lenders) and the Building Societies' Association.

12.102 Christopher Jessel (solicitor) thought that some insurance companies asked for information about the structure of the building, and who was occupying it, and other questions which a commonhold association might find it impossible to answer. He suggested that an insurer should not be allowed to refuse cover on this basis.

### Discussion and recommendations for reform

12.103 One consultee suggested that it should be for the commonhold association to insure the common parts and for the unit owners to insure their units, as is the case in Australia. Adopting this practice would be a marked departure from the way that blocks of flats are almost always insured in England and Wales. The near universal practice is for the building to be insured under a single policy. Requiring the commonhold association to insure the common parts and the unit owners to insure their units raises the question of how a commonhold would be reinstated or rebuilt if some owners were uninsured or underinsured.

12.104 We consider that it is better to adapt commonhold for current insurance practices rather than provide a bespoke regime for commonhold. We turn now to consider what changes are necessary to ensure that commonhold is compatible with current insurance practices.

### Satisfying the indemnity principle

12.105 The indemnity principle permits a policyholder to recover only the amount of their actual loss.[39] As noted above, if a commonhold association insures the commonhold units and they are damaged or destroyed, it may be argued that it has not suffered a loss and is therefore not entitled to claim the costs of reinstating or rebuilding the whole commonhold.[40]

12.106 Following consultees near universal support, we recommend that, if unit owners specify that the commonhold association is under a duty to insure the commonhold units, the association should be obliged to repair, reinstate or rebuild (as appropriate) the whole of a horizontally-divided building – including the parts of the commonhold owned by the unit owners.[41] As noted in the Consultation Paper, for the indemnity principle to be satisfied, a loss must leave the policyholder "financially poorer than before".[42] Our recommendation ensures that the indemnity principle is satisfied as the association must meet the costs of repair, reinstatement or rebuilding the whole of the commonhold. If the association failed to repair, rebuild or reinstate the commonhold, it would be financially liable to the unit owners.[43]

12.107 In the Consultation Paper we referred to an obligation to rebuild "the parts of the building which are owned by the unit owners". However, we consider that it is necessary in our recommendation to refer to "the parts of the *commonhold* which are owned by the unit owners". There might be situations where the owners of flats also owned, say, garages on the site. These garages would be a part of the commonhold, but it would not be clear that they formed "part of the building". Although the CCS might provide for houses forming part of the commonhold to be separately insured, it would not generally make sense for unit owners to have to take out separate insurance for, say, garages which formed part of a unit.

12.108 We also consider that it is necessary to include "repair" in addition to "reinstate or rebuild" in our recommendation. We intended in our provisional proposal for "reinstate" to include "repair", and we wish to put it beyond doubt that a commonhold can validly insure against the costs of repairing damage the commonhold that does not amount to reinstatement.

### Commonhold associations having an insurable interest

12.109 Following analysis of consultees' responses, we do not consider that it is necessary that statute deems commonhold associations to have an insurable interest in the parts of the building owned by unit owners.

12.110 An insurable interest is generally present for the purposes of insurance law where the insured party holds a legal or equitable interest in the subject matter of the insurance

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39 CP, para 9.76.

40 Para 12.92.

41 As noted above, the CCS must specify whether unit owners or the association is to insure the units: see para 12.87.

42 CP, para 9.78, quoting MA Clarke, *Law of Insurance Contracts* (5th ed 2006) Ch 16-2A.

43 CP, para 9.78.

policy.[44] In relation to buildings, the fact that a party owns a property gives rise to an insurable interest in respect of it. However, an insurable interest may also exist in respect of property a party does not own if he or she is responsible for, or would suffer loss in the event of, damage to the subject matter of the insurance policy.[45] Put differently, despite holding no rights in the property, an insurable interest may be present in circumstances where there is a real probability that the insured will suffer a loss or incur a liability on the occurrence of the insured peril.[46]

12.111 If the CCS places an obligation on the commonhold association to insure the units in addition to the common parts, and, as we recommend above, the commonhold association is then obliged to repair, reinstate or rebuild the whole of the commonhold in the event it is damaged or destroyed, we consider that these obligations provide the commonhold association with a valid insurable interest in the parts of the commonhold it does not own. Although we think there would be benefits to making this clear in legislation, we recognise that legislation is not generally used for clarificatory purposes and we do not therefore go so far as to make a recommendation on these terms.

12.112 Some consultees expressed concern that imposing an obligation to rebuild might in some cases be inappropriate. However, our recommendation needs to be considered in the light of the current law. The prescribed CCS already contains a requirement that "the commonhold association must use the proceeds of any insurance taken out in accordance with paragraph 4.4.1 for the purpose of rebuilding or reinstating the common parts".[47] Our recommendation therefore extends this obligation to the parts of the building owned by the unit owners, but it would not prevent the commonhold association from resolving to terminate rather than reinstating the building.

12.113 Whether the insurer's payment is conditional on the funds being used to reinstate the commonhold is a matter for the terms of the policy. We understand that most buildings policies do provide that payment is conditional on reinstatement. In our view, the commonhold association will suffer a loss if it does not reinstate the premises, thus satisfying the indemnity principle, as it will be financially liable to unit owners if it fails to do so.[48] We anticipate that insurers will resolve claims in a pragmatic manner. It may in many cases be more expensive to cover the full costs of reinstatement as opposed to paying a sum representing the value of the units.

### Any other legal difficulties in obtaining insurance

12.114 Consultees raised the problem of underinsurance and suggested that Government should bear the loss if an insurer failed to pay out on a Government-approved insurance policy. We do not feel able to recommend that Government should need to intervene to this extent.

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44 CP, para 9.67.

45 *Colinvaux's Law of Insurance* (12th ed 2019), para 4-027.

46 Insurance Contract Law: Post Contract Duties and Other Issues. A Joint Consultation Paper (2011) Law Commission Consultation Paper No 201, para 11.68.

47 Commonhold Regulations 2004, sch 3, para 4.4.2.

48 CP, para 9.78.

12.115 Consultees also suggested a statutory requirement that commonholds must have comprehensive insurance, and also suggested various risks which commonholds should insure against. As we noted in the Consultation Paper, the current law prescribes fire as the only risk which commonhold associations must insure against.[49] While it would be desirable for numerous risks to be included within buildings insurance policies, we consider that prescribing further risks which commonholds must insure against may inadvertently create a requirement that is impossible to comply with if insurers will not cover particular risks.[50] Insurance cover for risks such as flood, subsidence, and heave may be difficult to obtain in some areas. We are conscious that if such risks were prescribed it may create a requirement that is impossible to comply with. We therefore consider that commonhold associations are best placed to secure the appropriate level of cover for the risks they face. To aid the directors in this task, we consider that guidance for commonhold directors should be produced which details the risks commonhold associations should consider insuring against.

12.116 Finally, we are not aware that the problem Christopher Jessel raises is at present a problem for leaseholder-controlled companies, or for other landlords. We therefore cannot see why it should be a greater problem for commonholds.

**Recommendation 60.**

12.117 We recommend that, if unit owners impose the obligation to insure the commonhold units on a commonhold association, the association should be obliged to repair, reinstate or rebuild (as appropriate) the whole of a horizontally-divided building – including the parts of the commonhold owned by the unit owners.

### Provision of information about the insurance policies which cover the commonhold

12.118 Under the current law, the commonhold association is required to allow unit owners to inspect the insurance policy for the common parts, and a unit owner may require that he or she be provided with a copy upon payment of the association's reasonable charges. The prescribed CCS does not entitle a unit owner to verify that insurance is on foot, and to obtain a copy of the policy. Instead these matters are left to local rules.[51] To standardise requirements we provisionally proposed that the CCS should require a copy of the buildings policy and schedule, or sufficient details of it, should be supplied to all unit owners on or before they acquire a unit, and when the terms of the policy change.[52]

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49 CP, para 9.66.

50 Para 12.115, above.

51 CP, para 9.68.

52 CP, Consultation Question 47, para 9.90.

12.119 We also provisionally proposed that the commonhold association should confirm to unit owners and their mortgage lenders that the insurance is in existence on an annual basis, and when reasonably required at other times.[53]

### Consultees' views

12.120 Our provisional proposals were nearly universally supported.

12.121 Four consultees suggested that the requirements to provide details of insurance should be stricter than we had proposed. Notting Hill Genesis (housing association) and Consensus Business Group (landlord) thought that a complete copy of the policy should always be supplied, and that there should not be the option of providing "sufficient details" of it.

12.122 Two consultees thought that our proposal to require a copy of the insurance policy and schedule, or sufficient details of it to be supplied to unit owners, was unduly onerous. Christopher Jessel thought that details should be supplied only on request, and that it should not be necessary to supply everyone with details if only minor changes were made. The joint response expressed similar views.

12.123 Similarly, some consultees thought that our proposal as regards confirmation of the existence of insurance were too onerous. The most frequent criticism was that it would be unduly onerous to require the association to notify all owners and all their lenders every year that the insurance was in existence. Those who took this view thought that it would be sufficient for confirmation to be given only when requested. Notably, both support for, and disagreement with, our provisional proposal in this respect was given by organisations with wide experience of insurance matters in relation to leasehold buildings.

### Discussion and recommendations for reform

12.124 Although there was very widespread support for our provisional proposal that the CCS should contain a requirement for details of insurance to be provided to unit owners and their mortgage lenders, there is clearly some disagreement as to the precise extent of this obligation, and as to how it should be expressed. We consider that our proposal draws the right balance as regards the extent of the obligation. We agree, however, that greater use may be made of online platforms to provide information. Notwithstanding, we think that it is important that those who wish to receive a paper copy of insurance information are provided with it.

12.125 However, on reflection we do not believe that it is necessary to provide purchasers with a right to receive a copy of the insurance policy before they acquire a unit. We think that if unit owners are provided with a copy of the buildings insurance policy (or sufficient details of it) when acquiring a unit, and whenever the terms of the policy change, purchasers can insist in the conveyancing process to be provided with a copy (or sufficient details of the policy). If a purchaser was buying from a developer, he or should could similarly insist that the developer supply such details. We therefore recommend that all unit owners are entitled to be supplied with a copy a copy of the

[53] CP, Consultation Question 47, para 9.91.

buildings insurance policy and schedule, or sufficient details of it to all unit owners when they acquire a unit, and whenever the terms of the policy change.

**Recommendation 61.**

12.126 We recommend that commonhold associations should supply a copy of the buildings insurance policy and schedule, or sufficient details of it, to all unit owners when they acquire a unit, and whenever the terms of the policy change.

12.127 We recommend that commonhold associations should be required to confirm to unit owners and their mortgage lenders that the insurance is in existence on demand.

12.128 We recommend that these obligations may be satisfied either by publishing the relevant documents online or distributing hard copies. However, hard copies must be supplied if a unit owner insists.

## Public liability insurance

12.129 In the Consultation Paper we explained that public liability insurance is an important issue in preventing the insolvency of a commonhold association which has become liable for a catastrophic loss.[54] We noted that experience from other jurisdictions suggests that their equivalents of commonhold associations do occasionally face claims for catastrophic losses when they are uninsured or underinsured.[55] Requiring commonhold associations to hold an adequate level of public liability insurance ought considerably to reduce the incidence of their insolvency.

12.130 We asked consultees whether commonhold associations were likely to find that public liability insurance was generally available. We provisionally proposed that, if it was likely to be generally available, it should be compulsory, with minimum levels of cover, and other conditions, to be prescribed by regulations to be made by the Secretary of State.[56]

### Consultees' views

#### The availability of public liability insurance

12.131 No consultees saw any real difficulty in public liability insurance being made available. In particular, the British Institute of Insurance Brokers ("BIBA") did not foresee any difficulty in commonhold associations obtaining public liability insurance where it was purchased as part of a commercial/residential property owners' insurance package or block flats policy. They thought it was less likely that

54 CP, para 9.62 to 9.63.

55 Examples from other jurisdictions were given para 7.14 of the Consultation Paper, footnote 19. The implications of such claims do of course differ, depending on whether the jurisdiction offers limited liability to the equivalent of the commonhold association, or whether unit owners are individually liable for its debts.

56 CP, Consultation Question 48, para 9.93.

commonhold associations would be able to purchase public liability insurance so easily as a stand-alone policy.

### Whether public liability insurance should be compulsory

12.132 The vast majority of consultees supported our provisional proposal for requirements relating to public liability insurance to be prescribed in the CCS. A few consultees thought that public liability cover should be restricted to liability to visitors in common areas, and a few expressed concerns that the level of insurance would need to take account of the size of the development, and their level of exposure to risk.

12.133 Significantly, however, BIBA opposed making it compulsory for commonhold associations to take out public liability insurance because of the consequential need to prescribe a minimum level of cover. They were worried that commonhold associations would assume that whatever level of public liability insurance cover was prescribed as a minimum should be taken to be an adequate level for all commonholds. The larger the commonhold, the more likely it would be that an incident would involve a large number of people, and thus potential claimants. A higher level of cover would then be appropriate. In addition, commonholds which undertook activities carrying with them a higher risk of serious accidents – such as running a swimming pool or gym – would also need to take out a higher level of cover.

12.134 BIBA felt that the insurance needs of commonhold associations would vary so widely that it should be left to them whether they took out cover or not, and that all should be encouraged to take advice from a broker as to what level of cover would be appropriate for them.

### Discussion and recommendations for reform

12.135 If BIBA are correct in their analysis of the situation, then to require that commonhold associations take out public liability insurance, but not to prescribe a minimum level or levels of cover, would seem to aggravate the problem that they identify. It would encourage insurers to make their standard offering a low level of cover, which would sometimes, perhaps often, be inadequate for the needs of some commonholds.

12.136 While BIBA do make strong points, we are aware that it is compulsory for the drivers of motor vehicles to take out insurance, and also for employers. In both cases there are criminal penalties for non-compliance. In the former case claimants are protected from the consequences of drivers not holding insurance by the Motor Insurers' Bureau schemes. (There is no equivalent scheme for employers.) It seems to us that the same difficulty can arise in respect of such requirements, and that the prescribed minimum level of cover may sometimes prove inadequate.

12.137 The Association of British Insurers (the "ABI") also indicated that they would prefer that public liability insurance should not be made compulsory. Its reasons for holding this view were similar to those of BIBA, namely that it felt that the terms of insurance and level of cover should be worked out with the assistance of a broker, and that prescribing a statutory minimum could lead to commonhold associations taking out a "package" of cover which offered the statutory minimum but which was in fact inadequate.

12.138 The ABI was also concerned that commonhold associations would find themselves in difficulties if unforeseen changes in the insurance market had the effect that insurance became impossible to obtain, or if it could be obtained only from a very limited range of providers. They did not, however, express outright opposition to our proposals.

12.139 We note the similar concerns that both BIBA and the ABI have expressed, but think on balance it is better to prescribe compulsory public liability insurance. We consider that public liability insurance will help protect the solvency of commonhold associations and help ensure that claimants are compensated for their injuries. However, we do not have sufficient information to recommend what that level of cover should be. Similarly, we are not in a position to say whether a single minimum level of cover would be appropriate, or whether this should vary, depending upon the size and number of units in the commonhold, and/or some other factors. We also recommend that the level of public liability cover required of commonhold associations should be kept under review, and that Government will need to respond promptly if circumstances should develop where commonholds find it difficult to obtain such cover.

12.140 We acknowledge that the prescribed minimum level of cover may prove inadequate in some circumstances. We therefore consider that guidance for commonhold directors should urge upon them the need to take proper advice from a broker on the level of public liability cover which would be appropriate for their commonhold. We also consider that guidance should cover the risks that directors should consider insuring against in their public liability policy.

12.141 Two individual consultees made the point that making it compulsory for commonhold associations to take out public liability insurance would mean that they were treated differently from leaseholder-controlled companies. It would be possible to justify the difference in approach on the basis that the consequences of a commonhold association becoming insolvent are more serious than when a leaseholder-controlled company becomes insolvent.

12.142 We note BIBA's comment that public liability insurance is likely to be widely available, if taken out as part of an insurance "package" for a block, although it might be more difficult to obtain "stand alone" cover. It is likely to be very rare for a commonhold to need stand-alone public liability insurance. Practically the only circumstances in which the issue is likely to arise would be if a commonhold association had been set up purely to maintain estate roads. It seems more likely that developments comprising vertically-divided buildings will be set up as commonholds when there are additional communal facilities to be managed, such as a private sewerage scheme, or security services. Scenarios such as those are likely to need to take out insurance to cover the common parts, and their related activities.

**Recommendation 62.**

12.143 We recommend that it should be compulsory for all commonhold associations to take out and maintain public liability insurance. The minimum level of cover, and permissible exclusions and excesses, should be prescribed from time to time by the Secretary of State. Different levels of cover might be prescribed for different sizes and types of commonhold.

## Directors' and officers' insurance

12.144 Those who take on the role of directors incur potentially large personal liabilities. In the Consultation Paper we noted that commonhold associations are not required to take out directors' and officers' insurance ("D&OI"), although it could be made a local rule by a commonhold association and, even in the absence of such a rule, there would be nothing to prevent the directors from taking out insurance.[57] The availability of insurance may be significant in encouraging people to become directors. While we did not consider it necessary to make taking out insurance compulsory, we provisionally proposed that the CCS should contain an express power for the commonhold association to do so, in order to place the matter beyond doubt.[58]

### Consultees' views

12.145 The vast majority of consultees were in favour of our provisional proposal.

12.146 Some of those who opposed our proposal either appeared to misunderstand the role and potential need for D&OI, or thought that our proposal was that it should be compulsory for all commonholds to take out D&OI. In contrast, a few consultees, including the Leasehold Knowledge Partnership ("LKP") and the PBA appeared to favour going further and making it compulsory for commonhold associations to take out D&OI.

12.147 BIBA questioned why an express power was needed, as taking out D&OI would fall within the general powers enjoyed by all commonhold associations.

### Discussion and recommendations for reform

12.148 We acknowledge the point made by BIBA that it would already be possible for a commonhold association to take out D&OI as part of their general powers of management. As we explained in the Consultation Paper, however, we think that an express power remains desirable to put the matter beyond doubt, and to serve as a reminder to the directors that it is something that they should consider.[59]

12.149 There is a further advantage in providing an express power. If the power were included in the prescribed CCS, then it would be impossible for a commonhold to have a local rule which prevented its directors from taking out D&OI, or from passing a

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57 CP, para 9.71.

58 CP, Consultation Question 49, para 9.96.

59 CP, para 9.95.

resolution to that effect. This would seem desirable, in view of the concerns expressed to us in response to our Call for Evidence that it would sometimes be difficult to find unit owners prepared to serve as directors.[60]

12.150 We have considered the argument that it should be compulsory for all commonhold associations to take out D&OI. It appears to us that a small commonhold might consider this an unnecessary expense, where it is small enough for all the unit owners to be directors. We do not therefore recommend that it should be compulsory for a commonhold association to take out D&OI.

12.151 We further consider that Government guidance for commonhold directors should recommend that directors should consider whether it was desirable for the association to take out directors' and officers' insurance.

**Recommendation 63.**

12.152 We recommend that the CCS should contain an express provision confirming that commonhold associations have the power to take out directors' and officers' insurance.

## THE STANDARD OF MAINTENANCE OF THE BUILDING

12.153 In the Consultation Paper we considered five distinct issues relating to the obligations to repair the buildings (and any other structures) which form part of the commonhold which are currently included in the CCS.[61] These issues can be summarised as follows.

(1) Whether it is possible for the CCS to specify a higher standard of repair than the obligation "to repair" would generally signify.

(2) Whether the obligation of the commonhold association to repair the common parts needs to be modified.

(3) Whether it would be advantageous for the provision of thermal insulation measures to be deemed to be a repair.

(4) Whether matters relating to the internal repair of horizontally-divided units can be left to local rules.

(5) Whether matters relating to the external and internal repair of vertically-divided buildings can be left to local rules.

12.154 We consider each question in turn.

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60 CP, para 9.80

61 CP, paras 9.97 to 9.104.

### Whether the CCS can impose a higher standard of repair

12.155 We noted in the Consultation Paper that the current law requires the commonhold association to keep the common parts in adequate repair.[62] This basic standard of repair may not be sufficient for all properties; for example, in the case of a listed building.[63] We noted that there is nothing in the current law to prevent a local rule supplementing the repairing obligation. We suggested, however, that it was desirable to put the matter beyond doubt. We therefore provisionally proposed that it should be possible for the repairing obligations required by the CCS to be supplemented by a local rule requiring a higher standard of repair.[64]

#### Consultees' views

12.156 The vast majority of consultees expressed support for our provisional proposal. The case for having such a provision was well summarised by Peter Smith (academic):

> It would seem important, so as to provide further assurances for purchasers and to reflect the fact that the quality of commonholds is likely to vary, to allow for local rules, as in up-market commonhold schemes, to impose a higher standard on the management body.

12.157 One leaseholder thought that the presence of such a rule could give rise to bullying conduct. The rules should ensure only that the common parts were safe and fit for purpose, and comply with a fair level of aesthetics. Another consultee was unconvinced that the provision was necessary, as unit owners would choose what standards to set when considering whether to have works done.

#### Discussion and recommendations for reform

12.158 We consider that allowing for local rules to impose a higher standard of repair would offer assurance to unit owners that the common parts would be repaired and redecorated to the standard which they would expect.

12.159 We consider that concerns of unit owners being bullied are misplaced. We think it most likely that a local rule requiring a higher standard of repair and maintenance would generally be included when the commonhold was set up. Removing this requirement, or adopting such a local rule later, would therefore require unit owners to pass a resolution to amend the CCS, in the same way that other aspects of the CCS can be amended by local rules. Following our recommendations in Chapter 10, an amendment to the local rules would require a special resolution (75% of the votes cast).[65] As we note there, this high threshold helps ensure that local rules are not easily amendable so as to protect unit owners' expectations.

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62 CP, para 9.106.

63 CP, para 9.109.

64 CP, Consultation Question 50, para 9.113.

65 See Ch 10, para 10.70 to 10.91.

**Recommendation 64.**

12.160 We recommend that it should be possible for the repairing obligations required by the CCS to be supplemented by a local rule requiring a higher standard of repair.

### Is an obligation "to repair" sufficient?

12.161 The commonhold association is required to "repair and maintain" the common parts.[66] As we noted in the Consultation Paper, both terms originate in landlord and tenant law, and an obligation to repair has generally been interpreted to mean "to put in repair".[67]

12.162 There is ambiguity as to whether the commonhold association's repairing obligation extends to replacing an item when necessary.[68] In the Consultation Paper, we noted that courts have taken differing views as to whether adding words such as "amending and renew" actually extends the landlord's obligation so as to require replacement of an item.[69] The commonhold association's obligations in this scenario should be beyond doubt. We therefore provisionally proposed that the obligation to repair extends to "renewals" so that the commonhold association must replace an item if it is beyond economic repair.[70]

#### Consultees' views

12.163 Our provisional proposal received almost universal approval.

12.164 Some of those who did not agree with our provisional proposal seem to have assumed that we were proposing that the commonhold association should always be *restricted* to renewing or replacing like with like.

12.165 A few consultees seemed concerned that our proposal would be used by the directors and officers of commonholds to extract large sums of money from unit owners.

12.166 The PBA was concerned that the proposal that an item is replaced when beyond economic repair may lead to doubt as to the full extent of the obligation. The PBA pointed out that there might be circumstances where "renewal" might not be possible, and that the obligation should therefore be "to renew, and, where necessary, to replace".

#### Discussion and recommendations for reform

12.167 While doubt has been raised in landlord and tenant law as to whether a landlord's repairing obligation extends to renewals, we do not believe that the same doubt

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66 CP, para 9.100.

67 CP, para 9.104.

68 CP, para 9.107.

69 CP, para 9.107.

70 CP, Consultation Question 50, para 9.111.

should exist in commonhold. We consider that a commonhold association's repairing obligation should extend to include renewal. This avoids uneconomic use of unit owners' money, and ensures that the commonhold is kept in good condition. We consider that a commonhold's repairing obligation should operate in the following way.

### When an item must be replaced

12.168 We provisionally proposed that the commonhold association must replace an item if it is beyond economic repair. We accept the point made by the PBA that there would appear to be cases in which "renewal" is not possible for reasons other than the item being beyond economic repair and that replacement would then instead be required.[71] For example, it may not be possible to repair or renew an original sash window, and it would have to be replaced. We therefore recommend that the obligation to repair should extend not only to renewal, but also to replacement where neither repair nor renewal is possible.

### The standard of renewal or replacement

12.169 We consider that if it is necessary to replace an item the commonhold association should be obliged to replace it on a "like for like" basis. By this term we mean that a replacement must be of a similar nature and quality to the original item. We think that this standard minimises the scope for disputes and protects unit owners' expectations. If the standard of replacement was undefined, disputes may arise if an item is replaced with an item of lesser quality, or with an item that is significantly different in specification, design or aesthetics.

12.170 However, this does not mean that the directors must procure the same item when replacing it. An exact replacement may not be possible if an item is no longer manufactured, or if regulatory standards and specifications change. For example, floor tiles in the common parts containing asbestos could not be replaced with exactly the same item. In these circumstances, we consider that the association's obligation to replace an item on a "like for like" basis if repair is not possible requires that it procures a replacement that complies with relevant regulations and which is as close to possible in specification to the original item.

12.171 Our approach would not preclude a commonhold from upgrading an item that it must replace. Consultees were concerned that our proposal would restrict the association to renewing or replacing like with like. However, our intention was to ensure that, if repair was not possible, the association should be obliged *at least* to renew "like with like". If the directors, or the unit owners by a resolution, wished to treat the need to replace as an opportunity to improve the fabric of the commonhold in some way, then they could do so. The same procedure would then apply as in the case of any improvement.[72]

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71 Eg *Wright v Lawson* (1903) 19 Times Law Reports 510 (CA).

72 In Ch 13, we outline the process by which the commonhold authorises expenditure. Under our recommendations, the cost of repairs or renewals must be detailed in the budget and approved by an ordinary resolution of unit owners. Expenditure in respect of improvements must also be approved via unit owners' approval of the budget, coupled with an additional ordinary resolution specifically authorising the improvements. If the CCS contains a costs threshold in respect of expenditure on improvements and a

12.172 Some consultees were suspicious that any scope for the commonhold to make renewals would be used to extract money from unit owners. We do not think this concern is merited as the directors will be elected by unit owners and be accountable to them.

12.173 Our provisional proposal, and the discussion in the Consultation Paper, referred only to the obligation to repair that is placed on the commonhold association. Where a unit owner is placed under an obligation to repair, it seems to us that the obligation must be interpreted in the same way. Therefore, we have extended the scope of our recommendation to apply to obligations to repair imposed on unit owners, as well as the prescribed obligation on the commonhold association.

**Recommendation 65.**

12.174 We recommend that the provision in the CCS requiring the repair of the common parts should be extended to impose an obligation "to renew, and where necessary to replace": that is, the replacement of "like with like" if something should be beyond economic repair.

12.175 We recommend that these amendments should also apply to unit owners, so far as any obligations to repair are imposed on them by the CCS.

### Should the provision of thermal insulation be deemed to be a repair?

12.176 In the Consultation Paper, we noted that the Climate Change (Scotland) Act 2009 includes "the installation of insulation" in provisions relating to general powers to repair and maintain.[73] We provisionally proposed that the installation of adequate insulation should be deemed a repair, so that it would apply to all commonholds through the prescribed CCS.[74] We noted that it would be open for a commonhold to include such a provision as a local rule.

#### Consultees' views

12.177 The vast majority of consultees were in favour of our provisional proposal.

12.178 The PBA, however, opposed our proposal on the basis that it blurs the distinction between repairs and improvements. Other consultees were concerned that it could result in the owners of commonhold flats having to meet Government policies on insulation which would not apply to other homeowners. There was also concern as to what an "adequate" standard of insulation might be, how it would be defined, and whether it might require disproportionate expenditure.

minority are outvoted they may refer the proposed expenditure on improvements to the Tribunal to determine whether it should be allowed.

73 CP, para 9.108.

74 CP, Consultation Question 50, para 9.112.

### Discussion

12.179 We note the concerns expressed by a number of consultees as to the effect our provisional proposal may have, and the potential uncertainty as to the scope of our provisional proposal. As noted in paragraph 12.176 above, our provisional proposal was based on a provision in the Climate Change (Scotland) Act 2009. On further consideration we do not in fact consider that Act to be an appropriate comparator. The effect of the Scottish legislation is to grant a power to install insulation. The commonhold association already has a power under the general law to put in hand improvements. The difficulties which are often encountered in improving the insulation of blocks of leasehold flats would not therefore arise within a commonhold.[75]

12.180 In contrast, the CCS imposes on the commonhold association an obligation to repair and maintain the common parts.[76] To treat the provision of insulation as a repair, therefore, would have the effect of imposing a duty on the commonhold association to carry it out. This would be problematic, when it might be difficult for the unit owners within an old building to bring it up to current standards of insulation. It is not clear what alternative standard of insulation should be applicable.

12.181 In spite of the level of support for our provisional proposal, for these reasons we have decided not to bring forward a recommendation for reform.

## Whether the internal repair of units within horizontally-divided buildings can be left to local rules

12.182 Duties in respect of the repair and maintenance of the commonhold units are left to be determined by local rules.[77] If there is an internal load-bearing wall within a unit, or if a unit contains a drain, pipe or wire that serves more than one unit, then it will form part of the common parts, which the commonhold association is under an obligation to repair. We noted that other units could be affected by a failure to keep in repair water or drainage pipes within a unit that serve only that unit, but that such issues could be addressed by local rules, and would also be governed by the general law of nuisance.

12.183 We provisionally proposed that matters related to the internal repair of units within horizontally-divided buildings such as flats should be left to local rules.[78] This provisional proposal reflects the idea that, as commonhold is freehold ownership, unit owners should only be placed under obligations in respect of their own unit if there is good reason to do so.

### Consultees' views

12.184 The vast majority of consultees supported our proposal.

12.185 Those who welcomed the proposal thought that it would mark a welcome move away from obligations to repair which are a traditional hallmark of leasehold. Requirements,

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75 See N Roberts, *Keeping warm communally* (2010) 160 New Law Journal 897.

76 Commonhold Regulations 2004, sch 3, para 4.5.1.

77 CP, para 9.102.

78 CP, Consultation Question 50, para 9.114.

for example, to carry out internal redecorations at specified intervals were thought to be unnecessary and intrusive.

12.186 Other consultees, including a few who identified as leaseholders such as Colette Boughton, thought that it was "good to have some standardized rules that apply to all flats so that extremes do not happen in local rules".

12.187 ARMA agreed with our proposal, but expressed reservations which were shared by others:

> Given that the central premise of commonhold is the freedom for a unit owner to do as they see fit within their own unit, how will oversight be maintained for the installation of noisy wooden flooring, installation of bathrooms over bedrooms and removal of structural walls. The current leasehold system requires landlord consent, thereby achieving that oversight for the good of the many.

12.188 The chief concern of those who opposed our proposal was the need to ensure that a failure to carry out repairs within a unit did not adversely affect other neighbouring units. Several of those who supported our proposal also made a comment, or expressed a reservation, to the same effect

### Discussion and recommendations for reform

12.189 Our discussion of the current position in the Consultation Paper did not explain the requirements of the 2002 Act. The 2002 Act requires that the CCS "must make provision imposing duties in respect of the insurance, repair and maintenance of each commonhold unit".[79] This would therefore appear – at least on its literal interpretation – to permit such obligations to be allocated either to the unit owner or to the association, but to require that they must be imposed either on one, or the other. If, as our provisional proposal intended, it is desired that *neither* the unit owner nor the association should be obliged to carry out all, or certain categories, of internal repairs, then the Act needs to be amended.

12.190 We consider that, in general, matters of internal repair can be left to the individual unit owners. There is no need for an obligation to repair to be imposed either on the commonhold association or the unit owners, as the 2002 Act currently appears to require. We are nevertheless persuaded that, to a limited extent, some aspects of internal repair will always need to be addressed by local rules. We therefore recommend that matters relating to the internal repair of units in horizontally-divided buildings should be left to local rules. The 2002 Act should not therefore require an obligation relating to the internal repair of units to be imposed on either the commonhold association or the unit owners. The CCS will therefore always require compliance with certain minimum standards.

12.191 However, pipes and drains which lie within one unit, and serve only that unit, will – unless the CCS specifies otherwise – form part of that unit. Clearly, a failure to keep elements such as these in repair can cause problems for other unit owners. In retrospect we do not consider that it is sufficient to rely on the law of nuisance in the absence of local rules as a pipe may have fallen out of repair and have begun to leak

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79 CLRA 2002, s 14(2).

before it would necessarily have reached the stage where a neighbour would be able to take action in nuisance. We therefore recommend that that the CCS should:

(1) require unit owners to keep in repair "relevant services";[80] and

(2) not allow any other part of the unit to fall into such a state of disrepair so as adversely to affect any other unit, or the common parts.

12.192 This "basic minimum" standard of repair at (1) ensures that leaking pipes and so on have to be repaired before they cause a nuisance to neighbouring owners. The provision set out at (2) ensures that internal parts of a unit are not allowed to deteriorate to the state where, for example, dry rot becomes established and threatens to spread to other units or to the common parts. Imposing a low "basic minimum" standard does not prevent the CCS from including a local rule imposing on the owners of units a higher and more comprehensive obligation to repair the interior of their units. We think that many developers will in practice wish to include more comprehensive internal repairing obligations on unit owners. These would, however, be local rules, and so be capable of being amended by the unit owners.

**Recommendation 66.**

12.193 We recommend that matters relating to the internal repair of units in horizontally-divided buildings should be left to local rules.

12.194 We recommend that the CCS should require, as a minimum, that owners of horizontally-divided units keep all "relevant services" in repair, and that an owner should not allow a unit to fall into such a state of disrepair so as adversely to affect another unit or the common parts.

12.195 We note that this recommendation does not affect the requirement in section 26(c) of the 2002 Act that the commonhold association must keep common parts in repair. "Common parts" includes the structure and exterior of buildings containing flats, and may include the exterior of houses.

### Whether the external and internal repair of units within vertically-divided buildings can be left to local rules

12.196 In the Consultation Paper we provisionally proposed that in the case of vertically-divided buildings all matters relating to repair of the units – both external and internal – should be left to local rules.[81] Vertically-divided buildings incorporates all houses, whether detached, semi-detached or terrace. It would also include other vertically-divided buildings such as commercial units. Our provisional proposal reflects the fact that matters of repair in relation to houses and other vertically-divided buildings are generally left to the owner.

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80 This is defined in reg 9(2) of the Commonhold Regulations 2004 as "services provided by the means of pipes, cables or other fixed installations".

81 CP, Consultation Question 50, para 50(5).

### Consultees' views

12.197 The vast majority of consultees supported our proposal. Those who welcomed the proposal that internal and external repairs to houses should be left to local rules tended to stress the importance of owners' autonomy, unless their actions, or inactivity, directly affected their neighbours.

12.198 People for Places Group Ltd (developer) opposed our proposal on the basis that owners of units should be under: "an obligation to keep their property clean and in good repair to prevent nuisances from occurring. We don't see the justification to leave that to local rules".

12.199 Another consultee opposed our proposal because he thought that requiring that properties be kept in repair plugged a gap in the common law. This gap is that a freehold easement of support imposes a duty not actively to withdraw that support, but does not require the owner of the property which is subject to that obligation to keep it in repair.

12.200 Other consultees pointed out that, as terraced or semi-detached houses shared a roof, a lack of repair in the roof over one house might affect a neighbouring property.

### Discussion and recommendations for reform

12.201 As was the case with our discussion of horizontally-divided buildings, the Consultation Paper did not explain the current position in relation to obligations to repair. It appears that the 2002 Act currently requires that either the commonhold association or the unit owner is made responsible for the repair and maintenance of a unit.[82] In the case of a vertically-divided building, this means that local rules must impose an obligation relating to the external and internal repair of the building on one of those parties.

12.202 There may have been a widespread misunderstanding as to the scope of the present law. We framed our consultation question on the basis that, with houses, all matters relating to repair (whether internal or external) could be left to local rules. We did not discuss the current position in any detail. We may have given the impression that how far repairing obligations were imposed on both the commonhold association and on individual unit owners could, under the current law, be left to the drafter of the CCS to draft as local rules. This is not strictly correct. As was noted when discussing the internal repair of flats (see paragraph 12.189 above), the 2002 Act would appear to require that either the commonhold association or a unit owner must be made responsible for the repair and maintenance of a unit.[83] This would extend to the internal and external repair of houses. Local rules might impose repairing obligations on either the unit owner, or on the commonhold association, but could not omit imposing them on one or the other. It may in general be desirable that properties are kept in good repair, but the owners of freehold houses are not generally placed under

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82 CLRA 2002, s 14(2).

83 CLRA 2002, s 14(2).

such a duty.[84] The intention behind our provisional proposal was that local rules should be allowed to determine both whether there should be an obligation to repair a house, and whether any such obligation should be placed on the unit owner or the commonhold association.

12.203 The point about the shortcomings of an easement of support is well made, but the fact remains that this is the position under the general law. If the law is in need of reform generally, then reform of the law of easements would be more appropriate.[85] Within any individual commonhold, it would still be possible to address the shortcomings of the general law by framing an appropriate local rule.

12.204 We accept that there may be commonhold developments where, in order to preserve the appearance and general amenities of the estate, owners of houses are required to keep their properties in good repair and decorated externally to an appropriate standard. There may be other developments where the need to preserve uniformity of appearance is thought so important that the obligation to carry out external repairs and exterior decoration of houses is placed on the commonhold association, rather than on individual owners. There is nothing to prevent local rules from making appropriate provisions which adopt either of these approaches.

12.205 We therefore take the view that the question of the internal and external repair of houses can be addressed by making a recommendation which is similar to that which we have made in respect of the internal repair of horizontally-divided buildings; that is, to enable, but not require, local rules to impose repairing obligations. In the case of units in horizontally-divided buildings, we have explained at paragraph 12.191 above that there is a need to impose certain minimum standards. They reflect the fact that in the case of a unit in a horizontally-divided building, a failure to keep internal parts in repair may impact on other units. The same is true to a lesser extent in respect of houses and other vertically-divided units, and therefore our recommendation is more limited.

**Recommendation 67.**

12.206 We recommend that matters relating to the internal and external repair of units in vertically-divided buildings should be left to local rules.

12.207 We recommend that the CCS should requires, as a minimum, that owners of vertically-divided buildings should not allow a unit to fall into such a state of disrepair so as adversely to affect another unit or the common parts.

12.208 As is the case with Recommendation 66, nothing in this recommendation affects the requirement in section 26(c) of the 2002 Act that the commonhold association must

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84 It is acknowledged that this may in rare cases be required by estate management schemes made under the Leasehold Reform Act 1967, s 19; and that a local authority may require repairs be carried out under the provisions of the Housing Acts.

85 The Law Commission's proposals in Making Land Work: Easements, Covenants and Profits à Prendre (2011) Law Com No 327 would largely address this criticism of the current law.

keep common parts in repair. "Common parts" may include the exterior of houses if the CCS is drafted accordingly.

## RIGHTS OF ENTRY

12.209 The current law does not automatically provide the commonhold association with a right to enter commonhold units.[86] Instead, the matter is left to local rules. With blocks of leasehold flats, it is common for the lease to reserve extensive rights of entry for the landlord and/or management company, and for neighbouring leaseholders.[87] It could be argued that some rights of entry will be required in all commonholds, and that some express provision could therefore be made in the prescribed CCS.

12.210 We asked consultees' views as to whether rights of entry should be prescribed, or are better left to local rules. We also asked various supplemental questions on how, if rights of entry were to be prescribed, those rights should be worded.[88]

### Consultees' views

12.211 Just over half of consultees considered that rights of access should be contained in local rules; while a significant minority considered that they should be prescribed.

12.212 Leaseholders and other individual consultees fell heavily in favour of rights of entry being left to local rules. Some consultees expressed strongly-held opinions that rights of entry should be highly restrictive, and should be exercised only in an emergency.

12.213 Some consultees who supported having prescribed rules did so on the basis that it would be possible for them to be supplemented by more detailed local rules. This approach echoed a course of action we had suggested in our discussion in the Consultation Paper.[89] A few other consultees, however, thought that, in the interests of standardisation, the prescribed rules should be comprehensive, and amendable only when there was a compelling reason, for example, in the case of warden-assisted retirement homes.

12.214 Consultation responses demonstrated the existence of divergent views on how extensive rights of entry would need to be, and the type of unit in respect of which rights of entry should be prescribed. For example:

(1) the APPG and LKP were in favour of prescribing rights of entry for flats and horizontally-divided commercial premises, but not for houses. Other consultees did not think it would be necessary or appropriate to distinguish between houses and flats at all;

(2) Trowers & Hamlins LLP thought that a distinction should be made between residential and non-residential units, as more extensive rights might be applicable to the latter; and

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86 CP, para 9.120.

87 CP, para 9.119.

88 CP, Consultation Question 51, para 9.128.

89 CP, para 9.122.

(3) an individual consultee would also have made the same distinction between residential and non-residential units, and would additionally distinguish between units which were occupied and those that were not.

### Discussion

12.215 It became apparent from considering the responses that either prescribed rights of entry would have to be set at a very low threshold or different levels of rights of entry would have to be prescribed, depending on the type of building. If rights of entry were set at a low threshold then they would need to be supplemented, in most cases, including most commonholds involving horizontally-divided buildings. Even if an attempt was made to standardise rights of entry, but to have different levels of rights for different types of building, there would often be a need for further, bespoke, rules. This seemed to encourage confusion rather than standardisation.

12.216 Further, if distinctions were made between units depending on their physical characteristics and use, then the situation could arise that one unit might have more extensive rights of access over an adjoining unit than the adjoining unit would enjoy over it This seemed to be in principle undesirable, and a recipe for further confusion.

12.217 While having a degree of standardisation seemed a desirable aim, it is clear that, in any event, a degree of local provision is almost inevitable. That being the case, we have concluded that the matter is best left to be decided by local rules. As Boodle Hatfield LLP (solicitors) put it:

> If a general right were to appear in the CCS, it is nearly always going to have to be tweaked by local rules. Therefore, one may as well leave that matter to the local rules alone.

12.218 We therefore consider that no change to the law is necessary, and rights of entry should be left to local rules. In the Consultation Paper we noted that Government guidance on the drafting of a CCS includes specimen wording for the local rules that may typically be required.[90] We consider that MHCLG should similarly publish specimen rights of entry which would be applicable to different types of building. These could then, where appropriate, be adopted by those who draft the CCS, or amended where bespoke rules are required.

## CONSENT TO ALTERATIONS

12.219 The current law forbids the commonhold association from making or permitting any alteration to the common parts unless the proposed alteration has been approved by an ordinary resolution of unit owners.[91] This approach could be unduly restrictive where alterations to a unit requires a minor alteration to the common parts. For example, installing the flue for a new boiler, or an opening for a ventilation fan, will pass through an external wall (or even, in the latter case, a window). As this affects the common parts, it would therefore require consent of all unit owners by an ordinary resolution.

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90 CP, para 9.121.

91 Commonhold Regulations 2004, sch 3, para 4.6.1. See also the discussion in the CP, paras 9.132 to 9.135.

12.220 We provisionally proposed that alterations to the common parts which were incidental to internal alterations made by a unit owner to his or her own unit should not need the consent of an ordinary resolution of unit owners, but should instead require the consent of the directors.[92] We also invited consultees' views on how to define "minor alterations to the common parts", so as to distinguish such minor alterations from those that would still need the consent of an ordinary resolution of unit owners.[93]

### Consultees' views

12.221 Our provisional proposal attracted widespread support. A minority who disagreed considered that all members of the commonhold association have an interest in the condition of the common parts, and therefore favoured the need for any alteration to require a resolution. Conversely, some leaseholders expressed the view that unit owners should be free to make such alterations as they pleased within units and the commonhold association should have no right to interfere with them doing so.

12.222 Consultees raised two questions relating to the decision-making process by the directors. First, whether directors should be required to consult with neighbouring unit owners (or all unit owners) before making a decision. Second, whether there should be some oversight of the directors' decisions, either by requiring them to act reasonably (which would imply the need for some supervisory jurisdiction by the court or the Tribunal), or by enabling any contentious matter to be referred to the unit owners for the passing of a resolution. On both issues, consultees expressed a range of views. Several consultees suggested that directors should expressly be required to act reasonably in making their decision, and that unit owners should be able to challenge the directors' decision in the Tribunal if directors refused consent, or imposed unreasonable conditions on giving consent.

12.223 Consultees almost universally agreed with our definition of "minor alterations to the common parts which are incidental to internal alterations made by a unit owner to his or her own unit". A couple of consultees suggested that a more detailed definition was needed, and others made general observations as to the difficulty in defining what was meant by "minor" and "incidental". Martin Wood (solicitor) noted the difficulty in deciding where to draw the dividing line between minor and other works. He raised the possibility of enabling the directors to give consent in all cases, subject to unit owners having the opportunity to object if consent is given, and to the right to have the matter put to a general meeting where consent is refused.

### Discussion and recommendations for reform

12.224 While it may be good practice for directors to consult with other unit owners, it would be difficult to prescribe the nature of consultation that should take place, as what is appropriate may differ according to the size of the commonhold and the alteration being undertaken. A policy to consult with everyone might be workable in a small commonhold, but would be cumbersome in a larger one. In certain cases, it would not be sufficient to consult only with immediate neighbours. It would be difficult to define which owners would be directly affected, as subjective elements would be involved.

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92 CP, Consultation Question 52, para 9.139.

93 CP, Consultation Question 52, para 9.141.

This would be particularly the case if owners claimed that their outlook, or the overall appearance of the building, was being adversely affected.

12.225 Our provisional proposal would not prevent the directors from referring a decision to a general meeting if the directors thought that it was contentious and more appropriately dealt with in that way. Further, we consider that if any unit owner were to challenge a decision by the directors before it was acted upon, the decision to approve the alterations would pass to the unit owners to be decided by ordinary resolution.[94] It would also be possible for unit owners to include a provision in the CCS requiring the directors to act reasonably when considering requests for permission to make minor alterations to the common. By including a local rule in a CCS to this effect, unit owners would be able to invoke the dispute resolution procedure if they are unhappy with either the directors' refusal or approval of a request.

12.226 While consultees identified potential difficulties that might arise in defining "minor alterations to the common parts which are incidental to internal alterations made by a unit owner to his or her own unit", a more workable definition did not emerge. We think this definition accurately captures the type of alterations that it is appropriate to delegate to directors. We do not consider that it would be preferable to enable all decisions on alterations to the common parts to be delegated to directors, given the significant interest unit owners will have in many such decisions. We therefore make a recommendation which incorporates these considerations.

**Recommendation 68.**

12.227 We recommend that minor alterations to the common parts which are incidental to internal alterations made by a unit owner to his or her own unit should not require the consent of the commonhold association by an ordinary resolution. Instead, the granting of consent to such proposals should be delegated to the directors.

12.228 We recommend that any unit owner should be able to challenge a decision by the directors of a commonhold association under this recommendation before it is acted on, in which case the decision would have to be made by the unit owners by ordinary resolution.

## COMMONHOLDS AND LONG-TERM CONTRACTS

12.229 Commonhold associations are bound by long-term contracts entered into by developers.[95] Experience of similar situations in leasehold developments suggests that unit owners may take the view that they have been bound into an unfair bargain. In the Consultation Paper we noted that one existing commonhold felt that it had been

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94 We take the view that in these circumstances the vote should be treated as though the association was reassuming delegated powers. It would not therefore be necessary for the decision to require the special resolution which would normally be necessary for the unit owners to require the directors to act in a particular way.

95 Paras 9.142 to 9.150.

left bound by a disadvantageous contract entered into by the developer.[96] We consider that there is a danger that commonhold will offer scope to perpetuate abuses which have sometimes been encountered in leasehold.[97]

12.230 We invited consultees' views as to their experience of long-term contracts in leasehold.[98] We provisionally proposed that commonhold associations should be given a six-month period from the time they take effective control of the commonhold association to cancel long-term contracts (which we defined as a contract which must run for more than 12 months).[99] Finally, we invited consultees' views as to specific problems that can arise where the long-term contract involves the hire of equipment (such as door entry systems) which remains the property of the contractor, and which the contractor has reserved the right to remove if the contract is terminated.[100]

## Consultees' views

### Experience of long-term contracts in leasehold

12.231 A sizeable majority of consultees said that they were aware of leaseholders encountering the problems with long-term contracts, and some consultees offered examples of these. Consultees' responses demonstrated that there was some exploitation of long-term contracts currently taking place within leasehold, and that there would be similar, or broader, scope for exploitation within commonhold.

12.232 LKP and the APPG pointed out that long-term combined heat and power contracts were sometimes imposed by some local authorities which wished to implement area heating and power systems. It was often not possible to say whether they were bad for the consumer, but they sometimes did not seem to offer good value for money. Both consultees pointed out that other long-term contracts provided a means whereby the cost of installing capital equipment such as lifts and door entry systems, could be passed by the developer to the leaseholders via the service charges.

### A right to cancel long-term contracts

12.233 Almost all consultees agreed with our provisional proposal to enable commonhold associations to cancel long-term contracts. Those who opposed the proposal did so chiefly out of a concern that developers would find it difficult to secure service providers. Providers would be unwilling to invest time and money only to face the termination of their contract within a shorter period than they had bargained for. Alternatively, it was suggested that suppliers would price the risk of termination into long-term contracts, and so increasing the cost to consumers.

12.234 Berkeley Group Holdings PLC raised the issue of ensuring that warranties and guarantees under maintenance contracts continued after units had been sold; and of dealing with the complications where facilities were provided on an estate-wide basis. They thought contracts should be protected while a development was being

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96 Para 9.146.

97 CP, para 9.150.

98 CP, Consultation Question 53, para 9.152.

99 CP, Consultation Question 54, paras 9.15 to 9.156.

100 CP, Consultation Question 55, para 9.157.

completed, though they thought a commonhold association might be given the right to apply to the Tribunal to challenge the reasonableness of long-term contracts.

12.235 There was very substantial support for our proposed definition of a long-term contract as one which must run for more than 12 months. This definition was based on the definition of a "qualifying long-term agreement" for the purposes of section 20 of the Landlord and Tenant Act 1985. Many of those who made comments explained that they thought it was sensible to follow an established definition here, and that there was no good reason to choose some different period.

12.236 Similarly, the vast majority of consultees supported our proposal that the commonhold association should be given six months from the time unit owners take control of the commonhold association to cancel long-term contracts. Only one consultee suggested a shorter period, while several thought that the period of time given should be longer, or that no fixed period should be given.

### Problems where the contract involves the hire of equipment

12.237 Finally, a number of consultees provided an example, or expressed a view, on the possible difficulties where a long-term contract involves the hire of equipment, which the supplier has reserved the right to remove. The examples provided covered a range of equipment, including entry phone systems, lifts, air-conditioning equipment and fire safety equipment. LKP thought that this problem could be countered by strong anti-avoidance provisions, including deeming all property supplied under contract to become the property of the commonhold association.

## Discussion and recommendations for reform

12.238 We consider that the potential for abuse of long-term contracts requires a response. Unit owners may be subject to an agreement that runs for many years, entered into by the developer, without having had an opportunity to assess the terms of the contract. Leasehold offers some protection against unfavourable long-term contracts. First, the reasonableness of costs can be challenged by leaseholders.[101] Second, if leaseholders exercise the right to manage, they will not be bound by long-term contracts entered into by the landlord.[102]

12.239 We believe that it is necessary to provide comparable protection in commonhold. As leaseholders can end long-contracts by exercising the right to manage, we consider that a time limited right to cancel long-term contracts upon taking control of the commonhold association would offer analogous protection. We outline below how such a right would operate in the light of consultees' views.

### When the right to cancel arises

12.240 Our provisional proposal suggested that the right to cancel a long-term contract should arise "within a set period from the date when the unit owners take effective control of the commonhold association".[103] While a simple majority might seem appropriate, we do not believe it can be said that unit owners have taken effective

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101 Landlord and Tenant Act 1985, s 19.

102 See the RTM Report, para 9.173.

103 CP, para 9.154.

control of the association at this point. Even if unit owners controlled 51% of the votes, a large block of votes would still be held by the developer. We think that unit owners can be said to have taken effective control when they are able to pass a special resolution, which requires 75% of the available votes. We therefore recommend that the right to cancel long-term contracts should arise when unit owners can exercise 75% of the available votes. For the purpose of this recommendation, the unit owners in control of 75% of the available votes must be actual "arms-length" purchasers so as to prevent a developer from frustrating exercise of the right by transferring a number of units it its associates.

12.241 Exercise of the right to cancel long-term contracts requires that unit owners are aware that they have taken effective control and know of the existence of any long-term contracts to which the association is a party. We therefore recommend that developers are obliged to notify owners when they hold 75% of the available votes, and must disclose the existence of any long-term contracts to which the commonhold association is a party. As the developer will have this information and it can be communicated by a standard letter, we do not consider this to be an onerous requirement.

12.242 We note that a decision to cancel long-term contracts is for the directors. It may be the case that the developers' directors are still in post upon unit owners taking effective control. We consider that unit owners should make prompt arrangements to appoint their own directors upon taking effective control.

### The time period in which a right to cancel may be exercised

12.243 We remain of the view that the commonhold association should be given a defined period within which to exercise the right to cancel a contract. The right to cancel is designed to ensure that the commonhold association is not left with a bad bargain entered into by the developer. However, we think it is reasonable, and provides for commercial certainly, to require the commonhold association to assess whether it wishes to continue with the contract, in a defined period. We therefore recommend that the commonhold association may exercise its right to cancel long-term contracts within a period of six months from the point at which unit owners take effective control of the commonhold association.

### Protections for contractors

12.244 Thus far we have outlined that unit owners may serve notice to cancel a long-term contract within six months of unit owners taking effective control of the commonhold association (the point at which they can exercise 75% of the available votes).

12.245 We appreciate that the ability to cancel long-term contracts may cause concern for contractors. We believe that provision should be made to protect contractors. First, we acknowledge that the commonhold association must give sufficient notice of the cancellation. As a contract is considered to be long-term if it must run for more than 12 months, we recommend that no less than 12 months' notice of termination should be given. We believe that this offers a sufficient degree of protection to most contractors. They will know that they will have at least 12 months' return on the contract, and will have sufficient time to make effective business decisions around the cancellation.

12.246 Second, we acknowledge consultees' concerns that contracts which involve significant up-front expenditure may not be viable if they are subject to challenge by unit owners. These contracts might include district heat and power facilities, and utilities where the company installs significant infrastructure as part of the contract. We recognise that, without additional safeguards, contractors may be unwilling to enter into long-term contracts with commonhold associations, while they were still under the control of developers, if the agreement is liable to cancellation upon unit owners taking effective control. We believe it is necessary to provide a measure of protection for contractors in these circumstances. We consider that a mechanism that would prevent the cancellation of long-term contracts which involve significant up-front expenditure provides certainty for contractors.

12.247 We therefore recommend that it should be possible for a developer to obtain advance approval from the Tribunal of any long-term contract involving significant capital expenditure. If such approval is obtained, the long-term contract would be excluded from being cancelled by the commonhold association when unit owners take effective control. Suppliers could therefore enter with confidence into such long-term contracts with developers, or with commonhold associations while they were under the control of developers, knowing that they would be immune from being cancelled when the unit owners gained control of the commonhold association.

12.248 As the right to cancel long-term contracts is a measure to protect unit owners from unfavourable agreements, we recommend that advance approval is given on the basis that the long-term contract is fair. We appreciate that this term is wide ranging, and therefore recommend that guidance be produced to aid the Tribunal in its determination.

12.249 We recognise that the application for advance approval is an unusual one, as there would be no obvious respondent, and the Tribunal is not set up to carry out an extensive investigatory role. However, the Tribunal does have experience of long-term contracts, through its role in dealing with leasehold service charges, and will gain experience of long-term contracts within commonholds. Its experience of the consultation requirements with qualifying leasehold contracts should help it to judge whether appropriate tendering has been carried out before a long-term contract has been awarded.

12.250 In the light of our concerns we consulted the Tribunal judges on this point. The judges did not consider that the lack of respondent would cause difficulty, but did stress the importance of defining "fairness" for the purpose of the application. As noted above, we recommend guidance be produced to aid the Tribunal in this respect.

12.251 An alternative approach may be that an ombudsman or regulator takes on the function of pre-approving long-term contracts. We are aware that the problem of the owners of new property being tied into disadvantageous long-term contracts is not one that is confined to commonhold. It may affect purchasers on all new developments, whether leasehold or freehold. We are aware that Government is proposing the setting up of a New Homes Ombudsman. If Government should set up a New Homes Ombudsman, then the advance approval of long-term contracts – for commonholds, and more generally – is a role which could be given to such an Ombudsman.

### Anti-avoidance

12.252 Consultees noted that the right to cancel may be undermined if the contract involves the hire of equipment that remains the property of the supplier. Commonholds may be unwilling to cancel unfair contracts if it results in significant disruption, such as the removal of equipment necessary for the service. For example, LKP suggested that cancellation of a contract would result in the removal of equipment and cables being cut off at the wall. Leaseholder-controlled companies therefore reluctantly continue with the contract, rather than facing the inconvenience and expense of having to retrofit new equipment when they cannot make use of existing cabling. We do not think that there is a workable means of addressing difficulties that may arise where equipment remains the property of the supplier. We do not consider that it would be feasible to deem the property to become that of the commonhold association. That would significantly change the nature of a contract for hire and maintenance of equipment. Such contracts are commonly used in a variety of circumstances and it is not feasible fundamentally to alter their operation in the specific instance of commonhold.

12.253 We note that there are particular concerns about disadvantageous long-term contracts in relation to door entry systems. This particular problem is potentially solved by new technology. We understand that it is now possible for door entry equipment to make use of wireless connections, so retro-fitting a new entry system in an existing building has become much more feasible.

12.254 Finally, we note that developers could not preclude the exercise of the right to cancel long-term contracts through development rights. As development rights are local rules, they cannot prevent the exercise the commonhold association's statutory right to cancel long-term contracts.

**Recommendation 69.**

12.255 We recommend that commonhold associations should have the right, within six months of the unit owners taking effective control of the association, to give not less than 12 months' notice to contractors of their desire to cancel a long-term contract which had been entered into by the developer, or by the commonhold association when it was under the control of the developer. This statutory right should not affect any rights of cancellation that may arise under the terms of contract.

12.256 We recommend that the developer should be required to notify unit owners when they have taken effective control of the commonhold association, and must disclose the existence of any long-term contracts to which the commonhold association is a party.

12.257 We recommend that a contractor should be able to apply for a ruling from the Tribunal that a contract is fair before entering into a long-term contract which involves significant up-front capital expenditure. If the Tribunal rules accordingly, the long-term contract should be exempt from subsequent cancellation when the unit owners take effective control of the commonhold association.

12.258 For the purposes of this recommendation, a “long-term contract” should be defined as a contract which must run for more than 12 months; and the association should be considered to have come under the effective control of the unit owners when they are able to exercise 75% of the available voting rights, providing that the units have been sold to “arms-length” purchasers of the units.

# Chapter 13: Contributions to shared costs

## INTRODUCTION

13.1 The commonhold association must set and collect contributions to cover the commonhold's expenses. These contributions are referred to in the Commonhold and Leasehold Reform Act 2002 (the "2002 Act") as the "commonhold assessment".[1] We referred to them in the Consultation Paper as "contributions to the shared costs". These contributions cover the costs of repairing and maintaining the commonhold, the costs of insurance and the provision of facilities and services. In summary, the contributions to shared costs will include all the heads of expenditure which in leasehold may form part of the service charge.[2] Unit owners may also contribute to a reserve fund to cover future repairs – this is considered in the next chapter.

13.2 It is important that commonholds have sound finances if commonhold is to be widely adopted. In this chapter we make recommendations intended to ensure that:

(1) unit owners have a greater level of control over the commonhold's expenditure;

(2) the minority are protected when the commonhold association approves excessive expenditure;

(3) costs can be allocated under different "heads of cost" so that services and facilities enjoyed by a limited number of units are paid for only by those units;

(4) unit owners are required to contribute a reasonably proportionate amount to the commonhold's expenditure, and that sufficient protections are in place to guard against disproportionate allocations; and

(5) any arrears of contributions to expenditure are dealt with upon the sale of a unit so as to protect the solvency of commonhold associations.

13.3 As each of these topics are distinct, we deal with each in turn.

## APPROVAL OF CONTRIBUTIONS TO SHARED COSTS

13.4 The directors are responsible for maintaining a commonhold's finances. The directors estimate the income that they will need to cover the commonhold's expenditure in the forthcoming year and set the contributions to the shared costs required from unit owners in a budget. The directors are required to consult with the unit owners on the estimated budget, but they do not have to take account of owners' observations.[3]

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1 CLRA 2002, s 38. See Glossary.

2 CP, para 10.1.

3 CP, para 10.17.

### Ability to vote on the commonhold budget

13.5 Respondents to the Call for Evidence thought that the current law did not sufficiently engage unit owners in the process of setting the contributions required to run their own commonhold.

13.6 We therefore provisionally proposed that, in addition to consulting with unit owners when setting the level of contributions to the shared costs, the directors' proposed contributions should require the approval of the unit owners.[4] We provisionally proposed that approval should require an ordinary resolution (over 50% majority) rather than a special resolution (at least 75% majority).[5] We noted that this approval would generally be given by a resolution passed in a general meeting, though it could be passed by the written procedure, which can be used to pass a resolution of the commonhold association without requiring a meeting of the members.[6]

13.7 We proposed no change to the requirement that the directors must consult with unit owners before setting the contributions. Under our proposals, directors would therefore be required to consult with unit owners when drafting a budget, and it must then be approved by unit owners.

#### Consultees' views

#### Approval of unit owners

13.8 The vast majority of consultees agreed with the proposal that the level of contributions to shared costs should require the approval of the unit owners. Comments from consultees in favour of the proposal tended to echo the arguments we made in the Consultation Paper: approval has the advantages of increasing unit owners' engagement with the running of the commonhold, may reduce problems around late payment as unit owners will be conscious of the costs and distributes responsibility for ensuring the commonhold is on sound financial footing among members and directors.[7]

13.9 Very few consultees opposed the proposal. Most of those who disagreed argued that the responsibility for managing a commonhold lay with the directors, and it was wrong in principle that their decision should be subjected to a vote of the unit owners. A leaseholder argued:

> No, this is a complete and utter waste of time. Setting the appropriate contributions is fundamentally what the members expect the directors to do for them (as we see in leaseholder management companies). Don't forget that these are only pre-estimates of what the shared costs will be; the actual shared costs (in each accounting period) will need to be paid off by the members in due course through adjustments at the end of the accounting period.

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4 CP, Consultation Question 56, para 10.35.

5 CP, Consultation Question 56, para 10.36.

6 See Glossary.

7 CP, para 10.22.

> Approval by members will just be a mechanism to expose every minor gripe leading to a painful and longwinded process… If the directors are being unreasonable in their behaviour (when setting contributions) there are other powers for members to curb them.

13.10 A few other individual consultees also seemed inclined to leave management matters in the hands of the directors.

13.11 Places for People Group Ltd (developer) was concerned at what would happen if the directors' proposals were repeatedly rejected. Other consultees voiced similar concerns in responding to other parts of this consultation question.

13.12 Although agreeing with our proposals, the Association of Residential Managing Agents ("ARMA") stressed that setting the service charge in leasehold is often a contentious matter. It noted the need of those setting the service charge to strike a balance between the conflicting interests of those who are likely to sell in the shorter term and the longer term, and between owner-occupiers and non-resident landlords. Similarly, FirstPort (managing agents) indicated that they supported our proposals, but suggested that the absence of an outside landlord does not mean that the approval of the budget is without difficulty. They suggested that the directors may act in their own interests. Alternatively, they suggested that conflicting expectations as to maintenance and repair levels between unit owners are likely to cause problems.

13.13 The Leasehold Knowledge Partnership ("LKP"), The All-Party Parliamentary Group on Leasehold and Commonhold Reform (the "APPG") and The Leasehold Advisory Service ("LEASE") all thought that it might be better if the directors could approve a budget provided that it did not increase the previous year's contribtuions by a certain percentage, but that a larger increase would require a resolution of the unit owners. In addition, LEASE and Berkeley Group Holdings PLC (developer) were particularly concerned by the difficulty of ensuring that meetings were quorate.

### Approval by ordinary resolution rather than special resolution

13.14 The vast majority of consultees agreed with our provisional proposal that owners' approval of proposed expenditure should require an ordinary resolution rather than a special resolution. Few consultees were in favour of requiring the higher threshold of support. Most thought there would be a real risk that it would be difficult to secure the approval of 75% of the available votes, whether at a general meeting or by the written resolution procedure. However, the joint response of some members of London Property Support Lawyers Group (the "joint response") thought that a special resolution would be preferable, as it would offer greater protection for the minority of those opposed. They proposed reducing the possibility of a deadlock arising by providing that, if the contributions were approved by an ordinary resolution, but not a special resolution, the directors should be able to apply to the the First-tier Tribunal (Property Chamber) in England and the Leasehold Valuation Tribunal in Wales (the "Tribunal")), for approval.

13.15 A few consultees argued that an ordinary resolution in favour of the proposed level of contributions should always be by written resolution, so ensuring an absolute majority. Berkeley Group Holding PLC added that if the decision were taken at a meeting, a quorum of 20% would mean that the directors' proposals might be passed with the

support of only 11% of unit owners. The Chartered Institute of Legal Executives ("CILEx"), however, welcomed the flexibility offered by being able either to pass the resolution in a general meeting, or to use the written resolution procedure.

## Discussion and recomendations for reform

### Principle of approval by members

13.16 Commonhold unit owners may be in a disadvantageous position in comparison to leaseholders if they do not have a greater level of control over the of expenditure for which they are responsible. Leaseholders enjoy certain rights to challenge service charges. However, we do not think a comparable right should exist in commonhold because of the danger that a successful challenge may leave the commonhold association with a shortfall in its finances and be unable to meet its liabilities. We consider that the preferable option is to provide unit owners with control over the directors' proposed expenditure, rather than a right to challenge it subsequently. We note consultees' support for this approach.

13.17 Control over expenditure offers an advantage over leasehold ownership, where the landlord sets expenditure, and leaseholders can only challenge afterwards. While unit owners will have no right of subsequent challenge, the fact that unit owners can control costs means that there will be a built-in incentive for the costs to be set at a reasonable level. We also recommend an additional protection for unit owners who are outvoted on decisions to incur costs on improvements and new facilities, and enable them to refer excessive expenditure to the Tribunal to determine whether the expenditure should be allowed. [8]

13.18 We recognise that to make the directors' decision subject to approval of the unit owners is a departure from the general principles of company law. However, we think this departure is justified in the light of the specialised role of commonhold associations in comparison to other companies. Unit owners, as members of the commonhold association, are ultimately responsible for the expenditure which the association levies, and own the property on which the funds will be spent. We therefore think it is right that they authorise the directors' proposals rather than have a right to challenge expenditure later. Requiring that contributions are authorised by unit owners carries the further advantage that unit owners may take a more active role in the management of their commonhold.

13.19 We acknowledge that there is a danger that requiring unit owners' approval may put pressure on the directors to set the level of contributions too low. Ultimately, however, unit owners must take responsibility for the good management of their commonhold by authorising the necessary funds to enable the directors to comply with their obligations in the commonhold community statement (the "CCS").

13.20 We also recognise that contrasting expectations as to expenditure on the common parts may be a cause of dispute within commonhold. While we consider that the majority of unit owners are likely to wish to maintain commonhold contributions at a modest level, we make recommendations below to enable the directors to act if authorisation is not forthcoming – if the directors' proposed budget is not approved,

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8 Para 13.135, below.

the previous year's budget will take effect.[9] A dispute would not therefore undermine the day-to-day management and repair of the commonhold.

13.21 For these reasons, and following the very widespread support our provisional proposal, we recommend that the proposed contributions to shared costs should require the approval of the unit owners. We turn now to the level of support necessary for such approval.

### Ordinary resolution or special resolution

13.22 We consider that the approach favoured by consultees of approval by ordinary resolution offers a measure of protection to unit owners, without making the procedure too difficult to operate.

13.23 As noted above, a few consultees thought that it should always be compulsory to use the written resolution procedure, rather than by a resolution passed at a meeting. We agree with CILEx that some degree of flexibility on the procedure is desirable. In company law the two procedures for passing resolutions are generally available as alternatives, and in this respect we do not see any need to depart from general company law. Unit owners would therefore have flexibility as to whether it is a resolution at a general meeting or a written resolution.

13.24 We acknowledge the concern that, if a vote is taken at a meeting and a relatively low number of unit owners attend, a budget could be passed without the involvement of all unit owners. However, it is the unit owners' responsibility to vote on matters which are important to them, and we would expect financial contributions to be a matter on which unit owners are interested. Unit owners who do not turn up to vote would still be able to rely on the minority protection regime discussed above, however the fact that they did not vote would be a factor the Tribunal would take into account on making its determination. We therefore recommend that an ordinary resolution should be required to approve a commonhold's annual budget.

### Dispensing with the need to approve contributions

13.25 The suggestions made by consultees that approval could be waived if the increase from the previous year was below a particular percentage led us to consider whether unit owners would necessarily wish to be involved in approving the commonhold contributions every year. These responses suggested that some commonholds might consider it an unnecessary formality. We agree that this is a possibility, and we believe that unit owners should be able to dispense with the requirement to authorise contributions, and therefore leave the matter to the directors, if they wish to do so. We therefore recommend that the requirement to approve a proposed budget may be dispensed with by unit owners passing an ordinary resolution to that effect. Any resolution dispensing with the need for approval could be rescinded at any time by an ordinary resolution.

13.26 A resolution dispensing with the need for approval might be in general terms, and of indefinite duration. Alternatively, a resolution dispensing with the need for approval, might be subject to conditions. For example, it would be possible for the resolution:

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[9] Para 13.38, below.

(1) to be effective for a set number of years (in which case it could still be rescinded early by another ordinary resolution); or

(2) to dispense with the need for unit owners' approval on condition that the increase in any year did not exceed a stated percentage (and again, unit owners would be able to rescind this position by an ordinary resolution).

### Authorising expenditure on alterations and improvements

13.27 Finally, we consider that it is necessary to rationalise the means through which proposed expenditure in respect of alterations and improvements is authorised. Under our recommendation, the commonhold budget must be approved by unit owners.[10] Additionally, the model CCS currently requires that any alteration to the common parts requires an ordinary resolution.[11] That requirement reflects the fact that, as the owners of the common parts, unit owners should approve any alteration to them. As it is very unlikely that an alteration would not also incur expenditure, this requirement has the effect of requiring approval for both the budget as a whole by ordinary resolution and additional approval of the alteration by ordinary resolution. Both votes can generally take place at the same time.

13.28 We believe that the same requirement should apply in respect of improvements. As unit owners own the common parts, it is right that they authorise any changes to them – whether the change amounts to an alteration or improvement. What matters is that unit owners are in control of their commonhold. If control is dependent on the categorisation of the work then disputes are likely to occur. Accordingly, we recommend that improvements to the common parts should require the approval of unit owners. Approval of any proposed improvement or alteration would therefore both require approval by ordinary resolution, which can generally take place at the same time that the vote on the proposed budget takes place. However, it may be prudent for directors to separate out expenditure on any proposed improvement or alteration so that if the proposal fails, the budget may still be approved.

**Recommendation 70.**

13.29 We recommend that the proposed contributions to shared costs should require the approval of the unit owners as members of the commonhold association by ordinary resolution.

13.30 We recommend that a commonhold association should be able to dispense with the requirement to approve proposed contributions to shared costs by passing an ordinary resolution to that effect. This resolution could be in general terms, or subject to conditions, and could be of indefinite or finite duration. It could be rescinded at any time by another ordinary resolution.

13.31 We recommend that improvements to the common parts should require the approval of unit owners by ordinary resolution.

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10 Para 13.29, above.

11 Commonhold Regulations 2004, sch 3, para 4.6.1.

### Consequence if contributions to shared costs are not approved

13.32 We invited consultees' views on our suggestion that, if the directors' proposed level of contributions was not approved, the level of contributions required in the previous financial year should continue to apply.[12] We also invited consultees' alternative proposals as to what should happen if the unit owners failed to approve the level of contributions proposed by the directors.[13]

#### Consultees' views

13.33 Over half of consultees considered that where contributions are not approved the level should remain the same as in the previous year. Others supported variants on this suggestion: for example, that the contributions should be set at the average of the preceding three years, or that some uplift should be applied to it. Various suggestions were made as to how the uplift should be calculated.

13.34 Although not suggested in the Consultation Paper, the alternative which attracted most support was that, in the event of the directors being unable to secure agreement from the unit owners for their proposed level of contributions, the Tribunal should be required to determine what the level of contributions should be.

#### Discussion and recommendations for reform

13.35 We acknowledged in the Consultation Paper that allowing the contributions to continue at the level set the previous year was a "rough and ready" solution.[14] We considered whether it should be possible for contributions to increase by a specified amount in the following year, either by reference to a public index (such as the Retail Prices Index or Consumer Prices Index) or an amount set by regulation. We concluded that neither existing indices, nor a sum set by regulation could accurately capture the likely causes of increases, such as insurance and building costs. Ultimately, none of these approaches seems to address the underlying issue that increases in contributions may simply be unavoidable if basic costs rise.

13.36 The possibility of passing the matter to the Tribunal where contributions are not agreed attracted support from several professionals with relevant experience of the types of isuses that are likely to be involved. We are concerned, however, that the ability to have the matter resolved by the Tribunal might act as an incentive for unit owners to reject the directors' proposals in the hope of securing a reduction. If resorted to too frequently the proposal seems likely to overburden the Tribunal, and might even mean that, in a signficant percentage of cases, the commonhold contributions were being set by the Tribunal rather than the directors. It is clearly undesirable for resort to the Tribunal to become the rule rather than the exception. That result would ultimately undermine the nature of commonhold as a self-governing entity for which owners have to take responsibility.

13.37 We do not, therefore, feel able to recommend a procedure which is not likely to result in a high proportion of cases going to the Tribunal. As no index or prescribed rate of

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12 CP, Consultation Question 56, para 10.37.

13 CP, Consultation Question 56, para 10.38.

14 CP, para 10.33.

increase is likely to be suitable for all commonholds, but at best can be only an approximation, we think that the balance of advantage lies in keeping the method of calculation as simple as possible. We therefore recommend that if the directors' proposed contributions should fail to secure approval, the level of contributions required in the previous financial year should continue to apply.

**Recommendation 71.**

13.38 We recommend that, if the directors' proposals as to the level of contributions should fail to secure approval, the level of contributions required in the previous financial year should continue to apply.

## SHARES OF THE CONTRIBUTIONS TO BE PAID BY EACH UNIT

13.39 Contributions to the shared costs and the reserve fund are divided between units in percentages specified by the CCS.[15] We noted that the CCS requires each unit to be allocated a percentage share of the commonhold contributions (both in respect of the shared costs and the reserve fund(s)), and requires the percentages to total 100%. It is not necessary that the same percentage be allocated to each unit: larger units might, for example, be required to contribute more. Furthermore, the contributions required towards shared costs and the reserve funds might be different from each other.

13.40 In this part of the chapter, we first consider how those contributions are allocated to units by those drafting the CCS, and then turn to how unit owners can challenge an allocation.

### Allocating contributions under heads of cost

13.41 While the percentage share of contributions allocated to each unit may differ, the CCS does not appear to permit units to contribute different percentages of different "heads" of costs. A unit owner who had been allocated 10% of the commonhold contributions in the CCS, for example, would be required to pay 10% towards every commonhold cost, irrespective of the extent to which they benefit from particular works or services. In practice, it may be appropriate for some units not to have to contribute towards certain heads of expenditure at all. For example, some units within a block might have a right to use a basement parking area, while others might not have this right.

13.42 If it were possible to allocate percentage contributions to different heads of cost, the costs relating to the upkeep of the car park could be allocated only to those units which had a right to use it. Units which did not enjoy the use of a parking space would not be required to contribute to its upkeep. A similar mechanism is available in the leasehold context. The Royal Institution of Chartered Surveyors refers to this ability in

[15] CP, para 10.82.

leasehold as calculating a service charge by reference to "schedules" of expenditure.[16]

13.43 We said in the Consultation Paper that the lack of provision for units to contribute a different percentage for different heads of cost was likely to inhibit the use of commonhold, particularly for commonhold developments which were in any way complex. We therefore provisionally proposed that it should be possible to allocate to individual units within a commonhold different percentages that it must contribute towards different heads of cost.[17] We invited consultees' views as to whether each commonhold should have total flexibility in how different costs are allocated, or whether there should be any limitations on their ability to do so.[18]

### Consultees' views

#### Whether it should be possible to allocate expenditure under heads of cost

13.44 The vast majority of consultees agreed with our proposal to facilitate different heads of cost.

13.45 A few of those who opposed our proposals may, in fact, have misunderstood their effect. One consultee thought our proposals would mean that the owners of top floor flats could be made solely responsible for the upkeep of the roof or guttering. We address this concern below. Some who opposed the proposals did so on the basis that all unit owners within a commonhold should contribute exactly the same proportion to expenditure, or that any difference in contributions was justifiable only if there was a significant difference in the size of the units.

13.46 CILEx welcomed greater flexibility in the way that expenses are allocated among unit owners, but was not convinced that our proposals would be more straightforward in achieving this objective than setting up sections.[19] They thought that the proposals risked duplicating procedures and causing confusion.

13.47 The British Property Federation pointed out that arrangements similar to those envisaged by our proposal are common in complex leasehold developments and thought that, provided that they were used in an equitable way, heads of expenditure should pose no difficulties in commonhold.

13.48 ARMA did not directly answer this question, but commented that:

> This is technically feasible from a management point of view as modern accounting packages can accommodate this, although set up costs would be increased. The benefit compared to the additional complexity, cost and potential disharmony (arguments about each line items allocation) should be assessed.

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16 Eg in RICS, *Service charge residential management Code and additional advice to landlords, leaseholders and agents* (3rd ed 2016), para 7.7. The Code is approved in respect of England only by the Secretary of State under the Approval of Code of Management Practice (Residential Management) (Service Charges) (England) Order 2016, SI 2016 No 518.

17 CP, Consultation Question 59, para 10.96.

18 CP, Consultation Question 59, para 10.97.

19 See Ch 8.

13.49 ARMA concluded by pointing out that it would make the setting up of the CCS more difficult and possibly more contentious.

### Flexibility in creating heads of cost

13.50 Just over half of those who responded to this part of the question were in favour of commonholds having total flexibility on this issue. A significant minority thought that there should be some limitations. Some did not answer the binary question, but preferred to offer comments.

13.51 Support for the existence of limitations was drawn mainly, but not exclusively, from leaseholders and other individual consultees. Iain Macfarlane (solicitor) observed that as total flexibility could be achieved under the leasehold model, so commonhold should be equally flexible. One confidential consultee considered that the fact that the payment of commonhold contributions are controlled by unit owners offers an inherent protection.

13.52 Consultees who were in favour of there being some limitation on the establishment of heads of cost suggested that flexibility should be limited by reasonableness, and a couple specifically mentioned that it should be possible to refer the point to the Tribunal. Two individual consultees argued in favour of having some safeguards to prevent abuse.

13.53 A few of those who opposed flexibility did so on the basis that they thought that standardised arrangements should apply across all commonholds. An anonymous residents' association wished to steer clear both of complete flexibility and limitations, and favoured the issuing of guidelines.

### Discussion and recommendations for reform

13.54 We note the overwhelming support given by all categories of consultees for our proposal to facilitate separate heads of cost in commonhold. Facilitating heads of cost would provide those setting up the commonhold with the flexibility they need to ensure that only those who benefit from certain services are responsible for contributing towards them. To address the concern expressed by one consultee above, it is anticipated that "benefit" would be considered broadly. Owners of top floor flats will not be the only individuals who stand to benefit from the roof being in repair. All owners will have an interest in the structural integrity of the building in which their flat is located, and should contribute to its upkeep. Conversely, an individual who does not have access to a car parking space cannot be said to benefit from that space in any way, and should not be responsible for its maintenance costs.

13.55 As referred to by a number of consultees, a similar mechanism to heads of costs is frequently used in leasehold developments. Leases often include schedules which set out the costs which some, but not all leaseholders in the development are responsible for contributing towards. If commonhold is to be accepted by developers, it needs to offer a comparable degree of flexibility to leasehold. Developers will therefore be well accustomed to the idea of separating out costs, and will be able to decide whether it will be appropriate and cost-effective to set up heads of costs in a particular commonhold.

13.56 We note the observations of some consultees that it will not be necessary to provide both for heads of cost and sections. However, our view is that it would be useful to provide both for sections and heads of cost for commonholds. Sections and heads of cost fulfil sufficiently different purposes to justify making both available, and facilitating both offers greater flexibility. As explained more fully in Chapter 8, it may be sufficient in a particular commonhold to separate out who pays towards certain costs, rather than taking the additional step of separating out who pays the costs and who is able to vote on decisions affecting these costs (as would be the case on creating a section). We therefore recommend that it should be possible to allocate to individual units within a commonhold different percentages that each unit must contribute towards different "heads" of cost.

### Flexibility in the allocation of costs

13.57 We acknowledge consultees' concerns about the risk of abuse in the creation of heads of cost. It would not be acceptable, for example, for the developer to allocate all costs to certain units, in order to make other units more attractive. Below we make recommendations that will ensure costs are allocated in a way that is reasonably proportionate, and explain that these protections will extend to allocations made under heads of costs.

**Recommendation 72.**

13.58 We recommend that it should be possible to allocate to individual units within a commonhold different percentages that each unit must contribute towards different heads of cost.

## Allocating proportionate financial contributions

13.59 Currently, there are no guidelines which would assist those establishing a commonhold as to how to allocate shares of the of expenditure among the commonhold units in a proportionate manner. We therefore invited consultees' views on whether internal floor area would offer a satisfactory default basis on which to allocate financial contributions in purely residential commonholds.[20] We further invited consultees views as to whether internal floor area would offer a satisfactory default basis upon which to allocate financial contributions in commonholds which included (a) commercial and residential units and (b) commercial units of different kinds.[21] We also invited views on alternative methods.

### Consultees' views

### Floor area as the basis of allocating contributions

13.60 A sizeable majority of consultees considered that internal floor area would be a satisfactory default basis for the allocation of financial contributions in purely

[20] CP, Consultation Question 60, CP para 10.102.

[21] CP, Consultation Question 60, CP para 10.103.

residential commonholds. Those who endorsed it tended to refer to floor area being widely adopted in leasehold practice as a fair basis for allocation service charges.

13.61 Those who did not support the use of floor area put forward various other views. An anonymous residents' association was concerned that using floor area as a basis for allocating service charges could over-complicate matters. It was worried that flats which were substantially the same would have to pay different percentages of contributions because of minor discrepancies in their floor areas. An individual leaseholder made the point that allocated parking spaces might also have to be taken into consideration in calculating the total floor area.

13.62 Several leaseholders and other individual consultees thought that more weight should be given to the use made of facilities, and the number of occupants of the unit, than to the size of the unit. Others favoured equality of contributions, regardless of the size of the units, on the basis that all made equal use of the common parts. Christopher Jessel (solicitor) suggested that in an estate of houses, the length of the access road serving a property might be a relevant consideration. Some consultees, including LKP and the APPG, thought that more attention should be given to the extent that units could make use of certain facilities.

### Floor area in mixed-use commonholds

13.63 There was considerably less support for using internal floor area as a default basis for the allocation of contributions where there were commercial elements in a commonhold. Only a minority, albeit a significant one, supported its use when commercial elements were involved.

13.64 ARMA suggested that "floor area has become the accepted mechanism to allocate common costs" in leasehold. Others expressed similar views.

13.65 A L Hughes & Co (solicitors) and the Westminster and Holborn Law Society thought that rateable values for Business Rates would provide an appropriate way of allocating expenditure as between commercial units, but did not offer a view as to how expenditure should be allocated between residential units and commercial units.

13.66 In response to another question, Berkeley Group Holdings PLC thought that it should be possible for variable rather than fixed contributions to be set to cover commonhold expenses. They suggested that in their experience contributions for leasehold service charges were usually set on the basis of what was "fair and reasonable" and service charges with fixed percentages were unusual.

13.67 A few consultees thought that allocation of contributions when there were commercial elements were involved was a difficult issue which would need the professional expertise of surveyors.

## Discussion and recommendations for reform

### Allocating costs proportionately

13.68 It is important that the shares of expenditure allocated to units are allocated in a proportionate manner. In respect of residential commonholds, a sizeable majority of consultees considered that internal floor area is a suitable default basis for determining the allocation of financial contributions. As it is an objective way of

comparing different units it has an advantage over more subjective bases of comparison. Floor area is also a well-established in the leasehold field as a means of allocating liabilities. Accordingly, in many purely residential commonholds, floor area will offer a satisfactory basis on which to allocate contributions in a proportionate manner.

13.69 However, floor area will not always offer a satisfactory basis on which to allocate proportionate financial contributions. For example, while it is likely to be the most suitable basis of comparison to use for flats, it is not necessarily the best method to use where a commonhold includes houses. Furthermore, the floor area of parking spaces cannot be treated as equating with the floor area of residential units. Parking spaces may be treated as integral parts of a residential unit, as separate units themselves, or as limited use areas (and not therefore technically part of a unit at all). It is not obvious – even if they form part of a unit – that their floor area can directly be equated with the floor area occupied by the residential part of the unit. We therefore do not consider it appropriate to prescribe floor area as the method through which residential commonholds must allocate financial contributions.

13.70 Consultees offered alternative methods of allocating contributions in residential commonholds. However, these also present difficulties. Allocating contributions by reference to under- or over-occupation of units would represent a significant departure to the nature of the contribution to shared costs as representing the cost of maintaining the commonhold. We do not see such a departure as appropriate. Further, it would require intrusive and probably unworkable monitoring of who was residing in each flat. Concentrating on "equal use of the common parts" overlooks the point that the exterior and roof of a building will form part of the common parts: they need to be repaired and insured; and larger units represent a larger share of the building. In the light of the problems of floor area and alternative approaches, we do not consider that it is either desirable or possible to prescribe a single methodology that is appropriate in all cases when allocating contributions in residential commonholds.

13.71 Determining allocations in mixed-use developments represents a greater level of complexity, suggesting that a prescribed methodology is also not appropriate in mixed-use commonholds. For example, in leasehold, RICS note that apportionment of service charges in mixed-use developments are often based on the perceived benefit and use of services provided to occupiers of the building.[22] Further complication is added in that different classes of commercial users may derive differing levels of benefit and use – an office, for example, will not benefit from some services and uses in the same manner as a retail unit.[23] RICS also make the point that floor area does not necessarily indicate the cost of servicing units within the same building – in a shopping centre, the cost of servicing a large unit is likely to be proportionately less per square meter than servicing a small unit, due to economies of scale. Although a variation on internal floor area is used, RICS stresses that there is no such thing as "standard weighting formula" in apportioning contributions to expenditure.[24]

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22 RICS, *Managing mixed use developments* (2012).

23 RICS, *Service charges in commercial property* (2018).

24 RICS, *Service charges in commercial property* (2018), section 4.2.8.

13.72 In view of the elements of subjectivity and professional judgment involved in determining proportionate allocations of expenditure, we do not feel able to recommend a default methodology by which financial contributions should be allocated in either residential commonholds or those comprising a commercial element. We consider that expert guidance is necessary to aid those drafting the CCS, directors, unit owners and the Tribunal as to the allocation of costs in commonhold.

13.73 We therefore recommend that a Code of Practice is produced to guide the allocation of reasonably proportionate financial contributions in residential, mixed-use and purely commercial commonholds. Any such Code could then be put forward for the approval of the Secretary of State and the Welsh Government, in similar manner to the Code approved under section 87(1) of the Leasehold Reform, Housing and Urban Development Act 1993. As we turn to below, a Code could be relied on by the Tribunal when determining whether allocations are proportionate. As RICS is an expert body with experience in producing guidance on the allocation of service charges in leasehold property, we consider that RICS would be best placed to produce a Code of Practice on the proportionate allocation of commonhold contributions.

**Recommendation 73.**

13.74 We recommend that the Secretary of State approves a Code of Practice on the allocation of proportionate financial contributions in residential, mixed-use and purely commercial commonholds.

### Challenging the share of expenditure allocated to a unit

13.75 Once the shares of expenditure have been allocated to the units in the CCS, the allocations may only be varied subsequently by a special resolution of unit owners. Variation is subject to unit owner's right not to have his or her unit allocation altered if the effect of the alteration, taking into account all the circumstances of the case, would be to allocate a "significantly disproportionate" percentage to his or her unit.[25] This provision has been criticised on a number of grounds:

(1) it has been suggested that "significantly disproportionate" is too vague;[26]

(2) the right of challenge appears to arise only if the percentage allocated is changed: there would be no basis to challenge the initial allocation, no matter how unfair;

(3) it is unclear whether the reference in the current law to "the circumstances of the case" would include an initial allocation which was unfair; and

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25 Commonhold Regulations 2004, sch 3, para 4.8.12.

26 *Clarke on Commonhold,* para 18[6].

(4) it appears to allow the re-allocation to be "disproportionate", provided that it is not "significantly disproportionate".

13.76 We provisionally proposed to retain the possibility of varying the percentage of expenditure allocated to each unit by amending the CCS by special resolution, subject to a unit owner's right not to have a significantly disproportionate amount of the commonhold contributions allocated to his or her unit.[27]

13.77 We also invited consultees' views as to whether any proposed variations to allocations should be considered on the basis that the original allocated percentage was fair; and whether safeguards against disproportionate allocations should only apply if the allocated percentage is altered.[28]

### Consultees' views

#### Challenging initial allocations

13.78 There was no consensus on the issue of whether safeguards against disproportionate allocations should only apply when an allocation is altered. Around a third of consultees thought it should be assumed that the initial allocation of contributions was fair, and that could be the starting point in assessing the fairness of any variation. These consultees were opposed to the idea that unit owners could challenge the initial allocation of expenditure established in the CCS.

13.79 Around a quarter of consultees, on the other hand, indicated their definite opposition to the idea that safeguards should only apply if an allocation is altered. These consultees stressed that it could not be assumed that an original allocation by developers is fair. Clutton Cox Conveyancing and the Conveyancing Association both gave the hypothetical example of a developer intending to retain some units to rent out, and therefore weighting the contributions so that units to be sold would pay more. LEASE was also in favour of unit owners being able to challenge the initial allocation of contributions, though upon limited criteria.

13.80 Those who did not fall into either of these main groups tended to adopt different approaches. The National Leasehold Campaign could not see why the proposed provision would ever be necessary if the CCS had been set up properly in the first place.

#### Challenging amendments to the allocation of financial contributions

13.81 The vast majority of consultees were in favour of our provisional proposal to retain the existing provisions on varying contributions.

13.82 Almost all consultees seemed to recognise that there would be some extreme, and therefore unusual, circumstances in which an initial allocation of contributions would have to be altered. These circumstances would include:

(1) if an initial error had been made;

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27 CP, Consultation Question 60, para 10.100.

28 CP, Consultation Question 60, para 10.101.

(2) if certain units were compulsorily purchased, and therefore had to be removed from the commonhold; and perhaps; and

(3) if additional units were added.

13.83 Most consultees therefore agreed that a unit owner should have a right to challenge an amendment of the contribution allocated to his or her unit if it was altered by a special resolution.

13.84 Some consultees who supported our proposal qualified their responses in various ways. Boodle Hatfield LLP (solicitors) thought that "significantly disproportionate" needed to be more closely defined, but the Westminster and Holborn Law Society was content for the Tribunal to interpret this provision.

13.85 Berkeley Group Holdings PLC thought that there needed to be flexibility, and the right not to have a significantly disproportionate share allocated to a unit was sufficient protection for an owner. The joint response, on the other hand, favoured an overriding right to apply to the Tribunal to determine the fairness of the allocation.

13.86 Most consultees who opposed the proposal took issue with the ability to vary commonhold contributions subsequently. They recognised that a commonhold might have been set up on the basis that the size of contributions might vary (generally with the size of unit), but took the view that, once this had been set in the CCS, it should not be changed. This view seems to be shared by the Federation of Private Residents' Associations (the "FPRA"). The FPRA accepted that the contributions should always total 100%, but seemed reluctant to allow variations unless it was necessary to make an amendment to the allocations to ensure that they totalled 100% of the commonhold's expenditure.

### Discussion and recommendations for reform

#### Challenging allocated contributions to expenditure

13.87 In light of consultees' support, we consider that it should continue to be possible to challenge amendments to financial contributions. We also consider that it should be possible to challenge an initial allocation in the CCS. While a minority of consultees shared this view, we think this is necessary for the following reasons.

13.88 First, consultees raised convincing reasons as to why it should not be assumed that an initial allocation is fair. For instance, a developer may intend to retain some units with a view to renting them out, and may allocate the contributions so that owner-occupiers pay more.[29] In addition, consultees highlighted that there may be instances in which allocations which were originally proportionate subsequently become disproportionate through a change in circumstances. For example, if unit owners have access to a facility such as a swimming pool and contribute to its upkeep, and units are subsequently added and are granted access to the pool, the allocation of expenditure among the units would require amendment so that the costs are shared between the existing and new owners. It is also possible that an initial allocation is

[29] See para 13.79, above.

simply incorrect as a result of a drafting error. We think unit owners should have a right to challenge the allocation in these circumstances.

13.89 Second, the experience of other jurisdictions highlights why it cannot be assumed that initial allocations are proportionate. This suggests that safeguards are needed. Dr Cathy Sherry suggested to us that in New South Wales experience has shown that in mixed-use strata developments costs are often allocated in a manner that benefits commercial units. New South Wales subsequently introduced a requirement that costs must be allocated fairly, and that financial allocations must be reviewed after any change in the shared facilities or services, or at least once every five years if no such change has occurred. We think that a right to challenge the allocation provides a sufficient degree of protection without imposing an obligation on commonhold associations to regularly assess the allocations.

13.90 Third, many leaseholders enjoy a right to challenge the apportionment of service charges in a lease. It is common for modern leases to provide that the leaseholder pays a fair and reasonable proportion of the landlord's costs in maintaining the building. Inclusion of this provision enables a leaseholder to challenge the apportionment on the basis that it is not fair or reasonable, and the Tribunal may substitute its own determination of an appropriate apportionment.[30] In the absence of a requirement that the service charge apportionment must be fair and reasonable, leaseholders may alternatively challenge the initial apportionment on the more limited basis that the service charge provisions are unsatisfactory.[31] We think commonhold would be in a disadvantageous position if leaseholders could challenge the service charge apportionment as initially drafted but commonhold unit owners could not.

13.91 For these reasons, we recommend that commonhold unit owners should be able to challenge the percentage of expenditure allocated to his or her unit as it stands, not just when an amendment to that allocation is proposed. It would therefore be immaterial whether the disputed allocation is the initial allocation in the CCS or has been subsequently amended by a special resolution of unit owners – a unit owner could challenge the allocation in either case. This approach mirrors the manner in which leaseholders' rights to challenge service charge apportionments arises.

13.92 We turn not to consider the basis on which an allocation may be challenged.

### The basis on which the expenditure allocated to a unit can be challenged

13.93 As noted above, the current law only permits a unit owner to challenge an allocation on the basis that it is "significantly disproportionate".[32] We share consultees' concerns over the vagueness in its meaning. The current law would appear to leave open the possibility that disproportionate costs can be allocated, providing that they are not *significantly* disproportionate. We do not consider that our revised approach, which would allow a unit owner to challenge an allocation as it stands, rather than only when an allocation has been varied, should rely on this test.

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30 The challenge is made under s 27A of the Landlord and Tenant Act 1985.

31 Landlord and Tenant Act 1987, ss 35 and 37.

32 Para 13.75.

13.94 Instead, we consider that a unit owner should be able to challenge the percentage of expenditure allocated to his or unit on the basis that it is not "reasonably proportionate" in relation to what other units are paying. The contribution allocated to a unit should therefore approximately correspond to what other units are paying in light of all the relevant factors. Accordingly, the fact that a unit is paying a larger contribution in proportion to other units will not necessarily mean the contribution is not reasonably proportionate if, for example, that unit is larger and enjoys rights or services to a greater extent than other units. Determining whether an allocation is "reasonably proportionate" will always depend on the circumstances of the commonhold. A Code of Practice, which we recommend above, will offer guidance on how to allocate reasonably proportionate contributions in both residential and mixed-use commonholds.

13.95 We recommend that challenges to the allocation of expenditure should be heard by the Tribunal. In making its determination as to whether an allocation is reasonably proportionate in relation to what other units are paying, we consider that relevant considerations for the Tribunal include:

(1) the extent to which the unit has access to particular rights and services;

(2) the internal floor space of the commonhold. As we note above, this has its shortcomings, but it generally offers an objective way to consider whether allocations between units are reasonably proportionate;

(3) any Code of Practice on the allocation of commonhold contributions;[33] and

(4) the voting rights allocated to the unit. We consider that cross-checking the allocation of financial contributions with the allocation of voting rights would form a useful additional factor in deciding whether each was "reasonably proportionate", although subject to two constraints:

(a) logically it would seem that establishing the proportionality of the financial contributions ought to come first: the allocation of voting rights would then follow on from that; and

(b) it would need to be recognised that, for administrative convenience in conducting meetings, and even in passing written resolutions, it might be necessary for votes to be allocated in a rather more "broad brush" way than would be appropriate for financial contributions.

13.96 We recommend that, in making its determination, the Tribunal should have the power to substitute its own determination of a reasonably proportionate allocation. The Tribunal's determination should not be open to subsequent challenge by other unit owners. However, we acknowledge that the Tribunal may not always be in a position to substitute its own determination. For example, if one unit owner's allocation is not reasonably proportionate, it may be the case that other allocations are similarly not reasonably proportionate. Alternatively, there may be complex calculations to be made that require additional information about the commonhold to which the Tribunal does not have access. We therefore recommend that the Tribunal should be able, if it

[33] We recommend above at para 13.74 that such guidance should be created.

considers it necessary, to refer the matter back to the commonhold association to produce a reasonably proportionate allocation. It is for the Tribunal to determine the appropriate course of action.

13.97 We consider that if the Tribunal determines that an allocated financial contribution is not reasonably proportionate, the commonhold association should not be liable to reimburse any previous contributions. To provide otherwise would threaten the solvency of commonhold associations. This is consistent with our policy in that costs cannot be challenged after they have been incurred.

13.98 Finally, we note that our recommended test should also apply in respect of costs allocated under separate heads of cost. Accordingly, if a commonhold had created a separate head of cost for maintaining a gym, and a unit owner felt that he or she had been allocated a disproportionate financial contribution towards this cost, the allocation under the head of cost could be challenged in the same way as a challenge to the total unit allocation. The Tribunal would determine whether the allocated contribution under the particular head was reasonably proportionate, and would have the power to substitute its own allocation, or may refer the matter back to the commonhold association to produce a reasonably proportionate allocation.

### When amendment to financial contributions should be possible

13.99 We would not consider it appropriate for a commonhold association to modify unit owners' allocated shares of expenditure as a matter of course. Instead, we believe amendments should only be possible to ensure that contributions are reasonably proportionate. In practice, this is likely to mean that once contributions are set in the CCS, an amendment would only be possible in circumstances that require amendment so as to ensure that unit owners' contributions are reasonably proportionate.

13.100 The addition of units to a commonhold, for example, is such a situation in which it would be necessary to amend existing contributions to ensure an appropriate distribution. Alternatively, the removal of some units from the commonhold, which we make provision for in Chapter 20 under the partial termination procedure, would likely require amendment of the contributions for the remaining units.

13.101 A recommendation to this effect provides a degree of certainty for unit owners. Once contributions are established in the CCS, they can only be amended where there is good reason for doing so. We therefore recommend that allocated contributions can only be made where it is necessary to ensure that they are reasonably proportionate.

**Recommendation 74.**

13.102 We recommend that unit owners should have the right not to have more than a reasonably proportionate share of the commonhold's expenditure allocated to his or her unit. We recommend that this right should apply to the allocation as a whole and to shares allocated under specific heads of costs.

13.103 We recommend that a unit owner's right not to have more than a reasonably proportionate share of the commonhold's expenditure allocated to his or her unit should apply both to the contributions initially allocated by the CCS, and to any allocations resulting from an amendment to the shares by a special resolution of unit owners.

13.104 We recommend that a commonhold association should only be able to amend the share of expenditure allocated to a unit to ensure that the share is reasonably proportionate.

13.105 We recommend that challenges to the share of expenditure allocated to a unit should be heard by the Tribunal. We recommend that, in making its determination as to whether the share of expenditure allocated to a unit is reasonably proportionate, the Tribunal should be required to have regard to:

(1) the rights and services enjoyed by the commonhold units;

(2) the internal floor space of the commonhold units;

(3) any Code of Practice on the allocation of commonhold contributions;

(4) the voting rights allocated to the unit; and

(5) any other matter the Tribunal considers relevant.

13.106 We recommend that the Tribunal should be able to substitute its own determination of a reasonably proportionate share, or may refer the matter back to the commonhold association to produce a reasonably proportionate allocation.

## CHALLENGING EXPENDITURE ON IMPROVEMENTS AND ENHANCED SERVICES

13.107 Following our recommendations above, the directors must continue to consult with unit owners when setting a commonhold's annual budget, and the proposed expenditure must then be approved by unit owners.[34] We think it is likely that most unit owners would want to keep commonhold contributions at a moderate level, and would not therefore wish to embark on "gold-plating" facilities or services.[35] However, as

[34] Para 13.4 to 13.31.

[35] CP, para 10.40.

commonhold is generally subject to majority rule, those who are outvoted on a decision to incur these items of expenditure currently have no right of challenge.

13.108 In this section, we make recommendations to enable unit owners to challenge proposed expenditure in excess of a prescribed amount in the CCS. We first consider consultees' views on whether it should be possible to include such a provision in the CCS, and then turn to how a unit owner could challenge expenditure in excess of the prescribed amount. Finally, we consider how such a provision could be varied or removed from the CCS.

### An index-linked threshold in the CCS on the cost of improvements and enhanced services

13.109 We think that an inability to challenge excessive expenditure in commonhold may cause problems. A buyer may feel that he or she purchased a unit on the understanding that the level of services would remain broadly the same. It is also possible that several unit owners may struggle to afford subsequent substantial improvements to the common parts or enhanced services provided to the commonhold.

13.110 We believe that there should be some protection of the minority who are outvoted in these circumstances. There is a balance to be struck between the principle of majority rule and minority protection which the law does not currently achieve. We also consider that it is likely that many developers will want to offer purchasers some additional protection against a majority of unit owners approving significant increases in the level of contributions.

13.111 We therefore provisionally proposed that it should be possible for the CCS to include, as a local rule, an index-linked cap on the amount of expenditure which could be incurred on the cost of improvements, and separately, a cap on enhanced services.[36] By enhanced services we have in mind extensions of services that are already provided within the commonhold; for example, the extension of a daytime concierge service to a 24 hour service.[37] If a unit owner believed that proposed expenditure would breach the cap, then he or she could refer the matter to the Tribunal to determine whether it should be allowed.

#### Consultees' views

13.112 The vast majority of consultees supported our provisional proposals that it should be possible for the CCS to include as a local rule index-linked caps on the amount of expenditure which could be incurred on the cost of improvements to the fabric of the common parts and enhanced services.

13.113 ARMA considered that the proposal is a "sensible compromise". Antonia Marjanov (consultee) considered that the proposal would protect unit owners from unnecessary improvements such as "beautification". Jay Beeharry (leaseholder) considered that "a cap would be good to safeguard against future costs unless residents are in favour of further improvements". A confidential consultee suggested that a cap on the cost of

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36 CP, Consultation Question 57, paras 10.41 and 10.42.

37 CP, para 10.40

improvements would prevent overcharging of residents – a problem they suggest currently exists in leasehold.

13.114 Martin Wood (solicitor) expressed doubt as to whether a cap should be included, but could see no reason for preventing its inclusion in the CCS. He considered that "it will be for the market to decide whether such a provision should be included".

13.115 The Property Litigation Association (the "PLA") supported our provisional proposal, but considered that the cap should be restricted to exclude only cases which involve a significant hike in contributions and a significant uplift in facilities.

13.116 The principal category of consultees who opposed our proposals was leaseholder representative bodies. Some of those who opposed the proposal in respect of improvements argued that a cap on expenditure might prevent urgent work being carried out which was necessary for safety reasons.

13.117 A number of those who opposed our proposals in respect of a cap referred to the need for local rules to prevail, or suggested that an ordinary resolution should suffice to exceed the threshold.

13.118 Although LEASE supported our proposals in respect of improvements, they made the important point that it could be difficult to draw the line between repairs and improvements. They called for the CCS to offer clarity on this. The Society of Legal Scholars made a similar point, calling for "improvements" to be narrowly defined.

13.119 Although "enhanced services" is a novel term, only one consultee suggested that it would need to be more clearly defined. Stephen Desmond (consultee) suggested that enhanced services should be considered to be "the equivalent of discretionary service charge expenditure".

### Discussion and recommendations for reform

13.120 In retrospect, we consider that the term threshold better reflects the aim and effect of our provisional proposal. Cap – the term we used in the Consultation Paper – suggests an amount of expenditure which cannot be exceeded, when in fact the amount specified is actually a threshold point at which unit owners in the minority who oppose the expenditure can refer the matter to the Tribunal to determine whether the expenditure should be allowed. We therefore refer to this as a "costs threshold" throughout the following discussion and in the rest of this Report.

13.121 In requiring unit owners to approve expenditure, commonhold provides a superior level of protection for unit owners in comparison to leasehold where decisions about expenditure are often made by an external landlord. While unit owners are unlikely to be willing to subject themselves to unnecessary expenditure, we consider that it is desirable to make provision for a costs threshold for the following reasons.

13.122 First, many purchasers are likely to acquire a unit in the hope and expectation that future expenditure will broadly remain the same. A costs threshold can provide reassurance to prospective unit owners that they are not agreeing to open-ended financial commitments.

13.123 Second, many commonholds are likely to be made up of unit owners of varying financial means. There is potential for that to be more pronounced where a commonhold is made up of units let by registered providers of social housing, shared ownership leaseholders and owner-occupiers. If commonhold is to accommodate these range of tenures within a single scheme, we consider that it is necessary to make provision to protect those unit owners (whether individuals or social landlords) who may face difficulties in contributing towards improvements past a certain level. A costs threshold offers a measure of protection in this respect.

13.124 Third, a costs threshold would also protect the solvency of the commonhold, and prevent the approval of expenditure which a number of unit owners are unable to meet.

13.125 Finally, leasehold legislation offers some protection to leaseholders against excessive charges. A leaseholder may challenge service charges on the basis that they are not reasonable. The ability for unit owners to approve the directors' proposed costs and challenged proposed expenditure in excess of a costs threshold would ensure that unit owners are protected in a manner that is tailored to the commonhold model and improves on the position in leasehold.

13.126 We accept that what unit owners see as improvements or enhanced services will vary and that it may therefore be a cause of tension. Some may consider a particular item of expenditure as essential whereas others will see it as unnecessary. We do not however consider that this outweighs the arguments in favour of a costs threshold.

13.127 We also accept that the inclusion of a costs threshold in the CCS may be seen as diluting the principle that commonholds are self-governing in that the Tribunal may refuse to allow expenditure which has been approved by a majority. However, it should be stressed that the inclusion of a threshold is optional, and, as we detail below, if the requisite majority is met, the threshold can be removed. We note that the inclusion of a costs threshold is not a prescribed term of the CCS. Instead, it will be for unit owners, but perhaps more likely, drafters of the CCS, to make provision for it. We anticipate that unit owners will want the security offered by a costs threshold, particularly in the social housing sector, and that its inclusion would therefore make the units more attractive to buyers

13.128 We also note concerns that a threshold may delay or prevent urgent work being carried out which is necessary for safety reasons. However, it is important to note that the threshold would not prevent urgent repair work, and where improvements become necessary for reasons of safety, it seems inconceivable that the Tribunal would not allow the threshold to be exceeded.

13.129 Suggestions that an ordinary resolution should suffice to exceed the threshold, overlooks the point that we proposed (and recommend above) that expenditure will in any event require the approval of an ordinary resolution of the unit owners. It also fails to address the reason why we suggested that applying the basic principle of majority rule might be inappropriate here.[38] We therefore consider that a threshold is the correct approach, and we recommend that it should be possible for the CCS to

[38] See para 13.109 above.

include, as a local rule, an index-linked threshold on the amount of expenditure which could be incurred on the cost of alterations and improvements and enhanced services.

13.130 We have expended on our provisional proposal so that a costs threshold on improvements also applies to proposed expenditure on alterations. Both improvements and alterations can incur significant expenditure. Ensuring that both forms of expenditure are covered by a costs threshold prevents dispute as to which category the expenditure falls into.

13.131 We do not have the expertise to recommend which index is the appropriate benchmark for a costs threshold to be linked to. The appropriate index is therefore a matter to be determined by the Secretary of State.

13.132 It would clearly be important for unit owners to know whether or not expenditure on improvements or on enhanced services was subject to a costs threshold, and, if so, what in each case that threshold was. So as to leave no room for doubt on this, we recommend that the relevant section of the model CCS should clearly indicate, by means of boxes which would have to be completed:

(1) whether a costs threshold applies to alterations and improvements, and if so, what the threshold amount is; and

(2) whether a costs threshold applies to enhanced services, and if so, what the threshold amount is.

### Defining "improvements"

13.133 The borderline between "repairs" and "improvements" can be difficult to draw, and for that reason we have generally sought to avoid having to make the distinction within commonhold. However, for the purpose of a costs threshold, it matters which category an item of expenditure falls into. Repairs and renewals are not subject to a costs threshold given that undertaking a repair – unlike an improvement – is likely to be necessary.[39] Accordingly, if a budget which authorised repairs is approved by a majority of unit owners via an ordinary resolution, the minority would have no further route to challenge the expenditure.

13.134 On balance we take the view that it is better to leave the term "improvements" undefined. A definition applicable only to commonhold would tend to increase the likelihood of borderline cases having to be settled by litigation. A definition would mean that the case law on what were classed as "improvements" within commonholds would from then on diverge from the general law. If left undefined, we would expect that, in case of dispute, legal advisers – and courts and tribunals – would rely on the considerable amount of case law in landlord and tenant law, and apply it in the same way.

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[39] The commonhold association is under an obligation to repair and maintain the common parts, and under recommendations, to renew where something is beyond repair: see Ch 12, paras 12.161 to 12.175.

**Recommendation 75.**

13.135 We recommend that it should be possible for the CCS to include, as a local rule, index-linked thresholds on the amount of expenditure which could be incurred annually on the costs of:

(1) alterations and improvements; and

(2) enhanced services.

13.136 We recommend that the relevant section of the model CCS should clearly indicate, by means of boxes which would have to be completed:

(1) whether a costs threshold applies to alterations and improvements, and if so, what the threshold amount is; and

(2) whether a costs threshold applies to enhanced services, and if so, what the threshold amount is.

## Challenging proposed expenditure in excess of a costs threshold

13.137 As noted above, if a unit owner believed that proposed expenditure would breach a costs threshold, then he or she could refer the matter to the Tribunal to determine whether the expenditure in excess of the threshold should be allowed.[40] To help protect the solvency of commonhold associations, we provisionally proposed that any application by a unit owner to challenge proposed expenditure in excess of a costs threshold should be made before it was incurred, and that expenditure, once incurred, should not be open to challenge later.[41]

### Consultees' views

13.138 The vast majority of consultees supported our provisional proposal. Support was drawn from a wide spectrum of consultees. A majority of residents' associations supported it. Buckingham Court Residents' Association stated:

> Yes. This is missing from the existing leasehold system and is open to persistent abuse.

13.139 The British Property Federation commented that:

> It is a common theme in these proposals on expenditure that a challenge can be made before expenditure is incurred but not after. This is intended to prevent protracted contention on expenditure and the withholding of contributions which has been all too often been the case in leasehold service charge regimes.

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40 Para 13.111.

41 CP, Consultation Question 57, para 10.44.

13.140 The Society of Legal Scholars supported the proposal, but specifically restricted their comment to exceeding the threshold. The Society did not think that we should rule out challenges relating to, for example, proper purposes and good faith.

13.141 Others did not agree with our proposals, including some who are particularly involved with the administration of leasehold service charges. Consensus Business Group (landlord) considered that expenditure in excess of the threshold should be open to challenge after it had been incurred. They argued that the fact that the threshold had been exceeded without the Tribunal's approval is "likely to be an occasion of incompetence on the part of the directors", and a penalty should therefore be imposed upon them. Notting Hill Genesis (housing association) also thought that there should be a right of subsequent challenge, observing, "the reasonableness of costs cannot be judged fully until costs have been incurred and services provided".

13.142 FirstPort and Places for People Group Ltd opposed our proposal on the basis that actual expenditure often exceeded budgeted expenditure. They argued that our proposal, if generally applied, would mean that only budgeted expenditure could be challenged, and if the actual expenditure was excessive, a unit owner would be left without redress.

13.143 ARMA argued that to remove the right to challenge expenditure after it had been incurred would mean that commonhold offered an inferior level of protection to unit owners to that provided in leasehold. They did not accept the argument that the right to challenge expenditure after it had been incurred would threaten the finances of the association: if the Tribunal ruled against the association, then the costs should be refunded. They also made the broader point that, in leasehold, including where leaseholders own the freehold via a freehold management company,[42] the risk of bearing the cost of expenditure which turns out to be unreasonable falls on the landlord, whereas in commonhold it would fall on the unit owner.

### Discussion and recommendations for reform

13.144 We have considered the objections raised by those who have expressed opposition to our provisional proposal. It seems however to be self-evident that, for the financial health of a commonhold association, it should not be placed in the position where it has incurred expenditure which it cannot recover. In the Consultation Paper, we pointed out that many leaseholder-controlled companies can currently find themselves in a difficult financial situation as a result of leaseholders making challenges to expenditure after it had been incurred.[43] We do not accept the argument that commonhold thereby puts unit owners in a worse position than leaseholders. In commonhold, the unit owners have control over the budget, and ultimately over the appointment of the directors and the managing agents if dissatisfied as to how the commonhold is being managed.

13.145 The more extreme examples that we have been given of the potential for abuse of the system on the part of directors would appear to involve a breach of directors' duties. We noted in the Consultation Paper that if the directors deliberately ignored the threshold and incurred expenditure in excess of a threshold, or disregarded a pending

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42 See Glossary.

43 CP, para 10.6.

application to the Tribunal, they would be in breach of their duties as directors. They may therefore be personally liable to the commonhold association. This provides a strong incentive for the directors to respect a costs threshold.

13.146 We therefore recommend that if the CCS contains a costs threshold, a unit owner should be able to apply to the Tribunal if the directors propose to incur expenditure over and above the amount specified in the threshold to determine whether the expenditure in excess of the threshold should be allowed before the costs are incurred. The application should be made in accordance with our minority protection regime set out in Chapter 17. The Tribunal will therefore take into account the following factors when determining whether the expenditure should be allowed:

(1) whether the applicant had voted against the decision being complained of and, if so, whether the unit owner voted for or against the decision;

(2) the impact and the degree of impact of the decision on the applicant;

(3) the reason(s) the commonhold association had for voting for the decision being complained of;

(4) the terms of the CCS, taken as a whole; and

(5) any other relevant factor.[44]

13.147 In practice, the right to challenge expenditure that exceeds a costs threshold would therefore operate in the following way.

(1) Unit owners are consulted on the directors' proposed expenditure and the contributions required from unit owners in the usual way.[45] It is at this point that unit owners are likely to learn of any proposed expenditure which would exceed a costs threshold.

(2) Unit owners may notify the directors of their objections, but as noted above, the directors are not required to act on these.[46] The directors may, however, choose to revise down the expenditure in the light of unit owners' objections.

(3) Unit owners vote on the directors' proposed expenditure and the contributions required from unit owners. If a majority of unit owners approve expenditure which exceeds a costs threshold in the CCS, the right the challenge the expenditure in excess of the threshold amount arises. Unit owners may refer the question of whether the excess expenditure should be allowed to the Tribunal. The Tribunal will apply the test outlined above.[47]

(4) If a unit owner challenges the approval of expenditure in excess of a costs threshold, the budget remains approved up to the point of a costs threshold,

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44 See paras 17.29 to 17.61.

45 See above, paras 13.4 to 13.31.

46 See para 13.4.

47 See para 13.146.

and the directors are entitled to require contributions towards this expenditure from unit owners. However, payment of the amount over the threshold could not be required unless and until the Tribunal approved the excess expenditure.

(5) The fact that the Tribunal had permitted the threshold to be exceeded in response to one application would not affect the future applicability of the threshold. It would continue to apply, unless removed or varied by unit owners.[48]

**Recommendation 76.**

13.148 We recommend that if a proposed budget includes expenditure in excess of a costs threshold and the budget is approved by unit owners, any unit owner who objects to a threshold being exceeded should be entitled to refer to the Tribunal the question of whether the expenditure should be allowed. The application should be made under the minority protection provisions. The expenditure in excess of a threshold should not be incurred unless and until the Tribunal has approved it. The remainder of the budget should be treated as approved.

13.149 We recommend that any application by a unit owner to challenge proposed expenditure in excess of a costs threshold should be made before it is incurred, and expenditure should not be open to challenge later. This principle should not affect any rights enjoyed by a unit owner or the association to challenge a director's actions on the basis that they amounted to a breach of a director's duty.

## Removing or varying a threshold

13.150 The principle that commonholds are self-governing would point towards the unit owners being able to remove the threshold if they saw fit. We recognised, however, that registered providers of social housing would want it to be possible for the cap to be removed or varied without stringent safeguards. We therefore provisionally proposed that if a CCS contained a costs threshold, it could be removed only with the unanimous consent of the unit owners, or with the support of 80% of the available votes, plus the approval of the Tribunal.[49]

### Consultees' views

13.151 The vast majority of consultees agreed with our provisional proposal, but did not offer reasons for their support.

13.152 However, several consultees opposed the proposal for varying reasons. Martin Wood thought that the threshold should be removed only with the unanimous consent of unit owners. Professor James Driscoll thought that the matter should be dealt with as a change to a local rule, and was against involving the Tribunal.

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48 We outline below at paras 13.150 to 13.156 how a commonhold association may vary or remove a costs threshold.

49 CP, Consultation Question 57, para 10.43.

13.153 Some consultees proposed alternative levels of support which should be required. These levels ranged from 50% to unanimity. Some consultees also suggested that the approval of the Tribunal should be required, either in all cases, or only if their preferred level of support was not attained. No clear consensus emerged.

### Discussion and recommendations for reform

13.154 As noted above, the purpose of costs thresholds in respect of costs on improvements, alterations and enhanced services is to protect expectations and offer protection to the minority opposed to the expenditure.[50] It follows from this purpose that there should be a sufficiently high level of support required to remove these safeguards from the CCS.

13.155 The lower levels of support suggested by some consultees do not offer a sufficient level of protection. We consider, for example, that it would be common for the proportion of affordable units in a commonhold to be less than 25%. These unit owners are in particular need of protection from excessive expenditure. Requiring a special resolution for the removal or variation of a threshold would not therefore sufficiently protect the position of the owners of such units (whether owned by the landlord, and rented out, or owned on a shared-ownership basis). We believe that a more stringent requirement would therefore be necessary. We therefore recommend that it should be possible to remove or vary a costs threshold only with the unanimous consent of the owners, or with the support of 80% of the available votes, and the approval of the Tribunal.

**Recommendation 77.**

13.156 We recommend that it should be possible to remove or vary a costs threshold only with the unanimous consent of the owners, or with the support of 80% of the available votes, and the approval of the Tribunal.

## LIABILITY FOR CONTRIBUTIONS TO EXPENDITURE ON THE TRANSFER OF A UNIT

13.157 As noted in the Consultation Paper, the underlying premise of commonhold is that obligations attach to ownership of a commonhold unit, enabling positive obligations to bind successive freehold owners.[51] Many obligations will only be relevant and practicable when a person actually owns a unit. Financial obligations, however, raise particular issues. It is vital that commonhold associations can recover contributions to the commonhold's expenditure from unit owners in order to protect their solvency. If a unit owner sold his or her unit without ensuring that his or her contributions were satisfied, the commonhold association would likely face difficulty in tracing them and enforcing payment.

13.158 The current law therefore attaches liability for arrears of contributions to the shared costs to the unit, and a commonhold association may recover arrears of contributions

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50 Para 13.120, above.

51 CP, paras 10.104 to 10.107.

to the commonhold's expenditure incurred by a previous unit owner from the current owner of the unit.[52] The current law also provides a mechanism for purchasers to determine and limit his or her liability, enabling the purchaser to ensure that any arrears are settled by the seller.

13.159 In this section, we consider how liability for contributions to the commonhold expenditure attaches to commonhold units, and the steps purchasers can take to protect themselves.

### Retaining the Commonhold Unit Information Certificate procedure

13.160 The current law enables a the commonhold association to issue a Commonhold Unit Information Certificate ("CUIC"), which outlines the level of arrears of commonhold contributions attached to a unit at the date of issue.[53] Once the CUIC has been issued, the new owner cannot be required to pay more in respect of the arrears than the amount stated in the CUIC, up to and including the date of the certificate.

13.161 While the current owner requests this form, it is assumed that the conveyancers for the new owner will insist on seeing a copy of it. The commonhold association is under an obligation to provide the CUIC within 14 days of the request. It is expected that the purchaser will then look to cover any arrears from the seller during the conveyancing process. However, service of the CUIC does not prevent the association from recovering from the new owner any contributions which have fallen due between the issue of the CUIC and completion of the sale or transfer. Additionally, service of the CUIC does not affect the outgoing owner's liability to pay for arrears which accrued while he or she was a unit owner. If the new owner is required to pay certain sums, he or she may look to the outgoing owner for reimbursement.[54] We provisionally proposed that the CUIC procedure should be retained.[55]

#### Consultees' views

13.162 Consultees almost universally supported our provisional proposal to retain the CUIC procedure.

13.163 The Conveyancing Association pointed out:

> …additional information would be required to facilitate the conveyancing of a unit. The Conveyancing Association would be happy to work with other stakeholders to create the equivalent to the Leasehold Property Enquiry Form (LPE1) and Freehold Management Enquiry Form (FME1) to ensure that the required information is collated and to avoid delays in the conveyancing process.

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52 That includes arrears of the commonhold assessment and contributions to any reserve fund: Commonhold Regulations 2004, sch 3, para 4.7.3.

53 The CUIC must use Form 9 in the Commonhold Regulations 2004, sch 3.

54 Commonhold Regulations 2004, sch 3, para 4.7.7.

55 CP, Consultation Question 61, para 10.118.

13.164 An individual consultee thought that the information on the CUIC should be provided as soon as an offer to purchase the property was made, so as to speed up the conveyancing process.

13.165 Julia Burgess (consultee) was concerned at "re-inventing the wheel". She thought that a straightforward amendment to form LPE1 (Leasehold Property Enquiry Form 1) would be sufficient. She commented that it would not be worth "designing workflows" for a limited number of commonhold units.

### Discussion and recommendations for reform

13.166 In the light of consultees' overwhelming support, we consider that the CUIC procedure should be retained. The CUIC protects the solvency of the association by ensuring that arrears can be demanded from the incoming owner, while at the same time protecting the purchaser. As we explore below, the purchaser can, in reliance on the CCS, take steps to ensure that any arrears are paid by the former unit owner as part of the sale. Such steps may include, requiring that the existing unit owner clears the arrears before the transfer takes place, requiring the current unit owner's conveyancer to undertake to clear the arrears from the proceeds of sale; or making provision for an agreed deduction from the money due to the unit owner on completion. Such deductions are often referred to as "retentions". The buyer's conveyancer could hold an amount of the purchase price so that if any liabilities do arise in the future, the funds could be used to satisfy this amount.

13.167 Given that consultees overwhelmingly supported retaining the CUIC procedure, and the important function it performs, we consider that the CUIC procedure should be retained.

### Ensuring liability continues where a unit owner becomes insolvent

13.168 While we did not consult on this issue, we consider that there is potential for the solvency of the commonhold to be threatened if a unit owner is subject to a court order or arrangement which discharges his or her debts after a specified period of time, such as bankruptcy.[56]

13.169 We noted above that liability for commonhold contributions attaches to the unit, and that liability extends to contributions unpaid by a previous owner.[57] However, if a unit owner's debts are discharged by a court order or other arrangement, any contributions owing in respect of the unit are no longer recoverable by the commonhold association. The possibility that the debt is no longer recoverable by the association undermines the intention in the current law that liability is incidental to unit ownership, enabling arrears to be recovered by whoever is the current owner. It would seriously threaten the solvency of the commonhold association if the arrears in respect of a unit could not be recovered from the new owner. We therefore recommend that a court order or

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[56] Other arrangements include individual voluntary arrangements ("IVAs") and County Court administration orders ("CCAOs"). IVAs enable a person to enter into an agreement with his or her creditors to repay a proportion of the debts he or she owes. CCAOs may permit a debtor pay a money judgment of less than £5000 over an extended period, and the court may state in its order that a proportion of the debt to be written off at the end (County Courts Act 1984, s 112(6)).

[57] See para 13.157, above.

arrangement which discharges a unit owner's debts should not extinguish any arrears of contributions to the commonhold expenditure associated with his or her unit.[58]

**Recommendation 78.**

13.170 We recommend that a court order or arrangement which discharges a unit owner's debts should not extinguish any arrears of contributions to the commonhold expenditure in respect of his or her commonhold unit.

### Sums falling due after issuing the CUIC

13.171 While a CUIC provides certainty as to the level of arrears up to the date of issue, a CUIC will likely be issued some time before the completion date. The buyer therefore runs the risk of further contributions falling due between the date the CUIC is issued and the date of completion. We invited consultees' views as to whether the possibility of further contributions (emergency contributions, or contributions to the reserve fund or funds) falling due after the issue of a CUIC is likely to present practical problems to conveyancers.

13.172 To mitigate against the risk that the buyer could become responsible for further assessments falling due after a CUIC has been issued, of which he or she was unaware, we provisionally proposed that an incoming unit owner should not be liable for further contributions which fall due, unless the commonhold association or its agent has notified the current owner's conveyancers of the further liabilities.[59]

#### Consultees' views

#### Practical problems to conveyancers

13.173 Several consultees thought that the possibility of further contributions falling due after the issue of a CUIC would not in fact cause problems for conveyancers. These consultees comprised residents' associations, leaseholders and other individuals. Around the same number, however, thought the issue would cause problems for conveyancers, but did not explain further, or suggest solutions. LKP and the APPG did not think the situation would generally arise, apart from in the case of genuine emergencies.

13.174 Stephen Desmond wished to distinguish a genuine emergency from the situation where the commonhold association could have foreseen the need to make an emergency assessment when it issued the CUIC, though he conceded it would be difficult to make this distinction.

13.175 Some consultees thought that the problem identified could be mitigated if not eliminated if the CUIC was available as an online document, to which the relevant conveyancers could be given access. A L Hughes & Co, for example, thought the

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58 A debt claim in respect of the arrears against the previous owner would, however, be prevented under insolvency legislation.

59 CP, Consultation Question 61, para 10.120.

state of accounts between the commonhold association and a unit owner who was selling could be available online. They then proposed that a CUIC could be issued just before completion, with a priority period of, say, four weeks.

13.176 The National Leasehold Campaign seemed prepared to allow the purchaser to bear the risk that the commonhold association might require unforeseen contributions immediately before completion.

13.177 Several consultees thought that conveyancers acting for buyers would in practice insist on a retention being made, in order to cover the possibility of further assessments.

13.178 Trowers & Hamlins LLP (solicitors) explained how they thought the apportionment procedure ought to operate on the sale of a commonhold unit. They thought that the CUIC ought to give details to warn purchasers of any impending assessment. They warned that a seller would be imprudent to allow deductions if it might prejudice his or her ability to repay a mortgage.

13.179 The Conveyancing Association also put forward a detailed explanation of how they thought the procedure should operate. If there was uncertainty as to what financial obligations the buyer might have to meet, then there might be a need for a retention to be made. They stressed, however, that retentions were inefficient as they held the seller's money "in stasis", and could require that files be kept open for up to two years. They thought that commonhold could obviate the need for these complexities by ensuring that the CUIC gave some finality to the seller's financial obligations.

### Requirement to notify the buyer of additional sums

13.180 The vast majority of consultees supported our provisional proposal that after a CUIC has been issued an incoming unit owner should not be liable for further contributions which fall due, unless the commonhold association or its agent has notified the current owner's conveyancers of the further liabilities.

13.181 Professor James Driscoll thought it was a "very sensible proposal". Two leaseholders did not think conveyancers always addressed this problem adequately in leasehold conveyancing.

13.182 The PLA, the Society of Legal Scholars and LEASE all commended our proposals as a way of mitigating any problems.

13.183 Although they supported our proposals, the Conveyancing Association thought that the commonhold association might impose a "work-around" by insisting that the seller's conveyancer give an unequivocal undertaking to clear all arrears on completion before relevant information would be disclosed. The Conveyancing Association noted that conveyancers are unwilling to give such open-ended undertakings their precise terms had to be negotiated, which adds to delays in conveyancing.

13.184 Of those who opposed the proposal, several consultees made the point that the risk of subsequent contributions should fall on the buyer, so that the commonhold association would not be out of pocket. The Society of Legal Scholars and the PLA also both suggested that the purchaser should bear the risk of late contributions.

13.185 Notting Hill Genesis was concerned that other unit owners should not have to be required to make up a shortfall because the association could not recover contributions from either buyer or seller.

### Discussion and recommendations for reform

13.186 As noted above, a purchaser of a commonhold unit is liable for any commonhold assessments issued after the date of the CUIC, despite the fact he or she will not yet own the unit until the sale is completed.[60] Consultees were divided as to whether the possibility of further contributions falling due after the issue of a CUIC is likely to present practical problems to conveyancers. Several consultees thought that it would not cause a problem, and that in any event conveyancers acting for buyers would in practice insist on a retention being made in order to cover the possibility of further assessments. Additionally, a further CUIC could be requested closer to completion.

13.187 On reflection, we consider that our provisional proposal is overly bureaucratic and unnecessary as it is a matter that can dealt with in standard conveyancing practices. Conveyancers of leasehold property are familiar with apportioning liability of service charges through the use of a retention. We therefore consider that this is not a matter with which the commonhold legislation needs to be concerned. Instead, we think how liability for further assessments that arise after a CUIC is issued will be apportioned as between the buyer and seller can be left to the parties to determine as part of the conveyancing process.

13.188 This would therefore mean that the buyer would continue to run the risk of further contributions falling due. However, conveyancers acting for the buyer can protect their client through the use of a retention, by requesting an updated CUIC and/or by attempting to make sure that they were aware of any further contributions which fell due between exchange of contracts and completion of the purchase. While some consultees objected to this principle, we are persuaded by those who suggested that that the risk of late contributions should fall on the buyer in order to protect the solvency of the commonhold association. As we note above and in the Consultation Paper, it is more practicable to recover sums from the buyer than the seller.[61] The buyer can take steps to ensure that the seller ultimately pays any arrears.

13.189 While we did not consult on this specific point, we think that the prescribed CUIC form (form 9)[62] as it is currently drafted is potentially misleading. The prescribed form does not warn the prospective purchaser that he or she may be liable for further contributions which arise after the issue of the CUIC but before completion. The buyer will also be liable for regular contributions which fall due after the date of issue of the CUIC but before the likely date of completion. This is likely to apply whenever the contributions to current expenditure are payable by monthly instalments. We therefore consider that the prescribed form should be amended to clarify that the buyer will still be liable for any contributions which fall due after its date of issue, including both (a)

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60 See para 13.158, above.

61 CP, para 10.105.

62 Commonhold Regulations 2004, sch 3.

any regular contributions and (b) any further contributions which are not known as at the date of its issue.

### An online CUIC

13.190 We agree with the suggestion that provision for an online CUIC which could be issued immediately before completion would largely address the problem of a gap between the issuing of a paper certificate and the date of completion. The buyer would have instant access to information about the level of arrears at any given time, and could take steps to protect his or her position accordingly. We consider that a CUIC should be available electronically in future. However, we do not feel able to require electronic certificates at this stage. The likely spectrum of commonhold associations is too large for us say now with confidence that it would be possible. Small commonholds might not have the technology. For large commonholds, issuing electronic certificates might be expensive to set up and administer.

### Time period of a CUIC

13.191 While we did not consult on this point, we note that some consultees felt that the CUIC should only be valid for a certain period of time. However, we do not consider that there are advantages in providing that a CUIC has a defined period of validity. The CUIC does not prevent the association demanding and recovering additional amounts after the CUIC has been issued. It simply provides a clear statement of account up to the date of issue. Given that it is not uncommon for the buying and selling of property to be delayed by unexpected factors, we believe time limiting a CUIC likely to add complexity and potential for further delay. For example, if completion was expected to occur within the validity period, but an unexpected delay meant that completion would occur outside the validity period, the CUIC will no longer protect the buyer in respect of arrears prior to its issue, but the buyer would nonetheless be bound to complete the sale. In other words, the buyer could no longer rely on the CUIC as conclusive evidence of the arrears accrued up until the date of the certificate. A time period may also have the adverse effect of placing additional time pressures on the buying and selling of units to ensure that completion happens within the validity period, and require extensive work to ensure that contracts for the sale of a unit cover the eventualities were the CUIC to expire.

### Distinguishing between emergency assessments and foreseeable assessments

13.192 One consultee suggested that the liability for further assessments be determined by whether the assessment is a genuine emergency, or whether the commonhold association should have foreseen that an assessment would have to be made. We consider that this approach would be too complex to implement in practice, and would likely cause much litigation to determine which category an assessment falls into. It is likely to be especially difficult in larger commonholds where a number of units may be in the process of being sold.

13.193 Furthermore, the commonhold association needs to be able to recover all sums necessary for the effective management of the commonhold. If it failed to foresee a particular expense it would be prevented from recovering the sums, and this would jeopardise the solvency of the commonhold association. As we suggest above, we consider that the most practical solution is to place responsibility on the buyer to

check whether sums have become due after the CUIC, and to protect themselves from liability by a retention and other means in the conveyancing contract.

**Recommendation 79.**

13.194 We recommend that the Commonhold Unit Information Certificate ("CUIC") should be amended to clarify that the buyer will still be liable for any contributions which fall due after its date of issue, including both (a) any regular contributions and (b) any further contributions which are not known as at the date of its issue.

## Whether a CUIC should be amendable after service

13.195 It has been suggested that, once issued, a CUIC is conclusive of the arrears up to the date of service, even if the buyer had not relied upon it, and even if he or she had not seen it.[63] This might even prevent the commonhold association from correcting its mistake if a further CUIC was requested, on the basis that it remained bound by what it had stated in its original CUIC. We asked whether a CUIC should be conclusive of any arrears once issued, and we sought consultees' views on what problems would arise in practice if a CUIC could be amended and how any problems might be addressed.[64]

### Consultees' views

13.196 The vast majority of consultees thought that the CUIC should be amendable.

13.197 A few consultees with experience of the kinds of disputes that are likely to arise from leasehold, and who stated that they favoured a right to amend the CUIC, qualified their answer by placing strict limitations on the ability of the commonhold association to amend it. These included LEASE, LKP, the APPG and ARMA.

13.198 However, some consultees felt that the CUIC should be conclusive (and therefore not amendable) qualified their answer by saying that it should be conclusive only in limited circumstances, or with a limited list of exceptions.

13.199 Of those thinking that the CUIC should be conclusive, Consensus Business Group thought that if the CUIC was not conclusive, then retentions would become routine. The Society of Legal Scholars thought that, even if it was not conclusive, a buyer ought to be able to show that he or she had relied on it, but acknowledged that this may lead to "entanglement in difficult questions of causation, good faith, state of knowledge, relevance of agents, etc".

13.200 The PLA suggested that the CUIC should be conclusive. The association also pointed out the difficult issues of reliance which would be relevant if the CUIC was amendable. CILEx considered that the CUIC should be conclusive, but that it should, in exceptional circumstances be possible to correct it.

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63 CP, para 10.112.

64 CP, Consultation Question 61, paras 10.124 and 10.125.

13.201 A leaseholder who had previously suggested that accounts should be made available online thought that that would make our question redundant. Berkeley Group Holdings PLC made a similar comment.

### Discussion and recommendations for reform

13.202 If the CUIC is to serve its purpose, then we think it is essential that a buyer should be able to rely on the CUIC as conclusive evidence of the arrears up to the date of the certificate. The buyer will use the information provided in the CUIC to ensure that all outstanding arrears are dealt with as part of the sale. We consider this protection to be necessary, if the buyer can be made liable for all arrears which have accrued before he or she became an owner. If the information provided on the CUIC form omitted certain amounts by mistake, and the buyer did not ensure the full amount of arrears were accounted for before completion of the sale, it would be unfair for the association to subsequently recover the full amount from the buyer.[65] The conclusive nature of the CUIC will encourage commonhold associations to ensure the information it provides on the CUIC form is accurate. We therefore recommend that the CUIC is conclusive of the level of arrears which have accrued to the date of the certificate, subject to one limited exception discussed below.

13.203 Although a CUIC would not be amendable on the initiative of the commonhold association, our view is that, if the buyer (or his or her solicitor) requests provision of a further CUIC, the revised certificate can correct any mistake within a previous CUIC. The revised CUIC would be conclusive of the level of arrears up to the date of the revised certificate, and replace the previous certificate. If the buyer requests a further CUIC this suggests that there is still opportunity for the buyer to make arrangements with the seller for the apportionment of commonhold contributions. We therefore consider that there should be one limited exception to the conclusive nature of the CUIC that would enable a commonhold association to amend a CUIC: if the buyer requests the provision of a new CUIC, the new CUIC can correct any mistake on the previous one.

**Recommendation 80.**

13.204 We recommend that the CUIC should continue to be conclusive once issued, and that it should not be amendable; but that the law should be clarified to ensure that if the buyer requests the issue of a new CUIC, the new CUIC can correct any mistake on the previous one.

## Fee for the issue of CUIC(s)

13.205 We provisionally proposed that a maximum fee for the provision of a CUIC should be set by regulation, and kept under review. [66] The fee would ensure the association is reimbursed for its expenditure, while not exposing the unit owners to excessive amounts.

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65 However, the association could still seek to recover the arrears from the seller.

66 CP, Consultation Question 61, para 10.121.

### Consultees' views

13.206 The vast majority of consultees supported this proposal. FirstPort thought that, in view of the level of standardisation inherent within commonholds, it would be possible to set a fixed or maximum fee, which should then be index-linked. The National Leasehold Campaign commented:

> This maximum fee needs to ensure that we do not replicate the current problems in the leasehold sector where high fees are charged for routine administrative tasks to generate profit for the management company and/or freeholder. In this digital age, we should look to adopt technology advances to make processes more efficient and cheaper.

13.207 There was no consensus on whether a single fee should apply for all commonholds. LKP and the APPG, thought that "the fee should vary according to the size and complexity of the development and prescribed fee levels set by the government".

13.208 Consensus Business Group did not agree with our provisional proposal, suggesting that the fee should vary with the complexity of the commonhold, whether managing agents were engaged, and other factors. Mark Chick (solicitor) opposed the idea of a fixed fee as he thought that there was a need for commercial flexibility to accommodate commonhold developments of different sizes. Places for People Group and Christopher Jessel also did not agree with our proposal, but thought any fee should be reasonable.

13.209 Clutton Cox Conveyancing took an intermediate position, suggesting that there should be a fixed fee, with the option for the commonhold association to get the Tribunal to set a higher fee if the complexity of the commonhold justified it.

13.210 Berkeley Group Holdings thought that the bigger issue would be the fees charged for general management information, which often caused delays. They remarked that unit owners, as members of the commonhold association, would already have to hand the information required to respond to enquiries when a property was being sold.

### Discussion and recommendations for reform

13.211 In view of the overwhelming support for prescribing a maximum fee for the provision of the CUIC, we are making a recommendation accordingly. We are concerned that if those managing the commonhold were free to charge whatever amount they saw fit for the issue of a CUIC, this could lead to the replication of abuses relating to fees which have been reported in the residential leasehold sector. A maximum fee would protect against this.

13.212 On balance our view is that, in the interests of simplicity, a single standard fee could be prescribed, even where the commonhold contributions include contributions set by sections, or comprise different heads of cost. The enabling legislation should, however, be broad enough to allow the Secretary of State to prescribe differential fees, if experience should suggest that they are needed.

13.213 There seemed to be confusion in the minds of some consultees between the role of the CUIC and the "sale pack" or "management pack" which is customarily requested from the managing agents at the outset of any leasehold sale; an equivalent will

clearly be necessary on the sale of a commonhold unit. It is sufficient for the purposes of this discussion to say that a "sales pack" will need to include a dossier of information about the commonhold, whereas a CUIC contains only the very limited information which is required by the prescribed form.[67]

13.214 The resentment at the prices sometimes charged for the issue of a leasehold "management pack" raises serious issues, but these are beyond the scope of this Report. If Government does address this issue when it legislates to regulate managing agents, then any such legislation could also address the charges made by managing agents for issuing the equivalent "management packs" for commonholds.[68] Self-managed commonholds would seem to have an in-built incentive to keep their charges at a moderate level.

**Recommendation 81.**

13.215 We recommend that a maximum fee for a CUIC to be issued should be set by regulations, and kept under review.

## Sanctions

13.216 A CUIC is issued by the commonhold association. While the association is required by the CCS to provide the CUIC within 14 days, if the commonhold association delays issuing the CUIC, there is little that the current unit owner can do to expedite matters. It would be possible for the unit owner to make an urgent court application requiring the association to comply with this requirement, it is unlikely to be practicable and cost-effective to do so.[69]

13.217 We invited consultees' views on the related question of what sanction or convenient remedy there should be if a commonhold association failed to issue a CUIC within the prescribed 14-day period.[70]

### Consultees' views

13.218 A substantial majority of consultees thought that the lack of any sanction was likely to cause problems in practice. Several of these (including the Conveyancing Association, and a few law firms) thought that there would be a problem, but did not suggest any possible solution.

13.219 Consultees offered various possible solutions.

(1) Several suggested that some form of fine should be imposed on the commonhold association.

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67 See Form 9 in the Commonhold Regulations 2004, sch 3.

68 See para 1.63 for an overview of the measures Government intends to bring forward to reform home ownership.

69 CP, para 10.109(2).

70 CP, Consultation Question 61, paras 10.122 and 10.123.

(2) A few suggested that, if the CUIC was not provided within the time limit, whoever was in default should lose the right to charge a fee for its provision.

(3) A couple of consultees suggested that, if a CUIC were not provided on time, then the commonhold association should lose the right to recover any arrears from the buyer.

(4) A L Hughes & Co suggested that, if a CUIC was not provided within the specified period, the unit owner's liability to pay contributions should be suspended.

(5) LEASE suggested that:

> A longer period could be given for producing the CUIC, for example, one month. If not provided within this time limit, there could be a limit placed on the maximum amount payable, for example £500. The new owner could then make retention of this amount pending actual figures being given, if actual figures are not provided by completion date. There should be an ability to amend if error discovered after issue.

(6) ARMA made the point that, in leasehold, sanctions were being proposed for managing agents who fail to provide information in a timely manner, and thought that sanctions ought equally to apply to the board of a commonhold which managed itself.

(7) The National Leasehold Campaign suggested that, if a commonhold engaged a managing agent, compliance with any requirement to provide CUICs should be built into the contract, with a penalty clause if the service standard was not met. Government should publish statistics on commonhold associations with a poor record on providing CUICs.

13.220 Some consultees were pessimistic about the effectiveness of any possible remedies or sanctions. The PLA pointed out that the seller could go to court to compel the directors to issue of a CUIC, but would be unlikely to have the time or inclination to do this. Damages are likely to be an inadequate remedy, and making the default a criminal offence would be inappropriate. The joint response echoed these views, and added that imposing penalties on directors would make it more difficult to find unit owners willing to serve. The Society of Legal Scholars, like the PLA, foresaw difficulties in barring the commonhold association from collecting arrears if a CUIC was not issued on time.

13.221 A minority of consultees did not think there would be a problem. FirstPort thought that commonholds which appointed managing agents would find that their agents could perform the task for them. A leaseholder and an individual consultee thought that the problem could be solved by use of a centralised electronic database. A residents' association and an individual consultee thought that the problem would be reduced if a longer period was allowed for compliance. Another residents' association and another leaseholder thought that a longer period should be allowed for self-managing commonholds.

### Discussion and recommendations for reform

13.222 It is clear from the responses that the problem of what remedy or sanction should be available if a CUIC is not provided in time is an intractable one. We commend the idea from the National Leasehold Campaign that a commonhold which appoints a managing agent should include within their contract a service standard for providing any CUICs within the time limit. As that is a matter of individual contracts, not law, we do not make a formal recommendation to this effect. We would, however, suggest that any official Guidance offered to commonhold directors should include this advice. The only sanction that we feel able to recommend is that, if the CUIC is not provided in time, the obligation to provide it should continue, but the fee should be irrecoverable (and if it has been paid in advance, it should be refunded).

**Recommendation 82.**

13.223 We recommend that, if a commonhold association or its agent should fail to issue a CUIC within the prescribed time limit, there should be a continuing obligation to issue it, but that it should not be entitled to charge any fee for providing it (and any fee which has been pre-paid should be refunded).

# Chapter 14: Reserve funds

## INTRODUCTION

14.1 A "reserve fund" is a fund which is set up to meet the future costs of maintenance and repair, such as the replacement of a lift or roof. Commonhold associations are permitted, but not required, to establish reserve funds. Currently, the directors of a commonhold association are required, within a year of the commonhold being established, to consider whether a "reserve study" should be carried out, and the results are used to determine whether reserve funds should be set up.[1] The directors must thereafter commission a study at least every ten years.[2] They have a duty to consider the study, but not necessarily to act on its recommendations.[3] The unit owners may also require, by ordinary resolution, that a reserve fund should be set up.[4]

14.2 In this chapter, we make recommendations intended to ensure commonholds have adequate reserve funds, and that these are protected from the claims of creditors and on the insolvency of a commonhold association.

## WHETHER IT SHOULD BE COMPULSORY TO HAVE A RESERVE FUND

14.3 We have emphasised elsewhere that we think it is important to ensure that commonhold associations become insolvent as rarely as possible.[5] We think that insolvency is less likely to occur if commonholds have adequate reserve funds to meet the cost of major works. It is therefore important that the law facilitates and encourages their use. We provisionally proposed that it should be compulsory for all commonholds to have a reserve fund from the outset.[6]

### Consultees' views

14.4 Almost all consultees supported our provisional proposal that all commonholds must have a reserve fund. The Westminster and Holborn Law Society noted that reserve funds became mandatory for condominium developments in the United States in the 1990s and that this has proved to be invaluable. The Society of Legal Scholars argued that:

> Without compulsion, the unit owners are likely to suffer inertia and fail to set up the administration even though they recognise it as a prudent step. Compulsion forces the association administrators over that barrier, leaving the only question how much. We also think that the compulsory requirement of a reserve fund can be justified in part by the fact that contributions to commonhold association funds protect the

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1 Commonhold Regulations 2004, sch 3 para 4.2.6.

2 Commonhold Regulations 2004, sch 3 para 4.2.7.

3 Commonhold Regulations 2004, sch 3 para 4.2.8.

4 Commonhold Regulations 2004, sch 3 para 4.2.10.

5 See para 19.13, below.

6 CP, Consultation Question 58, para 10.71.

interests of commonhold creditors and therefore go towards justifying the limited liability of unit owners.

14.5 The Conveyancing Association suggested that mandatory reserve funds are "a vital element to avoid the commonhold association from becoming insolvent and to smooth out budgeting for unit holders".

14.6 The Property Litigation Association (the "PLA") considered that:

> The reserve fund is a good idea and it needs to be made compulsory. If left non-compulsory, those running the association may never get round to it (due to the hassle factor in the planning, paperwork and banking), even though they recognise the sense of having such a fund.

14.7 Heather Keates (conveyancer) pointed out the implications of having no reserve funds and therefore called for it to be a mandatory requirement:

> In my 30 years plus in conveyancing I have encountered numerous developments where the building has deteriorated due to the all too familiar "ad hoc" arrangements where sums are collected only where a repair has become necessary.

14.8 Very few consultees objected to the idea that it should be compulsory for a commonhold to have a reserve fund. Those who were not in favour came up with a variety of objections. The Residential Landlords Association suggested that having a reserve fund could be recommended in a best practice guide, but should not be compulsory. A couple of consultees thought that it should be left to each commonhold to decide the point. Others said that a reserve fund would not be necessary for very small commonholds, with little shared areas. A couple of consultees thought that unit owners should each budget for communal repairs in the same way that individual homeowners budget for their own homes.

### Discussion and recommendations for reform

14.9 We acknowledge consultees' suggestion that budgeting for repairs should be left to individual owners. We do not believe that this would be a satisfactory approach in commonhold. Generally, if the owner of a house has not budgeted so as to be able to afford repairs, only that owner will be adversely affected.[7] However, the position with flats is not the same. With flats, the inability of one owner to meet the cost of repair might have adverse consequences for all the others. The absence of a reserve fund can have disastrous effects on a block of flats when urgent repairs are needed. We noted in the Consultation Paper that it is difficult to envisage circumstances when it would not be appropriate for a commonhold to have reserves.[8]

14.10 We are not persuaded that a best practice guide would adequately ensure that commonholds establish reserves. As consultees pointed out, without compulsion, there is significant potential for many commonholds to neglect to establish a reserve

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7 It must be conceded that a neighbour's lack of resources may have an impact where repairs are required to a semi-detached house, or house within a terrace, but generally not to the same degree as in a block of flats.

8 CP, para 10.60.

fund. Requiring that all commonholds have a reserve fund from the outset helps ensure that a commonhold will have planned for future expenditure and will have sufficient funds available to meet repair costs. We therefore recommend that it should be compulsory for every commonhold to have a reserve fund. This might be a designated reserve fund, or an undesignated reserve fund. We consider the difference between the two types of funds below.[9]

**Recommendation 83.**

14.11 We recommend that it should be compulsory for all commonhold associations to have a reserve fund.

## RESERVE FUNDS AND CONTRIBUTIONS TO SHARED COSTS

14.12 As discussed in the previous chapter, the commonhold association must set and collect contributions to the shared costs.[10] This contribution is known as "the commonhold assessment". These contributions cover the costs of repairing and maintaining the commonhold, the costs of insurance and the provision of facilities and services. The current law treats contributions to the shared costs and contributions to the reserve funds as distinct contributions that must be estimated and collected separately. We provisionally proposed that the scheme for financing the commonhold should continue to distinguish between contributions to the shared costs and contributions to the reserve fund or funds.[11]

14.13 We further provisionally proposed that the required annual contributions to the reserve fund or funds should be approved by the members in the same way as the contributions to the shared costs, and, if possible, at the same time because of the possibility that a resolution of members might otherwise approve one, but not the other.[12] Approval of contributions to the reserve fund(s) would therefore require an ordinary resolution of unit owners.

### Consultees' views

#### Distinguishing between contributions to the shared costs and contributions to the reserve fund(s)

14.14 Our provisional proposal to continue to distinguish between contributions to the shared costs and contributions to the reserve fund(s) was met with near universal approval. Several of those who supported our proposal thought that keeping contributions to reserves separate from those for shared costs was desirable to promote transparency.

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9 See para 14.36, below.

10 See para 13.4, above.

11 CP, Consultation Question 58, para 10.72. For an overview of contributions to the shared costs, see Ch 13.

12 CP, Consultation Question 58, para 10.81.

14.15 A few of those who opposed the principle of making it compulsory for a commonhold to have a reserve fund, or who objected to the principle of reserve funds, did not wish reserve fund contributions to be requested separately from contributions for shared costs. Some of those who opposed our proposal may have misunderstood the effect of our proposal. For example, the Guinness Partnership (housing association) thought that "the cost of future work should be as much a consideration when buying a property as the current charges".

14.16 An anonymous residents' association expressed concerns that requesting payments separately could lead unit owners to think that the reserve fund contribution was an optional extra.

### Approving contributions to the reserve fund by ordinary resolution

14.17 Consultees also offered near universal support for our provisional proposal that the annual contributions to the reserve fund or funds should be approved by the unit owners in the same way as the contributions to the shared costs, and, if possible, at the same time. Those who did not support it tended to do so on the basis that they disagreed with our proposal that the contributions to the shared costs should be approved.[13] For example, Graham Webb (leaseholder) suggested that all contributions – both to the reserve fund and to the shared costs – should be set by the directors. Other consultees had favoured the principle that a set addition should be made to the contributions to shared costs, and that that should be paid into the reserve fund. (We shall consider those suggestions further when addressing how the contributions for the reserve fund or funds should be set at paragraph 14.23 below).

### Discussion and recommendations for reform

14.18 We agree with the point made by the Guinness Partnership that the cost of future work should be a consideration when buying a property. However, showing the two sets of contributions separately should, as suggested by another consultee, promote transparency. We note the concern that a distinction may lead some to view the reserve fund as an "extra". We believe that a compulsory reserve fund (which will help unit owners with budgeting and will ensure works can be afforded) will mean that unit owners appreciate its need.

14.19 We also agree with consultees' suggestion that two separate sets of contributions should promote transparency. While the law could treat these two sets of contributions as a single entity, and therefore subject to a single vote when the directors propose annual contributions, we do not consider that this is desirable. Distinguishing between proposed contributions to the reserve fund and proposed contributions to the shared costs has the advantage that if one set of proposed contributions did not attract the support of unit owners, the other proposed contributions might still be voted on and passed.

14.20 Requiring unit owners to approve proposed contributions to the reserve fund or funds via ordinary resolution also carries the same advantages as our recommendation that unit owners approve proposed contributions to the shared costs via ordinary resolution

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[13] See paras 13.5 to 13.31, above.

– it provides that unit owners with a greater level of control over the commonhold's expenditure.

14.21 We therefore consider that the law should continue to distinguish between contributions to shared costs and the contributions to the reserve fund or funds, and we recommend that the proposed contributions to the reserve fund should be approved by unit owners via ordinary resolution, if possible, at the same time as contributions to the shared costs.

**Recommendation 84.**

14.22 We recommend that the proposed contributions to the reserve fund or funds should require the approval of the unit owners by ordinary resolution, and, if possible, at the same time the proposed contributions to the shared costs are approved.

## MINIMUM ANNUAL CONTRIBUTIONS TO THE RESERVE FUND

14.23 Although we provisionally proposed that it should be compulsory for a commonhold association to have some form of reserve fund, we provisionally proposed that no minimum contribution towards the reserve fund or funds should be specified.[14] We invited those who did not agree with our proposal to provide suggestions as to how a requirement for minimum contributions might operate.[15]

### Consultees' views

14.24 The vast majority of consultees agreed with our provisional proposal that there should be no minimum contribution towards the reserve fund specified by law.

14.25 A couple of consultees affirmed our point that requiring a commonhold to set up a reserve fund, but not setting a level of minimum contributions, still serves a useful function. The Society of Legal Scholars noted that the requirement:

> still serves the function of overcoming the inertia which deters the major step of setting up the system.

14.26 A few of those who agreed with our provisional proposal nevertheless made comments which supported some compulsory structuring of the directors' discretion that we were proposing. Christopher Jessel (solicitor) noted that:

> The directors should be required to consider at least once a year if the reserve fund is sufficient for anticipated liabilities.
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> Where there is a requirement for a reserve fund, there should be a legal requirement for a forward ten-year plan so as to quantify any future contributions. The plan is revised annually by the association.

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14 CP, Consultation Question 58, para 10.73.

15 CP, Consultation Question 58, para 10.74.

14.27 Those who opposed our provisional proposal tended to put forward some mechanism or formula for determining what the minimum contribution to the reserve funds should be. These tended to fall within one of two categories: those who suggested that it should be compulsory for a commonhold to commission, and act on, an expert report, and those who suggested some formula based on the contributions for the shared costs, or other formulae, such as the capital value or floor area of units. A few suggested some combination of the two approaches.

14.28 The Association of Residential Managing Agents ("ARMA") were concerned that directors of commonhold associations would think in short-term time frames, based on how long they personally expected to own their units. They therefore argued that it should be essential for a commonhold to commission an independent and professionally calculated planned maintenance programme, and unit owners should then be obliged to contribute at the recommended level.

14.29 FirstPort (managing agents) took a similar stance, but added that, in default, unit owners should be required to contribute 10% of current expenditure to reserves. The Leasehold Knowledge Partnership ("LKP") and the All-Party Parliamentary Group on Leasehold and Commonhold Reform (the "APPG") also favoured an addition of a compulsory minimum of 10% for reserves, and an obligation to meet a rolling five-year capital expenditure plan. Other consultees favoured lower percentages being paid into reserves each year. A residents' association suggested 5%. A leaseholder suggested 2.5%. Alternative bases for the calculation of minimum contributions included formulae based on the capital value of units, or the floor area of units. The Leasehold Advisory Service ("LEASE") drew our attention to the strata property regulations in British Columbia, which requires a minimum contribution to the reserve fund equivalent to 25% of the annual operating fund.[16]

14.30 Berkeley Group Holdings PLC (developer) criticised what they saw as the limitations of the current law's requirement to undertake a reserve fund study:

(1) there is little point in having a reserve fund study if the directors are not required to follow its recommendations;

(2) having a study carried out every 10 years is inadequate: it should be carried out every year;

(3) long-term maintenance plans are standard good practice in the management of any building or estate, and should be carried out by appropriate professionals; and

(4) there is a particular need for proper planning when there is no third-party landlord who can fund expenditure if necessary.

### Discussion

14.31 As noted above, most consultees responding to this question were opposed to the imposition of a minimum contribution towards the reserve fund.

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[16] Strata Property Regulations B.C. Reg. 43/2000, pt 6.

14.32 Amongst those who were in favour of a minimum amount, there was no consensus as to what this amount should be. In particular, while several consultees suggested setting the minimum amount as a percentage of the shared costs, views as to the appropriate percentage varied widely. If the percentage were set towards the upper limit suggested, some commonholds would be accumulating too much in their reserves. But setting towards the lower end would mean that some commonholds were building up too little. Indeed, there is a danger that unit owners would be lulled into a false sense of security. They might assume that by complying with the law, they would be building up adequate reserves. The reality is that buildings differ so much from each other that it is impossible to devise a formula – whether based on a percentage of contributions to the shared costs or some other measure – which will apply across the board. We therefore do not feel able to act on this suggestion.

14.33 Consultees also suggested that a study should be carried out and that the directors should be required act on its results. Views differed widely on how frequently this would be necessary. However, we consider that the current law is sufficient. The directors are currently required to consider commissioning a reserve fund study in the first year that the commonhold is established.[17] Thereafter, the directors must commission a reserve fund study at least once every ten years.[18] The directors must use the results of a reserve fund study to consider whether it is appropriate to establish a reserve fund and maintain any existing reserve fund. If it is appropriate to establish a fund or maintain any existing fund then the directors must do so. Additionally, the directors must, at appropriate intervals, decide whether it is appropriate to establish a fund or maintain an existing fund. If the directors decide that establishing a fund or maintaining an existing fund is appropriate, then they must do so.[19]

14.34 The directors are therefore under an ongoing obligation to obtain information as to whether it is appropriate to establish additional reserve funds and to consider the appropriate level of contributions necessary to build adequate reserves. To reinforce these obligations, we consider that guidance for commonhold directors stresses these obligations and the importance of building adequate reserve funds.[20] We therefore do not consider it necessary to recommend any change to the current law.

14.35 We also think that the commonhold system itself incentivises unit owners to build up adequate reserves. Sensible unit owners are likely to wish to plan for future maintenance and unexpected expenditure. We also understand from other jurisdictions that the market plays a role. Developments with reserves are seen as more attractive purchases. There is therefore an incentive for the unit owners to build reserves to protect their investment in their home. For these reasons, we do not consider it necessary to prescribe a minimum contribution to reserve funds.

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17 Commonhold Regulations 2004, sch 3, para 4.2.6.

18 Commonhold Regulations 2004, sch 3, para 4.2.7.

19 Commonhold Regulations 2004, sch 3, para 4.2.9.

20 We note at para 12.115, above, that guidance for commonhold directors should be produced.

## DIRECTORS' ABILITY TO SET UP DESIGNATED RESERVE FUNDS

14.36 As we discuss in the Consultation Paper, some commentators have inferred that the current law permits a reserve fund to be "earmarked" by designating the sums within the fund only to be used for a particular activity.[21] The current law is not, however, explicit on this point. We therefore provisionally proposed that it should be clarified that the directors should be able to set up such designated reserve funds as they saw fit.[22]

### Consultees' views

14.37 The vast majority of consultees supported this proposal. Both the Society of Legal Scholars and the PLA welcomed the flexibility that it would bring. The Society of Legal Scholars commented that:

> it adds flexibility to the setting up of the funds and certainty once the funds are running.

14.38 Some of those who supported our proposal suggested various qualifications to it. Trowers & Hamlins LLP (solicitors) thought that the directors should act only if they had considered appropriate professional advice. A few consultees thought that the directors' decision should be subject to a requirement of reasonableness, though they did not specify how this might be assessed, or how it would be adjudicated in the case of dispute. LKP supported our proposal, provided the directors also complied with their suggested requirement to have a rolling 5-year capital expenditure plan. One consultee suggested that, during the first ten years of a building's life, when guarantees are likely to be in place,[23] the need to have reserves is likely to be lower than in subsequent years.

14.39 The views of those who opposed our proposal tended to fall into one of two categories. A few consultees thought the creation of reserve funds and the level of contributions should be determined by Government regulation and so directors and unit owners should have no discretion. Rather more consultees thought that directors should always be obliged to consult with, or to obtain the approval of, the unit owners before designating a reserve fund.

### Discussion and recommendations for reform

14.40 It should be pointed out that, although our proposal would permit directors to set up designated reserve funds, this would not affect the existing power of the unit owners to require that a general reserve fund should be set up,[24] or our recommendation that

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21 CP, para 10.52.

22 CP, Consultation Question 58, para 10.75.

23 Those building the development are likely to provide guarantees that certain component parts of the development will not fail within a certain number of years, and will not require unit owners to pay for their repair/replacement.

24 Commonhold Regulations 2004, sch 3 para 4.2.10; and see above paras 14.44 to 14.50.

the level of annual contributions to the reserve fund would require the approval of the unit owners by an ordinary resolution.[25]

14.41 A few consultees commented specifically upon the novel aspect of our provisional proposal, which clarified that the directors could set up several reserve funds with different designations. Westminster and Holborn Law Society appreciated this aspect of our provisional proposal, but suggested that putting reserves into separate funds was unnecessary. They considered that with proper budgeting, a single reserve would work and would offer greater flexibility. Other consultees also favoured having a single reserve fund.

14.42 Having a single reserve fund, with contributions to it being calculated on the basis of the various items of cyclical expenditure which it may be required to cover, is a perfectly reasonable approach for a commonhold to adopt. Our provisional proposal does not *require* separate funds to be established, but gives each commonhold the option of doing so. However, the creation of separate designated reserve funds has a particular advantage in the context of enforcement proceedings. We recommend below that designated reserve funds should be protected from enforcement action by creditors, unless their claim relates to the specific purpose for which the designated reserve fund was set up.[26] We note below that if a commonhold had a single, general reserve account, the fund would be available to creditors to meet any claim relating to the directors' obligations in the commonhold community statement (the "CCS") in respect of the common parts.[27]

**Recommendation 85.**

14.43 We recommend that the directors of commonhold associations should be able to set up such designated reserve funds as they see fit.

## UNIT OWNERS' ABILITY TO SET UP DESIGNATED RESERVE FUNDS

14.44 Following our recommendation above, all commonholds will be required to establish a reserve fund at the outset. We also recommend that the directors of commonhold associations should be able to set up such designated reserve funds as they see fit. The current law allows unit owners to require, by ordinary resolution, that the directors establish a general reserve fund. We provisionally proposed that it should also be possible for the unit owners within a commonhold to require, by ordinary resolution, that a designated reserve fund or funds should be set up.[28]

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25 See para 14.22, above.

26 See para 14.70, below.

27 See para 14.68, below.

28 CP, Consultation Question 58, para 10.76.

### Consultees' views

14.45 Our provisional proposal received almost universal support, although consultees did not offer substantive reasons for their support.

14.46 The few who opposed our proposal, or who did not respond directly but made comments, took a variety of views. One residents' association favoured flexibility as to how the sums might be used, and was therefore opposed to the concept of designated reserve funds. One consultee was unhappy with the idea that a bare majority of unit owners could impose a financial commitment on all of their neighbours. Another consultee was concerned that a single unit owner who owned a substantial number of units might be able to force through the setting up of a reserve fund relating to a limited-use area which particularly benefited his or her units, and which all owners might be required to contribute towards. He therefore favoured the imposition of some form of higher majority to pass a resolution to require the setting up of a designated reserve fund.

### Discussion and recommendations for reform

14.47 The concern raised that a single unit owner who owned many units (and so could exercise the majority of votes) could force the creation of a designated reserve fund relating to a limited use area benefitting his or her units can readily be addressed. If the limited use area – a car park, for example – benefits only some unit owners, then another of our recommendations (allocating costs under different "heads" of expenditure) ensures that the costs associated with the limited use area can be allocated exclusively to the units that have a right of access to the area.

14.48 Although we would generally expect the directors to take the lead in identifying the need for reserve funds, it seems advantageous also to enable the unit owners to take the initiative. The creation of a simple process whereby unit owners can require that a designated reserve fund be set up may help ensure that a commonhold has sufficient reserves to meet future expenditure. We have already made the point that having reserves makes it less likely that an association is ever faced with insolvency.

14.49 We accordingly recommend that it should be possible for the unit owners to require, by an ordinary resolution, that a designated reserve fund be set up.

**Recommendation 86.**

14.50 We recommend that it should be possible for the members of a commonhold association to require, by ordinary resolution, that a designated reserve fund or funds should be set up.

## THE LEVEL OF PROTECTION GIVEN TO RESERVE FUNDS

14.51 The protection afforded to reserve funds from the claims of creditors is unclear. Under the current law, it appears that if a judgment creditor[29] seeks to enforce a judgment

[29] See Glossary: creditor.

against a reserve fund, that fund will be protected, unless the claim relates to the purpose for which the reserve fund was set up. But it would appear that the reserve fund then becomes available if the judgment creditor petitions for the association to be wound up due to insolvency. This provision offers an incentive to the judgment creditor to resort to the more drastic remedy of insolvency, thereby undermining what we are seeking to achieve: that insolvency will be invoked as rarely as possible.

14.52 We therefore provisionally proposed that:

(1) a designated reserve fund should be protected from enforcement action by creditors, unless their claim related to the specific purpose for which the fund had been set up; and

(2) designated reserve funds should continue to receive equivalent protection if the commonhold association became subject to insolvency proceedings.

14.53 The proposal at (1) was a clarification of the current law; the proposal at (2) marked an extension to the protection given to reserve funds.

### Consultees' views

14.54 Both proposals met with almost universal support. Some of those who supported our proposal commented that it was right that creditors could enforce against a reserve fund if their claims related to the purpose for which it had been set up (for example, roofing repairs).

14.55 Those who opposed the proposal considered that all of a commonhold's assets should be available for its creditors. For example, ARMA said:

> If the commonhold association runs up debts, they will likely have been incurred for the benefit of the commonhold and the unit owners. Why should the funds of those unit holders then be ring-fenced from the creditors whom the owners have benefited from? A normal company cannot say that its debts cannot be settled by means of its reserves being ear-marked for something else.

14.56 Some of those who did not specifically answer one or both of the questions expressed reservations. The Federation of Private Residents' Associations (the "FPRA"), for example, had reservations about giving reserve funds a status which extended beyond "internal…accounting" and impacted third-party creditors.

14.57 Westminster and Holborn Law Society supported our proposal, but nevertheless expressed similar reservations to the FPRA.

14.58 Some of those who supported the proposal also expressed less serious reservations. Berkeley Group Holdings PLC, for example, thought that safeguards should be put in place to ensure that the protected status of reserve funds was not abused. Trowers & Hamlins LLP agreed with our proposal, subject to the proviso that the court should have discretion to order otherwise. The PLA was chiefly concerned over how any rule would be drafted:

> We expect that the proposed rule about "claims relating to the specific purpose" will be difficult to apply in many cases because of uncertainty in its scope unless the drafting is tightened up.

14.59 Although we consulted separately on the protection to be given to reserve funds from enforcement proceedings by creditors while the commonhold was functioning and when the commonhold association was being wound up, consultees tended to apply the same approach to each. Those who favoured protection being given in the former case tended to favour it in the latter, and those who were against giving reserve funds protection from enforcement proceedings were against giving them protection on insolvency.

14.60 Few consultees distinguished the two sets of circumstances, and would have offered protection to reserves while the commonhold was solvent, but not on the insolvency of the association. Professor James Driscoll voiced doubts as to whether the two situations should be treated in the same way. Additionally, Letitia Crabb (academic) considered:

> Whether and in what manner [the statute] operates to protect the reserve fund when the commonhold association is a going concern [i.e. solvent], I do not think that this protection should endure if it is wound up. There is no trust. The fund belongs to the insolvent commonhold association, legally and beneficially and should be applied according to the normal rules of priority set out in the Insolvency Act 1986, s175. Any re-assurance given to reserve fund creditors by giving them priority status may well be out-weighed by a negative message received by the others. Furthermore while one may have sympathy for unit holders needing to take commonhold association assets in the form of basic common parts into a successor association, one has less sympathy for the transfer of surplus assets from a reserve fund.

14.61 Christopher Jessel echoed some of Letitia Crabb's concerns, and he also pointed out the risk that directors might transfer funds from the general fund into a designated reserve fund, in order to defeat claims. He thought that in such a case the provisions of insolvency law which operated to nullify such arrangements should apply.

14.62 Although we did not consult on the point, a few consultees thought that reserve funds should be given trust status. Other consultees assumed that the protections that we were proposing to give to designated reserve funds meant that they would have the status of trust funds.

### Discussion and recommendations for reform

14.63 Some of the objections to giving designated reserve funds a measure of protection are expressed in terms which could equally be considered to be an objection to the commonhold association having limited liability at all.[30] We have also noted that the current law already appears to give protection to reserve funds, at least unless and until the association is insolvent, although the precise extent of that protection is uncertain.[31]

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30 The limited liability of commonhold associations is discussed at in Ch 19 at para 19.17.

31 See para 14.51, above.

14.64 We note that there was overwhelming support for our proposal that designated reserve funds should enjoy protection from claims which do not relate to the purpose for which they have been set up, and we have not been persuaded that it is wrong in principle. We note the argument of the PLA that the legislation will require careful drafting. How commonhold associations describe their designated reserve funds may prove crucial, and it is quite possible that some borderline cases may generate litigation. But borderlines are always problematic, and that is not a compelling reason not to attempt to address the issue. We note above that guidance should aid the commonhold directors in managing reserve funds.[32] That guidance can also help directors in adequately designating particular funds.

14.65 We also accept that giving protection to reserve funds may raise the same issue which we address when discussing the insolvency of commonhold associations generally: that contractors who deal with commonholds may insist on personal guarantees from directors, or other steps to safeguard their position.[33] However, we suggest that there may be a better way forward. The directors might simply offer the contractor evidence that the necessary funds are already available in the relevant designated account.[34] However, we accept that this is a pragmatic solution to overcome the need for personal guarantees. There will be instances when there is no reserve account for a particular contract, and personal guarantees may continue to be relied upon in those circumstances. The fact that designated reserve funds offer this advantage may act as an incentive for commonholds to set up designated accounts.

### Giving trust status to reserve funds

14.66 We consulted on the level of protection to be given to reserve funds on the basis that they would not enjoy trust status.[35] Consultees' comments have, however, prompted us to re-examine our views.

14.67 Upon further consideration, we conclude that in substance what we had proposed in the Consultation Paper was consistent with reserve funds being held on statutory trust, and that it is preferable to adopt this approach. Doing so also addresses the concerns raised by Letitia Crabb, who could not see the justification for reserve funds enjoying protection if the commonhold association should be insolvent. If they are trust funds, then lawyers would expect them to be protected, unless creditors' claims relate to the purpose for which they have been set up. Furthermore, the reserve funds of freehold management companies are protected from creditors, and leaseholders' service charge accounts are held on trust for the leaseholders.[36] We consider that it would be anomalous if commonhold reserve funds were not protected from creditors' claims. We believe that the protection afforded to reserve funds and service charges in leasehold should be, so far as possible, replicated in commonhold.

14.68 We therefore recommend that reserve funds set up by commonhold associations should be held on statutory trusts. For designated reserve funds, we recommend that

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32 See para 14.34, above.

33 See para 19.113, below.

34 We also discuss this possibility in Ch 19 at para 19.113.

35 CP, paras 7.64 to 7.66.

36 Landlord and Tenant Act 1987, s 42.

the funds are held on trust for the purpose which they have been expressed to be set up. If for any reason the purpose of that fund is no longer applicable, we recommend that the fund is held on trust for the commonhold association. Our recommendation that reserve funds should enjoy protection through a statutory trust status is based on the principle that they have been set up with a particular purpose in mind. So that general funds can enjoy trust status, we recommend that an undesignated fund should be deemed to have been set up for the commonhold association to comply with its obligations in the CCS in respect of the common parts. An undesignated fund would therefore enjoy protection from enforcement proceedings relating to any claim which did not relate to this purpose. Accordingly, on the insolvency of a commonhold association, a general fund could be used only to satisfy the claims of creditors who were claiming in respect of costs incurred by the directors in compliance with their obligations in the CCS in respect of the common parts. In practice, that is most likely to mean that undesignated reserve funds will be available to creditors who are claiming in respect of repair costs.

14.69 As explained above, the existence of an undesignated fund which was deemed to have this broad purpose would not affect the power of a commonhold to set up designated reserve funds with more specific purposes.[37] Although we would expect larger commonholds to set up separate designated reserve funds for different items of future expenditure, we recognise that this may not be a viable option for some small commonholds. It is an entirely reasonable approach for a commonhold to set up a single general reserve fund to cover future repairs. Under our recommendation, this would enjoy protection from enforcement proceedings.

**Recommendation 87.**

14.70 We recommend that reserve funds should be held on a statutory trust for the purpose for which they have been set up and, if that is no longer capable of fulfilment, then for the commonhold association.

14.71 We recommend that designated reserve funds should be protected from enforcement action by creditors, unless their claim relates to the specific purpose for which the designated reserve fund was set up.

14.72 We recommend that designated reserve funds should continue to receive equivalent protection if the commonhold association should be subject to insolvency proceedings.

14.73 We recommend that general (that is, undesignated) reserve funds should be held on a statutory trust for the commonhold association to comply with its obligations in the CCS in respect of the common parts.

37 See para 14.42, above.

## REDESIGNATING RESERVE FUNDS

14.74 If separate reserve funds are to be set up for specific designated purposes, then the question arises whether an existing designated fund can be "redesignated" if it appears that it needs to be used urgently for some other purpose. We provisionally proposed that it should be possible to redesignate the purpose for which a designated reserve fund might be held.[38]

14.75 We would expect that the facility to redesignate would rarely be needed, but it will provide flexibility. Say, for example, a commonhold had set up a designated reserve fund to replace its lift. It was projected that it would need to do this in 50 years' time, and is setting contributions to it on that assumption. However, assume that 10 years in to this period some urgent expenditure was required. It seems unduly rigid to suggest that the commonhold association should either have to raise the money that was urgently required by imposing contributions that unit owners may have difficulty in affording, or that the association should have to resort to borrowing. It would not be ideal for the association to use funds from the lift reserve to meet the urgent expenditure, but it might be preferable to do so rather than to raise funds in other ways. The directors could still recalculate the future contributions to the "lift reserve" so as to reach the required sum by the target date.

14.76 We acknowledged in the Consultation Paper that for an association to redesignate a reserve fund in this way would be a serious step. We therefore provisionally proposed that it should be permissible with at least 80% support of unit owners, and in all cases, the approval of the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal").[39] We thought that this safeguard would be necessary to ensure that a commonhold could not use a last-minute redesignation as a way of ensuring that a creditor did not have recourse to a reserve fund which would otherwise have been available to satisfy its claim. In cases of less than unanimous support, we also suggested that Tribunal approval offers protection to the minority who opposed changing the designation.[40]

### Consultees' views

14.77 Our proposals were supported by a substantial majority of consultees. A couple of consultees indicated that it was right that the requirements for redesignating a reserve fund should be so high. Others indicated support for the intention behind our proposals, but thought that threshold for support should be lower, or that the approval of the Tribunal ought not to be required.

14.78 All those who opposed our proposals, and stated reasons for their opposition, did so in the basis that the safeguards that we were proposing were too onerous. A number suggested that the requirement should be either 80% support or the approval of the Tribunal. Some of those who opposed our proposals were in favour of there being

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38 CP, Consultation Question 58, para 10.79.

39 CP, Consultation Question 58, para 10.79.

40 CP, para 10.68.

one, general reserve fund (or assumed that this would be the case), and for them the issue did not arise.

14.79 The Chartered Institute of Legal Executives ("CILEx") considered that the requirement of Tribunal approval might offer protection to creditors against unit owners supporting redesignation unanimously in order to avoid their obligations:

> The involvement of the Tribunal should help protect against directors abusing this process to escape creditor action.

### Discussion and recommendations for reform

14.80 No consultee came up with an alternative to a Tribunal application as a means of protecting creditors from a redesignation of reserve funds.

14.81 In the light of consultees' support, we recommend that commonhold associations should be able to redesignate reserve funds by passing a resolution with the support of at least 80% of the available votes, and in all cases, the approval of the Tribunal. We think that Tribunal approval is necessary for two reasons. First, in cases of less than unanimous support, Tribunal approval offers protection for a minority who oppose redesignation. We recommend that in cases of less than unanimous support, the Tribunal applies the minority protection test outlined in Chapter 17. Second, Tribunal approval offers a degree of protection to creditors. The Tribunal should be alert to the possibility of a commonhold association changing the designation of a reserve fund to ringfence its funds when faced with legal proceedings and/or the threat of insolvency. The Tribunal could decline to authorise redesignation in these circumstances so as to protect creditors. This possibility is present where redesignation is unanimously supported by unit owners. Tribunal approval is therefore necessary in all cases of redesignation – even where unit owners support the proposal unanimously. However, in cases of unanimous approval, the Tribunal would not need to consider issues of minority protection – it should only be concerned with protecting the interests of the creditors.

14.82 We note that our recommendation should permit both the redesignation of an existing designated reserve fund, and/or the conversion of a general reserve fund into a designated fund. This would provide commonholds with greater flexibility to manage their finances.

14.83 We also note that the directors of a commonhold association, when applying to redesignate a reserve fund, could be made to provide the Tribunal with a financial statement setting out all actual and contingent liabilities of the association, including any existing contracts which could give rise to future claims. They could also be required to serve notice of the application, and a copy of the statement, on any creditors who were likely to be affected by the redesignation. Those creditors would then be able to apply to become a party to the application, and to oppose it, if they so wished. However, the precise detail of this would be a matter for the rules of the Tribunal.

**Recommendation 88.**

14.84 We recommend that it should be possible for a commonhold association to change the designation of an existing designated reserve fund, or to convert a general reserve fund into a designated one, by passing a resolution with the support of 80% of the available votes, and with, in all cases, the approval of the Tribunal.

14.85 We recommend in determining an application for the redesignation of a reserve fund, the Tribunal should:

(1) in cases of less than unanimous support, apply the same test as if the application was made under the minority protection provisions; and

(2) in all cases, consider whether the redesignation is pursued to frustrate the claims of creditors or the effects of insolvency proceedings.

## INTERNAL BORROWING FROM A RESERVE FUND

14.86 We invited consultees' views on whether a commonhold association should be able to "borrow" from its reserve funds and, if so, what safeguards should be imposed.[41] By borrowing, we mean using money in one fund to meet some other pressing financial need of the association which did not fall within the designation of the fund (or, in the case of an undesignated fund, using money in the fund for any purpose other than repair). The intention would be that the "loan" would be "repaid" as soon as possible.

### Consultees' views

14.87 A sizeable majority of consultees were in favour of the commonhold association being able to borrow from its reserve funds. Most of those in favour, however, suggested that borrowing should be permissible only subject to conditions. The conditions ranged from those which would be quite easy to satisfy, to the highly onerous. Suggestions as to the level of support which should be required to authorise an internal "borrowing" ranged from an ordinary resolution to unanimity.

14.88 Notting Hill Genesis (housing association) stated that they were opposed to allowing borrowing. They thought any shortfall could be met instead by redesignating a reserve fund so that it could be used for the new purpose.

14.89 Trowers & Hamlins LLP thought that it would be appropriate to require a similar level of support as for the redesignation of a reserve fund, namely 80% of the available votes, plus the approval of the Tribunal.

14.90 The PLA, and Damian Greenish (solicitor), on the other hand, both thought that requiring the approval of the Tribunal (and in the case of the PLA, also requiring a resolution of unit owners) would mean that the internal borrowing procedure could not be used to meet a pressing cash-flow problem.

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41 CP, Consultation Question 58, para 10.80.

14.91 Some of those who were opposed to internal borrowing either could not see that it would ever be necessary, or thought that it could arise only through mismanagement on the part of the directors. Some wished to cast any resulting losses or financial liabilities on to the directors.

14.92 Both ARMA and FirstPort said that with leasehold service charges, it was common for managing agents to resort to reserves in order to ensure that payments that fell due at the beginning of the financial year were met.

### Discussion and recommendations for reform

14.93 We acknowledge that imposing restrictions on internal borrowings would make it much more difficult for managing agents to run accounts in the manner described by ARMA and FirstPort. It will not be possible to borrow from a reserve fund without following the requisite procedure. However, as contractors may be willing to contract with commonhold associations if they can prove that they have adequate reserves to cover their obligations, it is reasonable for contractors to have the assurance that the relevant reserve fund actually exists. Therefore, a more stringent procedure is needed to use the funds in order to safeguard both contractors and the ability of the commonhold to contract. We accept that commonhold associations may need to accumulate and retain a sum in their current account which is adequate to meet the point made by ARMA and FirstPort.

14.94 We accept that redesignation could be used as a "workaround" if internal borrowing is not permitted. Alternatively, if borrowing is permitted, but with less stringent restrictions than for resignation, directors would simply borrow, and be able circumvent the policy reasons for restricting designation. It also seems likely that, if the safeguards for the two procedures were different, many directors, agents and practitioners would tend to confuse them. We are therefore adopting the view taken by Trowers & Hamlins LLP, that it would be best if the same formalities were required for both redesignation of reserve funds, and internal borrowings from them.

**Recommendation 89.**

14.95 We recommend that a commonhold association should be able to make an internal borrowing from a reserve fund, for the credit of either another reserve fund, or for the shared costs of the commonhold, by passing a resolution with the support of 80% of the available votes, and with, in all cases, the approval of the Tribunal.

14.96 We recommend in determining an application for an internal borrowing from of a reserve fund, the Tribunal should:

(1) in cases of less than unanimous support, apply the same test as if the application was made under the minority protection provisions; and

(2) in all cases, consider whether the borrowing is pursued to frustrate the claims of creditors or the effects of insolvency proceedings.

# Chapter 15: Responding to emergencies

## INTRODUCTION

15.1 In this chapter, we consider how a commonhold might respond to entirely unexpected calls upon its resources. The recommendations elsewhere in this Report will help ensure that commonholds are able to respond in these circumstances. For instance, a commonhold association can deal with projects requiring substantial future expenditure which is predictable by building up a reserve fund, and we have made recommendations to ensure that commonholds build up adequate reserves for future expenditure.[1] Furthermore, many unexpected emergencies, such as damage from fire or storms, will be covered by insurance, and we have made recommendations to ensure that commonholds are properly insured.[2] It is also possible for the directors to require emergency financial contributions to deal with unexpected expenditure, and we have made no change to this provision.[3]

15.2 However, the tragic Grenfell Tower fire in June 2017 illustrates that a commonhold association might need to make urgent repairs, alterations or improvements to prevent an occurrence of a similar nature to their building, which could not readily be financed simply by requiring increased financial contributions from the unit owners. We discussed the implications for commonhold in the Consultation Paper.[4] Although a tragedy such as Grenfell Tower is fortunately rare, there have been similar cases in the past where inherent defects have needed urgent rectification. Some will be aware of the partial collapse of the Ronan Point tower block in Canning Town in May 1968. A gas explosion caused a corner of the block to collapse through its entire 22 storeys. The incident led to similar blocks being checked, and a revision of the building regulations. Again, in February 1974, the collapse of a roof beam at the John Cass School in Stepney due to the incorrect use of high alumina cement led to safety checks having to be made on the many public buildings which had made use of the material.[5] It would be unduly optimistic to assume that incidents of a similar nature will not occur in the future.

15.3 Although Grenfell Tower was publicly owned, we noted in the Consultation Paper that in October 2018, there were stated to be 457 tower blocks in England over 18 metres high which, because of the presence of cladding, would be unlikely to meet building regulations guidance. Of these, 168 were publicly-owned or managed in the social sector by local authorities or housing associations, with the remaining 289 being privately-owned residential blocks, including hotels and student accommodation.[6] By 31st May 2020, there were still 300 high rise publicly owned and residential buildings

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1 See Ch 14.

2 See para 12.85 onward.

3 See Ch 13.

4 CP, paras 11.11 to 11.17.

5 *Hansard* (HC), 9 May 1975, vol 891, cc 1893-906.

6 CP, para 1.78.

that were yet to be remediated.[7] 140 of these buildings have commenced remediation works. Existing privately-owned residential blocks are likely to consist entirely of long leasehold flats.[8]

15.4 The response of some commentators immediately post-Grenfell was to insist that landlords ought to pay for the necessary works to be done to long-leasehold blocks of flats. The reality is that most residential long leases are drafted on the basis that the landlord will have no ongoing financial responsibility for the building. Although the landlord will in almost all cases be *responsible* for the repair of the main structure, and the exterior, including the external walls, this will almost invariably be on the basis that the cost can be *recovered* in full from the long leaseholders via the service charge. Accordingly, financial responsibility for repairs will ultimately fall on the leaseholders, not on the landlord.

15.5 One example where this was felt particularly keenly, post-Grenfell, was the Cityscape complex in Croydon, South London. It was discovered that the cladding covering the whole block was flammable, and the landlord sent statutory notices to the leaseholders informing them of remedial works that needed to be carried out to the block and that the costs would be recovered from them under the terms of their leases. Their challenge in the First-Tier Property Tribunal in 2018 was unsuccessful. While the dispute continued, a waking watch of the block was imposed at substantial additional cost to the leaseholders, whose problems were compounded by their properties becoming unsaleable and unmortgage-able. It was only after national publicity of their issue that the original builders agreed to step in to bear the cost of the remedial works.

15.6 The position in many cases may be even more complicated than as set out above. The question of who should meet the costs has been aptly described as “a legal quagmire”.[9] An obligation “to repair” in a lease may be given a restrictive interpretation. If so, then unless the lease specifically includes a broader definition, an obligation in a lease “to repair” may not cover the remediation of sub-standard construction, such as the replacement of undamaged but unsuitable cladding. It will also be necessary to consider whether the original developer, or the National House Building Council (“NHBC”),[10] can be held liable for the replacement of defective cladding. Only an original purchaser is likely to have any recourse against the developer; those who purchased the property second-hand will have to rely on the NHBC or an equivalent scheme. Each potential claim may be governed by a different time limit.

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7 MHCLG, *Building Safety Programme: Monthly Data Release* (May 2020), at https://www.gov.uk/government/publications/building-safety-programme-monthly-data-release-may-2020. The breakdown of those buildings that had not yet started remediation works was as follows: 8 social sector residential; 126 private sector residential; 6 student accommodation; 15 hotels, 5 publicly owned buildings.

8 Those that are hotels, or student accommodation, would of course be the exception.

9 House of Commons Library Briefing Paper, *Leasehold high-rise flats: who pays for fire safety work?* (May 2018), p 1, at http://researchbriefings.files.parliament.uk/documents/CBP-8244/CBP-8244.pdf.

10 The NHBC operates the “Buildmark” scheme which covers many new and newly-converted properties. Other similar schemes are operated by other providers.

15.7 It has been suggested that the presence of a landlord who owns the freehold can help to resolve these difficulties. City and Country Group PLC have stated that "the role of the professional freeholder cannot be underestimated".[11] Long Harbour cited the removal and replacement of unsafe cladding from high-rise residential buildings as "an example of the role that freeholders play". They noted an example in Liverpool where the freeholder provided "emergency free loans to fund critical emergency measures, such as the presence of fire marshals on site 24/7, as well as works to remove and replace the unsafe cladding".[12] They therefore strongly imply that the absence of a landlord within commonhold developments places commonhold at a disadvantage when compared with leasehold.

15.8 We acknowledge that some freeholders have been adopting a highly responsible stance in some cases. This stance may include the provision of "soft" loans, and identifying appropriate experts to advise. Further, developers – whether or not they still retain the freehold – have sometimes been willing to undertake remedial work at their expense regardless of whether they are legally required to do so. They may feel under a moral obligation to assume responsibility, or they may be motivated by a need to preserve their commercial reputation. We are, however, aware of many other cases where no such assistance has been forthcoming from a freeholder.

15.9 We also note that, although interest-free or other "soft" loans may have been provided to cover emergency measures such as the provision of fire marshals, the considerable cost of this service will ultimately be met by the leaseholders via their service charges.[13] Lease provisions of this nature are standard, and there is no incentive on landlords *not* to pass the cost of remedial or improvement works onto leaseholders.

15.10 If there is an entrenched notion that the presence of a freeholder is essential to manage and co-ordinate remedial works, this is only because it reflects current and traditional practices. In her Independent Review of Fire Safety, Dame Judith Hackitt recommends that the dutyholder (the person responsible for safety in a block) should be the building owner or superior landlord. However, she also sets out in her review the principles of transparency of safety information and partnership with residents, principles that are wholly suitable to the commonhold structure. There is no reason why the dutyholder in this scenario could not be the commonhold association.

15.11 We do not therefore think that the presence within leasehold of freeholders[14] can in practice do anything more than sometimes mitigate the sort of problems which have

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11 Written evidence of City and County Group PLC (September 2018) to the House of Commons Housing, Communities and Local Government Committee's report on Leasehold Reform. See Housing, Communities and Local Government Committee, *Leasehold Reform* (2017-19) HC 1468, para 10, at https://publications.parliament.uk/pa/cm201719/cmselect/cmcomloc/1468/1468.pdf.

12 Written evidence of Long Harbour (September 2018) to the House of Commons Housing, Communities and Local Government Committee on Leasehold Reform. See Housing, Communities and Local Government Committee, *Leasehold Reform* (2017-19) HC 1468, para 15, at https://publications.parliament.uk/pa/cm201719/cmselect/cmcomloc/1468/1468.pdf.

13 In one block the cost of £4,000 per week was quoted: House of Commons Library Briefing Paper, *Leasehold high-rise flats: who pays for fire safety work?* (May 2018), at http://researchbriefings.files.parliament.uk/documents/CBP-8244/CBP-8244.pdf.

14 In an unknown number of cases the freeholder may be a company which is owned by the leaseholders (a "freehold management company" (FMC)). These cases will replicate the position under commonhold, as the

been brought to light by the cladding issue. In expressing this view, we are mindful that freeholders have not assumed responsibility in most cases and that Government has had to step in set up a remediation fund for the private sector.[15] As this will cover the removal of only a particular type of cladding, Government has announced its intention to set up a further "Building Safety Fund" to ensure that all combustible cladding can be removed from both private and social residential buildings above 18 metres in height.[16]

15.12 We think a commonhold association could respond more effectively to emergencies than a landlord could in leasehold property. Elsewhere in this Report we make recommendations that will help a commonhold association respond to an emergency. These include:

(1) the use of an emergency assessment if the sums required are unexpected, but not too large. An emergency assessment is a request for a contribution to shared costs which does not have to be preceded by a consultation;[17] and

(2) the ability to draw on reserve funds which have been built up for other purposes. Because we are incorporating incentives for commonholds to have reserve funds, we think it is more likely that they will have them and so internal "borrowing" of this kind will be an option. We do not think internal "borrowing" is generally to be encouraged, but we argue that it may sometimes be the most viable option.[18]

15.13 In this chapter we consider three more mechanisms that will assist commonhold associations:

(1) the creation of a "floating charge" over the commonhold's undertaking. This device would enable the lender to take control of the funding of the commonhold, but only if the association failed to meet its financial obligations to the lender. This strategy is sometimes described as "borrowing on the security of the commonhold's income stream";

(2) the creation of a fixed charge over the whole or (more likely) part of the common parts. Such a charge might be created over a specific facility (for example, part of the garden, or a recreational facility); and

(3) the "sale off" of part of the common parts. The most feasible options are likely to be for the commonhold to sell attic space for conversion into additional units, or the sale of airspace over the roof for the construction of an extra storey or storeys;

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leaseholders are both liable to make the necessary modifications, and ultimately responsible for the cost, unless Government can provide financial assistance.

15 See Ministry of Housing, Communities and Local Government, *Private sector ACM cladding remediation fund: prospectus* (July 2019), at https://www.gov.uk/government/publications/private-sector-acm-cladding-remediation-fund-prospectus.

16 See *Budget speech 2020*, at https://www.gov.uk/government/speeches/budget-speech-2020.

17 CP, para 11.8.

18 See Ch 14.

15.14 We think these options can function more smoothly under commonhold than could be attempted under leasehold. In this chapter, we make recommendations to improve the procedures through which a commonhold can raise the necessary funds in the event that it must respond to an emergency.

## THE CREATION OF A FIXED OR FLOATING CHARGE BY THE COMMONHOLD ASSOCIATION

15.15 An emergency assessment would not be an appropriate or effective way of raising funds for essential works if the sums required from individual unit owners would simply be unaffordable. A commonhold may therefore look to raise emergency finance through borrowing. While a commonhold association has the capacity to borrow money, it would be more likely to be able to do so, and at a lower rate of interest, if it could offer security. Such security might take either of two forms (or a combination of both):

(1) a fixed charge over its common parts, or over part of them;[19] and/or

(2) a floating charge over its "undertaking".[20]

15.16 The 2002 Act appears to give commonhold associations the power to grant a fixed charge, but there is no express provision for a floating charge. While it is likely that a commonhold association could grant a floating charge under general company law, we think the matter should be put beyond doubt. We therefore provisionally proposed that commonhold associations should be given explicit power to raise money through a floating charge.[21]

15.17 We also considered the level of consent required to grant a fixed or floating charge. There is an inconsistency in the level of consent required from unit owners to create a fixed charge or a floating charge under company law. The 2002 Act requires the unanimous consent of unit owners to create a fixed charge over the common parts.[22] However, the 2002 Act makes no express provision relating to floating charges. It would appear, therefore, that general company law would apply and a floating charge could be created by the directors without the permission or prior knowledge of the unit owners, and without consulting them.

15.18 Granting either a fixed charge or a floating charge might have a considerable impact on the unit owners. It is inconsistent that the requirements for granting each of them should vary so widely. We therefore provisionally proposed that a charge over the common parts or a floating charge should only be able to be granted with either the unanimous support of unit owners, or if 80% of the unit owners consent to the charge,

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19 CP, paras 11.14 to 11.16.

20 CP, paras 11.17 to 11.21. We also explain what is meant by a "floating charge" and a company's "undertaking", and how in practice it might operate.

21 CP, Consultation Question 63, para 11.36.

22 CLRA 2002, s 29.

and the approval of the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal").[23]

15.19 We expected that lenders (on an individual unit) might have reservations about how a commercial lender's fixed charge over the common parts, or a floating charge, would affect the value of their own securities over individual units. We thought that they might therefore include a provision in their mortgage conditions to require their borrowers not to vote in favour of the creation of any charge by the association without first obtaining their lender's consent.

15.20 We therefore invited consultees' views as to whether the need for unit owners to obtain the consent of their mortgage lender to support the commonhold association granting a fixed or floating charge is likely to be a significant difficulty in raising emergency funding. If consultees considered that there might be difficulties, we invited views on what measures could be put in place to alleviate these difficulties, including whether the Tribunal should be able to override a mortgage lender's refusal to give consent.[24]

15.21 Finally, a fixed charge over *part* of the common parts was likely to be more attractive, both to the association and to the lender, than a fixed charge over all the common parts.[25] Each would know better where they respectively stood. We therefore provisionally proposed that a commonhold association (having obtained the requisite consent of unit owners) should be able to grant a charge over part of the common parts, and that the part so charged could be registered with a separate title number at HM Land Registry.[26]

## Consultees' views

### An explicit power to grant a floating charge

15.22 The vast majority of consultees supported our provisional proposal that commonhold associations should be given explicit power to raise money through a floating charge. They were drawn from across the spectrum of our consultees. A couple of the consultees who supported our proposal in principle, and a couple of others who had not directly answered the question, expressed reservations as to whether lenders would in practice be prepared to offer secured loans to commonhold associations.

15.23 The small number of those who opposed our provisional proposal were more concerned with the issue of its practicality, and tended not to express objections to the principle underlying it.

15.24 Several consultees disagreed with the proposal. They comprised mainly leaseholders, but also included one law firm, and individuals.

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23 CP, Consultation Question 63, para 11.37.

24 CP, Consultation Question 62, para 11.28.

25 We explain our thinking behind this in the CP, paras 11.12 and 11.15.

26 CP, Consultation Question 64, para 11.40.

### The level of consent required to a fixed or floating charge

15.25 A sizeable majority of consultees supported our provisional proposal that the requirements of consent for the creation of both fixed and floating charges should be standardised along the lines that we suggested. Supporters were drawn from across the broad spectrum of our consultees. A few of those who on this point supported our proposals continued to voice reservations about their practicality.

15.26 Some of those who supported the proposal made specific comments:

(1) The Leasehold Knowledge Partnership ("LKP) and the All-Party Parliamentary Group on Leasehold and Commonhold Reform (the "APPG") thought that, if 80% of unit owners supported the proposal, the matter should need the approval of the Tribunal only if one or more unit owners actively objected; and

(2) Berkeley Group Holdings PLC (developer) were in favour of the proposal, with the proviso that so long as the freeholder/developer retained an interest in a communal facility, it should not be possible for the commonhold association to charge the common parts even with the consent of the Tribunal.

15.27 Those who were against our proposal included two individuals who were on our advisory group. Of these two individuals, only Professor James Driscoll was in favour of retaining the requirement for unanimity.

15.28 Most of those who opposed our proposal did so from the opposite standpoint. Damian Greenish (solicitor) thought that a special resolution of unit owners should suffice. He thought that requiring the consent of the Tribunal, or lenders' consent, would make it impossible for a commonhold association to respond meaningfully to an emergency. The Society of Legal Scholars also thought that to save time and costs, it should not be necessary to obtain approval from the Tribunal.

### Whether it should be possible to override lenders' consent

15.29 Fewer consultees than usual offered substantive responses to this part of the question. Most consultees who responded thought that the Tribunal should not be able to override lender consent, although some of these consultees qualified their support in important respects.

15.30 Bodies representing legal professionals were prominent among those who supported the proposal, including the Westminster and Holborn Law Society, The Conveyancing Association, the PBA, CILEx and the Society of Legal Scholars. A few of these bodies focussed on the mechanics of obtaining consents from lenders. They identified a need for a provision which deemed that a lender had consented, unless a refusal was given within a specified period. They said that without such a provision, it would be impossible to obtain consent from multiple lenders within a realistic time scale.

15.31 Some consultees thought that if fixed or floating charges by the commonhold association were to be viable, it would be necessary to have a provision whereby the Tribunal could override a lender's refusal to consent. These consultees warned, however, that lenders might then be more reluctant to lend on commonhold units.

15.32 This argument was borne out by UK Finance (an association representing mortgage lenders), which expressed its outright opposition to any suggestion that lenders' views should be capable of being overridden. They made the following point:

> A charge over the common parts would have a direct effect on the property's security and valuation and it would not be appropriate for a refusal to give consent to be overridden.

15.33 Developers and commercial freeholders also stressed that enabling lenders' wishes to be overridden in this area would deter lenders from lending on commonhold units.

15.34 Developers and commercial freeholders also tended to be sceptical of the prospects of a commonhold association being able to borrow on a secured basis, and thought that the whole process would take too long. They stressed the constructive role that they claimed that commercial freeholders could play in helping leaseholders respond to emergency situations: we have referred to this above.[27] LKP, on the other hand, disputed the suggestion that freeholders were in fact lending funds to leaseholders. LKP suggested that this was happening in only a "small minority of cases" and then often "for other than altruistic reasons".

### Charge of only part of the common parts

15.35 The vast majority of consultees agreed with our proposal that it should be made explicit that a commonhold association's power to create a charge over its common parts should also include creating a charge over only part of those common parts. Those who supported it were drawn from across the broad range of our consultees.

15.36 Some of those who opposed this proposal did so on the basis that they opposed in principle the idea of the commonhold charging its common parts. Others thought that it would not be practicable for a commonhold to source secured funding.

15.37 Some consultees with experience of conveyancing, including The Conveyancing Association and Clutton Cox Conveyancing, thought that it would be more straightforward for the part of the title to the common parts to be charged to be indicated by appropriate colouring on the filed plan. They did not think it would be necessary or appropriate for the part charged to be given a separate title number.

15.38 HM Land Registry noted that it

> would want registration of a charge of part to remain at the discretion of the registrar. It may not be operationally feasible to apply this to certain complex titles, such as those with multiple layers or floor levels

15.39 Further discussions with HM Land Registry have elicited that it has no objection in principle to registering a charge of part of the common parts. It would, however, wish to preserve its existing discretion as to whether it created a separate title for the parts which were charged, or whether it kept the common parts as a single title. In the latter case it would indicate the parts which were charged in some other way. HM Land

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27 Para 15.7

Registry therefore accepts that it is possible for the commonhold association to create a charge over a part of its common parts.

### Discussion and recommendations for reform

15.40 It is clear that UK Finance strongly objects to the principle that unit owners, as borrowers, should be able to support the creation by a commonhold association of a charge without the consent of their lenders. These objections apply to the creation of both a fixed charge (over the whole or part of the common parts) and a floating charge. We accept that lenders will have made mortgage loans on individual units on the basis that the units enjoy the use of communal facilities in the common parts. The creation of a fixed charge over the whole or part of the common parts therefore puts the continued availability of those facilities at risk. The creation of a floating charge does not put any of the common parts at risk. But, as with a fixed charge, it imposes a liability to repay a loan on the commonhold association, which will have the result that a share of that liability has to be included in the contributions payable by that unit each year. Either of these factors will tend to depress the market value of the unit, and thus its value as a security.

15.41 It is, however, worth examining the position of lenders as it currently is when lending on leasehold flats, and as it is, under the current law, when lending on commonhold units. We find it difficult to imagine that the proposed majority of unit owners – 80% of available votes – would be considering the creation of a charge over the common parts, or a floating charge, unless it was to address some crisis situation. This could well be the pressing need for works to be done to the commonhold. As noted in the Consultation Paper, and in paragraph 15.2 above, although the Grenfell Tower tragedy comes to mind, other situations may arise in the future which require that urgent work be done. The situation may be confined to a specific property, or, like the cladding issues that have arisen in the wake of the Grenfell Tower tragedy, be part of a more widespread problem.

15.42 It should be noted that the need for expensive remedial work to be done on a property – particularly if it needs to be carried out for health and safety reasons – will have an adverse effect on the saleability of that property. We are aware that the owners of some leasehold flats which have cladding similar to that installed at Grenfell Tower, or other flammable cladding, are finding it impossible to sell their flats. If they attempt to do so then surveyors are valuing them either at nil or at a fraction of their previous value.

15.43 Some consultees have told us that they think it unlikely that commercial lenders would be willing to offer secured lending of any kind to commonhold associations. Although the market has not been tested, we think it is more likely that commonhold associations will be able to borrow, and at lower rates of interest, if there is a viable method by which they can offer security. We therefore recommend that associations should be given explicit power to raise money through a floating charge to supplement their existing power to create fixed charges under the 2002 Act.

15.44 However, the current law contains an anomaly which we can see no good reason to perpetuate. It has become clear from consultation responses that substantially the same implications arise for owners and their lenders when a commonhold association creates both fixed and floating charges. We therefore consider that the same

threshold of support should apply for both fixed and floating charges. We think that the current requirement of unanimity – for the creation of a fixed charge – sets the bar too high. It would generally be impossible in practice to achieve it, and so a lower threshold would be appropriate for both fixed and floating charges provided that those who object have the opportunity to put their arguments before the Tribunal. We therefore recommend that it should be possible to create a fixed or floating charge with the unanimous support of unit owners, or, where that is not possible, 80% support, plus the approval of the Tribunal.

### Whether lender consent to a fixed or floating charge can be overridden

15.45 We acknowledge consultees' concerns about protecting mortgage lenders. They could include a requirement in their mortgage deeds that the borrower (that is, a unit owner) vote in a particular way when a fixed or floating charge is proposed. If that requirement could be overridden, lenders would treat that as a reason not to lend on commonhold. As UK Finance was strongly against our proposal, we have decided not to recommend that provisions in a mortgage deed controlling how the unit owner should vote should be overridden. Instead, we make a recommendation that would remove the need for lenders to include such a provision.

15.46 We recommend that, in addition to the levels of unit owner support outlined above, where a mortgage is secured against any unit, the proposed fixed or floating charge should require the approval of the Tribunal – and that lenders should be able to raise objections which the Tribunal would consider when making its decision.[28] Accordingly, even the unanimous consent of the unit owners would not be sufficient for a commonhold to create a fixed or floating charge without Tribunal approval and the input of lenders. We consider that this offers lenders an appropriate degree of protection.

15.47 Our recommendation also represents a marked improvement on the position in leasehold. Many modern leases include a provision that allows a landlord, or a residents' management company, to borrow money to meet its obligations as a landlord (in practice, usually its repairing obligations) and then charge the interest to the service charge account. There is no corresponding provision in legislation enabling leaseholders' mortgage lenders to oppose such borrowing.

15.48 Accordingly, in the event it is necessary for a commonhold to raise funds to respond to an emergency, lenders on commonhold will be protected against the possibility of unnecessary borrowing diminishing the value of their security. We think that, in most cases, the interests of unit owners and their lenders will be aligned. Unit owners are unlikely to be willing to charge their property unless absolutely necessary, and it is in lenders' interests that emergencies are dealt with to protect the value of their security. Neither party would therefore wish to charge the commonhold unless the circumstances required it. Requiring Tribunal approval if mortgages are secured on the units provides protection in the unlikely event unit owners and their lenders disagree on whether a charge is necessary.

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[28] See para 15.44, above.

### Charge of part of the common parts

15.49 We note that it is already possible under the current law to charge part of the common parts, but we considered that that it was advisable for the matter to be placed beyond doubt.

15.50 We proposed that it should be possible for the segment of the common parts which was subject to a charge to be registered under a separate title number. HM Land Registry has confirmed that they do not at present require that the common parts always be registered under a single title number.[29] We therefore recommend that it should be possible for a commonhold association to create a charge over part of its common parts, as an alternative to creating a charge over the whole of its common parts. We are satisfied that, if this recommendation is implemented, it can be left to the discretion of HM Land Registry whether to create a new title, or whether the parts of the common parts that are subject to the charge can be indicated in some other way. Any points of detail can be left to amendments to the Land Registration Rules.

15.51 One consultee raised the issue of the rights which unit owners might continue to need to enjoy over a part of the common parts which had been sold by a lender to whom a legal charge had been granted. The sale of part of the common parts under a lender's power of sale would in fact raise some difficult issues. The rights which a unit owner enjoys over the common parts are rights which are specific to commonhold. Although functionally equivalent to easements and other rights granted by a lease, they are not easements as such.[30] If part of the common parts is sold, it might be necessary to create a considerable number of cross-easements between the property sold off and the parts remaining within the commonhold, including easements for access, support, and for "conducting media" such as cables, pipes, and drains, and for the provision of services. Under the current law, it is not possible for such easements to be created at the same time as the charge. This is because the part charged, and the part that is retained free from charge, remain in the same ownership, namely that of the commonhold association.

15.52 Although no consultee raised the issue, it has occurred to us that, besides cross-easements, there might also be a need for "cross-restrictive covenants": restrictions placed on the land sold off to protect the amenities of the land retained, or on the retained land to protect that sold off.

15.53 We have suggested that it would be essential for a commonhold association and a lender to know, at the point when a charge is granted, precisely what part of the common parts is being offered as security, and thus placed at risk of loss. It is also likely to be advantageous for issues relating to cross-easements and any cross-restrictive covenants to be resolved when the charge is granted. If those issues are left – as the current law requires – until the point when the relevant parts are actually sold – they would remain subject to negotiation, with the potential for a dispute to arise. We recognised in a previous report that the inability to set up easements so long as two parts of the same title remain in common ownership is a defect of the law of England and Wales which causes problems when a legal charge is created over

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29 We explained in the CP, para 11.39, why we thought it arguable that HM Land Registry appeared to insist upon the common parts being registered under a single title number.

30 *Clarke on Commonhold*, para 7[4], n 2.

part of the land within a title.[31] In that report we made a recommendation which would address the issue, and that recommendation would cover any difficulties here.[32] We do not therefore make any further recommendation, though we observe that our previous recommendation in that report would need to be implemented if a charge of part of the common parts is to function properly.

15.54 Similarly, it may be desirable – if a part of a commonhold is sold by a lender to which it has been charged – for there to be restrictive covenants imposed either on the land sold, or on the land retained, or on both. It would be impossible to impose such covenants under the current law, as all the land would be in the same ownership when the legal charge was created. In Making Land Work, we recommended that land obligations should take the place of restrictive covenants, and we further recommended that it should be possible to put these in place even when titles remained in the same ownership.[33] Implementing land obligations would therefore enable the charging of part of the common parts to function better. It would also permit positive as well as restrictive obligations to be enforced between the land that is sold off and the land that is retained.

**Recommendation 90.**

15.55 We recommend that it should be possible for the commonhold association to grant a fixed charge over the whole or part of its common parts, or a floating charge, subject to the following levels of support:

(1) the unanimous consent of the unit owners; or

(2) 80% of the available votes of the unit owners, and approval is obtained from the Tribunal.

15.56 We recommend that, in all cases where there are mortgages secured on the units, the grant of the charge should require the approval of the Tribunal. Any unit owner's mortgage lender or other secured lender should have an automatic right to be joined in the proceedings to set out any objections to the charge.

15.57 The preceding discussion deals with the creation of fixed and floating charges. Lenders will not, however, be willing to lend on the security of part (or the whole) of the common parts if they face practical legal obstacles in exercising their power of sale. We have briefly alluded to similar obstacles in our discussion in Chapter 19, including whether the liquidator of an insolvent commonhold association would be able to dispose of part of the common parts to raise money for its creditors.[34] Equivalent issues arise if the unit owners themselves wish to sell off part of their

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31 Making Land Work: Easements, Covenants and Profits à Prendre (2011) Law Com No 327, paras 4.34 to 4.38.

32 Above, para 4.44.

33 Making Land Work: Easements, Covenants and Profits à Prendre (2011) Law Com No 327, para 4.44.

34 See para 19.120, below.

common parts. As we noted at the beginning of this chapter, they might wish to do so in response to a financial emergency, to avoid insolvency. There might, however, be instances where they simply wished to dispose of a facility which is no longer wanted, or that they consider has become too much of a financial burden.

15.58 While we did not consult on these issues, our recommendations to better facilitate the charge of the common parts and raise emergency finance require that lenders can effectively exercise their power of sale. We therefore turn now to consider the practicalities of selling the common parts in more detail, and make recommendations to address uncertainties.

15.59 We first consider the power of a lender to sell the charged common parts under its power of sale. Second, we consider the position of a liquidator when selling the common parts on the insolvency of a commonhold association. Finally, we consider how the commonhold association could itself sell the common parts to raise emergency finance.

### The position of a lender selling under a legal charge

15.60 In this section we consider the case of the lender who has lent a sum of money to a commonhold association on the security of a legal charge over part of the common parts.[35] If a borrower defaults, a lender with the benefit of a charge over part of a registered title is normally able to pass title on sale to a purchaser. In the context of the current commonhold legislation, however, the significance of paragraph 4.8.5 of the commonhold community statement (the "CCS") needs to be considered. It appears to require that the CCS cannot be amended to deprive a unit of its rights over the common parts without the prior consent in writing of the unit owner and any lender.[36] A similar provision applies if the CCS is amended so that a unit loses its right to use a limited-use area.[37]

15.61 The Commonhold Land Registration Rules also appear to support the view that it is not possible for the sale of part of the common parts by a lender to deprive unit owners of their rights over those parts without their consent. The Registration Rules require that, whenever an application is made to register a transfer of part of the common parts, it must be accompanied by an amended CCS.[38] The amended CCS would need to be signed on behalf of the commonhold association,[39] which would require the active co-operation of the association and its directors. The signatory would need to be satisfied that the necessary resolution to amend the CCS had been

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35 Similar issues would arise if the lender had lent to the commonhold association on the security of the whole of the common parts: it seems much more likely that in practice the lender would concentrate on selling the most readily realisable parts of the common parts.

36 Commonhold Regulations 2004, sch 3, para 4.8.5.

37 Commonhold Regulations 2004, sch 3, para 4.8.6.

38 Commonhold (Land Registration) Rules 2004, r 16.

39 Commonhold Regulations 2004, reg 15(4). Para 4.8 of the CCS does not make more specific provision, so presumably the requirement applicable in the Commonhold Regulations 2004, reg 15(4) applies generally

passed. He or she would also need to be satisfied that all necessary consents to the amendments had been obtained.[40]

15.62 On this view of the law, if the unit owners declined to co-operate, it would in practice be impossible for a lender to complete the sale of part of the common parts.[41] It should be borne in mind that, under our recommendation, the creation of a legal charge of part of the common parts will already have obtained either the unanimous consent of the unit owners, or the consent of 80%, plus the approval of the Tribunal.[42] It therefore seems wrong in principle that any unit owner or (residential) lender should then have the power to prevent a sale by a lender who was acting under that charge.

15.63 However, on the other hand, it could be argued that the lack of an owner's consent would prevent a lender from selling part of the common parts. The 2002 Act currently provides:

> Nothing in a commonhold community statement shall prevent or restrict –
>
> > (a) the transfer by the commonhold association of its freehold estate in any part of the common parts.[43]

15.64 This provision is susceptible to at least two interpretations.

(1) A broad, literal, meaning of the provision would suggest that nothing should stand in the way of a transfer of part of the common parts by a commonhold association. Once it had resolved to do so (or, by extension, created the charge which would give a lender the power of sale), then the requirement for individual unit owners to give their consent would simply fall away.[44]

(2) A narrower, perhaps more purposive, reading of the provision would confine it to preventing a CCS from providing that a certain part of the common parts could never be sold. On this interpretation, the consent of unit owners to a sale by the lender would still appear to be necessary, even after consent to the mortgage has been obtained.

15.65 There is clearly uncertainty here. Our recommendation above is intended to facilitate lending on the security of a fixed charge of the common parts or, more likely, part of them. These recommendations will not be workable if there is any possible argument that a lender is not able to exercise its power of sale without:

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40 In the case of a sale of part of the common parts by a liquidator, he or she would have assumed the functions of the unit owners as members, and so could "pass" any necessary resolution. But on the view of the law set out here, the consents would still be required.

41 Or for a liquidator.

42 See paras 15.55 to 15.56, above.

43 CLRA 2002, s 27(1).

44 A necessary inference of this interpretation would be that the provision noted above in the Commonhold (Land Registration) Rules 2004 was in conflict with the CLRA 2002 and thus of no effect.

(1) obtaining the co-operation of the commonhold association in amending its CCS; and

(2) obtaining the individual consent of every unit owner (and their lenders) who may be adversely affected, by losing rights over the part sold.

15.66 We therefore consider that the law should be clarified to ensure that a lender can effectively exercise its power of sale under a fixed or floating charge.

15.67 It is clearly a serious step for a unit owner to be deprived of rights without his or her express consent. However, under our recommendation, it is only possible for a commonhold association to be able to charge its common parts with a very high level of support from unit owners. Additionally, if there are any mortgages secured on the units, Tribunal approval will be necessary – even if the proposed charge is supported by all unit owners. The effect on the owners of the loss of the facility which they are losing could, and should, have been considered at that stage. Lenders will at that point have had the opportunity to put their views before the Tribunal.

15.68 We therefore recommend that there should be no requirement for unit owners or their mortgage lenders to consent to the loss of rights under the CCS on the sale of part of the common parts by a lender in the exercise of its power of sale; and on a sale of part of the common parts by a lender under its power of sale, there should be no requirement that an amended CCS should be filed at the same time. To insist upon this requirement could be used by unit owners to obstruct or at least to delay the registration of the transfer to the buyer. A buyer from the lender is entitled to know that the transfer can be registered without delay.

15.69 This does not of course remove the need for the commonhold association to register a revised CCS which:

(1) reflects the reduced size of the common parts (and of the commonhold itself);

(2) removes any reference to rights which have become obsolete; and/or

(3) modified the references to rights which need amendment.

15.70 The association would therefore be under a duty to register a revised CCS as soon as possible. If they failed to do so, then the existing procedure under section 40 of the 2002 Act could be extended to cover the present situation. Currently any unit owner may apply to the court for a declaration as to whether the CCS or the Articles of Association of a commonhold comply with the relevant legislative provisions. Under our proposed extension to that procedure, any unit owner would be able to apply to the Tribunal for an order amending the CCS so that it accurately reflected the state of the commonhold following the sale of the part of the common parts.

**Recommendation 91.**

15.71 We recommend that there should be no requirement for unit owners or their mortgage lenders to consent to the loss of rights under the CCS on the sale of part of the common parts by a lender in the exercise of its power of sale.

15.72 We recommend that, on the sale of part of the common parts by a lender in the exercise of its power of sale, there should be no requirement that either the buyer or the commonhold association simultaneously file an amended CCS at HM Land Registry. This would not, however, detract from the requirement for the commonhold association to regularise its position, and file an amended CCS as soon as possible thereafter.

15.73 We recommend that, if the commonhold association fails to register an amended CCS within a specified period, any unit should be entitled to apply to the Tribunal for all necessary amendments to be made to the existing CCS.

### The position of the liquidator

15.74 We note in Chapter 19 that similar issues to those arising on the sale of part of the common parts by a lender would arise if the liquidator of an insolvent commonhold association wished to sell off part of the common parts in order to reduce the indebtedness of the association. We explain in Chapter 19 how the liquidator would, as in any company insolvency, "step into the shoes" of both the directors and the members, and so could "pass" any resolution which required a vote of the unit owners. Any consents which were required from owners or their lenders to the loss of rights over the common parts would be supplied by the Insolvency Court which would already have oversight of the insolvency. Owners and their lenders would have the right to make representations to the court.[45]

## SALE BY THE COMMONHOLD ASSOCIATION OF PART OF THE COMMON PARTS

15.75 A commonhold association might wish to raise emergency funds by voluntarily selling off part of its common parts, particularly where the land is suitable for development. Alternatively, a commonhold might find that running a facility such as a swimming pool or a fitness suite was proving too expensive, and might wish to sell it off.

15.76 The position of a commonhold where the directors wished to sell off part of its common parts is, for the reasons explained above, not entirely clear.[46] As we explain above, the current law would appear to point in opposing directions.

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45 See para 19.122, below.

46 See paras 15.61 to 15.64, above.

(1) Paragraph 4.8.5 of the CCS would suggest that this course of action would not be possible without the prior written consent of the owner (and lender) of every unit which enjoyed rights over the part intended to be sold.[47]

(2) Alternatively, if section 27(1) of the 2002 Act is given its broader meaning, the sale would remove unit owners' rights over the land sold off, even if steps were not taken at the same time to amend the CCS. No specific provision is made under the current law for the level of agreement required for the commonhold association to sell off part of its common parts. It may have been assumed that as the sale would require the filing of an amended CCS, which requires an ordinary resolution,[48] this would afford unit owners a measure of protection. But this protection would be illusory if section 27(1) has the effect that a purchaser would automatically take free from unit owners' rights under the CCS. The directors of the association could resolve to sell off part of the common parts without consulting and without the consent of the unit owners. The directors might be in breach of their obligations to the unit owners, but the sale would nevertheless be valid, and the purchaser would take free of the owners' rights. This result must surely have been unforeseen by those who drafted the 2002 Act.

15.77 Neither of the outcomes outlined in the preceding paragraph is desirable.

(1) We can see no justification for the directors of a commonhold being able to sell off part of the common parts without the approval of at least a substantial proportion of the unit owners. To permit a unit to lose rights without the consent of the unit owner runs contrary to the idea that commonhold is freehold ownership. To permit the loss of rights over the common parts with the consent of an ordinary resolution satisfies the principle that a majority should support the change, but most substantial changes within a commonhold require a higher threshold of support.

(2) The alternative outcome is to maintain the requirement of paragraph 4.8.5 of the CCS that a unit may not be deprived of rights over the common parts without the consent of its owner and any lender. This affords owners and lenders the highest level of protection. It would, however, in practice mean that the unit owners could agree to a sale of part of the common parts only with the unanimous consent of the owners, and their lenders. We think this would be going too far.

15.78 Requiring the unanimous consent of all owners and their lenders before part of the common parts could be sold might be unduly inflexible. Owners who persisted in withholding their consent might, in effect, be able to hold their neighbours who favoured a sale to ransom. There would, additionally, be an element of inconsistency in affording owners this very high level of protection.

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47 The Commonhold Regulations 2004, sch 3, para 4.8.6 makes similar provision if a part of the common parts which is designated a "limited use area" is to be sold, and the unit is designated as one which is entitled to make use of that area.

48 Commonhold Regulations 2004, sch 3, para 4.8.3.

(1) We are recommending that the support of 80% of the available votes, plus the approval of the Tribunal, should be sufficient to approve the association granting a legal charge of part of the common parts, which could result in a sale.[49]

(2) The 2002 Act enables a commonhold to be terminated with the support of 80% of the available votes, plus the approval of the Tribunal, which is self-evidently the most far-reaching decision that a commonhold can take.[50]

(3) The 2002 Act contains provisions which allow the extent of a unit to be redefined without the consent of the unit owner,[51] and without the consent of any lender,[52] "in prescribed circumstances". Although no circumstances have, as yet, been prescribed by regulation, the framework of the 2002 Act thus makes it possible for a unit to be made smaller without the consent of the owner and lender.

15.79 It therefore seems anomalous for there to be no provision which permits the generally less serious step of depriving a unit of rights which it enjoys over any part of the common parts without unanimous consent.

15.80 If no provision is made for a unit to be deprived of any rights without the consent of the owner and any lender, then this would create an undesirable result when a commonhold association is facing a large financial claim. In Chapter 19, we recommend that, in the event of the commonhold association being insolvent, and a creditor presenting a petition for it to be wound up, the liquidator would be able to sell off part of the common parts with the permission of the court.[53] But a commonhold association faced with impending insolvency might well foresee that the sale of part of the common parts was the likely outcome. As such a sale would require the consent of every unit owner and every lender, it is unlikely that the association could carry it out of its own volition. The commonhold may therefore be forced to become insolvent, to facilitate the sale taking place. It seems highly undesirable that a commonhold association should have to incur the heavy expense involved in winding-up proceedings just so that it can achieve a result which a substantial majority of the owners are willing to accept voluntarily. Consultees, including UK Finance, have expressed concerns to us over the high costs which will be incurred if a commonhold association becomes insolvent. It seems desirable that these costs should be avoided wherever possible.

15.81 We acknowledge that some consider that a unit owner should not be deprived of any of the rights which it enjoys without the consent of the owner and any lender. We note, however, that the 2002 Act appears to countenance the extent of a unit being reduced without the consent of its owner and any lender, although the relevant regulations have never been prescribed. Further, we recommend below that the consent of the

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49 See paras 15.55 to 15.56, above.

50 See Ch 20.

51 CLRA, s 23(2).

52 CLRA, s 24(3).

53 See para 19.120, below.

owner and any lender should not be required if part of the common parts are sold either by a liquidator or a lender which is exercising its right to sell part. Moreover, the most serious step which a commonhold may resolve to take – its termination – should not require unanimity, and we recommend no change to this requirement.[54]

15.82 Bearing in mind these points, it seems desirable for there to be a clear procedure whereby a commonhold can authorise the sale of part of its common parts, and at the same time remove the rights enjoyed by the owners over the parts which are sold. We therefore that it should be possible for the commonhold association to sell part of its common parts, and at the same time to ensure that the rights granted to all units are modified, so that they can no longer be enjoyed over the land which is sold, provided that:

(1) it does so with the unanimous consent of the unit owners; or

(2) it does so with the consent of 80% of the available votes of the unit owners, and approval is obtained from the Tribunal.

15.83 As a voluntary sale of the common parts may have a result which is very similar to that which may result from the creation of a charge, we think it is right to require the same level of support as that needed to create a charge. Similarly, as the sale of common parts may impact the value of the units, we recommend that, in all cases where there are mortgages secured on the units, the proposed sale of common parts should require the approval of the Tribunal.

15.84 Similar considerations to those which apply to the rights of unit owners over the common parts would apply if the CCS were amended so that unit owners were no longer entitled to make use of the part of the common parts designated as a limited use area. We therefore recommend that corresponding provision should be made for the sale of limited use areas (which of course form part of the common parts).

15.85 We have identified a potential means by which unit owners may attempt to frustrate the sale by a lender under a legal charge of part of the common parts. We therefore recommend the removal of the requirement that an applicant lodges the amended CCS at the same time as the deed transferring part of the common parts.[55] There is, however, no need to abrogate the current requirement when the commonhold association is selling part of its common parts voluntarily. How the sale would affect existing rights would be part of their discussion, and so the amended CCS could and should be approved at the same time.

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54 See Ch 20.

55 See paras 15.71 to 15.73, above.

**Recommendation 92.**

15.86 We recommend that it should be possible for the commonhold association to sell part of its common parts, and at the same time to ensure that the rights granted to all units are modified, so that they can no longer be enjoyed over the land which is sold, provided that:

(1) it does so with the unanimous consent of the unit owners; or

(2) it does so with the consent of 80% of the available votes of the unit owners, and approval is obtained from the Tribunal.

15.87 We recommend that, in all cases where there are mortgages secured on the units, the sale should require the approval of the Tribunal. Any unit owner's mortgage lender or other secured lender should have an automatic right to be joined in the proceedings to set out any objections to the sale.

# Part VI: Dispute resolution, minority protection and enforcement

# Chapter 16: Dispute resolution

## INTRODUCTION

16.1 A feature of the commonhold system is that it includes its own dispute resolution procedure. This aims to encourage early communication between neighbours and out-of-court resolution when disputes arise. The dispute resolution procedure is set out in the prescribed terms of the commonhold community statement ("CCS") and is explained in detail in the Consultation Paper.[1] In brief, there are three separate timelines that apply depending on the parties to the dispute: disputes between a unit owner and the commonhold association; those between the commonhold association and a unit owner; and those between unit owners (and/or their tenants). The procedure must be followed where it is alleged that a unit owner, tenant or the commonhold association has breached the CCS, unless in an emergency or where the dispute relates to a duty to pay money. In either of these two cases, the dispute resolution procedure is optional.

16.2 In this chapter, we make recommendations to streamline, and improve, this procedure, including:

(1) ensuring that the commonhold association's role in unit owner and tenant disputes is appropriate, and does not lengthen the procedure unnecessarily;

(2) removing procedural requirements which may become traps for unwary complainants, such as the requirement to use particular forms;

(3) clarifying the consequences where the procedure is not followed;

(4) streamlining the previously separate alternative dispute resolution and ombudsman provisions;

(5) giving greater prominence to methods of alternative dispute resolution within the procedure;

(6) providing that, where possible, hearings are carried out by the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal"), rather than a court;

(7) future-proofing the procedure, by recommending that it is adopted as a pre-action protocol for any new Housing Court; and

(8) providing an indemnity to ensure that other unit owners do not suffer a financial loss when the rules of the commonhold are not followed.

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1 CP, paras 13.7 to 13.10.

## THE COMMONHOLD ASSOCIATION'S ROLE IN UNIT OWNER AND TENANT DISPUTES

16.3 In disputes between unit owners, or tenants, the first step in the dispute resolution procedure is to ask the commonhold association to take action against the defaulting unit owner or tenant. The commonhold association can decide to take on the complaint itself, in which case the association will follow the procedure for a dispute by the commonhold association against a unit owner or tenant.

16.4 Alternatively, the commonhold association can decide that inaction on its part is best to maintain harmonious relationships within the commonhold, provided that it would not cause significant loss to any unit owner or tenant. The commonhold association also has the power to prevent the complaint being taken further by the unit owner or tenant by commencing legal proceedings if the association reasonably considers that there has been no breach of the CCS, or that the complaint is vexatious, frivolous or trivial. If it did this, and the complainant wished to pursue the matter, the complainant would need to treat the matter as a dispute with the commonhold association. He or she would not be able to take direct action against the unit owner or tenant who is alleged to have breached the CCS unless the dispute with the commonhold association had been resolved in his or her favour.

16.5 In the Consultation Paper,[2] we noted that the commonhold association is not a judicial body and, as such, may not be best placed to decide whether a dispute between unit owners or tenants is frivolous, vexatious or not a breach of the CCS. A flawed decision by the commonhold association will lengthen the time it takes for a genuinely aggrieved unit owner, or tenant, to have the situation resolved.

16.6 We provisionally proposed to remove the commonhold association's power to prevent a unit owner commencing legal proceedings, and to replace this with a right for the commonhold association to *inform* the complainant that it considers the complaint to be frivolous, vexatious, trivial or that it does not consider the matter to be a breach of the CCS.[3]

### Consultees' views

16.7 Our provisional proposal received almost universal approval. Consultees noted that the commonhold association's ability to prevent a claim progressing, until a separate dispute had been raised and resolved against it, would delay proceedings and would be an administrative burden on all parties.

16.8 It was also noted that the commonhold association may not be best placed to intervene in such disputes. Malcolm Wood described it as "deeply inappropriate", while the Chartered Institute of Legal Executives ("CILEx") considered that decisions such as these were for the courts and tribunals.

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2 CP, para 13.24.

3 CP, Consultation Question 73, para 13.26.

16.9 Some consultees cautioned against the commonhold association becoming involved in what may essentially be neighbour disputes. Other consultees raised concerns about a commonhold association giving an incorrect opinion.

### Discussion and recommendations for reform

16.10 We note the large amount of support for the proposal and therefore recommend that the ability of the commonhold association to prevent disputes between unit owners or tenants from being pursued is removed from the dispute resolution procedure. Under our reformed procedure, a commonhold association could not prevent a unit owner or tenant from commencing legal proceedings against another unit owner or tenant. Instead, the commonhold association may inform the complainant that it reasonably considers the complaint to be frivolous, vexatious, trivial or that it does not consider the matter to be a breach of the CCS.

16.11 In view of the concerns over the commonhold association becoming involved in unit owner or tenant disputes, we add that the association will not be *required* to provide its opinion on the dispute.

16.12 Notwithstanding, we consider that an opinion from the commonhold association may, in some instances, be beneficial, and may help to discourage unfounded complaints from being pursued. For instance, the association may be able to offer guidance on interpreting potentially controversial local rules, such as those relating to standards of sound insulation when carpets are being replaced with hard flooring.

16.13 The decision to intervene and provide an opinion will always be at the commonhold association's absolute discretion. If the directors have concerns over their competence to make such a statement, or otherwise consider it would be unwise to intervene, there would be no obligation on them to do so.

16.14 Regarding concerns raised by some consultees that the commonhold association should not be involved at any stage in the procedure, we consider that it is still useful for there to be a requirement to notify the commonhold association of the dispute and request that it takes action itself. The disputes may, for instance, be caused by wider issues within the commonhold which the commonhold association is able to address. We consider that it may also be useful for a commonhold association to be aware of disputes relating to the CCS, or breaches of other duties in the commonhold legislation. The association may be able to use this knowledge to help prevent further disputes from occurring in future.

#### Recommendation 93.

16.15 We recommend that a commonhold association should not be able to prevent a unit owner or tenant taking further action in a dispute with another unit owner or tenant. Instead, the commonhold association should have a right, at its discretion, to notify the unit owner, or tenant, that it reasonably considers a claim to be frivolous, vexatious or trivial or that the matter complained of is not a breach of the CCS.

## USE OF PRESCRIBED FORMS

16.16 There are a number of prescribed forms that accompany the dispute resolution procedure. The forms provide space for the unit owner, tenant or commonhold association to set out details of the claim, accept or deny the complaint and prompt the complainant to consider alternative dispute resolution (on which see paragraph 16.46 onwards).[4] The forms, or forms to the same effect, are required to be used.

16.17 Respondents to the Call for Evidence raised concerns that the required use of prescribed forms, or forms to the same effect, in the dispute resolution procedure was too prescriptive, effectively creating a trap for the unwary. There were concerns that a mistake could be used by the other party tactically, or as a way of delaying the process. In the Consultation Paper we provisionally proposed that a failure to use the forms should not automatically prevent a claim from progressing.[5]

### Consultees' views

16.18 Our provisional proposal was supported by the vast majority of consultees.

16.19 Consultees who supported the proposal noted that the procedure would be used by people who may be unfamiliar with legal processes. Consultees considered that a technicality should not prevent a genuine grievance from being resolved and that, if this was not the case, a mistake could be deliberately used to frustrate legitimate complaints. For instance, Stephen Bedford (leaseholder) stated "genuine grievances may exist and decisions should not be formed on technicalities". CILEx stated that its members had called for the:

> ability to challenge the validity of administrative tasks, such as notices and forms, to be limited so that this is not abused as a means of frustrating processes on the basis of mere technicality.

16.20 A couple of the consultees who disagreed with our provisional proposal noted that the forms were short, clear and easy to use and that the use of forms was commonplace in virtually every walk of life. There was a comment that the forms could be easily adapted by commonhold associations into an electronic format and used with electronic systems.

16.21 A few consultees noted the benefits of requiring that particular forms are used, referring to the guidance and structure that this provides in resolving disputes. Consultees cautioned that removing the requirement to use the forms could lead to deliberate non-use, making the dispute resolution system harder to use for the party against whom the complaint was made and losing the benefit of the guidance and structure provided by the forms. For instance, David Johnson (leaseholder) stated "I think the dispute should follow prescribed guidelines, it would help with resolution".

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4 Examples of the forms are provided at Appendix 7 to the CP.

5 CP, Consultation Question 74, para 13.32.

### Discussion and recommendation for reform

16.22 In view of consultees' support, we recommend that a failure to use the correct form should not automatically prevent a claim from progressing. Mistakes in the use of prescribed forms should not be used by the other party tactically or as a way of delaying the process. Instead, the forms should be used as a tool to assist the parties to comply with the procedure and make the process easier. We agree with consultees that use of the forms may often be beneficial in ensuring that both sides to a dispute understand the next steps and are provided with the information needed to enable resolution of the dispute. We therefore recommend that, although it will not be a requirement, there should still be an expectation that the forms, or forms to the same effect (which may include electronic versions), will be used.

**Recommendation 94.**

16.23 We recommend that:

(1) the dispute resolution procedure makes clear that there is an expectation that the forms which accompany the procedure will be used; however

(2) a failure to use the forms, or forms to the same effect, should not in itself prevent a claim from progressing.

## FAILURE TO FOLLOW THE DISPUTE RESOLUTION PROCEDURE

16.24 We noted in the Consultation Paper that the sanctions for failing to follow the dispute resolution process are not set out expressly in the legislation. We provisionally proposed that, where any part of the dispute resolution procedure has not been followed, a court or tribunal which subsequently considered the dispute should have full discretion to disregard the non-compliance, or to order the parties to take any steps it considers appropriate, in accordance with its case management powers.[6] We considered it important to maintain flexibility, given that the individual circumstances of the dispute are likely to vary widely from case to case.

### Consultees' views

16.25 Almost all consultees agreed with our provisional proposal. CILEx considered that our proposal would provide flexibility and may assist the tribunal or court in ensuring the protection of vulnerable interests.

16.26 A couple of consultees suggested a default financial penalty for failure to use the dispute resolution procedure.

### Discussion and recommendations for reform

16.27 We consider that default financial penalties for failing to use the dispute resolution procedure may result in undesirable consequences. It could, for instance, disadvantage those without previous knowledge of the dispute resolution procedure

6 CP, Consultation Question 76, para 13.56.

who inadvertently make mistakes in the process and favour the financially stronger, or more organised party, regardless of the merits of the complaint. We would also be concerned that automatic default penalties may result in further disputes about the penalty itself.

16.28 We recommend that, where a dispute results in legal proceedings, a court or tribunal should have full discretion to disregard non-compliance with the dispute resolution procedure, or order the parties to take steps it considers appropriate in accordance with its case management powers. At this stage, the court or Tribunal will be able to provide independent oversight of the dispute, and consider the circumstances surrounding the failure to follow any of the steps within the dispute resolution procedure. The aim of the procedure is to encourage the resolution of disputes, not to create further hazards for unwary unit owners or associations, or opportunities for point-scoring by aggressive complainants. A complainant who deliberately disregards the procedure will do so in the knowledge that, if the matter reaches legal proceedings, their actions will be scrutinised and may result in an adverse order. Equally, where the procedure has accidentally not been followed, a court or tribunal may, for instance, decide to stay proceedings to allow the parties the opportunity to resolve the matter by properly engaging with the procedure.

**Recommendation 95.**

16.29 We recommend that where the dispute resolution procedure has not been followed, in full or in part, any court or Tribunal, which subsequently considers the dispute, should be able to order the parties to take any steps it considers appropriate, or to disregard the non-compliance in accordance with its general case management powers.

## THE ROLE OF THE OMBUDSMAN

16.30 The current law requires a commonhold association to be a member of an approved ombudsman scheme and for certain disputes to be referred to an approved ombudsman as part of the dispute resolution process. At present, it is not possible to comply with this requirement because no ombudsman scheme has yet been approved.

16.31 In the Consultation Paper, we noted that ombudsmen are usually used when an individual is in dispute with either a business or a public body, and that a commonhold association is neither of these.[7] Rather the commonhold association is the organisation through which the unit owners themselves control the management of the commonhold. There is therefore not the separation between a unit owner and the commonhold association that may be seen between, for instance, a business and its customer. A commonhold association may well have limited resources and have no better access to expert legal advice than a unit owner.

[7] CP, para 13.46.

16.32 We also noted concerns that the commonhold association would be bound by any decision of an ombudsman, while a unit owner, or tenant, would be free to disregard a decision against it and to pursue the dispute further.[8] We suggested that this disparity, and the compulsory use of an ombudsman, may not be appropriate for commonhold disputes.

16.33 In light of these issues, we provisionally proposed that membership of, and use of an ombudsman, should be optional, as part of the consideration of alternative dispute resolution, rather than compulsory.[9]

### Consultees' views

16.34 The vast majority of consultees agreed with the proposal in the Consultation Paper that referral to an ombudsman should not be a required part of the dispute resolution procedure. Well over half of consultees who responded to the question considered that membership of an approved ombudsman scheme should be at the commonhold's discretion rather than being required in all circumstances.

16.35 The majority of consultees who agreed with the proposals either did not give reasons, or expressly agreed with the reasons set out in the Consultation Paper.[10] Irwin Mitchell LLP (solicitors) suggested that an ombudsman works best where there is a power imbalance and suggested that this did not seem to be the case in commonhold. Other consultees considered that the proposal would provide flexibility for commonholds as to which type of alternative dispute resolution to use.

16.36 The Property Ombudsman noted that requiring the commonhold association to comply with an ombudsman's decision, while the unit owner or tenant was able to disregard it, would create a power imbalance and place the association in a difficult position.

16.37 A few consultees considered that, for a small commonhold, mandatory membership could be an unnecessary expense and formality.

16.38 Several consultees noted the potential benefits of membership of an ombudsman scheme. These were not limited to resolution of disputes; the Property Ombudsman, for instance, referred to the provision of advice and consumer guidance which an ombudsman may also be able to provide.

16.39 Several consultees who opposed our provisional proposals were concerned that, without the requirement to use an ombudsman, there may be no consideration of alternative forms of dispute resolution and no procedure on which to fall back. Other consultees drew comparisons with the requirement for membership of an ombudsman for managing agents and social landlords and questioned if there was sufficient evidence to change the current requirement for membership of an approved ombudsman in commonhold.

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8 CP, para 13.45.

9 CP, Consultation Question 75, paras 13.52 to 13.53.

10 CP, paras 13.44 to 13.51.

### Discussion and recommendations for reform

16.40 We note that use of an ombudsman is only one part of the commonhold dispute resolution procedure. As such, removal of the requirement for membership of an ombudsman would not remove alternative dispute resolution from the procedure altogether. Consideration of alternative forms of dispute resolution is a requirement in the existing commonhold dispute resolution procedure, both at the outset and prior to legal proceedings being started. We do not propose to change this requirement and we consider what alternative forms of dispute resolution will be available to a commonhold association below. We note the potential benefits, in appropriate circumstances, of using an ombudsman to resolve disputes. Our proposal would enable commonholds to consider the use of an ombudsman alongside other forms of alternative dispute resolution.

16.41 Compulsory membership of an ombudsman scheme is currently untested, since no ombudsman scheme has yet been approved. We note the comments of consultees who were concerned at the cost of mandatory membership for small commonholds. In this regard, although much of the focus has been on larger commonholds, a commonhold could be as small as two units, for instance, an upstairs and downstairs pair of flats or maisonettes. Under our proposal, some commonholds may choose to become members of an ombudsman scheme, while others may decide against membership. We consider that our proposal provides flexibility, rather than inconsistency. The dispute resolution procedure would continue to be consistent across all commonholds, involving the same prescribed steps with a view to resolving the dispute.

16.42 We consider that the requirements for membership of an ombudsman in other areas of housing law highlight why compulsory membership may not be appropriate for commonholds. Consultees referred to requirements for membership of an ombudsman in social housing and for managing agents. As set out in the Consultation Paper, the commonhold association is neither a business, nor a public body. It is also not a landlord. It is an organisation set up to enable unit owners to manage the commonhold effectively. Its members are the unit owners themselves, who are able to exercise control of the association through voting rights. The commonhold association is not therefore a third-party organisation over which a unit owner has no control and it does not present the same power imbalances that may be present in landlord and tenant relationships, or relationships with managing agents appointed by and answerable to a landlord. It does not therefore present the same concerns which have led to the requirements for compulsory membership of an ombudsman in other areas.

16.43 We note the existing requirement for managing agents to be members of an ombudsman. Where a managing agent has been engaged to carry out the property management functions of the commonhold association, unit owners will be expected to have access to an ombudsman for complaints against that managing agent. We also note the work of the working group on the regulation of property agents in this area.[11]

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[11] Lord Best, *Regulation of property agents working group: final report* (July 2019), at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/818244/Regulation_of_Property_Agents_final_report.pdf.

16.44 For the above reasons, and given the high level of support for our provisional proposal, we recommend that membership of an ombudsman becomes optional rather than compulsory for commonhold associations. We also recommend that the requirements to refer disputes to an ombudsman are removed from the dispute resolution process and that the use of an ombudsman is instead considered alongside other forms of alternative dispute resolution.

**Recommendation 96.**

16.45 We recommend that:

(1) referral to an ombudsman should not be a mandatory part of commonhold dispute resolution procedure. Instead, it may be used, on an optional basis, instead of, or alongside, other forms of alternative dispute resolution; and

(2) membership of an ombudsman scheme be made optional for commonhold associations.

## ALTERNATIVE DISPUTE RESOLUTION (ADR)

16.46 As explained in the introduction, the commonhold dispute resolution procedure lays out the three distinct timelines that apply depending on the parties to the dispute. Each of these three timelines requires the complainant to consider and, after exchange of notices, reconsider whether it might be possible to resolve the dispute through negotiation or through a form of alternative dispute resolution such as arbitration, mediation or conciliation.

16.47 Where a complainant fails to comply with any part of the dispute resolution process, which will include consideration of ADR, we recommend above (paragraph 16.29) that the court or Tribunal may order the parties to take any steps it considers appropriate in the circumstances. It may, for example, stay court proceedings to enable ADR to be complied with, or impose cost penalties where a party has unreasonably and wilfully failed to consider ADR. The court or Tribunal would also have power to disregard non-compliance with the procedure, depending on the circumstances.

### Consultees' views and recommendations for reform

16.48 While we did not ask consultees specifically about ADR in the Consultation Paper, a number of consultees commented on its benefits. Consultees told us that a procedure which encourages informal methods of dispute resolution is important within commonhold. For instance, the Property Ombudsman's perception was that consumers are put off using the complicated court system and they prefer a more informal approach to the resolution of disputes.

16.49 We agree with these views. The dispute resolution procedure within commonhold should be aimed at resolving the dispute quickly, amicably and cheaply, avoiding court proceedings wherever possible. An adversarial approach to resolving disputes could be especially harmful to the commonhold structure, when that structure is compared to a landlord-tenant relationship. The commonhold association is formed of the unit

owners themselves and an entrenched dispute could affect the ongoing relationship between unit owners, particularly where the unit owners live in close proximity to one another.

16.50 We are concerned, therefore, that informal methods of dispute resolution are given insufficient prominence in the existing dispute resolution process. The dispute resolution process as set out in the CCS simply requires parties to "consider" whether it might be possible to resolve the dispute informally. However, how does a court or Tribunal evaluate whether a complainant has considered or reconsidered ADR and what the benefit would have been if they had? This aspect of the procedure could make it difficult for a court or Tribunal to impose an appropriate sanction. A firmer direction may therefore be required to make any future pre-action protocol workable.

16.51 Our view is that the CCS should go further and require parties not only to "consider" forms of ADR, but also to engage with ADR if appropriate and proportionate. Additionally, the CCS, which will act as the unit owner's rulebook, should be updated to explain why informal methods of dispute resolution are important and to remind unit owners that court and tribunal proceedings should be an option of last resort. Currently, the CCS does not identify any independent body who may be able to assist the parties in the resolution of disputes, which creates a potential disincentive for an individual to attempt ADR. We suggest below a number of possible bodies that could be specified in the CCS to enable a complainant to focus properly on ADR as part of the dispute resolution process. It will also be important for a complainant to be consistently reminded of the need to explore ADR (rather than at specific points of the process) to avoid adverse consequences later.

16.52 The existing dispute resolution procedure directs the complainant to consider the following informal methods of dispute resolution: negotiation, arbitration, mediation, conciliation or "any other form of dispute resolution procedure involving a third-party". We explained the terms arbitration, mediation and conciliation in the Consultation Paper.[12] We also explained that another process that might be helpful in the commonhold context is "early neutral evaluation". This form of alternative dispute resolution involves a third-party, who is often a specialist on the subject matter of the dispute, giving an opinion on the dispute. The opinion can be used to guide negotiations and may be sufficient to encourage a party not to pursue the matter further, or to agree to reach a settlement. Additionally, we explain above that referral to an ombudsman may be considered an appropriate form of ADR in certain commonholds.

16.53 We consider that each commonhold could usefully set out in the CCS the approach it wishes to take to resolve disputes informally. Unit owners would therefore be familiar with the steps that should be taken each time they have a complaint. The appropriate response to a dispute could realistically vary from commonhold association to commonhold association. For example, it may be appropriate to name a certain individual or company (such as a managing agent or other third-party) to whom complaints could be sent in the first instance. That person could give advice on the parties' rights and obligations within the commonhold which, in many cases, may be sufficient to resolve the dispute. The nominated person may also be able to provide

[12] CP, para 13.35.

the parties with guidance on what other forms of informal dispute resolution may be appropriate. As we explain below, a Commonhold Regulator might be a suitable body for this task.

16.54 Other forms of ADR may also become available in the future. In her review of building regulations and fire safety, Dame Judith Hackitt states:

> where residents have raised concerns about safety and these matters have not been adequately addressed, then there needs to be a clear and direct route of escalation and redress to an independent body.[13]

In the wake of this report, the then Communities Secretary, James Brokenshire MP, announced plans on 24 January 2019 for a Housing Complaints Resolution Service ("HCRS"). The aim of this service will be to provide a single point of access to resolve complaints for housing consumers, when "in-house" complaint processes have been exhausted.

16.55 The HCRS is intended to be available to housing consumers only, which means it might not be available to commonhold associations when considering taking action against a unit owner or a tenant. The HCRS might only become available where the unit owner (or tenant) is commencing an action against the association. It may emerge that referral to the HCRS becomes an integral or even a mandatory aspect of commonhold dispute resolution. If so, the dispute resolution process would need to be updated to identify this body.

16.56 If the HCRS is introduced as a new form of ADR, one option to give ADR greater prominence within the dispute resolution procedure could be to require the complainant to obtain a certificate from the HCRS (similar to the procedure for ACAS conciliation in employment tribunal claims). This certificate can then be provided with a court or Tribunal application, once the dispute resolution process has been exhausted. This way, the complainant can demonstrate that they applied their mind to the HCRS procedure, without necessarily requiring them to exhaust that particular avenue and allowing them to access the court, if that is their chosen course.

16.57 Even though the HCRS would appear not to be available in a dispute initiated by the commonhold association against a unit owner, an association would still need to certify within a subsequent claim that they had complied with any necessary steps under a pre-action protocol, or indeed that they had approached an alternative independent body.

16.58 The HCRS is intended to work in co-ordination with the New Homes Ombudsman, which aims to provide a structured framework for proper resolution of a new homeowner's complaint. A commonhold dispute resolution procedure could therefore make the New Homes Ombudsman available to a complainant.

16.59 At paragraph 16.100 below, we suggest that it may be possible to follow the approach of other jurisdictions and create a regulatory body to oversee the operation of commonholds. One of the regulator's functions might be in assisting to resolve

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[13] Building a Safer Future – Independent Review of Building Regulations and Fire Safety: Final Report (2018) Cm 9607, para 4.30.

disputes. It could, for example, offer a form of early neutral evaluation. Unit owners and commonhold associations might be able to refer questions to the body about their rights and obligations under the CCS and the commonhold legislation which, in turn, could prevent unnecessary disputes within the commonhold.

16.60 In order to future-proof our recommended approach, if (1) proposals for a new combined Housing Court are taken forward by Government (see paragraph 16.80 below), and (2) jurisdiction for commonhold disputes is transferred to this court, the steps involved in the existing dispute resolution procedure should be moved to the court's pre-action protocol. We discuss the advantages of this approach from paragraph 16.74 onwards. It would be important to ensure that, if a specific pre-action protocol is created, forms of ADR will remain at the heart of the procedure.

16.61 There is a risk that transferring the dispute resolution procedure as it stands to a pre-action protocol could allow costs to escalate, by relegating or paying lip service to ADR. This will lead complainants to become focused on litigation in ignorance of the alternatives, resulting in penalties for misunderstanding the procedure, as some respondents have suggested. At the same time, it will not be possible (as the Consultation Paper recognises at paragraph 17.156) to force a unit owner to go down the route of ADR. If the dispute resolution procedure is moved to a pre-action protocol in the future, the measures we suggest above to assist in the informal resolution of disputes should be equally applicable.

16.62 Once the dispute resolution process is updated in the manner we suggest above, namely to require individuals to apply their minds actively to ADR, to signpost those individuals to suitable bodies and to require certification as part of any court or tribunal claim, we anticipate that the ADR and pre-action process will function more effectively for commonhold disputes.

**Recommendation 97.**

16.63 We recommend that the commonhold dispute resolution procedure should be updated to refer specifically to the Housing Complaints Resolution Service, the Commonhold Regulator and the New Homes Ombudsman, once these bodies are established.

16.64 We recommend that a unit owner and commonhold association, as part of a pre-action protocol, should be expected to engage with these independent bodies in order to provide the certification they need to bring a claim to a court or tribunal and generally to apply their minds consistently to ADR throughout the litigation process.

## TRANSFERRING JURISDICTION TO THE TRIBUNAL

16.65 Where a dispute has not been resolved through the commonhold dispute resolution procedure, jurisdiction currently lies with the court. In the Consultation Paper, we provisionally proposed that jurisdiction should be moved to the First-tier Tribunal

(Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal").[14]

16.66 We explained that the potential benefits of giving the Tribunal jurisdiction over commonhold disputes included the relatively informal proceedings (in comparison to court proceedings), the reduced emphasis on legal representation and the likelihood that the Tribunal's expertise in deciding leasehold disputes will be transferable to commonhold.

### Consultees' views

16.67 The vast majority of consultees agreed with our provisional proposal. Of the consultees who were in favour of the proposal, some considered that the Tribunal would be more affordable than the courts, while others considered that the types of issues which may arise in commonhold, such as neighbour disputes, would be familiar to the Tribunal from leasehold.

16.68 Some of those who disagreed did so because they doubted whether the Tribunal delivered the advantages that we had identified. However, not all consultees who doubted this were against the proposal. For instance, both the Leasehold Knowledge Partnership ("LKP") and the National Leasehold Campaign agreed with the proposal, but referred to a need for change in how the Tribunal operates.

16.69 Some consultees cautioned that the Tribunal may not be an appropriate forum for commonhold disputes in all circumstances. The example was given of where an order is sought which is not within the Tribunal's powers, such as an injunction. Consultees cautioned that there would be an increase in costs if two applications had to be made; one to the Tribunal and one to the court.

### Discussion and recommendations for reform

16.70 The concern at the possibility of separate applications being needed to the court and Tribunal is a legitimate one. We consider that this problem can be mitigated by the court retaining concurrent jurisdiction where an order is sought which the Tribunal does not have the power to grant. We recommend, however, that all applications should be made, in the first place, to the Tribunal. The Tribunal will then be able to transfer all, or part, of the dispute to the court, if an order, such as an injunction, is sought which is not within its power.

16.71 After such a transfer, we consider that the court should have the power to deal with all aspects of the dispute, even if some matters would normally fall within the jurisdiction of the Tribunal. We wish to avoid a situation in which a case is referred by the Tribunal to the court because a power is not within the Tribunal's power, only for the court to be unable to deal with any connected issues because the court cannot exercise a power only exercisable by the Tribunal. For example, in Chapter 12, we recommend that the Tribunal should be able to appoint directors to replace the elected directors in certain circumstances, and that it may refer the case to the court if an injunction is also necessary.[15] In that situation we consider that the court should be able to exercise the

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14 CP, Consultation Question 78, para 13.76.

15 Para 12.64.

jurisdiction of the Tribunal if it is necessary to deal with any connected issues in order to resolve the matter as efficiently as possible.

16.72 Other developments may minimise or remove the circumstances in which the Tribunal is not able to deal with a case. A "deployment pilot" has been run by the Tribunal, in which it trialled dealing with cases which previously would have required separate hearings in the county court and the Tribunal.[16] Further, proposals are being considered by the Ministry of Housing, Communities and Local Government, for a new specialist Housing Court combining the property work of the Tribunal and court.[17] We consider that if these developments are taken forward, then they should be applied to commonhold disputes.

**Recommendation 98.**

16.73 We recommend that:

(1) the Tribunal should have jurisdiction to hear disputes arising between commonhold associations, unit owners or tenants regarding duties arising in the CCS or from the commonhold legislation; and

(2) all applications should be made to the Tribunal. Where an injunction, or other order which is not available in the Tribunal is sought, the Tribunal should be able to refer all or part of the dispute to the court. After such a transfer, the court may exercise all the jurisdiction that the Tribunal could have exercised.

## THE HOUSING COURT AND PRE-ACTION PROTOCOLS

16.74 In the Consultation Paper, we noted the similarities between pre-action protocols, which set out steps which should be followed before starting certain types of court proceedings, and the commonhold dispute resolution procedure.[18] We highlighted concerns that having two overlapping systems may lead to difficulties. We explained that, since the commonhold legislation came into force, the number of pre-action protocols has expanded significantly, covering a range of property and housing-related disputes. We were therefore concerned that, if jurisdiction were to remain with the court, there would be potential for commonhold disputes to fall within the scope of one or more other specific procedures, which have not been designed with commonhold in mind.

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16 See Siobhan McGrath, *Report on Property Chamber Deployment Project for Civil Justice Council Meeting 26 October 2018*, at https://www.judiciary.uk/wp-content/uploads/2018/11/property-chamber-deployment-project-report-oct2018.pdf.

17 See speech of Sir Geoffrey Vos (Chancellor of the High Court), Professionalism in Property Conference 2018, para 24; Ministry of Housing Communities and Local Government, Considering the case for a Housing Court: A Call for Evidence (November 2018) p 6; and Updating the Land Registration Act 2002 (2018) Law Com No 380, para 21.72.

18 CP, paras 13.59 to 13.60.

16.75 We invited consultees' views on whether the commonhold dispute resolution procedure should be transferred to a pre-action protocol to avoid these concerns.[19] Pre-action protocols do not apply in the Tribunal and so it was suggested that transferring the procedure may only be possible if jurisdiction remained with the courts, or if proposals for a new combined Housing Court are taken forward.[20]

### Consultees' views

16.76 The vast majority of consultees were in favour of transferring the commonhold dispute resolution procedure to a pre-action protocol if jurisdiction were to remain with the court.

16.77 Consultees suggested that doing so would make it easier to keep the procedure updated, as it could be reviewed alongside the other pre-action protocols, and would reduce the risk of overlaps or conflicts between the commonhold dispute resolution procedure and pre-action protocols which may equally apply to the same dispute.

16.78 Several consultees favoured moving jurisdiction from the courts to the Tribunal and therefore did not consider that the dispute resolution procedure should be transferred to a pre-action protocol. A few consultees indicated support for moving the dispute resolution procedure to a pre-action protocol if a specialist Housing Court is created which has jurisdiction over commonhold. Conversely, Clutton Cox Conveyancing (conveyancers) questioned the benefit of moving to a pre-action protocol and considered that the term "pre-action protocol" itself was less clear than referring to a "dispute resolution procedure". A couple of consultees considered that the dispute resolution procedure was more accessible as part of the CCS than it would be if it were moved to a pre-action protocol.

### Discussion and recommendations for reform

16.79 We note the majority support for the dispute resolution procedure to be moved to a pre-action protocol and the potential benefits raised by consultees in terms of avoiding overlaps and duplication between two separate processes. We do not see any difficulties for court users in understanding or accessing a pre-action protocol. We therefore recommend that, if a new specialist Housing Court is created, with jurisdiction over commonhold disputes, the commonhold dispute resolution procedure should be transferred to a pre-action protocol for the court. Creating a specific pre-action protocol for commonhold disputes would have the effect of disapplying any other court pre-action protocols that might otherwise apply.

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19 CP, Consultation Question 77.

20 CP, para 13.66. See speech of Sir Geoffrey Vos (Chancellor of the High Court), Professionalism in Property Conference 2018, para 24; Ministry of Housing Communities and Local Government, *Considering the case for a Housing Court: A Call for Evidence* (November 2018) p 6; and Updating the Land Registration Act 2002 (2018) Law Com No 380, para 21.72.

**Recommendation 99.**

16.80 We recommend that, if a specialist Housing Court is created which has jurisdiction over commonhold, the commonhold dispute resolution procedure should be moved from the CCS to a pre-action protocol.

## INDEMNITY FOR BREACHES

16.81 Resolving disputes will often result in some form of cost. For instance, where a commonhold association has employed professional managing agents to carry out its day-to-day activities, fees are likely to be incurred for the time spent handling the dispute. Where mediation or arbitration is used there will be a fee to pay for the mediator or arbitrator's time, and where Tribunal or court proceedings follow, there will be hearing fees to pay.

16.82 When a unit owner, or tenant, is in breach of the CCS and the commonhold association seeks to remedy that breach, the commonhold association will incur any costs related to its side of the dispute. The only source of income for a commonhold association will often be the commonhold contributions made by the unit owners, and so it will be the unit owners who ultimately incur the cost of disputing a breach, or repeated breaches. In the Consultation Paper, we invited consultees' views on whether there should be an indemnity for any losses incurred as a result of breaches of the CCS, both for the commonhold association and for unit owners. [21]

### Consultees' views

16.83 The vast majority of consultees indicated that the CCS should include a provision enabling the other unit owners and the commonhold association to reclaim losses incurred due to a breach of the rules of the commonhold.

16.84 CILEx reported that 94.4% of its survey respondents considered that there should be an indemnity for losses reasonably incurred where a unit owner or tenant breaches the rules of the CCS.

16.85 A few consultees referred to equivalent provisions in most modern leases. Some consultees suggested that an indemnity provision may result in greater compliance with the CCS and less litigation.

16.86 Despite the large amount of support for such a provision, a number of significant concerns were raised. These included the potential for abuse by heavy handed commonhold associations, or vexatious unit owners. Several consultees said that the ability to obtain an indemnity should not be prescribed, but left to local rules. For instance, the Leasehold Advisory Service ("LEASE") stated, "we consider it should be left to unit owners to decide if such a provision should be included in the CCS rather than it being a prescribed part of the CCS".

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21 CP, Consultation Question 79.

16.87 LKP and the All-Party Parliamentary Group on Leasehold and Commonhold Reform ("APPG") raised concerns that provision for an indemnity to be paid by a unit owner or tenant could result in a power imbalance without an equivalent indemnity against the commonhold association where the association is in breach.

### Discussion and recommendation for reform

16.88 Given the support for our provisional proposal, we recommend that an indemnity should be included in the CCS that will allow the costs of taking action against unit owners and tenants who breach the terms of the CCS to be recovered. An indemnity will protect the owners in the building from being out of pocket after taking action against those who fail to comply with the CCS. We hope that the indemnity should also provide unit owners and tenants with an additional incentive to comply with the terms of the CCS. We note concerns that the commonhold association and unit owners might act in a vexatious manner when seeking to rely on the indemnity. However, we consider that it should only be possible to rely on the indemnity once the court or Tribunal has determined that a breach of the CCS had in fact occurred. This would protect unit owners and tenants from seeking to recover amounts in the absence of clear evidence that a breach had in fact occurred.

16.89 In addition, we do not consider that providing the association and unit owners with the right to an indemnity would create the same power imbalance that may be present between many landlords and tenants in leasehold, since unit owners are ultimately in control of the commonhold association. We also note the recommendation made for protection of the minority in the commonhold structure, discussed later in this Report.

16.90 In the Consultation Paper we explained our concerns about recommending that a unit owner or tenant could recover losses from the commonhold association where it is the association that is in breach of the CCS.[22]

16.91 A commonhold association is made up of unit owners. It is those unit owners who, through the payment of commonhold contributions, will provide the association's income. Where a unit owner has pursued a complaint against the commonhold association for a breach of the CCS and the complaint is upheld, it would be the other unit owners who would ultimately need to repay the complainant under the indemnity provision.

16.92 If other unit owners pursue the association in respect of the same or a similar breach, providing the owners with an entitlement to claim against the association could have repercussions for the association's liquidity. We are therefore cautious about recommending a reform that requires an indemnity to be given by the association, although it would be open for individual commonhold associations to agree an indemnity in appropriate cases.

16.93 In view of the large amount of support for a provision enabling losses to be recovered where they have resulted from breaches of duties in the CCS or duties in the commonhold legislation, we recommend that a provision is included in the CCS

[22] CP, para 13.78.

whereby individual unit owners indemnify other unit owners, tenants and the commonhold association for those breaches.

**Recommendation 100.**

16.94 We recommend that the prescribed CCS should include a provision that, where a unit owner or tenant breaches the duties in the CCS, or commonhold legislation, the unit owner or tenant indemnifies the other unit owners, tenants and the commonhold association for losses they reasonably incur as a result of the breach.

## A REGULATOR FOR COMMONHOLD

16.95 It may be possible to follow the approach of other jurisdictions and create a regulatory body to oversee the operation of commonhold.

16.96 We explained at paragraph 16.53 above that there might be a role for a regulator in helping to avoid disputes and in resolving them where they arise. A regulator could also be involved in ensuring that good practice is followed. For instance, to ensure that they comply with the commonhold legislation, a regulator might have to approve any new CCSs.

16.97 Alternatively, or additionally, the regulator could have an advisory function.[23] Unit owners might be able to refer questions to the body about their rights and obligations, which in turn, could prevent unnecessary disputes arising within a commonhold.

16.98 Furthermore, there are various issues, beyond dispute resolution, that arise within commonhold and on which an external decision-maker is necessary.[24] In this Report, we assume that the decision-maker would be the court or the Tribunal. However, we think that many of these decision-making functions could, in the future, be performed by a regulator.

16.99 The need for a body or bodies to provide a regulatory and advisory function is a matter for Government to consider as part of its reinvigoration of commonhold. However, we think that, at least so far as the regulatory role is concerned, the arguments for its inception are, at present, muted. That is a consequence of there being a small number of commonholds. We anticipate those arguments will grow stronger as the number of commonholds increases.

**Recommendation 101.**

16.100 We recommend that Government consider creating a commonhold regulator.

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[23] We note here that LEASE has some guidance material on commonhold (see https://www.lease-advice.org/advice-guide/commonhold/).

[24] For example, in Ch 12 we recommend that the Tribunal should be able to determine if a long-term contract is fair prior to it being entered into, in order to avoid the possibility that it is later cancelled when unit owners take effective control of the commonhold association.

# Chapter 17: Minority interests within commonhold

## INTRODUCTION

17.1 Commonhold is a democratic scheme. Important decisions are made by unit owners voting as a body. Collective decision-making is one of the key advantages of commonhold. It allows unit owners to be given a direct say in the management of their commonhold, contrasting with the position in most leasehold blocks. However, at the same time, there is a risk that a majority of unit owners will make decisions that impact significantly upon the interests of the minority.

17.2 Currently the principle of democracy applies strictly within commonhold – what unit owners holding a majority of votes want to happen is what happens. In all but the smallest of commonholds, it is likely that decisions will be passed without the unanimous agreement of unit owners. This means a unit owner can be outvoted on issues that have a particularly undesirable or prejudicial consequence for them, without any means of redress. The dispute resolution procedure, as described in Chapter 16 of this Report, will not be available, because the commonhold association will have acted in accordance with the commonhold community statement ("CCS") when approving the decision.[1]

17.3 In the Consultation Paper, we highlighted a number of areas in which it would be inappropriate for majority rule to apply strictly. We suggested that, in certain defined circumstances, a unit owner affected by a decision might be able to challenge that decision in the First-tier Tribunal (Property Chamber) in England and the Leasehold Valuation Tribunal in Wales (the "Tribunal"). We refer to a unit owner's right to challenge decisions which have been validly taken by the commonhold association as "minority protection".

17.4 In this chapter we make a series of recommendations that will strike a better balance between majority rule and protection for the minority than is provided for by the current law. We set out the circumstances in which minority protection should be available, what test the Tribunal should apply and what remedies may be granted. Our recommendations will ensure that unit owners are not left without any ability to challenge decisions that harm their interests, while still enabling the commonhold association to function effectively as a democracy. [2]

## WHEN MINORITY PROTECTION SHOULD BE AVAILABLE

17.5 In the Consultation Paper we explained that the right to minority protection should not be drawn too widely. To allow unit owners to challenge every decision of the commonhold association would undermine the democratic nature of commonhold and

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1 We explain in Ch 16 that it is only mandatory to follow the dispute resolution procedure where there has been a breach of the CCS (other than in the event of an emergency or where the breach relates to a financial provision of the CCS).

2 We explain in Ch 11 that in certain circumstances shared ownership leaseholders should benefit from minority protection in the place of the unit owner.

would make the management of commonhold administratively difficult. We had provisionally identified four types of decision that should be covered by our recommended scheme of minority protection.[3] These were:

(1) Where a commonhold association votes to approve an amendment to the local rules in the CCS.

(2) Where a commonhold association approves the creation of a section (or sections) or where the commonhold association has approved the combination of two or more sections.

(3) Where a commonhold association approves a budget in excess of a "cap" set out in the CCS. (In this Report we refer to the "cap" as a "cost threshold", as this better reflects the intention behind our proposal and recommendation).

(4) Where the directors of the commonhold association revoke or amend powers that had been delegated to a section committee.

17.6 Together, the decisions that should give rise to a right to apply to the Tribunal are referred to throughout this chapter as the "gateways" to minority protection.

17.7 In the Consultation Paper we provisionally proposed the introduction of minority protection for all four of the gateways listed above. We then asked consultees to comment on whether there were any additional circumstances in which a unit owner (or owners) should be given a right to challenge a decision taken by the commonhold association.

### Consultees' views

17.8 Several consultees commented that the circumstances listed in the Consultation Paper were not exhaustive of all the circumstances in which a unit owner might need a right to apply to the Tribunal. Christopher Jessel (solicitor) said:

> There should be a general jurisdiction. It is impossible to forecast the sort of dispute which might arise and if this procedure is useful in the suggested cases it might be helpful in others.

17.9 Other consultees made suggestions equivalent to the introduction of a general right to challenge any decision of the commonhold association. For instance, the Chartered Institute of Legal Executives ("CILEx") said that a unit owner should be able to challenge any decisions taken by the commonhold association that were prejudicial to his or her interests.

17.10 One consultee, who was also concerned that the gateways listed in the Consultation Paper should not be exhaustive, suggested that it should be for individual commonholds to set out in advance the circumstances in which decisions taken by the commonhold association should be open to challenge.

17.11 Another set of consultees said there should be an additional right to apply to the Tribunal where a particular decision was being blocked by the majority. These

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[3] See CP, para 13.89.

consultees felt that high voting thresholds might prevent important decisions from being carried. In particular, high voting thresholds were raised as a potential issue in the context of the creation or combination of sections and in the context of amendments to the CCS. (We recommend elsewhere in this Report that a special resolution should be required in order to amend the CCS or to create and combine sections.) Irwin Mitchell LLP (solicitors) said:

> If there are more than 50% of unit holders seeking a change for a good policy or safety reason but there are not sufficient numbers to allow a change to be made then it may be appropriate to have the right for those unit holders to apply to the Tribunal. However, there will need to be carefully detailed rules for the Tribunal to follow as to when it would be appropriate to make such changes without sufficient support of the unit holders.

17.12 A few consultees raised issues over unit owners' ability to challenge the costs of the commonhold. Three consultees commented that including a minority protection right where a budget in excess of a cost threshold has been approved was not going far enough to protect unit owners. Instead, they thought it should be possible to challenge costs where they have been deemed unfairly or unreasonably incurred.

17.13 Two further consultees said that protection should be available where a particular group of unit owners, such as buy-to-let investors, are able to overrule the minority and push through their agenda.

## Discussion and recommendations for reform

### Should there be any further gateways to minority protection?

17.14 The most common suggestion made by consultees is that there should be a general jurisdiction for the Tribunal to review all decisions approved by the commonhold association.

17.15 We do not however agree that there should be a general right to challenge every decision of the commonhold association. As we explain above, extending minority protection to any decision of the commonhold association creates a risk that the Tribunal would become a forum for all disputes within commonhold. This could undermine the nature of commonhold as a democratic, self-governing entity. By limiting minority protection to specific, important votes of the commonhold association we can mitigate the risk of frivolous applications coming before the Tribunal and disputes becoming drawn out or vexatious as a consequence. In any event, most significant decisions falling outside the regime either already benefit from their own bespoke minority protection scheme (such as on voluntary termination),[4] or do not generate a risk for the minority in and of themselves (for example, a decision to appoint directors).[5]

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[4] At paras 20.4 to 20.21 below we recommend that the approval of the court should be required for the commonhold association to voluntarily terminate if unit owners did not agree unanimously.

[5] Directors are appointed and removed by a resolution of the commonhold association. However, the appointment of a specific person as a director does not negatively impact on a unit owner in and of itself. Rather, the way in which a director fulfils his or her duties and exercises his or her powers may impact on other unit owners. A failure to manage the commonhold in accordance with the CCS will enable a unit owner

17.16 We note the suggestion that individual commonholds should be able to set out in the CCS in advance when and how minority protection will be available to unit owners. However, in our view, this would overcomplicate the minority protection scheme and cut into the advantages of standardisation across commonhold. As we note above, our recommendations for minority protection strike a careful balance between ensuring that all unit owners benefit from a basic standard of protection and ensuring that commonhold's democratic nature is not undermined. This balance could not be achieved by leaving each commonhold to set their own regime of protection.

17.17 Several consultees also suggested that minority protection should be available where certain decisions of the commonhold association have not been approved. Consultees envisaged inverting the model of minority protection by allowing a group of unit owners, who are unable to gather enough support to carry a decision, to apply to the Tribunal to approve that course of action. However, for reasons set out more fully from paragraph 10.97, we do not recommend that such a right is provided. Enabling an application in these circumstances would undermine the policy reasons behind requiring a particular threshold to be met before a decision can be passed.[6] Allowing a minority to push through decisions which have not received the support of the majority would be a significant inroad into the democratic nature of commonhold and undermine certainty.

17.18 A number of consultees felt that there should be a general right for unit owners to challenge the reasonableness of commonhold contributions. However, as we explain in Chapter 13 of this Report, in order to preserve the solvency of the commonhold association it should not be possible to challenge costs after they have been incurred by the commonhold association.[7] Instead, unit owners will have rights which are more suited to the commonhold context. Where the commonhold association votes to make changes to the level of commonhold contributions allocated to individual units, any unit owner seeking to challenge that amendment will not be able to bring a minority protection claim. In Chapter 13 we make recommendations for a bespoke scheme that will enable unit owners to challenge the allocation of costs directly.[8]

17.19 We note suggestions that there should be an ability to challenge decisions of the commonhold where a majority of buy-to-let unit owners are in control. However, the fact that there may be a proportion of buy-to-let unit owners in a commonhold, who are able to form a majority and thereby carry many decisions is not something that should, in and of itself, give rise to a right to apply to the Tribunal. It is a part of the democratic nature of commonhold that a unit owner can exercise all the votes attached to his or her units, irrespective of who that unit owner is. A unit owner who owns the majority of units in the commonhold will therefore be able to exercise the majority of the votes, but would also be responsible for the majority of the

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to invoke the dispute resolution procedure. In extreme cases of mismanagement, we recommend an ability to replace the directors. See paras 12.36 to 12.71, above.

6 In particular we considered that increasing the threshold required to carry certain decisions (such as amending the CCS, which requires a special resolution) would strike a more appropriate balance between certainty to unit owners and flexibility.

7 Preventing unit owners from challenging costs that have been incurred protects the solvency of the commonhold association.

8 See paras 13.75 to 13.101, above.

commonhold's costs. The existence of a significant proportion of buy-to-let unit owners (or conversely owner-occupiers) would, however, form part of the relevant background for the Tribunal to consider when deciding whether to grant a remedy. We discuss the factors that the Tribunal should take into account from paragraph 17.29 below.

### Should our proposed gateways be introduced?

17.20 Turning to the four gateways listed in the Consultation Paper, consultees did not raise any specific objections to these gateways. Rather, consultees suggested additional circumstances in which minority protection might apply, or said that there should be a general right to apply to the Tribunal, which for reasons given above, we will not be taking forward.

17.21 However, following consultation, we recommend a revision to the circumstances set out in the Consultation Paper in which minority protection should be available. We have identified one gateway, which was set out in the Consultation Paper, to which we do not think minority protection should in fact apply.

17.22 We do not consider that minority protection should be available to challenge a decision of a director to revoke or amend powers delegated to a section committee (that is, the fourth gateway mentioned in paragraph 17.5(4) above). More broadly, we do not think minority protection should be available to challenge any decisions taken by the directors of the commonhold association, as opposed to decisions approved by a majority of unit owners voting. The purpose of minority protection is to enable decisions of the commonhold association to be challenged, if no other remedy is available. This is because minority protection is centred on protecting unit owners from the risks posed by collective decision-making. On reflection, therefore, we think that it is ill-suited to dealing with issues that could arise between unit owners and the directors of the commonhold association. More effective mechanisms, that do not risk disrupting directors' ability to run the commonhold, are available for unit owners to hold the directors accountable. Some options available to unit owners include:

(1) commencing the dispute resolution procedure against the directors if the directors have breached the CCS in making their decision (for example in breach of an obligation to act reasonably when making a decision);[9]

(2) bringing an unfair prejudice claim against the directors in accordance with company law;

(3) voting to remove the directors; or

(4) voting by special resolution to compel the directors to make a different decision.

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9 In Ch 8 we recommend that the directors should only revoke or alter the powers delegated to a section committee where reasonable to do so, and on providing the section committee with 14 days' notice. If the directors acted unreasonably in revoking/altering the powers, or failed to provide the committee with 14 days' notice, the committee would be able to invoke the dispute resolution procedure against the directors.

17.23 Additionally, in Chapter 12 we recommend that unit owners should have the right to apply to the Tribunal to replace the directors where there has been a persistent failure to comply with the CCS in some material respect.

17.24 Consultee responses which questioned the breadth of our recommended minority protection scheme have however prompted us to reconsider whether there are any other votes of the commonhold association that warrant additional protection through minority protection.

17.25 In commonhold, decision-making is allocated between the directors of the commonhold association and the unit owners, voting as a group. The Commonhold and Leasehold Reform Act 2002 (the "2002 Act") and the Commonhold Regulations set out the different matters that the commonhold association must vote on. In addition, unit owners can choose to pass resolutions to influence or compel the directors of the commonhold association to act in a certain way, even where responsibility to make that decision usually lies with the directors.[10] Given this, the commonhold association can theoretically vote on an extremely wide range of different issues. We are of the view that introducing minority protection for such votes would be too great an inroad into democracy in commonhold and could make decision-making too administratively difficult.

17.26 We then considered the decisions that legislation has specifically allocated to unit owners, voting as a body, and concluded that there is not sufficient evidence to indicate that minority protection is necessary for other votes. However, we consider that a future review of commonhold should consider whether minority protection should be extended to cover other decisions taken by unit owners.

17.27 In summary we are recommending that minority protection should be available following a vote to:

(1) vary the terms of the CCS;

(2) create a section (or sections);

(3) combine two or more sections; and

(4) approve a budget in excess of a cost threshold set in the CCS.

[10] The commonhold association can direct the directors to act in a certain way if more than 75% of unit owners present at a quorate meeting, or more than 75% of all unit owners voting using a written procedure, approve the resolution. See CP, para 9.12.

**Recommendation 102.**

17.28 We recommend that unit owners should be given a right to apply to the Tribunal to challenge a vote of the commonhold association, if:

(1) the commonhold association has approved an amendment to the terms of the CCS;

(2) the commonhold association has approved the creation of a section (or sections);

(3) the commonhold association has approved the combination of two or more sections; or

(4) the commonhold association has approved a budget above a cost threshold for improvements and enhanced services set in the CCS.

## THE TEST TO BE APPLIED BY THE TRIBUNAL

17.29 In the Consultation Paper we asked consultees to comment on the test that the Tribunal should apply when deciding whether to grant a remedy in minority protection cases. We asked consultees whether the Tribunal should consider the following factors, although we did not attempt to identify the appropriate statutory wording for them.[11]

(1) Whether the unit owner(s) making the application voted against the decision complained of, or had good reason for not doing so.

(2) Whether the decision complained of has a particular impact on the unit owner(s) making the application and, if so, what degree of impact should be necessary for a remedy.

(3) The reason behind the decision taken by the commonhold association, for example, whether the decision is in the best interests of the commonhold and/or is proportionate to the impact on the unit owner(s) in question.

17.30 We then sought consultees' views on whether the above factors would be equally relevant in every minority protection claim, irrespective of the type of decision under challenge.

### Consultees' views

#### Are the factors necessary?

17.31 Most consultees commented that some, or all, of the factors listed in the consultation question should be considered by the Tribunal when deciding whether to grant a remedy to an applicant.

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11 CP, para 13.95.

17.32 Other consultees argued that it would be unnecessary to provide the Tribunal with a list of factors, as those set out in the Consultation Paper "will be so obviously relevant" to the decision-making process. Christopher Jessel suggested instead that the Tribunal should "be required to have regard to all relevant matters" as "the Tribunal itself is capable of deciding what is relevant".

17.33 A small minority of consultees favoured adopting a different test entirely. Of the alternative tests put forward by consultees, two emerged more frequently than others. These were a test based on unfair prejudice in company law,[12] and a test based on the grounds on which a decision may be challenged by judicial review.[13]

### A preliminary test or a balancing exercise

17.34 Of those who commented that some or all of the factors set out in the Consultation Paper should be taken into account, two different interpretations emerged.

(1) A number of consultees interpreted the consultation question as setting out a three-part preliminary test. Under this interpretation, the Tribunal would not be able to consider the merits of a case unless the certain preliminary requirements had been satisfied. For example, the Tribunal would be prevented from considering the claim if the applicant had not actively voted against the decision complained of. Some consultees in this category therefore objected to certain factors (particularly the first two factors) as being unduly restrictive, rather than because they felt the factors were not relevant to the claim.

(2) Other consultees understood the factors to apply more flexibly. Under this interpretation, rather than the applicant needing to satisfy each of the three factors set out above, the Tribunal would be able to conduct a balancing exercise, in which it would take the factors into account.

17.35 Consultees commented on each of the specific factors that we suggested as follows.

### Factor 1: Did the applicant vote against the decision being complained of?

17.36 Many consultees said that the Tribunal should consider how an applicant had voted on an issue when deciding whether to grant a remedy in a minority protection application. One consultee commented that it should be necessary for an applicant to have voted against the decision as a means of limiting vexatious claims.

17.37 However, several consultees were concerned that the question of how an applicant had voted (or why an applicant had failed to vote at all) was not always related to the merits of a particular claim. The Association of Residential Managing Agents ("ARMA") said:

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12 Under company law it is possible for a member (or members) of a company to apply to court for a remedy if the applicant(s) think that the company is being (or has been) run in a way that is "unfairly prejudicial" to the interests of the members of the company: s 994(1) of the Companies Act 2006.

13 Judicial review is a type of action in which the court looks at whether a decision made by a public body was lawful. An applicant may bring a judicial review claim relying on one (or more) of the following grounds: (1) the public authority did not follow the correct procedures when making its decision, (2) the decision was one that the public body did not have the legal power to make, or (3) on the basis that it was an "irrational" decision.

> Sometimes the longer-term impact of a decision is not known, or the unit owner was not in a position to vote at all […]. For example, to keep harmony in the block someone may not publicly object to someone buying a dog. However, should that dog later become a nuisance it would be wrong to use the initial consent against someone.

### Factor 2: What impact does the decision have on the applicant?

17.38 Most consultees who responded said that, in order to obtain a remedy, a particular impact on the applicant should be demonstrated. However, few consultees suggested what degree of impact should be necessary. Two consultees suggested the impact should be "direct", one said it should be "not trivial", and another said that it should be "significant".

17.39 Several consultees were concerned that requiring a particular degree of impact would be problematic. Boodle Hatfield LLP, solicitors, commented that defining the precise meaning of a particular degree of impact would be very challenging. The Property Litigation Association (the "PLA") added that a set threshold might not offer sufficient flexibility:

> The problem with a set threshold is that it would have to apply across the vast range of commonhold owners. It would have to accommodate residential and commercial owners, it would have to accommodate millionaire owners and owners already struggling to make ends meet in an affordable unit. To accommodate this range would require a threshold so flexible as to be meaningless. The better approach is simply to have the degree of impact as a factor.

17.40 Similarly, the Consensus Business Group (landlord) said:

> If the decision impacts on the development such that it justifies a vote, then the outcome could in the perception of any individual unit holder have an impact which is important to them. To allow the commonhold association or Government when legislating to decide what constitutes an impact is impractical and unfair.

17.41 A number of other consultees were concerned that a requirement for a specific degree of impact would interfere with the Tribunal's ability to examine the merits of a case. ARMA commented that the degree to which a decision impacted on an individual unit owner should not make his or her input less valuable in a dispute.

### Factor 3: What was the reason for the commonhold's decision?

17.42 Very few consultees provided substantive commentary on whether or not the Tribunal should take account of the reasons why the commonhold association made the decision under consideration. Most consultees who responded simply indicated that it was a relevant factor to consider. However, the PLA did suggest an alternative means of framing this factor. It suggested that the Tribunal should consider "any expressed objectives which the association used to support its resolution" and "the positive impacts on the unit owners […] likely to result from the association's resolution".

### Should there be any additional statutory factors?

17.43 A few consultees suggested specific additional factors that should be considered by the Tribunal. CILEx said that the Tribunal might be assisted in making a determination

if it asked itself "what is fair and reasonable in accordance with the CCS". Stephen Desmond added that the Tribunal should consider how many unit owners had in fact voted in favour of the decision being complained of.

### Should the factors apply in all claims?

17.44 With regards to whether the suggested factors should apply equally in all minority protection applications (rather than varying in accordance with the decision in question) only one consultee provided substantive comments on this point. The Leasehold Advisory Service ("LEASE") responded to say that the factors did not sit well with two of the minority protection "gateways" suggested in the Consultation Paper. These two were:

(1) A decision by the directors to alter or revoke a section committee's powers (although, as explained above, we are no longer recommending that this gateway should exist); and

(2) A decision by the commonhold association to approve a budget exceeding a cost threshold in the CCS.

### What is the extent of the Tribunal's discretion?

17.45 A number of consultees were concerned that the factors suggested in the consultation question were not wide enough to cover every possible circumstance in which an applicant should be granted a remedy by the Tribunal in a minority protection case. These consultees suggested that, in addition to the factors set out by statute, the Tribunal should have discretion to consider any other factor it considered relevant.

## Discussion and recommendations for reform

### Are the factors necessary?

17.46 Most consultees responding to the Consultation Paper were in favour of providing the Tribunal with factors that should be taken into account when deciding whether to grant a remedy. While some consultees felt that the factors could be left entirely to the Tribunal's discretion, in our view, the factors will be a helpful guide for the Tribunal in making its determination in this new area of law. In addition, the factors will provide greater clarity for unit owners and the commonhold association when considering whether to make, or oppose a minority protection claim.

17.47 Additionally, we do not consider the alternative tests that were suggested to us – namely those based on "unfair prejudice" in company law, or on judicial review - provide an appropriate basis for minority protection for the following reasons.

(1) To bring an unfair prejudice claim under company law, the unit owner would need to demonstrate prejudice to his or her interests as a member of the commonhold association, which may be different to his or her interests as a unit owner.[14]

[14] Since the commonhold association is a company limited by guarantee, and general company law rules apply to it, a unit owner will be able to bring an unfair prejudice claim against the directors of the commonhold association in accordance with the Companies Act 2006 (the "Companies Act"). This will be

(2) Judicial review exists to ensure that public bodies are exercising their powers correctly. These cases often engage sensitive issues of public policy, constitutional law and politics. The tests employed are heavily influenced by such policy concerns, including to limit the circumstances in which the courts can intervene in decisions of public bodies. We think that it would be inappropriate to apply the same tests to disputes between private individuals in commonhold.

17.48 We therefore recommend the approach suggested in our consultation question, under which the Tribunal should be provided with factors that should be taken into account when determining whether to grant a remedy and which have been designed specifically for the commonhold context.

### A preliminary test or a balancing exercise?

17.49 With regards to the factors that should be considered, a majority of consultees thought that all three of the factors explained at paragraph 17.29 above were relevant to the Tribunal's decision-making. Consultees who raised concerns with one or more of the factors listed generally did so because of concerns that those factors would form a multiple-step test and could bar unit owners from obtaining a remedy in cases where their claim has merit. For example, the Consensus Business Group was concerned that unit owners should not be prevented from appealing a decision because they failed to meet the required level of impact.

17.50 We agree that it would be overly restrictive to use the factors as a preliminary threshold that must be satisfied before a case can be considered. Instead, the Tribunal should look at each case in the round, and take the above factors into account in reaching its decision. A preliminary threshold would also be difficult to apply in practice: The Tribunal would have to consider the facts of a particular case to determine if the requisite threshold had been met. Allowing the Tribunal to consider the merits of each case, and conduct a balancing exercise, will prevent costly litigation over whether a claim was eligible to be brought in the first place.

### Factor 1: Did the applicant vote against the decision being complained of?

17.51 Looking at each of the factors suggested in the Consultation Paper, the first factor generated the most concerns. Some consultees felt that it would be unfair to take into account the way in which the unit owner had voted, because that unit owner may have voted before realising the full implications of their decision. As noted above, the way in which a unit owner votes should not be determinative of whether he or she is able to obtain a remedy. In other words, it would not form part of a preliminary test. However, we do consider the way in which a unit owner voted to be a relevant factor for the Tribunal to consider when conducting a balancing exercise. Unit owners should be encouraged to carefully consider the implications of a particular decision for them before voting. As consultees pointed out, despite the fact that the consequences of a vote may not have been evident when the decision was first taken, generally speaking, we do not think that unit owners should seek to reverse decisions because of one-off incidents within the commonhold. There may be legitimate circumstances in

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the case irrespective of whether a minority protection application is available or not. However, as noted above, we do not consider unfair prejudice to be sufficiently broad as to capture the circumstances in which minority protection should be available, and should therefore not replace minority protection.

which an applicant's failure to vote should be viewed with leniency (such as where the applicant was unable to attend the meeting due to an emergency). However, the Tribunal should be cautious about reversing decisions with which unit owners initially agreed. Minority protection claims brought by applicants who voted to in favour of a resolution, as opposed to claims brought by applicants who attended a meeting and voiced their opposition, will be harder for the directors to anticipate and add an additional layer of uncertainty to unit owners' expectations.

### Factor 2: what impact does the decision have on the applicant?

17.52 Consultees were largely in agreement that the impact of the decision on the applicant was a relevant factor. However, consultees were divided as to whether any particular degree of impact should be required to be shown and, if so, as to what the degree of impact should be. We consider that the impact of the decision on the applicant(s) will be a relevant factor for the Tribunal to consider, because it should not be possible for a minority to undermine the proper functioning of the commonhold without demonstrating that the decision has had an adverse impact on them. We have been persuaded by consultees that it would be difficult to define a specific threshold of impact that is meaningful and flexible enough to cover the variety of circumstances that could arise. Instead, the Tribunal should be free to take into account the extent to which an applicant was impacted by the decision when deciding whether to grant a remedy, and what remedy to grant.

### Factor 3: What was the reason for the commonhold's decision?

17.53 We note that no consultee was opposed to the Tribunal considering the association's reasons for making the decision which is under challenge. In our view, the reasons why the association made the decision are relevant because the Tribunal will need to consider why the decision was supported by a majority of voting unit owners. In part this will help the Tribunal determine whether the decision is of benefit to unit owners in the commonhold. We agree with the comments made by the PLA, that the Tribunal's assessment of these reasons will need to be viewed objectively. It would not be possible for the Tribunal to attempt to assess why each participant had voted in a particular way. Instead, the Tribunal should look at the objectives of the commonhold association as a whole. While, as suggested by PLA, the Tribunal may wish to consider any objectives formally expressed by the commonhold association, we do not think the association should be prejudiced in a minority protection claim if clear objectives or reasoning for a resolution were not set out in advance of the vote having been carried out.

### Should there be any additional statutory factors?

17.54 With regard to the additional statutory factors suggested by consultees, CILEx commented that the Tribunal should consider what is "fair and reasonable in accordance with the CCS". In some cases, it will be relevant for the Tribunal to examine the decision in light of the terms of the CCS. For example, if a minority protection claim arises to challenge a budget exceeding a cost threshold, it will be relevant for the Tribunal to consider the existence of a cost threshold as part of its assessment. However, the Tribunal should not be restricted to assessing whether the decision subject to challenge is fair and reasonable in accordance with the CCS.

### Should the factors apply in all claims?

17.55 The same statutory factors should be relevant in all minority protection claims. We note LEASE's view that two of the gateways to minority protection set out in the Consultation Paper do not fit in well with the minority protection regime outlined. These gateways were: (1) the approval of a budget in excess of a cost threshold and (2) the revocation or amendment of powers delegated to a section committee by the directors of the commonhold association. For the reasons explained above at paragraphs 13.120 and 17.22, neither of these types of decision will attract minority protection in the manner envisaged in the Consultation Paper.

17.56 First, we described the threshold as a "cap" on expenditure in the Consultation Paper, which is likely to have created confusion as to the threshold's intended operation. In Chapter 13 we have clarified that the "cap" should be referred to as a "threshold", as the use of the term "cap" implied that it was not possible for the commonhold association to approve a budget exceeding that cap. Instead, the approval of a budget exceeding the "cost threshold" triggers a right to apply to the Tribunal for unit owners that they would not otherwise benefit from.

17.57 Second, directors' decisions do not fit into the minority protection scheme, for the reasons set out at paragraph 17.22. At paragraph 8.110 to 8.112 we explain how a section committee could challenge the amendment or revocation of their powers. Given there were no concerns raised over the other gateways, we think the same test is appropriate for any minority protection application, irrespective of the type of decision under challenge.

### What is the extent of the Tribunal's discretion?

17.58 Turning to the extent of the Tribunal's discretion, we agree with comments made by Westminster and Holborn Law Society and Boodle Hatfield LLP, that it is not possible for statute to predict all the factors that will be relevant in all minority protection cases. Instead, we think that the Tribunal should be able to consider all of the facts of the case, including those set out in statute. This will ensure that the test that the Tribunal will apply is flexible enough to respond effectively to different types of case. The Tribunal should be able to look at any relevant information to make any order it sees fit to make.

17.59 For example, it might be relevant for the Tribunal to consider whether the commonhold association had taken (or had offered to take) any steps to mitigate the impact of the decision on the applicant. It may also be relevant for the Tribunal to consider whether granting a remedy would cause any detriment to one or more other unit owners in the commonhold.

17.60 The Tribunal should balance the interests of the parties involved when coming to a decision on whether or not to grant the applicant a remedy. It follows, therefore, that the Tribunal should be provided with sufficient flexibility to deal properly with the cases that come before it. We therefore recommend that, in addition to considering a set of statutory factors, the Tribunal should be permitted to consider any other factors that it deems relevant in an individual case.

**Recommendation 103.**

17.61 We recommend that, on an application for minority protection, the Tribunal should consider the following factors when deciding whether to grant a remedy to the applicant:

(1) whether the applicant had voted against the decision being complained of and, if so, whether the applicant voted for or against the decision;

(2) the impact and degree of impact of the decision on the applicant;

(3) the reason(s) the commonhold association had for voting for the decision being complained of;

(4) the terms of the CCS, taken as a whole; and

(5) any other relevant factors.

## TIME LIMIT FOR BRINGING A CLAIM

17.62 As explained, a minority protection claim is a challenge to a decision which has been validly taken by the commonhold association. A minority protection claim therefore risks impacting on unit owners' certainty as to the prevailing legal position in commonhold. To minimise this risk and to increase confidence in decision-making, we consider that unit owners should only be able to bring a minority protection application to the Tribunal within one month, running from the point at which the commonhold association gave notice of the resolution in question. The right to make a complaint about a democratic decision of the commonhold association should not last indefinitely.

17.63 In most cases, the risk of a challenge will simply be a factor for the directors to consider when implementing a decision. Where a challenge is considered unlikely, the directors may decide to act on the decision straight away. In other situations, it may be prudent for the directors to wait until the one-month period for challenge has expired before acting. For example, in a case where the decision is over an amendment to the CCS, the amendment will only take legal effect once the revised CCS is registered with HM Land Registry by the directors. If the directors anticipate a challenge, they could choose to wait to register the CCS until after the time limit has expired. Taking this approach would ensure that unit owners can be confident that the rules applicable to them at any one time are those registered with HM Land Registry and would prevent unit owners from being adversely impacted by a reversal of the resolution in the Tribunal.

17.64 However, in one circumstance, we think the directors should be prevented from acting on a resolution of the commonhold association, until the time limit for a challenge has expired.

17.65 In the event that the commonhold association approves a budget in excess of a cost threshold specified in the CCS, the directors should be prevented from incurring costs

exceeding that threshold for one month following approval of the budget. This "cooling-off" period is necessary to ensure that unit owners have the opportunity to bring proceedings in the Tribunal. That is because, as we explain in Chapter 13, it will not be possible for unit owners to challenge any costs that have already been incurred.[15] Imposing a cooling-off period ensures that the directors are not able to head off applications for minority protection by incurring costs as quickly as possible following approval of the budget. If expenditure on an improvement of enhanced service is time sensitive due to an emergency, then the directors can make an emergency assessment. Such an emergency assessment would fall outside the scope of the minority protection scheme.

**Recommendation 104.**

17.66 We recommend that it should only be possible for a unit owner (or owners) to bring an application for minority protection within one month of the commonhold association giving notice of the resolution being complained of to unit owners.

17.67 We recommend that directors of the commonhold association should not be permitted to incur costs above a cost threshold set out in the CCS for a period of one month following the commonhold association's approval of a budget. That is to enable any unit owners opposed to the decision to bring a minority protection claim.

## REMEDIES

17.68 In the Consultation Paper we provisionally proposed that the Tribunal should be able to allow the decision being complained of to stand or to be annulled. We went on to say that, if the Tribunal were to allow a decision to stand, it should be able to attach conditions to its decision.

17.69 We envisaged that conditions could be used to mitigate the negative impact of the decision on the applicant. For example, the Tribunal might order the commonhold association to pay compensation to the applicant(s). Alternatively, the Tribunal might specify that the decision only applies for the future or does not apply to the applicant for a specified time period. For example, if the commonhold association decided to amend the terms of the CCS to ban pets, the Tribunal might agree for the CCS to be varied to prevent unit owners from acquiring pets in the future, on condition that any unit owner who already owns a pet is able to keep that pet.

### Consultees' views

17.70 The vast majority of consultees agreed with our provisional proposal.

17.71 CILEx agreed with the proposal on the basis that the powers envisaged were in keeping with the Tribunal's "current case management powers".[16] CILEx went on to

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15 See para 13.149.

16 See the Tribunal Procedure (First-tier Tribunal) (Property Chamber) Rules 2013.

say that “the Tribunal would be well placed to impose such conditions where it thinks fit and would do so with the interests of fairness and reasonableness at heart”.

17.72 Very few consultees disagreed with our provisional proposal. Those who did generally did so on the basis of general criticisms they had of the Tribunal. No consultees provided substantive reasons as to why the remedies put forward in our provisional proposal were unsuitable for minority protection claims.

### Discussion and recommendations for reform

17.73 In light of the strong support for the proposal, we recommend that the Tribunal should have the ability either to restore the previous state of affairs by annulling the decision being complained of or allow the commonhold association’s decision to stand. We also recommend that if the Tribunal allows a decision to stand, it should be able to place conditions on the decision to mitigate the negative impact of the decision on the applicant(s). By giving the Tribunal the ability to impose conditions, the Tribunal will be empowered to promote effective compromises between the applicant(s) and the commonhold association.

17.74 If Government formalises plans for a dedicated housing court then jurisdiction to decide minority protection claims might be better placed with that new body.

#### Recommendation 105.

17.75 We recommend that the Tribunal should be able either to annul a decision being complained of in a minority protection case or allow that decision to stand.

17.76 We recommend that the Tribunal should be able to attach conditions to a decision to allow a decision being complained of to stand.

# Chapter 18: Enforcement

## INTRODUCTION

18.1 In this Chapter, we consider the actions that a commonhold association can take where a unit owner, or their tenant, breaches a term of the commonhold community statement ("CCS"). Compliance with the CCS is particularly important in commonhold. Often unit owners will be living in close proximity and the actions of one unit owner can have a significant impact on others in the building. The CCS therefore contains rules designed to protect unit owners' enjoyment of their properties and to ensure the smooth-running of the commonhold.

18.2 Despite the importance of ensuring that rules are complied with, there are concerns that the commonhold association does not have sufficient powers to tackle breaches of the CCS. In particular, we have been told of concerns that there is no effective way for the association to enforce the payment of commonhold contributions. The absence of an effective means of doing so is of particular concern, as the failure of one unit owner to pay his or her share of the contributions could increase the sums payable by others. In extreme cases, a failure to pay might lead to the insolvency of the association.

18.3 To address these concerns, we make recommendations in this chapter that will enhance the association's powers significantly where a unit owner fails to pay his or her share of the commonhold contributions. The association will be able to take much swifter action to recover outstanding sums, which will help preserve the solvency of the association and protect the other unit owners in the building.

18.4 In this chapter we also explore the case for improving the association's enforcement powers when faced with other, non-financial, breaches of the CCS, such as an obligation to keep the unit in repair or a rule prohibiting pets. However, we do not make any recommendations in respect of such breaches at this stage. We do not currently consider there to be any additional power that would be helpful and appropriate within the commonhold context. We explain this position in more detail below, and discuss the remedies that are already available to the association under the general law.

## THE ASSOCIATION'S POWERS TO ENFORCE NON-FINANCIAL BREACHES

18.5 The association is not equipped with any bespoke powers to tackle non-financial breaches of the CCS over and above those available in the general law.[1] We explained in the Consultation Paper that, in other jurisdictions, the body equivalent to the commonhold association has specific powers to tackle non-financial breaches. For example, fines can be imposed in New South Wales (Australia), British Columbia (Canada), and in some American states. In addition, in British Columbia, the

[1] See CP, paras 14.8 and 14.9.

association can deny access to recreational facilities where an owner breaches certain rules.[2]

18.6 We invited consultees' views on whether the commonhold association's powers to address non-financial breaches should be enhanced, following the example of these other jurisdictions, and if so how.

### Consultees' views

18.7 The vast majority of consultees responding to this question said that the association should be given greater powers to tackle non-financial breaches of the CCS.

18.8 Of those in favour of enhancing the association's powers, a number said that enhanced powers would help deter unit owners from breaching the CCS. Some consultees also noted that non-financial breaches of the CCS might cause as much disruption as financial ones. Consultees referred in particular to problems caused by anti-social behaviour, excess noise, property damage, blocking of common parts and "nuisance tenants" in sub-let flats. The Confederation of Co-operative for example, commented that while the paper "refers to breaches such as keeping pets or requiring commonholders to maintain their properties… there could be much more serious cases of anti-social behaviour and major health and safety issues". They said that the lack of effective enforcement powers might "mean that commonholders have to endure months of suffering before a problem case is resolved through civil or general law".

18.9 Arguments against enhancing the association's powers fell within two broad categories. Some consultees did not see a need for greater powers over and above those available under the general law, or were not aware of any other powers that would be helpful. Others expressed concern that the use of enhanced powers might cause tensions within the commonhold or could be subject to abuse. The Federation of Private of Residents' Associations ("FPRA") said that the examples provided of the powers available in other jurisdictions appeared to be of a punitive nature "going beyond compensation for loss or damage or the cost of putting things right". They argued that such powers would be more properly exercised by a court rather than a private association.

18.10 With regards to how the association's powers might be enhanced:

(1) The most popular suggestion made by consultees was an ability for the association to impose fines. A number of consultees commented that a system of fines would offer a practical solution that would be easy to administer. However, some consultees argued that there would need to be adequate safeguards in place before fines could be imposed. For example, the Residential Landlords Association suggested that the power to impose fines should only be available through the courts and not directly imposed by the commonhold association.

(2) A smaller number of consultees said that the association should have the power to exercise "self-help". In other words, the association should be able to remedy

[2] CP, paras 14.27 to 14.28.

the breach itself and then charge the cost to the unit owner. One consultee, responding confidentially, thought that the power to carry out remedial works would be particularly helpful where the unit owner's actions in respect of his or her unit were causing damage to the common parts. Penny Atkinson also thought that it would be helpful for the association to be able to remove items left by a unit owner or tenant in the common parts.

(3) A couple of consultees favoured a power for the association to impose restrictions on a unit owner's access to the commonhold's facilities. However, others felt that this option would be difficult to enforce and would only be helpful on larger sites with shared facilities.

(4) Another remedy, suggested by Peter Smith (academic), would be to deprive the unit owner of his or her vote in commonhold decisions. He also suggested a power for the association to suspend a seriously disruptive tenant's occupation of the commonhold unit.

(5) Finally, several consultees thought that the association should be given a power to sell the defaulter's commonhold unit following serious breaches. Mark Chick (solicitor) said that the threat of the unit's sale would act as the "ultimate deterrent" and the joint response of some members of the London Property Support Lawyers Group (the "joint response") argued that, without such a power, the association's powers "lacked teeth". Other consultees were however opposed to such a power, saying that the sale of the unit would be draconian and disproportionate to the breach.

### Discussion

18.11 We acknowledge the high level of support for our provisional proposal, and agree that serious non-financial breaches of the CCS could make life very difficult for those in the commonhold. At the same time, we have reservations about the appropriateness of many of the powers suggested above.

18.12 We note that the most popular suggestion made by consultees was an ability for the association to impose fines. However, the ability to impose fines is unlikely to be appropriate in most commonholds. We have concerns about providing the association with a general ability to impose fines without first having obtained a court or Tribunal determination. There would be a risk of the association imposing fines in the absence of clear evidence that a breach had occurred. While the unit owner would be free to challenge the payment of this fine, the unit owner might feel under pressure to pay the fine in order to avoid the risk of court proceedings and legal costs. In addition, we are conscious of the social dynamic within the commonhold, where members of the commonhold association will be the neighbours of the defaulter. In certain commonholds, an ability for the association to impose fines directly on unit owners could enflame disputes or give rise to concerns of discrimination. For similar reasons, we do not consider it appropriate for the commonhold association to be given a general right to restrict a unit owner's access to parts of the commonhold or suspend voting rights without a court or Tribunal order. However, at the same time, it would not be cost-effective to require the association to obtain a court or Tribunal order before imposing a fine or other penalty, particularly for minor breaches of the CCS. It would

be possible to revisit this position in the future, should there be a quicker and more cost-effective way of obtaining a determination.[3]

18.13 In addition, imposing a fine (or restricting the owner's voting or access rights) would not be an appropriate way of tackling more serious breaches. For example, a fine would unlikely be a sufficient remedy where the unit owner's action (or inaction) is causing damage to the common parts.[4] An injunction which requires the unit owner to prevent or remedy the damage would be a more effective remedy in these circumstances and such a power is already available under the current law.

18.14 Consultees were particularly concerned about the need for effective enforcement powers where a unit owner's (or their tenant's) breach is compromising the health and safety of others, or where a unit owner or tenant is engaging in violent or abusive behaviour. However, in these circumstances, there are already statutory provisions in place to protect those in the commonhold. These provisions can be relied upon regardless of whether a term of the CCS has been breached. For example, the police, local authorities and housing providers have a range of powers available to tackle anti-social behaviour in both public and private housing.[5] Powers include an ability to grant anti-social behaviour injunctions against any person over the age of 10, which in more serious cases, may have the effect of preventing the individual from returning to the commonhold. Where unit owners are particularly concerned about the risk of nuisance arising from short-term lets or other occupancy arrangements, such as Airbnb lettings, they would be able to ban such arrangements in the local rules of the CCS, under our recommendations in Chapter 10.[6] Local authorities also have duties to investigate and tackle noise complaints and other nuisances, such as infestations and the accumulation of rubbish.[7] And unit owners would be required to comply with various pieces of health and safety legislation in respect of their premises.[8]

18.15 Under the general law, the association would also be able to exercise "self-help" in certain circumstances. For example, if the unit owner's or tenant's property were to encroach on or cause damage to the common parts, the association would be able to take certain steps to remove the items or to prevent further damage.[9]

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3 For example, if proposal for a new combined Housing Court are taken forward, or if a commonhold regulator is established. See Ch 16 for further discussion.

4 For example, because a unit owner may prefer to pay any fines ordered by the court and continue to flout the terms of the CCS.

5 In particular the Anti-social Behaviour, Crime and Policing Act 2014.

6 We recommend that, subject to certain exceptions (such as in the social housing sector), it should be possible for a CCS to include a local rule preventing lettings of up to six months. See discussion from para 10.42 onwards.

7 Under the Housing Act 2004 and the Environmental Protection Act 1990.

8 For example, unit owners will be required to co-operate with the commonhold association in carrying out its duties under fire safety regulation (Regulatory Reform (Fire Safety) Order 2005) and under asbestos regulation (Control of Asbestos Regulations 2012). Unit owners will also be under a duty to ensure that visitors to their premises, or others in the vicinity of their premises, are reasonably safe (Occupiers Liability Act 1957 and Occupiers Liability Act 1984).

9 The right of self-help or "abatement" will be available as a remedy where the unit owner is trespassing on another's property, or where the owner's actions constitute "private nuisance". Private nuisance arises, for

18.16 We note that there was some support amongst consultees for providing the association with a power to sell the commonhold unit as a way of addressing non-financial breaches of the CCS. We agree that such a penalty would give unit owners an incentive to comply with the CCS. However, as explained in the Consultation Paper, our view is that the sale of the unit would be a disproportionate response to non-financial breaches of the CCS and we do not recommend this power be introduced. Our view is that, so far as possible, commonhold should put unit owners in the same position as freehold house owners, unless there is sufficient reason to justify a different approach. While we appreciate that the likely proximity between commonhold units, and the existence of shared communal spaces within the commonhold carries a greater risk of inconvenience to others, owner-occupiers in terraced freehold houses will also be affected by the behaviour of their neighbours. Such freehold owners would need to rely on the remedies available under general law and would not be able to apply to the court for the sale of their neighbour's property.

18.17 In summary therefore, at this stage, we are not convinced that any of the powers put forward to strengthen the association's powers would be necessary or appropriate.

18.18 While we are not proposing the introduction of new statutory powers that should be available to the commonhold association as a matter of course, at present there would be nothing to prevent an individual commonhold from enhancing the association's powers by adding terms to the local rules of the CCS. The local rules of the CCS might, for example, include a right for the association to dispose of any property left in the common parts after a certain period of time. Although it is important to note in this respect that the association would never be able to add a local rule to the CCS which would require the sale of the unit, as a result of a particular breach.[10]

18.19 In order to enhance the association's powers in the CCS, there would need to be a high level of consensus amongst the unit owners. We recommend in Chapter 10 that, in order to introduce a new local rule, 75% of those turning up to vote would need to vote in favour. Additionally, if any unit owner was adversely affected by a change to the local rules, he or she would have the opportunity to challenge the amendment in the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal") under our recommendations for minority protection in Chapter 17. Such provisions mean that enhanced powers are very unlikely to be added to the CCS unless considered appropriate and desirable in that particular commonhold.

18.20 In addition, commonhold does not generate the same risks as can arise in leasehold: that owners will be required to pay excessive or punitive amounts following a breach. In the leasehold context, the landlord will normally draw up the terms of the lease and

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example, where the actions of one owner on his or her own land affects another's enjoyment of their property. There are certain restrictions on the exercise of self-help, for example, it must be possible to abate the nuisance peacefully. Additionally, the association would have certain rights to dispose of property left in common parts after serving a series of notices on the unit owner under the Torts (Interference with Goods) Act 1977.

10 For a discussion of the restrictions that may be imposed on the content of local rules, see para 10.13. In the second part of this chapter, we recommend that the association should have a statutory right to apply to court to seek the sale of the defaulter's unit to recover commonhold contributions following a financial breach. However, we attach a number of safeguards and conditions to the exercise of this right, which should not be undermined by less stringent conditions in the local rules of the CCS.

decide on the penalties that should be applied following a breach of these terms. In commonhold, the unit owners themselves can decide on the terms of the CCS and can decide whether any penalties should be included. The same individuals would be subjected to these penalties if they were to breach the CCS. It is therefore unlikely that unit owners will agree to subject themselves to excessive or unreasonable payments. Consequently, we view the risk of abuse as being very low and do not recommend any reform at this stage to address such a risk. If evidence of abuse arises in the future, it would be possible to respond in a targeted way to prevent the abuse from continuing. We therefore recommend that this position be kept under review, and should abuses arise in the future regarding the association's powers, legislation should intervene.[11]

18.21 We now move on to considering breaches of the CCS's financial provisions. The Consultation Paper sought to address two difficulties arising from the current legislation. First, the concern that the powers available to the commonhold association to enforce the payment of commonhold contributions are not effective enough. Second, the absence of any regulation governing the amount of interest that may be charged on the late payment of commonhold contributions.

## THE ASSOCIATION'S POWERS TO ENFORCE FINANCIAL BREACHES

18.22 In the Consultation Paper we explained how important it is that unit owners pay their commonhold contributions on time.[12] Funds will need to be available to pay for the maintenance of the common parts and for the provision of any services to the unit owners. Where a unit owner fails to pay his or her share of the commonhold contributions on time, there is a risk that the other unit owners will be required to make up the shortfall until the sums can be recovered. Where a unit owner fails to pay his or her share, there will not be any external third-party landlord who might be willing to cover the shortfall in funds until the debt can be recovered. If the other unit owners are unable to meet this shortfall, and the commonhold's costs go unpaid, those who are owed money by the association (the association's "creditors") might decide to bring insolvency proceedings against the association. While in Chapter 19 we introduce measures to protect unit owners and their mortgage lenders in the event of the association's insolvency, it would be far preferable to avoid an insolvency situation in the first place.

18.23 Despite the importance of ensuring that commonhold contributions are paid, the association has limited enforcement powers to recover sums from unit owners who fail

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11 Should such abuses arise in the future, they could be addressed by introducing a restriction on the local rules that may be included in the CCS through secondary regulation. Another way to address such an abuse would be to extend the regulation of administration charges, which applies in leasehold, to cover sums demanded by the commonhold association following a breach of the CCS. The regulation of administration charges is provided for in the Commonhold and Leasehold Reform Act 2002, sch 11. Under these provisions, leaseholders can challenge the reasonableness of sums demanded by their landlord in connection with a breach, or alleged breach, of lease terms. An ability to challenge such sums in commonhold would not have any impact on the solvency of the commonhold association (unlike an ability to challenge commonhold contributions after they have been incurred, see Ch 13).

12 CP, para 14.36.

to pay their share. The commonhold association has two bespoke powers provided by the commonhold legislation.

(1) The power to charge interest on the late payment of commonhold contributions (discussed further from paragraph 18.142 below). Whenever a unit owner fails to pay his or her share of the commonhold contributions on time, he or she must pay interest to the commonhold association at the rate prescribed in the local rules of the CCS.

(2) The power to divert rent from a tenant. If a unit owner fails to pay his or her share of the commonhold contributions, and the unit owner has let his or her property to a tenant, the commonhold association may require the tenant to pay any rent due under the tenancy agreement to the association instead of the unit owner.

18.24 The ability to charge interest will not, however, provide a means of recouping the amount owed and will not always act as a sufficient deterrent. Further, the diversion of rent procedure will only assist where the unit owner has let his or her property on a tenancy agreement. For the most part, the association will be in the same position as any other unsecured creditor[13] of the defaulting unit owner. To recover the debt, the association would be required to seek and enforce a money judgment or bring bankruptcy proceedings against the unit owner. As we explain in the Consultation Paper, these enforcement methods are complex and time-consuming, and may not always result in the association being paid in full.[14] For example, if the association wanted to enforce the sale of the commonhold unit in order to recover the debt, the association would have the same starting point as any other unsecured creditor. The association would be required to follow a lengthy procedure, incurring court fees and other legal costs. The association would first need to obtain a money judgment (which in itself involves several procedural steps), then an interim charging order over the property, followed by a final charging order, and then seek an order for the sale of the property in court. While the association is engaged in these lengthy enforcement procedures, sums owed by the defaulting unit owner will continue to accrue, and the association will rack-up further costs in court and legal fees.

18.25 Respondents to the Call for Evidence told us that the association's powers to address financial breaches of the CCS needed to be strengthened, and we agreed. We provisionally proposed in the Consultation Paper that the association should be provided with an automatic statutory charge (which is a type of security interest)[15] over the commonhold units for the payment of commonhold contributions.[16] We explained that previous iterations of commonhold legislation had recommended such a charge, and that precedent for such a charge can be found in other jurisdictions with a

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13 This means that the creditor does not have a security interest over property, which would entitle the creditor to be paid his or her debt in advance of other creditors on the sale of the property, see also para 18.26, below.

14 CP, paras 14.18 to 14.25.

15 See Glossary. Most mortgages are a form of charge. When a lender loans an amount of money, it will often seek a security interest over the borrower's property to ensure that the loan is repaid when the property is sold.

16 For discussion of the proposed charge, see CP, paras 14.45 to 14.68.

commonhold-equivalent. The proposed charge would enable the association to apply directly for the sale of the commonhold unit, rather than needing to take the additional steps of obtaining a money judgment, and applying for interim and final charging orders.

18.26 The statutory charge would put the association in the position of a "secured" creditor rather than an ordinary, unsecured creditor. That means that, on the sale of the debtor's property, the association would be paid the commonhold arrears from the proceeds of sale, and would be paid in advance of other creditors who do not own a security interest over the property. If a defaulting unit owner decided to sell his or her property, or if the unit owner became bankrupt and the property needed to be sold to repay his or her debts, the association would therefore be guaranteed an amount of money from the proceeds of sale in order to clear the arrears. That is provided there is sufficient value or "equity" in the property to do so.

18.27 In the Consultation Paper, we considered the way in which the association should be able to enforce the charge and exercise the sale of the commonhold unit.[17] Previous drafts of the commonhold legislation had suggested that the association should be able to arrange the sale of the unit itself, in a similar way to mortgage lenders. Our view, expressed in the Consultation Paper, was that it would be inappropriate for the commonhold association to be able to arrange for the sale of the property itself. We explained that sales by mortgage lenders are subject to a regulatory framework that has been designed to protect a borrower who is in default and ensure that the sale of a home is a last resort when the debt cannot otherwise be repaid. This regulatory framework would not apply if the association were able to sell the property. We therefore proposed that the association should be required to apply to court for an order selling the property in order to recover the commonhold arrears. A receiver would then be appointed to conduct the sale and distribute the proceeds.

18.28 For the association's charge to be effective, we proposed that the statutory charge should take priority over any other charges, such as mortgages, secured against the defaulter's commonhold unit.[18] On the sale of the unit, the association would be entitled to be repaid the commonhold arrears before any mortgage lender would be repaid. Any balance would then be returned to the unit owner. We were concerned that if the mortgage lender were repaid before the association, there might be insufficient equity in the property, after repaying the lender, to pay the commonhold arrears.

18.29 While at first glance, providing the association with a statutory charge which takes priority over mortgages might appear unattractive to lenders, we explained that, in reality, lenders would also benefit from the commonhold's enhanced powers. The statutory charge would provide a clear incentive for unit owners to pay their contributions on time. Such payments are necessary to ensure the maintenance of the commonhold and preserve the value of the units over which the lenders have a secured interest. Further, even after providing the association with a first-ranking charge, the security available to lenders over commonhold units would be an improvement to that currently available over leasehold flats. Leasehold properties are

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17 CP, paras 14.54 to 14.57.

18 CP, Consultation Question 85, paras 14.50 to 14.52 and para 14.60.

susceptible to forfeiture. Forfeiture enables a landlord to bring the leasehold interest to an end following a leaseholder's breach of the lease terms. On forfeiting the lease, the lender would lose its security over the leasehold interest. While there is an obligation for landlords to notify mortgage lenders of forfeiture proceedings, this does not always happen in practice and can cause significant inconvenience to lenders.[19] An advantage of commonhold for lenders is that a commonhold unit can never be forfeited or terminated. If a commonhold unit were sold under our proposals, the lender would remain a secured creditor, albeit that the association's security would take priority.

18.30 The sale of the commonhold unit would also be an improvement to leasehold forfeiture from the perspective of the defaulting unit owner. An order for sale is a much more proportionate response to financial breaches than that of leasehold forfeiture. Under our proposals for commonhold, the unit owner would be returned any balance from the proceeds of sale of the unit, after paying the commonhold association and any mortgage lender. Conversely, where a landlord forfeits a lease, the landlord is not required to pay any money to the leaseholder, even where the property is worth much more than the debt owed. Often, therefore, forfeiture results in a windfall for the landlord. In the Law Commission's separate report on Termination of Tenancies for Tenant Default[20] ("Termination of Tenancies Report"), we recommend that the landlord should no longer be able to terminate a lease by forfeiture. Instead, where a leaseholder breaches a term of the lease, the landlord will be able to apply to court for an order that is appropriate and proportionate in the circumstances.[21]

18.31 While more proportionate than forfeiture, the sale of a commonhold unit would still be a significant step. As the unit owner would be at risk of losing his or her property, the sale of the unit should be an option of last resort. In the Consultation Paper, we made several provisional proposals aimed at protecting defaulting unit owners who are faced with enforcement proceedings. In particular, we proposed that the commonhold association should be required to follow a pre-action protocol before applying to court for an order for sale, and that the court should only be able to order the sale of the unit where the arrears exceed a certain amount.[22]

18.32 We asked consultees whether they agreed with our proposed mechanism to enhance the association's powers when faced with financial breaches of the CCS.

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19 Under the Civil Procedure Rules, the claimant must serve the particulars of the possession claim on any party entitled to seek relief from forfeiture. Section 146(4) LPA 1925 provides that a lender is entitled to apply for relief from forfeiture. While forfeiture will bring the leasehold interest to an end (either on re-entering the property or on serving the possession proceedings), the lender can apply for the lease to be reinstated or ask the court to be granted a new tenancy over the property. In response to the Call for Evidence, one building society told us that there had been an increase in the number of forfeiture proceedings without prior warning and that the costs involved in seeking relief can be significant: see CP para 14.52.

20 (2006) Law Com 303.

21 We discuss our recommendations in the Termination of Tenancies Report in more detail from para 18.47 below.

22 CP, para 14.58.

### Consultees' views

18.33 A sizeable majority of consultees agreed with our provisional proposal to provide the association with a first-ranking statutory charge over the commonhold units for the payment of commonhold contributions. The proposal was strongly supported by leaseholders, residents' management companies, leaseholder representative groups, other individuals (including members of our advisory group), commercial freeholders and developers. In addition, more law firms and legal representative bodies supported than opposed the proposal. However, the only two housing associations and the only three trade associations responding, including UK Finance (association representing mortgage lenders) and the Buildings Society Association, disagreed with the proposal.

18.34 Beginning with the arguments in favour of the proposal. The All-Party Parliamentary Group on Leasehold and Commonhold Reform (the "APPG") referred to our proposal as a "long overdue reform". They noted that during the passage of the 2002 Act through Parliament, the Act was criticised for being "seriously deficient in lacking a real remedy" against those who fail to pay their commonhold contributions. Other consultees who agreed with the proposal said that the charge would help protect unit owners against additional demands for costs and would help preserve the solvency of the commonhold association. Consultees also argued that the proposal would help to ensure that funds are available to maintain the property, which would benefit unit owners and lenders alike. The Leasehold Knowledge Partnership ("LKP") said that lenders should "recognise the importance of the commonhold being adequately maintained and managed to preserve the value of the unit owner's interests in the commonhold". Further, Irwin Mitchell LLP (solicitors) commented that the charge in favour of the commonhold association would "focus people's minds" on the importance of complying with their obligations in the CCS.

18.35 Several consultees were however sceptical about lenders' acceptance of our proposed first-ranking charge, and thought our proposal might discourage lenders from lending on commonhold units. The British Property Federation, for example, said:

> the consultation suggests that mortgagees will see the sense in this proposal, as it could help prevent insolvency of an association and ought to allow the building to be kept in good repair and condition, which shortage of funds due to non-payment by unit holders might prevent. Unless mortgagees are happy to provide funding to unit holders however, the popularity of commonhold as a tenure must be in some doubt.

18.36 These concerns appear to be well-founded as both UK Finance and the Buildings Societies Association rejected the proposal. UK Finance said:

> [the proposal] would be unacceptable for mortgage lenders. Mortgage lenders do want commonholds to be able to ensure that individual unit holders pay their share towards the maintenance and long-term stewardship of a building, but this should not take priority over the interests of mortgage lenders. The introduction of a first-ranking statutory charge would deter mortgage lenders from accepting commonhold as security.

18.37 UK Finance also referred to the "significant risk" that:

where no action is taken against non-paying unit owners, the amounts secured by the first charge could increase indefinitely. The increasing balance would take priority over the mortgage lender's charge unless the lender was willing (and permitted by the mortgage contract) to step in to make the payments.

18.38 The Building Societies Association made similar comments, agreeing that there should be "a mechanism that ensures each unit holder pays their fair share" but that this mechanism "should not take priority over a lender's security". The association acknowledged that the lack of forfeiture within commonhold provided a clear advantage over leasehold, but said that it supported the Law Commission's work to revisit the "archaic law" of forfeiture.

18.39 The two housing associations responding also disagreed with the proposal. The Guinness Partnership was concerned that the association's prior charge might affect the ability of shared ownership leaseholders to obtain a mortgage. However, the association's statutory charge would be secured against the commonhold unit and should not therefore affect any lending secured against the shared owner's leasehold interest. Notting Hill Genesis argued that the charge should not come into effect without a court or Tribunal order.

18.40 Some consultees argued that the lender should be provided with an opportunity to pay the commonhold arrears and add it to the mortgage amount. Christopher Jessel (solicitor) commented that, in the leasehold structure, mortgage lenders often step in to pay outstanding rent and service charges and add it to the mortgage amount. He thought that there would be no practical difference if the commonhold unit were the security.

18.41 Other consultees were concerned about the impact of the first-ranking charge on unit owners. Some were of the view that the proposal would make it harder for unit owners to sell their properties, or to obtain additional finance. One individual, responding confidentially, said that the proposal might put owners at risk of losing their property for a small debt, and would make commonhold unattractive to prospective purchasers. In addition, Boodle Hatfield LLP (solicitors) argued that the proposal was a "disproportionate" response to financial breaches of the CCS, while Trowers & Hamlins LLP (solicitors) felt that the charge gave "inappropriate rights" to the association. It suggested instead that the association should be able to seek the sale of the property in court or Tribunal proceedings.

### Discussion

18.42 The consultation responses from UK Finance and the Buildings Society Association make it apparent that, if the commonhold association were provided with a first-ranking charge, there would be a real risk of deterring lenders from lending on commonhold units. If lenders were unwilling to accept commonhold units as adequate security, prospective purchasers might find it difficult to obtain the necessary financing to buy a commonhold unit. Existing unit owners might also face difficulty selling their units, or using their unit as security for additional borrowing. This is despite our view, set out above, that the charge would also be of benefit to lenders, and that the security available to lenders would be an improvement to that available over leasehold interests. Realistically, however, without lenders' acceptance we cannot proceed with our proposal to provide the association with a first-ranking charge for the payment of

commonhold contributions. The reinvigoration of commonhold would be significantly hampered, if not prevented, if lenders were unwilling to lend on commonhold units.

18.43 However, there still needs to be a mechanism that will enable the commonhold association to recover sums in a more efficient way. A high percentage of consultees responding to this consultation question argued that the existing powers of the commonhold association are deficient. UK Finance and the Building Society Association, while rejecting the idea of a first-ranking charge, agreed that the association's powers needed to be enhanced, but by another means. If the association's powers are not so enhanced, the lack of an effective enforcement mechanism might still deter lenders from accepting commonhold units as adequate security.

18.44 In our view, the revised enforcement mechanism should meet the following objectives, which will improve the powers of the commonhold association, while addressing the concerns expressed by lenders.

(1) The association should be placed in a better position than an ordinary unsecured creditor of the defaulting unit owner. We explain at paragraph 18.24 above that the enforcement mechanisms available to such creditors can be costly and time-consuming. The creditor would need to follow several procedural steps in order to recover its debt, and issue a number of court applications. If the commonhold association were not provided with any quicker route to recover commonhold contributions, there is a risk that the other unit owners would be required to meet the shortfall during the course of these lengthy proceedings. Additionally, without any quicker way of recovering these sums, there is a concern that there would not be sufficient funds available to maintain the property, and, in more serious cases, the solvency of the association could be put at risk. The association should therefore be provided with an ability to take swifter action to recover commonhold debts.

(2) However, to address the concerns of lenders, the association should not be provided with any security over the commonhold unit (such as a statutory charge) superior to that of the mortgage lender.

18.45 These objectives can be achieved by providing the association with a freestanding right to apply to court for the sale of the commonhold unit, without an accompanying charge over the commonhold unit.

18.46 Given the concerns expressed by lenders, we will therefore not be recommending that the association be provided with a statutory charge over the commonhold units for the payment of commonhold contributions, as we proposed in the Consultation Paper. Instead, we will be modelling our recommended approach on a procedure set out in our Termination of Tenancies Report, by providing the association with a freestanding right to apply to court for the sale of the commonhold unit. Our recommendations in the Termination of Tenancies Report have already received the acceptance of lenders. Given the importance of lenders' willingness to lend on commonhold units, adopting a similar approach for commonhold has the benefit of ensuring lenders will be supportive of our revised approach. In turn this ensures that prospective and existing unit owners will be able to buy, sell and remortgage their commonhold units.

We discuss the recommendations in our Termination of Tenancies Report, and its parallels with our revised enforcement mechanism for commonhold, below.

### An enforcement mechanism based on the Termination of Tenancies Report

18.47 The Law Commission's Termination of Tenancies Report recommends the abolition of forfeiture, and its replacement with a "simpler, more coherent statutory scheme based on what is appropriate and proportionate in the circumstances".[23] The law of forfeiture applies to commercial, agricultural and residential tenancies of any length but its principal significance relates to long residential leases of over 21 years and tenancies of commercial premises.[24] Under the regime recommended in the Termination of Tenancies Report, rather than the landlord bringing a tenancy to an end through forfeiture, the landlord would need to take the following steps:

(1) The landlord would need to serve a prescribed "default notice" on the tenant providing him or her with an opportunity to address the breach within a certain timeframe.

(2) If the leaseholder failed to remedy the breach within the time specified in the default notice, the landlord would be able to bring a termination claim in court. However, the termination of the tenancy would not be the only possible outcome. The court, once satisfied that a breach of the tenancy had occurred, would be able to make any order that it considered appropriate and proportionate in the circumstances. The court would be provided with a list of remedies under the statutory scheme which would apply in addition to powers available under the general law (such as the ability to grant injunctions). Powers available under the statutory scheme include:

(a) A termination order: This is the ultimate sanction and would bring the tenancy to an end on a specified day. The termination order would also bring to an end any interests granted out of that tenancy, such as any mortgages and sub-tenancies. This order therefore has similar consequences to forfeiture. The landlord would not be required to return any money to the tenant following the termination, and any lender's security over the tenancy would be lost. This order would be used where the court did not consider it appropriate to give the tenant any further chances to remedy the breach.[25]

(b) A remedial order: Where the court considers that the tenant should be given an opportunity to preserve the tenancy, a remedial order can be granted. The effect of the remedial order would be to stay the landlord's

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23 Termination of Tenancies for Tenant Default (2006) Law Com No 303, para 1.3.

24 This is because agricultural premises tend to be let on periodic tenancies (for example from "year-to-year") which are terminable by notice. In the remainder of the residential sector the law of forfeiture is rendered largely redundant by the statutory codes of security prevalent there (see Termination of Tenancies for Tenant Default (2006) Law Com No 303, para 1.2).

25 For a full discussion of the termination order see, Termination of Tenancies for Tenant Default (2006) Law Com No 303, paras 5.20 to 5.31.

termination claim for a period of three months to allow the tenant to remedy the breach.[26]

(c) An order for sale: Alternatively, the court would be able to order the tenant's interest to be sold. The tenancy would be sold subject to any pre-existing interests granted out of the tenancy, such as sub-tenancies and mortgages (so unlike the position where the tenancy is terminated, the sale of the unit would allow qualifying interests to be preserved). Anyone with a qualifying interest over the property, such as a sub-tenant or a mortgage lender, would be able to make representations to the court for the property to be sold, rather than terminated. A receiver would be appointed to distribute the proceeds of sale. Ordinarily, after paying the receiver's fees, the landlord would be paid any arrears from the proceeds of sale, followed by the repayment of any lenders with security over the lease. Any balance from the proceeds of sale would then be returned to the tenant (unlike the position following a termination order). The Termination of Tenancies Report notes that this remedy will be particularly useful where the tenancy has a significant capital value in excess of the sums owed to the landlord.[27]

18.48 Our revised recommendations to enhance the commonhold association's enforcement powers are modelled on the provisions in the Termination of Tenancies Report but only in relation to financial breaches. Further, only the order for sale will be available to the association. Given that the commonhold unit will likely have a significant capital value, the sale of the unit will be a much more proportionate response to that of termination. On the sale of the unit, there would not be a risk of the commonhold association receiving a windfall amount. The association would only receive the arrears of commonhold contributions, plus any interest and legal costs awarded by the court. Any balance remaining after the association and any mortgage lender have been repaid would be returned to the unit owner. Unlike the position on termination, the sale of the unit would also ensure that mortgage lenders preserve their security over the commonhold interest.

18.49 We now provide an overview of our revised scheme for commonhold, before looking at the scheme in more detail.

### Summary of our revised scheme

18.50 Under our recommended approach for commonhold, the association will, in certain circumstances, be able to apply to court for the sale of the commonhold unit in order to recover the commonhold arrears. Safeguards will be built into this process to protect the interests of the defaulting unit owner and any lenders who have an interest secured over the commonhold unit. However, without the benefit of a statutory charge, the association will not be in the position of a secured creditor. We discuss the implications of this where the unit owner, who owes money to the commonhold

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[26] For a full discussion of the remedial order, see Termination of Tenancies for Tenant Default (2006) Law Com No 303, paras 5.32 to 5.47.

[27] For a full discussion of the order for sale, see Termination of Tenancies for Tenant Default (2006) Law Com No 303, paras 5.48 to 5.72.

association, becomes bankrupt or his or her unit is repossessed by the mortgage lender.

### Order for sale and protections for lenders and unit owners

18.51 When deciding whether to order the sale of the unit, the court should take into account all the circumstances of the case, including the effects of the debt on the commonhold association.

18.52 The sale of the commonhold unit should be a matter of last resort. We recommend the following safeguards for unit owners at risk of losing their properties.

(1) The association should follow a specific pre-action protocol before applying to court. The protocol will require the parties to take a number of preliminary steps before considering court proceedings. As part of the protocol, the association should provide the defaulting unit owner with reasonable opportunities to clear the arrears and prevent court proceedings. A failure to comply with the protocol may result in the order for sale being refused, or proceedings being stayed while the protocol is complied with.

(2) To provide certainty to unit owners, and to protect them from undue pressure, the association will only be able to apply to court for the sale of the property once arrears reach a prescribed statutory threshold. We recommend that this statutory threshold be set at a fixed amount of £1,000, or any lower amount that has been outstanding for over one year. The threshold should not be viewed as a target figure, which would automatically entitle the association to obtain the sale of the unit. The court should only order the sale of the unit where reasonable and proportionate to do so.

18.53 If the court decides to order the sale of the unit, a receiver would normally be appointed to arrange the sale of the property and distribute the proceeds. However, a mortgage lender with a charge over the commonhold unit in question would instead be able to apply to take over the conduct of the sale, in order to control the costs involved.

18.54 The proceeds of sale would normally be distributed in the following order. After paying the costs associated with the sale (such as any receiver's fees, legal costs and disbursements) the association would be paid the commonhold arrears, followed by the repayment of secured creditors (such as mortgage lenders). Any balance would then be returned to the unit owner.

18.55 However, to protect any lender who has an interest secured over the commonhold unit, the lender should always have the opportunity to take steps to protect its interest, and prevent commonhold arrears being paid in advance of the mortgage amount. We recommend the following safeguards for lenders:

(1) The association should be required to notify the lender within a reasonable period of time of the arrears reaching the statutory threshold for legal action discussed above. Namely, the association will be required to notify any lender with an interest secured over the commonhold unit within a reasonable period of time of the arrears reaching £1,000, or of any lower amount becoming

outstanding for over a year. The association must then provide the lender with 28 days to take steps to protect its interest, before making an application for the sale of the unit. The lender may, for example, decide to clear the unit owner's arrears and add it to the mortgage amount or, if considered appropriate, seek the repossession of the property.

(2) If the association fails to notify the lender, and applies to court for the sale of the unit, the court may decide to stay the court proceedings for 28 days in order to provide the lender with an opportunity to protect its interest.

18.56 Our revised mechanism will put the association in a much stronger position than it is in at present with regards to taking enforcement action. The association will no longer have to follow the long-winded process of obtaining and enforcing a money judgment, resulting in significant delays and expense. At the same time, our recommended scheme addresses the concerns of lenders, and wider concerns at the potential impact of a first-ranking charge.

18.57 From consultees' responses, it also appears that our revised approach will be more reassuring to unit owners. Unit owners may be concerned about a statutory charge being in place over their properties, particularly because the charge would exist automatically without a court order having been obtained, and regardless of the level of arrears outstanding.

### Bankruptcy and repossession by a mortgage lender

18.58 We explain above that one of the advantages of the proposed statutory charge was that it would have placed the association in the position of a secured creditor. Consequently, if the unit owner became bankrupt and the property needed to be sold to repay his or her debts, the association would have been guaranteed an amount of money from the proceeds of sale. Without the statutory charge, however, the association would no longer be a secured creditor, and its position might be compromised on a unit owner's bankruptcy. If the bankrupt's property were sold, the association would be in the same position as any other unsecured creditor and, after the secured creditors (such as mortgage lenders) had been repaid, the association would have to share any value remaining with the other unsecured creditors. On bankruptcy, unsecured creditors often do not receive the full amount they are owed.

18.59 Given the importance of preserving the solvency of the association, and protecting the other owners within the building, it is important that the association should not be left out-of-pocket due to a unit owner's insolvency.[28] We therefore recommend at paragraph 18.132 below that a unit owner's insolvency should not prevent the association from being able to seek an order for sale of his or her unit.[29] This

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[28] We use the term insolvency here to cover any scenario in which the unit owner is subject to court order or arrangement which will discharge his or her debts after a specified period of time, including bankruptcy, individual voluntary arrangements and county court administration orders.

[29] It is likely that existing insolvency legislation would prevent the association from seeking the sale of the commonhold unit once the unit owner had been adjudged bankrupt. That is because there are general restrictions on what actions a creditor can take to recover a debt following a bankruptcy order: See Insolvency Act 1986, s 285.

recommendation aligns with the position under our Termination of Tenancies Report, on which we have modelled our revised commonhold enforcement scheme.[30]

18.60 Additionally, if the association did not wish to, or was unable to seek the sale of the insolvent owner's commonhold unit, because, for example, the arrears had not yet reached the statutory threshold of £1,000, the association would have an alternative remedy. As explained in Chapter 13, on the sale of an insolvent owner's property, it would be possible for the association to serve a notice on the incoming owner requiring him or her to pay the outstanding arrears. We recommend in Chapter 13 that the insolvency of a unit owner should not extinguish the debt owed to the commonhold association. The purchaser would therefore ensure that any arrears of commonhold contributions are dealt with as part of the sale.

18.61 A similar protection would be available to the commonhold association if a mortgage lender were to repossess and sell a commonhold unit in respect of which there are commonhold arrears. Without the benefit of the statutory charge, the association would not be in the position of a secured creditor and would therefore not be guaranteed an amount of money from the proceeds of sale. However, as explained above, as the incoming owner would be liable for any outstanding commonhold arrears, he or she would ensure any outstanding sums are addressed on purchasing the property. This is closely analogous with the position in leasehold. As landlords may be able to forfeit against an incoming leaseholder for pre-existing arrears (or seek a termination order under our recommendations to replace forfeiture), buyers will generally insist on pre-existing arrears being addressed when they buy.

18.62 We now look at each stage of our revised procedure in more detail and make several recommendations for reform. We consolidate these recommendations at paragraph 18.130 below.

### Our recommended scheme in detail

18.63 In the Consultation Paper, we asked a number of questions about how the sale of the commonhold unit might operate and the safeguards that could be built into the process for unit owners and their lenders. We set out these consultation questions, and consultees' responses to them below. In the Consultation Paper we had said that, even with the benefit of a statutory charge, the association would still be required to apply to court to enforce the sale of the unit, rather than being able to sell the property itself. While we are no longer recommending a statutory charge in favour of the association, many of the questions we asked about how the sale of the unit would operate remain relevant. Consultees' responses to these questions have aided us in putting together our revised recommended scheme set out below. When considering consultees' responses, however, we have kept in mind that consultees will have been responding to the proposed scheme as set out in the Consultation Paper, rather than our revised recommended scheme below.

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30 While insolvency legislation prevents a creditor from taking action to recover a debt from an insolvent debtor (see for example, Insolvency Act 1986, s 285) in the leasehold context, case law has determined that a landlord's right to terminate a lease following a leaseholder's breach should not be prevented where the leaseholder is bankrupt. See *Ezekiel v Orakpo* [1977] 1 QB 260 and more recently *Christina Sharples v Places for People Homes Ltd* [2011] EWCA Civ 813, [2012] Ch 382 (which was in the context of assured tenancies, but its general principles may be applied to long leases).

### Application to court

18.64 In the Consultation Paper, we proposed that the association should be required to apply to court for the sale of the commonhold unit.[31] This question arose largely due to our proposal to provide the association with a first-ranking statutory charge. We queried whether the association should be able to enforce the charge in the same way as a mortgage lender would by selling the commonhold unit itself, or should be required to seek an order for sale in court.

### Consultees' views

18.65 Nearly all consultees were in favour of requiring the association to apply to court for an order of sale of the commonhold unit. Consultees thought that a court order would be necessary to protect the interests of the defaulting unit owner. The Chartered Institute of Legal Executives ("CILEx") "strongly endorsed" the proposal, saying that:

> Homeowners need to be able to feel safe in their own homes, whether that is under a leasehold or commonhold scheme, and the ability to forcibly remove a person from their property requires very careful assessment of overarching natural justice principles.

18.66 Lucy Shepherd (solicitor) agreed with the proposal, arguing that the application to court was a necessary check on the association's power. Paul Fallows (leaseholder) said the court's independence would reduce the risk of discriminatory action being taken by the commonhold association. In addition, Peter Smith commented that the need to issue court proceedings would deter the commonhold association from taking action "save in serious cases of default where all else has failed".

18.67 The main argument made by those opposing the proposal was that the Tribunal, rather than the court, should be able to order the sale of the property. In addition, Christopher Jessel argued that the association should have the power to sell the property itself, "as an application to court takes a long time and incurs major expense".

### Discussion and recommendations for reform

18.68 We agree with consultees that the court proceedings will be an essential safeguard for unit owners. We do not consider it appropriate for the association, whose members will be the neighbours of the defaulter, to be able to sell the property without a court application. Further, unlike mortgage lenders who may be able to arrange the sale of the property without a court order, the association would not be subject to any external regulatory controls in arranging the sale.[32]

18.69 Our view is that the court, rather than the Tribunal, will be the appropriate body to consider the sale of the unit. The sale of a freehold property against the wishes of the

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31 CP, Consultation Question 86, paras 14.56 and 14.63.

32 CP, para 14.56(3). Most mortgage lenders, as financial service providers, are subject to significant regulation. The regulation places limitations on the powers available to lenders where the borrower is in default, for example, to ensure that the borrower is given every opportunity to pay and make the sale of the property a matter of last resort. Regulation is provided, in particular, by the Mortgages and Home Finance: Conduct of Business Sourcebook ("MCOB").

owner is a serious decision that should be made by a court.[33] In addition, the court will already be familiar with granting orders for sale. As we note above, one way in which an ordinary unsecured creditor might enforce repayment is by obtaining a money judgment against the debtor and securing a charging order over the debtor's property. The creditor would then be able to apply to court to enforce the charging order and seek the sale of the property.

### Pre-action protocol

18.70 We provisionally proposed in the Consultation Paper that the commonhold association should be required to follow a specific pre-action protocol before applying to court for an order for sale.[34] The protocol would set out the steps to be complied with before the association could take legal action. We suggested that the protocol could include a requirement for the association to provide information to the defaulting owner and make reasonable attempts to agree a repayment plan. We asked consultees whether they agreed that the association should be required to follow a pre-action protocol and invited views as to the steps to be included.

### Consultees' views

18.71 Our proposal received almost unanimous agreement. No consultee provided a substantive comment against the introduction of a pre-action protocol. Martin Wood (solicitor) argued that a pre-action protocol would be necessary to protect the defaulting unit owner from "aggressive enforcement action" by the association. Peter Smith said that, in the interests of fairness, the debtor should be warned of the pending court proceedings, and that following the protocol should encourage the parties to reach an out of court settlement.

18.72 Christopher Jessel agreed with the introduction of a protocol, but argued that following the protocol should not be made mandatory where a settlement is "obviously hopeless for instance in bankruptcy cases or on the death of a unit owner or if the unit owner is uncontactable". Catherine Williams (leaseholder) also thought that the steps required by the parties might differ depending on the circumstances.

18.73 A number of consultees suggested steps for inclusion in the pre-action protocol, including a requirement:

(1) For the association to provide information to the unit owner. Consultees said that the association should be able to evidence that outstanding sums have been correctly demanded and should provide copies of any documents requested by the unit owner.

(2) For the association to serve a warning notice, or an escalating series of notices, on the unit owner, providing a reasonable opportunity to pay the arrears.

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[33] For the same reason, in Ch 20 we consider that there should be no change to the requirement that the court, rather than the Tribunal, should authorise the voluntary termination of the commonhold where the decision to terminate is not unanimous.

[34] CP, Consultation Question 86, paras 14.58(1) and 14.61 to 14.62.

(3) For the parties to discuss the reasons for the missed payments and the unit owner's ability to pay within a reasonable period of time.

(4) For the parties to attempt to reach an agreement without resorting to court proceedings. A number of consultees said that court proceedings should be a matter of last resort and, where possible, a payment plan should be agreed. However, Christopher Jessel and Paul MacAinsh pointed out that a payment plan may not be appropriate in all cases and, when making any decision, the association should have regard to the other unit owners in the building who may be meeting any shortfall.

(5) For the association to notify any mortgage lender with an interest secured over the defaulter's unit. UK Finance said that the lender should be able to intervene, where appropriate, and pay off the unit owner's arrears.

18.74 Some consultees argued that it may be possible to use an existing pre-action protocol, such as the pre-action protocol for mortgage arrears. For example, the Conveyancing Association commented that "there are existing financial pre-action protocols which should be used to save unnecessary duplication".

18.75 Other consultees made more general comments that the protocol should be "in plain English",[35] "quick and easy",[36] "transparent"[37] and "as efficient as possible".[38] The APPG argued in favour of imposing time limits on the steps to be taken, so that matters "are not dragged out".

### Discussion and recommendations for reform

18.76 As supported by consultees, we recommend that a specific pre-action protocol be created for financial breaches of the CCS. It is important that unit owners are warned of the consequences of failing to pay and are provided with sufficient opportunity to clear the arrears. Selling the unit should be a matter of last resort where no other satisfactory arrangement can be made in the circumstances.

18.77 The specific protocol would also have the advantage of disapplying any other protocols which might otherwise apply. As referred to by some consultees, there are already a number of pre-action protocols in existence, covering a range of different disputes, including financial disputes. For example, there is a pre-action protocol for debt claims which businesses must follow before bringing a claim against an individual, a pre-action protocol for possession claims based on mortgage and home purchase plan arrears, and a pre-action protocol for possession claims made by social landlords. There is a risk that, unless a more specific pre-action protocol is introduced which covers financial breaches within a commonhold, the dispute might fall within the scope of another pre-action protocol which has not been designed with commonhold in mind. We have carefully considered whether any of the existing protocols might be appropriate, but have concluded that each would not be suitable for financial breaches

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35 The Leasehold Advisory Service ("LEASE").

36 Collette Boughton.

37 CILEx.

38 The National Leasehold Campaign.

of the CCS. While it may be helpful to adopt some of the same requirements and timescales as are contained within these protocols, many of the protocols include a number of detailed steps that would not be relevant in the commonhold context or would place the association under excessive obligations.

18.78 With regards to the content of the protocol, we think that the required steps should not be unduly prescriptive. We agree with Christopher Jessel and Catherine Williams that the appropriate steps might differ from case to case. For example, where it is evident that the defaulting unit owner has vacated the property, it would be unreasonable to expect the association to serve a series of escalating notices before being able to take action. Additionally, whether the association would be acting reasonably in agreeing, or refusing to agree, to a payment plan would depend on a number of factors, including the level of the arrears outstanding and the effect of the arrears on the association. We recommend that the pre-action protocol for commonhold should include a list of steps that the court would normally expect the parties to take. However, the steps only need to be taken where it is reasonable and proportionate to do so, and will depend on the particular facts of the case. In general terms, we think that the protocol should include the following steps:

(1) The association should notify the defaulting unit owner that it is considering taking legal action to recover the arrears, and should provide the unit owner with a reasonable period of time in which to clear the arrears in order to avoid further action. The notice should set out the level of arrears outstanding and provide evidence that the sums have been correctly demanded by the association.

(2) The association should respond to reasonable requests for further information and provide any documents requested.

(3) The parties should take reasonable steps to discuss the reasons for the arrears, the unit owner's financial circumstances and proposals for repayment of the arrears. The decision to apply to court for an order for sale should be one of last resort, and should not normally be started unless all reasonable attempts to resolve the situation have failed.

18.79 We also agree that the association should be required to notify any lender who has an interest secured over the defaulting unit owner's property. However, we make specific provision for the notification of lenders below.

18.80 If the association fails to comply with any of the steps in the protocol, when it would have been reasonable to comply, the court may decide to stay the court proceedings to allow the steps to be carried out. The court will also be able to take into account the extent of compliance with the protocol when deciding whether to make an order for the sale of the property, which we consider further below.

### Threshold of arrears before an order for sale may be made

18.81 We proposed in the Consultation Paper that, in order to be proportionate, the court should only be able to order the sale of the unit where the commonhold arrears exceed a certain financial threshold.[39]

### Consultees' views

18.82 The vast majority of consultees supported this proposal. Consultees argued that a financial threshold would be necessary to ensure that the sale of the unit is a proportionate response to the level of arrears. CILEx said that setting a threshold would also provide unit owners with "transparency and predictability" and The Guinness Partnership thought the proposal would prevent court action from being an easy, "go to" solution. Further, Peter Smith argued that if a threshold were not in place, there might be a risk of the association putting undue pressure on homeowners "as seemingly can occur with lease forfeiture".

18.83 Consultees who disagreed with the proposal said that it was unnecessary to require a threshold to be met. Christopher Jessel argued that, in reality, the commonhold association will not incur the cost of court proceedings in order to recover trivial amounts. Westminster and Holborn Law Society said that whether or not the sale of a unit can be justified should be left to the court's discretion:

> All orders for sale are discretionary, and the court will not make the order if all the circumstances, including the small amount owing, do not justify it. It is unnecessary to restrict the power of the court simply to assure defaulting unitholders that such is the case.

18.84 Regarding how a threshold might be set, a number of consultees said that the threshold for court action should not be so high as to put the association at risk of insolvency or to place undue burden on the other owners. Other consultees argued that the threshold should not be so low as to put unit owners at risk of losing their property for small amounts.

18.85 Several consultees made suggestions as to how the threshold might be set.

(1) As a fixed amount. Views as to what this amount should be varied between £1,000 and £40,000.

(2) By reference to the period for which the arrears have been outstanding. A couple of consultees suggested that the association should be prevented from taking enforcement action until the unit owner owes three months' arrears. UK Finance said that "lenders would only commence possession proceedings if mortgage payment arrears have reached at least three months. This could be a benchmark for commonhold associations". Other suggestions included a threshold of six months' arrears and a threshold of three years' non-payment.

(3) As a percentage of the value of the property. This threshold was a popular suggestion amongst consultees, however the recommended percentage varied between 1% and 85% of the value of the unit to be sold. The National

[39] CP, Consultation Question 86, paras 14.58(3) and 14.64.

Leasehold Campaign said that an advantage of this approach, as opposed to using a fixed amount, was that a fixed amount would lose value over time.

(4) As a variant to the above, one consultee, Villandry Property Ltd, suggested that the threshold could be set as a percentage of the commonhold contributions, and thought that 20% would be the correct amount.

(5) Other consultees suggested a combination of the above factors.

18.86 In addition, a number of consultees argued that, regardless of the level of arrears outstanding, it should be possible for the association to seek the sale of the property if the unit owner persistently fails to pay contributions on time. Antonia Batty (leaseholder), for example, said that "persistent, perpetual non-payment should be taken seriously, however low the amount".

18.87 Some consultees said that it would be difficult to put a threshold in place that would operate satisfactorily in all cases, "bearing in mind the huge variation of properties that potentially can be subject to commonhold".[40] LKP agreed, saying that:

> the importance of the amount outstanding will be dependent on the size of the site. For smaller sites the amount outstanding will represent a greater proportion of the service charge that is required to be spent.

18.88 The Association of Residential Managing Agents ("ARMA") suggested that, rather than a threshold set by Government, each CCS could include a bespoke threshold, appropriate for that particular building.

### Discussion and recommendations for reform

18.89 We agree with consultees that the court is unlikely to grant an order for sale in respect of trivial amounts. We also agree that it is unlikely that the association would go to the trouble and expense of issuing court proceedings to recover small sums. However, while the risk of a court application in these circumstances may be low, we consider it necessary to remove the risk entirely by setting a threshold in the legislation. Setting a threshold of arrears would provide reassurance to unit owners that they would not risk losing their home for trivial financial breaches. The threshold would also avoid the association putting undue pressure on unit owners by threatening court proceedings.

18.90 We do not agree that it could be left to the drafters of the CCS to set the threshold for each individual commonhold. We are concerned that the threshold could be set too high, undermining our recommendations to enhance the association's powers. Alternatively, the threshold could be set too low, so as to offer insufficient protection to defaulting unit owners.

18.91 Setting a threshold that operates satisfactorily in every commonhold is a difficult task. As consultees pointed out, commonholds are likely to vary significantly in terms of size, number of units, and property value. In smaller commonholds with very few units, a fairly low outstanding debt might quickly become a problem. However, in higher

[40] Damian Greenish (solicitor).

value properties, with expensive facilities and services, a low threshold might quickly be surpassed.

18.92 Setting the threshold as a percentage of the value of the commonhold unit was the most popular suggestion made by consultees. However, setting the threshold in this way would not overcome the difficulties created due to the varying size and number of units within a commonhold. Larger commonholds will still be able to absorb debts more easily than smaller commonholds. Setting the threshold in this way assumes that in higher value commonholds, the unit owners in the building will be able to withstand a larger shortfall. We do not agree with this assumption. It does not automatically follow that, because a property is worth more money, the other unit owners should be able to sustain a larger shortfall before being able to bring a claim. Further, setting the threshold in this way creates practical difficulties. The association might be required to obtain valuation evidence prior to taking legal action, and each unit in the building might have a different threshold, depending on its particular value. The value of the property is a more relevant consideration in the context of leasehold forfeiture, than on the sale of a commonhold unit. On forfeiting a lease, the landlord would not be required to pay any money to the leaseholder, even where the property is worth much more than the debt owed. Forfeiture of a high value property for a small debt would be clearly disproportionate and would create a windfall for the landlord. However, under our proposals for commonhold, the defaulting unit owner would receive the balance following repayment of the association's debts and any mortgages. The value of the commonhold unit is therefore less of a relevant consideration.

18.93 Having carefully considered the potential options, we have reached the conclusion that the best approach will be to set the threshold as a fixed amount. This option provides the most transparent and clear basis upon which to set the threshold. It is extremely important that unit owners have certainty as to the circumstances in which they might be at risk of losing their property.

18.94 We recommend that the threshold should be set as a fixed amount of £1,000, with a power for this figure to be updated by regulations from time to time.[41] We recommend £1,000 on the basis that few orders for sale are currently made in respect of debts below £1,000.[42] £1,000 is also consistent with the cost threshold in place to protect consumers under consumer credit regulation.[43]

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41 See para 18.134.

42 See for example: Ministry of Justice Impact Assessment, *Whether a minimum limit should be imposed on order for sale applications in relation to Consumer Credit Debts only* (February 2012).

43 The threshold is set in The Charging Orders (Orders for Sale: Financial Thresholds) Regulations 2012. Where the creditor is enforcing payment of a debt arising from a "regulated agreement" under the Consumer Credit Act 1974 (s 189(1)), the court will not be able to order the sale of the property in question where the amount owing is less than £1000. Whilst the unit owner's debt to the commonhold association will not fall within the consumer credit regime, some of the same reasoning behind the introduction of this threshold for consumer debts will apply to commonhold. Unlike mortgages which are regulated, consumer credit debts are formerly unsecured amounts which are not subject to any uniform rules or regulations. Similarly, debts owed to the commonhold association will be unsecured and will not be regulated. When the threshold was introduced for consumer contracts, concerns were raised about aggressive enforcement action being taken for disproportionate amounts, particularly against vulnerable individuals who may fail to attend the court hearings.

18.95 We acknowledge that, in more affluent commonholds, a cap of £1,000 might easily be surpassed. However, the threshold of £1,000 should not be viewed as a target figure which will guarantee an order for sale. The court will only order the sale of the unit where reasonable and proportionate to do so.

18.96 In addition, setting the cap as a fixed amount might mean that a unit owner would be able to withhold payments of up to £1,000 without any right of challenge. Such a shortfall may be particularly problematic within smaller commonholds. A number of consultees suggested that there should be a right to challenge smaller debts that have been outstanding for a certain period of time. We agree that debts should not be allowed to accrue indefinitely, or that unit owners should be immune to challenge up to the value of £1,000. However, so as not to undermine the certainty provided to unit owners, and to prevent the sale becoming disproportionate, the debt would need to be outstanding for a significant period of time before the unit may be sold. We therefore recommend that the court should be able to order the sale of a unit for amounts of less than £1,000, but only where such amounts have been outstanding for more than a year, and where it is reasonable and proportionate to do so.

### Notifying lenders of the arrears

18.97 In the Consultation Paper, we suggested that, before applying to court for an order for sale, the association would need to notify any lenders with an interest secured over the defaulter's unit.[44] When deciding whether to grant the order for sale, the court would check that the lender had in fact been notified.

### Consultees' views

18.98 While we did not ask a specific question on this point, a number of consultees commented that the lender should be notified as part of the enforcement process. Some consultees said that the lender should have the opportunity to pay the arrears and add them to the mortgage amount in order to prevent the sale of the unit. As we note above, UK Finance expressed concern that the arrears (which, under our proposals, would take priority over the mortgage) might continue to mount indefinitely, without the lender having been notified.

### Discussion and recommendations for reform

18.99 If the commonhold association is to be paid before the lender from the proceeds of sale, then we agree that the lender will need to be notified of the commonhold arrears at an earlier stage than that suggested in the Consultation Paper. As UK Finance points out, the commonhold association may delay taking enforcement action, during which time, commonhold arrears (which would be paid before the mortgage amount) would continue to accrue.

18.100 We therefore recommend that the lender should be notified of the commonhold arrears within a reasonable period of time of the arrears reaching the statutory threshold discussed above. Namely, the association will need to notify the lender within a reasonable period of time from the arrears reaching £1,000 or from any lower amount becoming outstanding for over a year, regardless of whether the association intends to take action at that point. The association should then provide the lender

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[44] CP, paras 14.58(2) and (4).

with 28 days in which to decide whether to pay off the arrears and add it to the mortgage amount or to repossess the property itself (if the unit owner is in breach of the mortgage terms). If the association fails to notify the lender, and commences court proceedings, the court may stay the court proceedings for 28 days to allow the lender to take steps to protect its security.

### Factors to be considered by the court when making an order for sale

18.101 In the Consultation Paper, we suggested various factors that the court should take into account when deciding whether to grant an order for sale.[45] First, the court would check that the sums in question had been properly demanded and were due. Next, the court would consider the extent to which the parties had complied with any pre-action protocol and would check that any mortgage lender has been notified of the claim. The court would then proceed to weigh up the competing interests of the defaulting unit owner and the impact of the arrears on the commonhold association. We invited consultees' views on whether these, and any other factors, should be considered by the court when determining whether to order the sale of the commonhold unit.

### Consultees' views

18.102 Some consultees simply agreed with the factors set out in the Consultation Paper and, in particular, the need to balance the competing interests of the defaulting unit owner and the commonhold association. A number of other consultees elaborated on the factors that the court should consider when carrying out the balancing exercise, including:

(1) the commonhold's ability to cover the outstanding debt, the risk of the commonhold association's insolvency caused by the arrears and whether unit owners have been required to meet any shortfall in commonhold costs.

(2) the amount of equity in the debtor's property, in other words, whether there is sufficient value in the property to clear the arrears.

(3) the reason for the default, such as job loss or temporary unemployment, the unit owner's financial means and the prospect of repayment within a reasonable period of time.

(4) the personal circumstances of the unit owner, particularly if the unit owner is vulnerable or there are children living in the property.

(5) the willingness of the association and the unit owner to find solutions to clear the arrears. Consensus Business Group (landlord) said that "if a unit holder can show that they are trying to sell to settle the debt (brochures, letters to/from estate agent) then this should be treated completely different to unit holders who have no desire to sell the unit to repay the debt"; and

(6) the unit owner's past record in paying commonhold contributions and whether he or she has kept to any agreed repayment plan.

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[45] CP, paras 14.58(4) and (5).

## Discussion and recommendations for reform

18.103 In our view, factors which are already considered by the court when making an order for sale will be relevant here.[46] The court has a wide discretion when deciding whether to enforce the charging order and order the sale of the property. Before making an order for sale, all the circumstances of the case have to be considered, including:

(1) The judgment debtor's conduct and attitude towards paying the debt.[47] The court will also consider whether the debtor should be provided with a final opportunity to pay.

(2) The size of the debt and the prospects of it being paid without the sale.[48] The court may also refuse to order the sale if the sale is unlikely to raise sufficient funds to satisfy the debt.[49]

(3) Human rights issues. The court will need to balance the creditor's rights with the debtor's right to respect for family and home life.[50] The court will consider whether the property is the debtor's home and the welfare of those living in the property.[51]

18.104 The above factors are also likely to be relevant where the commonhold association is seeking an order for sale and cover most of the factors suggested by consultees. We recommend that, when deciding whether to make an order for sale, the court should consider all the circumstances of the case, which will include the factors currently considered by the court on an application to enforce a charging order. However, additionally, the court should consider parties' compliance with the pre-action protocol, the unit owner's past conduct in paying commonhold contributions and the effect of the arrears on the commonhold association (including the association's ability to cover the outstanding amount without needing to make further demands from the unit owners).

## Appointment of a receiver

18.105 We provisionally proposed that, if the court were to order the sale of the commonhold unit, a receiver should be appointed to arrange the sale of the property and distribute

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46 In para 18.24 above, we explain that an ordinary unsecured creditor may apply to court for a charging order over the debtor's property to secure the repayment of the debt. The creditor may then make a further application to court for the sale of the property in order to repay the debt.

47 The court will consider whether the debtor is guilty of "contumelious neglect or refusal to pay": see Civil Procedure Rules, r 73.10C.

48 The case of *Packman Lucas Ltd v Mentmore Towers Ltd and Charles Street Holdings Ltd* [2010] EWHC 1037 (TCC), [2010] BLR 465 confirmed that size of debt relative to the asset is only one factor to be considered in deciding whether to grant an order for sale – a small debt does not create a presumption against sale: Civil Procedure Rules, r 73.10C.

49 *Amari Lifestyle Limited (T/A Amari Super Cars v Warnes)* [2017] EWHC 1891 (Ch), [2018] Ch 161.

50 *National Westminster Bank Plc v Rushmer* [2010] EWHC 554 (Ch), [2010] 2 FLR 362.

51 *Forrester Ketley v Brent and Pallette* [2009] EWHC 3441. Where the property is a home, and if occupied by the debtor's family, the court may take into account home rights under the Family Law Act 1996, which provides spouses and civil partners with a right to occupy despite having no proprietary interest in the property *(Fred Perry (Holdings) Ltd v Genis* [2015] 1 P & CR DG5).

the proceeds of sale.[52] We thought that the receiver, as an independent party, would be best placed to distribute the proceeds fairly.

### Consultees' views

18.106 The vast majority of consultees agreed that the court should appoint a receiver in order to distribute the proceeds of sale of the commonhold unit.

18.107 Of those who agreed with the proposal, very few provided a substantive comment. Peter Smith said that he agreed with the proposal due to the independent nature of the court appointed receiver. He said that "no sale should be conducted by the commonhold association as it is an interested party".

18.108 The main argument against the proposal related to the costs of appointing a receiver, which would need to be paid from the proceeds of sale. A few consultees suggested that the appointment of a receiver may not be necessary in straightforward cases and could be left to the court's discretion. Irwin Mitchell LLP, for example, suggested that the court should appoint a receiver unless the association demonstrated itself as capable of acting fairly and realising the full value of the unit. Other consultees said that receivers' fees should be "reasonable" or set at a fixed amount. Paul MacAinsh suggested that to control fees, any mortgage lender with a charge over the unit could be permitted to take on the role of the receiver and arrange the sale.

18.109 While neither agreeing nor disagreeing with the proposal, a couple of consultees, including HM Land Registry, asked for clarification on the anticipated role and legal status of the court-appointed receiver.

### Discussion and recommendations for reform

18.110 Given the significant amount of support for this proposal, we recommend its adoption. The court already has wide discretion to appoint receivers and can set out the receiver's powers in the terms of his or her appointment.[53] We therefore consider it unnecessary to create a bespoke receiver role in order to conduct the sale of the commonhold unit. We recommend that the court should appoint a receiver under its general powers, and provide the receiver with a power to sell the commonhold unit.

18.111 We note that several consultees were concerned about the receiver's fees. However, where a receiver is court-appointed, his or her fees must be determined by the court. Any remuneration awarded must be "reasonable and proportionate in all the circumstances".[54] In addition, under the existing law, there would be scope for the commonhold association to dispute the level of remuneration awarded.

18.112 Further, we agree that Paul MacAinsh's suggestion would offer additional reassurance to lenders. We recommend that any lender with a charge over the unit to be sold should be able to request to take over the conduct of the sale. If the court agrees, the lender would then be able to arrange the sale of the property itself, and would be subject to external regulation in doing so. The lender would be required to

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52 CP, Consultation Question 86, paras 14.58(7) and 14.66.

53 Senior Courts Act 1981, s 37(1); County Courts Act 1984, ss 38 and 107.

54 Civil Procedure Rules, r 69.7.

distribute the proceeds of sale in the order of priority set out in the court's order for sale. The advantage for the lender in making such a request is that the lender would gain control over the fees associated with the sale of the unit, which would be paid in advance of the mortgage amount.

### Order of distribution of proceeds of sale

18.113 We proposed that, on the sale of the commonhold unit, the proceeds of sale should be distributed in the following order.

(1) The receiver, if appointed, should be paid his or her fee for arranging the sale of the property.

(2) The commonhold association should be repaid any outstanding amounts of commonhold contributions, plus any interest payable on the arrears (under the terms of the CCS, see paragraph 18.142 below) and any costs awarded by the court.

(3) The proceeds of sale should then be used to repay any other party who has an interest secured against the unit, such as a mortgage lender.

(4) Any remaining amount should then be returned to the unit owner.[55]

### Consultees' views

18.114 Again, the vast majority of consultees agreed with the order of distribution proposed in the Consultation Paper, although hardly any consultees provided a substantive comment in support of their agreement.

18.115 Some consultees agreed with the proposal but pointed out that the costs of arranging the sale, such as conveyancing fees and disbursements, should also be recoverable at the same time as the receiver's fees.

18.116 Those who opposed the proposal generally did so due to concerns about the association being paid before the mortgage lender. Lucy Shepherd argued that, under the proposals as set out in the Consultation Paper, the lender would have no certainty over the amount it would receive after the association had been repaid. Other consultees reiterated concerns about the fees that would be payable to the court-appointed receiver.

### Discussion and recommendations for reform

18.117 We recommend that the proceeds of sale should be distributed in the order set out in the Consultation Paper, subject to the following modification. We agree with consultees that the reasonable costs associated with the sale of the property (such as legal costs and estate agent's commission) should also be paid from the proceeds of sale at the same time as the receiver's fees.

18.118 If the lender has been notified of the arrears and provided with 28 days to respond (as required by our recommended approach set out above, see paragraph 18.99) we consider it reasonable for the association to be paid before any mortgage lender from

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[55] CP, Consultation Question 86, paras 14.58(7) and 14.67.

the proceeds of sale. As we note above, under our revised scheme, the association will be required to notify the lender once arrears reach the threshold at which the association will be able to seek an order for sale. If the association fails to do so, and the association commences court proceedings, the court may stay the proceedings to enable the lender to take steps to protect its security. The lender might decide to repay the arrears and add it to the mortgage amount. Alternatively, the lender might decide to repossess the property under the terms of the mortgage deed if the unit owner is also in arrears in relation to the mortgage. The lender will therefore always have an opportunity to avoid commonhold arrears being paid in advance of the mortgage amount. If the lender has been notified, but has failed to take any action, we consider it correct that the association should be paid in priority to the lender.

### Position of tenants

18.119 In the Consultation Paper, we provisionally proposed that any tenancies granted out of the unit (and any sub-tenancies granted out of those tenancies) should continue following an order for sale. The purchaser of the unit following the order for sale would take ownership of the unit subject to existing tenancies.[56]

### Consultees' views

18.120 The proposal was strongly supported, particularly amongst leaseholders and individuals.

18.121 The main reason given in support of the proposal was that tenants, who pay their rent on time, should not be prejudiced by their landlord's breach of the CCS. In addition, Stephen Desmond's view was that, as the unit owner's freehold title was being sold, rather than being extinguished (as would happen on leasehold forfeiture), any tenancies granted out of the commonhold interest should simply continue after the sale.

18.122 Consultees who disagreed with the proposal said that continuing tenancies might make the commonhold unit harder to sell, or could reduce the market price.

18.123 Some consultees argued that a defaulting unit owner might attempt to frustrate the sale of his or her unit by granting a tenancy agreement on favourable terms, or to a family member, in order to make the property unattractive to prospective purchasers. Christopher Jessel said:

> if there is fraud or collaboration, for instance if a defaulting unit holder or one in dispute with the association deliberately puts in a tenant, perhaps on favourable terms, that should not continue. Likewise, if the tenant is a connected party such as a spouse, the court or Tribunal should be able to extinguish the tenancy.

18.124 Mark Chick suggested that tenancies, of which the association had not been made aware, should not be permitted to continue. A further consultee, responding anonymously, suggested drawing a distinction between those tenancies which have lawfully been granted in compliance with the CCS and those granted in breach of the CCS.

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[56] CP, para 14.58(8).

18.125 In addition, some consultees suggested that a tenant's failure to pay sums under the tenancy agreement might have contributed to the unit's arrears, and ultimately to the sale of the commonhold unit. In these instances, it may not be appropriate for the tenancy to continue on the sale.

### Discussion and recommendations for reform

18.126 Our view is that, in the ordinary run of cases, existing tenancies should continue on the sale of the unit. The receiver or the new unit owner, on taking ownership of the unit, would only be able to terminate the tenancy agreement in accordance with the terms of that agreement.

18.127 However, consultees have brought to our attention three circumstances in which it might be appropriate to make an exception to this general rule.

(1) Where the unit owner has created a tenancy agreement in an attempt to frustrate the sale of his or her commonhold unit.

(2) Where the tenancy agreement was granted in breach of the terms of the CCS.

(3) Where the tenant has not complied with the diversion of rent procedure discussed above at paragraph 18.23(2). The tenant might ignore the association's request to divert rent due under the tenancy agreement to the unit owner and continue to pay rent to the unit owner. Alternatively, the tenant might not make any payment at all. If a tenant fails to comply with the diversion of rent procedure, the tenant might be seen as contributing towards the need for the commonhold unit to be sold.

18.128 We therefore recommend that the court should be given a limited discretion to order that a tenancy agreement will not continue on the sale of the commonhold unit in the three circumstances outlined above.

18.129 To protect any tenants who might be affected by this provision, we recommend that the prescribed notice which must be given to tenants on entering a tenancy agreement within the commonhold, [57] should be updated. The notice should warn the tenant that the tenancy might be at risk on the sale of the commonhold unit in these three limited circumstances. The tenant would therefore be well advised to check the terms of the CCS before accepting the tenancy agreement and to enquire about the level of arrears over the unit.[58] The revised notice should also provide the tenant with an incentive to comply with the diversion of rent procedure, thereby reducing the risk of the commonhold unit being sold.

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[57] Under the current law, a prospective landlord of a commonhold unit must provide a prospective tenant with a prescribed notice (known as form 13) informing the tenant that he or she will be subject to obligations in the CCS. See Commonhold Regulations 2004, sch 3, para 4.7.12. Form 13 is and found in sch 3 of the Commonhold Regulations 2004.

[58] If the tenant enquires about the level of arrears and is falsely assured, the court can factor this into its decision whether or not to permit the tenancy to continue on the sale of the unit.

### Our recommendations

18.130 Above, we have made a number of recommendations that will provide the association with enhanced powers to tackle financial breaches of the CCS. We consolidate our recommendations for this new enforcement scheme below.

#### Recommendation 106.

18.131 We recommend that a commonhold association should be able to apply to court for the sale of a defaulting unit owner's unit, in order to recover arrears of commonhold contributions from the proceeds of sale.

18.132 We recommend that the unit owner's insolvency should not prevent the association from making an application for the sale of the unit.

18.133 We recommend that a pre-action protocol should be created which sets out the steps with which the parties will be expected to comply (where reasonable and proportionate to do so) before applying to court for the sale of the property. We recommend that the protocol should include the following steps.

(1) The commonhold association should notify the defaulting unit owner that it is considering taking legal action to recover the arrears, and should provide the unit owner with a reasonable period of time in which to clear the arrears in order to avoid further action. The notice should set out the level of arrears outstanding and provide evidence that the sums have been correctly demanded by the association.

(2) The association should respond to reasonable requests for further information and provide any documents requested.

(3) The parties should take reasonable steps to discuss the reasons for the arrears, the unit owner's financial circumstances and proposals for repayment of the arrears. The decision to apply to court for an order for sale should be one of last resort and should not normally be started unless all reasonable attempts to resolve the situation have failed.

18.134 We recommend that the court should not order the sale of the unit unless it is reasonable and proportionate to do so, and at the time of the commonhold association's application:

(1) the outstanding commonhold contributions, plus interest, amount to £1,000 or more; or

(2) any amount of commonhold contributions and/or interest has been outstanding for over one year.

18.135 We recommend that commonhold associations should be required to notify any party with a charge secured over a defaulting unit owner's property (the "chargee") within a reasonable period of time of the commonhold contributions (plus interest) reaching the threshold at which an association would be able to seek an order for sale. An association should provide the chargee with 28 days in which to take steps

to protect its security before the association applies to court for the sale of the unit. If an association fails to notify the chargee, and applies to court for the sale of the property, the court may decide to stay the court proceedings for 28 days to provide the chargee with an opportunity to take steps to protect its interest.

18.136 We recommend that, when deciding whether to make an order for sale, the court should consider all the circumstances of the case, including the factors currently considered by the court on an application to enforce a charging order. In addition to these factors, the court should consider:

(1) the commonhold association's and the defaulting unit owner's compliance with the pre-action protocol;

(2) the defaulting unit owner's past record in paying commonhold contributions; and

(3) the effect of the arrears on the commonhold association (including the association's ability to cover the arrears without needing to make further demands from the unit owners).

18.137 We recommend that, if the court orders the sale of a commonhold unit, a receiver should normally be appointed to arrange the sale of the unit and distribute the proceeds of sale. We recommend that the chargee should be able to request to take over the conduct of the sale of the unit in place of the receiver. If the chargee's application is successful, it must distribute the proceeds of sale in accordance with the court's order.

18.138 We recommend that the court should determine the order of distribution of the proceeds of sale when making an order for sale. Unless otherwise directed by the court, the proceeds of sale should normally be applied in the following order.

(1) Any receiver appointed by the court should be paid his or her fees, and any costs and disbursements properly incurred in arranging the sale of the property should also be paid.

(2) The commonhold association should be repaid any outstanding amounts of commonhold contributions, plus any interest payable on the arrears and any costs awarded by the court.

(3) Any chargee should be repaid, such as a mortgage lender.

(4) Any remaining amount should then be returned to the defaulting owner.

18.139 We recommend that, as a general rule, any tenancies granted in respect of a unit should continue automatically on the sale of the unit. However, we recommend that the court should have discretion to order that a tenancy does not bind the purchaser on the sale of the unit in the following three circumstances:

(1) where the unit owner has created a tenancy agreement in an attempt to frustrate the sale of his or her commonhold unit;

(2) where the tenancy agreement was granted in breach of the terms of the CCS; and/or

(3) where the tenant has not complied with the diversion of rent procedure.

18.140 We recommend that the prescribed notice given to tenants on entering a tenancy agreement should be updated to inform tenants that their tenancy might be at risk on the sale of the commonhold unit in the three circumstances above.

18.141 We now turn to the second issue relating to financial breaches of the CCS; the amount of interest that can be charged by the commonhold association on the late payment of commonhold contributions.

## THE RATE OF INTEREST ON LATE COMMONHOLD PAYMENTS

18.142 Whenever a unit owner fails to pay his or her share of the commonhold contributions on time, he or she must pay interest to the commonhold association.[59] The CCS requires those preparing the CCS to insert a percentage rate of interest into the local rules of the document. If no provision is made for the payment of interest in the CCS, the default rate of interest is 0%.[60] There is, however, currently no upper limit on the amount of interest that might be charged by the commonhold association. In the Consultation Paper, we expressed concern that the absence of regulation might leave unit owners vulnerable to excessive or punitive amounts of interest. We therefore provisionally proposed that there should be a statutory cap on the amount of interest that may be charged on the late payment of commonhold contributions and asked consultees whether or not they agreed.[61]

### Consultees' views

18.143 The proposal to introduce a statutory cap on the amount of interest that may be payable was almost unanimously supported.

18.144 Those in favour of imposing the cap agreed with our reasoning in the Consultation Paper that, without a cap, levying interest might be subject to abuse and unit owners should receive protection. Peter Smith, for example, argued that without the cap "there could be a potential danger of some over-zealous commonhold associations charging a rate of interest which was on any view excessive".

18.145 A few consultees, however, pointed out that there should be less scope for abusive practices within commonhold:

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59 Commonhold Regulations 2004, sch 3 paras 4.2.16 to 4.2.42.

60 Commonhold Regulations 2004, reg 15(6).

61 CP, paras 14.43 to 14.44.

If the commonhold association is the sum of its members then they should have a common interest in a reasonable rate, to avoid potentially expensive litigation challenging high rates of interest.[62]

18.146 Keith Hince (leaseholder) made the further point that as "anyone can fall on hard times it is pointless trying to punish anyone further if they can prove they have no means of paying".

18.147 The contrary view expressed by those who opposed the proposal was that unit owners should be free to set a level of interest that suits their particular commonhold and that it was unnecessary to "micro manage to this degree".[63]

### Discussion and recommendations for reform

18.148 Given that the commonhold legislation encourages those preparing the CCS to insert a rate of interest into the CCS, we consider it appropriate for the legislation also to provide the necessary protections. In the light of the strong support for this proposal, we recommend that there should be a statutory cap on the amount of interest that can be charged on the late payment of commonhold contributions. This cap will set the maximum percentage of interest that can be charged by the association, in order to protect unit owners from any abuse. The cap should not, however, be viewed as a target amount. Each commonhold should set a level of interest which is appropriate for their particular building or development in the CCS, up to the amount of the statutory cap.

18.149 Our view is that the "judgment debt rate" offers an appropriate and established basis on which to set the statutory cap. This rate prescribes the amount of interest that courts can order debtors to pay, following a judgment against them. Linking the statutory cap to the judgment debt rate will strike the correct balance between flexibility and certainty to unit owners. Flexibility because the rate may be amended from time to time by Regulations, if it becomes outdated. Once the rate is updated, such changes will apply automatically in the commonhold context.[64] It will not be necessary to amend the commonhold legislation to reflect the change. However, changes to the rate are unlikely to be frequent. The rate will be fixed in the sense that it will not fluctuate on a regular basis in accordance with external factors. The rate therefore offers a degree of predictability and certainty as to the amount that may be charged.

#### Recommendation 107.

18.150 We recommend that there should be a statutory cap on the amount of interest that may be charged by a commonhold association on late payments of commonhold contributions which is linked to the amount of interest payable on judgment debts.

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62 This consultee responded anonymously.

63 Iain Macfarlane (solicitor).

64 The CCS would have to be read in the light of any changes to the statutory cap. If the judgment debt rate were subsequently reduced, so that the percentage rate of interest payable under the CCS exceeded this cap, any amount in excess of the cap would not be enforceable.

## CONCLUSION

18.151 In this chapter, we have looked at the mechanisms available to the commonhold association to enforce both non-financial and financial breaches of the CCS. We recommend a new right for the association to apply to court for the sale of a commonhold unit in order to recover its debts. By providing the association with this new right, the association will be able to take much swifter action to recover outstanding commonhold contributions than is presently possible. This new right will help preserve the solvency of the association and will protect other owners from being required to cover the defaulting owner's share. At the same time, defaulting unit owners will be protected from losing their properties in respect of trivial amounts. Our recommended approach will also address lenders' concerns about the adequate maintenance of the commonhold, and will ensure lenders are kept informed of the commonhold arrears. We also recommend a statutory cap on the amount of interest payable on commonhold contributions in order to protect unit owners from the risk of abuse.

# Part VII: Insolvency and termination

# Chapter 19: Protecting the commonhold from insolvency and striking-off

## INTRODUCTION

19.1 This chapter deals with company and insolvency law matters affecting commonhold associations. We begin by considering whether any of the general requirements of company law should be relaxed for commonhold associations and then move on to consider the various ways in which insolvency law may be relevant to commonhold associations. We make recommendations as to how the law applicable to them might be clarified.

## FORMALITIES OF COMPANY LAW

19.2 The commonhold association must take the form of a company limited by guarantee, and, in general, is subject to the normal rules of company law.[1] A number of respondents to our Call for Evidence thought that it would be better if the commonhold association took the form of another existing corporate structure, or of a bespoke corporate body. We concluded that the balance of convenience lay with retaining the structure of the company limited by guarantee.

19.3 Stakeholders who argued that a bespoke corporate structure should be introduced for commonhold associations suggested that it could be subject to lighter regulation than is currently required for companies limited by guarantee. We therefore consulted on whether any existing requirements of company law should be relaxed for commonhold associations.[2] We did not make any specific proposals in this question, though we did identify two possible requirements which might be relaxed: the requirements to make an annual confirmation statement, and to file accounts.

### Consultees' views

19.4 Just under half of consultees opposed any relaxation of the current filing requirements. These included a broad cross-section of consultees, including solicitors, the Association of Residential Managing Agents ("ARMA"), members of our advisory group, academics, freeholders, developers and the Leasehold Knowledge Partnership ("LKP").

19.5 Consultees who opposed any relaxation of the rules tended to take the view that those requirements were not particularly onerous. Some added that, with the occasional exception, existing leaseholder-controlled companies did not find it difficult to comply with them. A few consultees commented that the discipline of having to file an account and make an annual confirmation statement ensured a degree of transparency.

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1 CP, paras 7.4 to 7.12.

2 See CP, Consultation Question 30, para 7.67.

19.6 A significant minority of consultees were in favour of dropping requirements such as those we specified. These tended to be mainly leaseholders and other individual consultees, though they included two law firms, and the Leasehold Advisory Service ("LEASE"). Others proposed dispensing either with accounts, or with the confirmation statement. A further group of consultees said simply that formality requirements of this kind should be kept as simple as possible, and a further group thought that such requirements should depend either on the number of units, the annual turnover, or the size of a commonhold's reserves.

19.7 A number of consultees stressed how important it was that commonhold associations should not be struck off due to an inadvertent failure to file a confirmation statement and balance sheet. The Federation of Private Residents' Associations ("FPRA") and the Chartered Institute of Legal Executives ("CILEx"), two bodies who appeared to have experience of similar problems with leaseholder-controlled companies, suggested that this would be less likely to occur if Companies House were to send letters warning a company that it was about to be struck off to the home addresses of directors, as well as to its registered office.

### Discussion and recommendations for reform

19.8 We are of the view that the formalities which a commonhold association must comply with should strike a proper balance between:

(1) being as straightforward as possible, bearing in mind that most commonhold directors will be inexperienced lay people; and

(2) ensuring that the records kept at Companies House are sufficiently transparent so as to inform members of the commonhold association and those who contract with commonhold associations of the financial standing of the association.

19.9 The justification often given for imposing formality requirements on limited companies is to inform and protect outsiders entering into contracts with them. Consultees, however, suggested that formality requirements also protect the members of leaseholder-controlled companies, by ensuring transparency on the part of the directors. This rationale applies, by extension, to the members of commonhold associations.

19.10 We note the view expressed by consultees who opposed any relaxation of the rules that the requirements are not onerous. In this respect, the requirements for filing accounts have been relaxed over the years. Although "small companies" still have to prepare a profit and loss account for their members, since 2016 they are only required to file a directors' report and a balance sheet with Companies House.[3] Many leaseholder-controlled companies qualify as "micro-entities",[4] a sub-class of "small

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[3] To qualify as a "small company" a company must fall within any two of the following three thresholds:

(a) annual turnover of not more than £10.2 million;

(b) balance sheet total of not more than £5.1 million;

(c) average number of employees not more than 50.

[4] To qualify as a "micro-entity" a company must fall within any two of the following three thresholds:

companies". Micro-entities only have to file a balance sheet at Companies House. Many commonhold associations will also qualify as "micro-entities". Whether commonhold associations qualify as "small companies" or "micro entities" may depend on whether their reserve funds are treated as being beneficially owned by the commonhold association.[5] In Chapter 14 we recommend that a commonhold's designated reserve funds should be held on trust.[6] Our primary intention behind making this recommendation is not to reduce the burden of company law requirements with which commonhold associations must comply. If, however, designated reserve funds are trust funds, they will not be beneficially owned by the association. An indirect consequence of this change would be that commonhold associations are more likely to qualify for a lower threshold of compliance with company law requirements than they otherwise would.

19.11 It has been suggested to us that it would help avoid the premature striking-off of commonhold associations if a warning letter was sent not only to the registered office of the association, but also to those recorded as being the directors, at their last-known private addresses. We agree that it would be useful to do so, given the particularly serious consequences of a commonhold association being struck off, and recommend that Companies House considers the feasibility of doing so.

**Recommendation 108.**

19.12 We recommend that Companies House consider whether, when they are about to strike off a commonhold association for failure to comply with filing requirements, they might send letters of warning to the directors at their private addresses as well as to the registered office of the association.

## INSOLVENCY ISSUES

19.13 Our priority is to ensure that commonhold associations rarely become insolvent. We therefore make a number of recommendations elsewhere in this Report to minimise the risk of insolvency.

(1) In Chapter 12 we recommend that commonhold associations should be required to take out public liability insurance to mitigate the risk of an association having to meet a "catastrophic loss" claim while uninsured or under-insured.[7]

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(a) annual turnover of not more than £632,000;

(b) balance sheet total of not more than £316,000;

(c) average number of employees not more than 10.

5 By "beneficially owned" we mean that the funds belong fully to the association.

6 See paras 14.66 to 14.69.

7 See paras 12.135 to 12.142.

(2) In Chapter 13 recommend that commonhold associations should have enhanced powers to ensure that unit owners pay their contributions to shared costs.

(3) In Chapter 14 we recommend that both designated and general reserve funds should be held on statutory trusts, so as to clarify their protected status. These recommendations will encourage commonhold associations to accumulate adequate reserve funds to minimise the risks of insolvency arising through the costs of major works.[8]

19.14 Where insolvency does occur, our objective is to ensure, as far as possible, that commonhold unit owners are in no worse a position than leaseholders who own the freehold of their block through a freehold management company ("FMC"). In this part of the chapter, we make recommendations to:

(1) to prevent a liquidator from requiring unit owners to make further contributions to reduce the indebtedness of the association; and

(2) to improve the operation of succession orders, including ensuring that the court cannot make it a condition of a succession order that the unit owners, or the successor association, contributes to the debts of the insolvent commonhold association.

19.15 These recommendations are designed to ensure that commonhold unit owners, as far as possible, benefit from limited liability to the same extent as leaseholders who own their freehold through an FMC, where the FMC becomes insolvent.

19.16 We also discuss, but do not make recommendations in respect of company voluntary arrangements ("CVAs"), and whether the threshold for insolvency of a commonhold association should be different (higher) than is the case for any other company.

### Problems with the current law

19.17 Under the Commonhold and Leasehold Reform Act 2002 (the "2002 Act"), a commonhold association is a company limited by guarantee. Any form of limited liability – whether through an existing or bespoke corporate structure – raises the possibility that the body corporate may become insolvent and therefore need to be wound up. In commonhold this may occur where a commonhold association is unable to meet its debts to its creditors, such as roofing contractors, gardeners or engineers. Dissolving the commonhold association raises particular difficulties for a commonhold, as the association owns the common parts, and is responsible for arranging for, among other matters, their upkeep, repair, and insurance. The association is also responsible for collecting the commonhold contributions, which are used to finance a commonhold's expenditure.

19.18 Dissolving the commonhold association would also mean that unit owners can no longer rely on any rights granted to them in the commonhold community statement (the "CCS"). This is because the CCS only exists as long as there is a commonhold association. Additionally, while unit owners would retain the freehold of their individual

[8] See paras 14.66 to 14.69.

units if the commonhold association ceased to exist, in the case of flats their freehold ownership would not extend to the exterior or main structure of the block. Each unit owner would, in effect, own their flat as a "flying freehold". It is unlikely that such a flat would be saleable at anything like its value when it was part of functioning commonhold. Lenders would, with some justification, say that they would be stuck with holding security over a property which they would never have considered as offering satisfactory security if it had been offered when they originally accepted it.

19.19 The 2002 Act endeavoured to reconcile the possibility that a commonhold association might become insolvent with the need to ensure that a body able to undertake the responsibilities of the association is always in existence. It did this by introducing the concept of the "successor association". It provided that the court might, when winding-up a commonhold association, make a "succession order" allowing another company to assume the functions of the insolvent association.

19.20 We are not aware of any commonhold association ever having become insolvent, so we do not know how this attempted solution would work in practice. As we explained in the Consultation Paper, doubts have been expressed as to how far the procedure would in fact deliver limited liability for the members of the insolvent association.[9] In summary, it has been argued that:

(1) financial contributions might be required by the court from members of the insolvent association as a condition of granting a succession order; and/or

(2) the liquidator might continue to demand contributions from unit owners, in their continuing capacity as members of the insolvent association. This might apply even though a successor association had been set up, and was already demanding contributions to meet its current expenditure.

### Comparing the position of a commonhold association with that of a freehold management company on insolvency

19.21 This outcome places commonhold unit owners in an unfavourable position following the insolvency of a commonhold association when compared with the position of leaseholders who own and control a block through an FMC if the FMC becomes insolvent. We shall refer to this as "enfranchised leasehold".

19.22 As we explain in Chapter 2, we are of the view that commonhold offers significant advantages over leasehold, even where leaseholders own the freehold of their block following a collective freehold acquisition.[10] However, we are keen to ensure that the advantages of commonhold are not overshadowed by the law operating more favourably for leaseholders who control their freehold than it does for commonhold unit owners in the event of an FMC's or commonhold association's insolvency.

19.23 In the Consultation Paper, we explored why leaseholders whose freehold is leaseholder-controlled enjoy limited liability that very nearly amounts to fully-limited liability.[11] Broadly speaking, we took the view that an FMC and a commonhold

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9 See CP paras 7.13 to 7.19 and 7.30 to 7.33.

10 See para 2.8 to 2.19.

11 See CP, Appendix 5.

association may become insolvent in very similar circumstances. However, while units in a commonhold risk being transformed into "flying freeholds" if the commonhold association is wound up, units in a block owned by an insolvent FMC would remain leaseholds after the FMC has been wound up. Although leasehold flats whose landlord has been wound up or struck off are not generally acceptable to purchasers or lenders, we suggested that it would be a comparatively straightforward and inexpensive exercise for the affected leaseholders to set up a new FMC and to reacquire the freehold reversion from the Crown.

19.24 The liability of an FMC is therefore informally "capped" at the total of (a) the cost of reacquiring the freehold and (b) the incidental legal costs which would be incurred. If an FMC were facing debts that exceeded these costs, it would be cheaper for it to allow itself to be wound up. However, as it would likely be difficult to sell or mortgage units until after the freehold reversion has been reacquired, flat owners are nevertheless incentivised to avoid a winding-up.

19.25 If "enfranchised leasehold" does offer virtually unqualified limited liability to FMCs, then this is clearly relevant to the position of commonhold associations. So long as enfranchised leasehold exists as a comparator:

(1) legal advisers advising those who are exercising the right of collective freehold acquisition using a limited company will advise their clients to consider carefully whether the benefits of commonhold outweigh the possible inroads into limited liability; and

(2) similar considerations may prompt legal advisers to advise their clients to buy-in to developments which are offered for sale on an "enfranchised leasehold" basis rather than a commonhold basis.

19.26 Direct comparisons between the current position on insolvency between commonhold and enfranchised leasehold are difficult.

(1) The degree to which the owners in an enfranchised leasehold will wish to avoid their FMC becoming insolvent will depend on the value of the freehold reversion.

(2) An enfranchised leasehold block with a reversion which includes assets that could be sold will have more incentive to avoid being wound up than a block where it would not be possible for a liquidator to sell off any assets.

(3) It is unclear whether the reserve funds and other service charge funds of an enfranchised block would be available to creditors. In view of the statutory trust of such funds,[12] it seems unlikely that they will, unless a creditor's claim related clearly to a matter covered by the service charge.[13]

(4) It is impossible to say with any assurance what the liabilities of unit owners may be if a commonhold association is wound up. It is uncertain whether a liquidator

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12 Landlord and Tenant Act 1987, s 42.

13 CP, Appendix 5, para 5.9(5) and Table to Appendix 5.

could continue to demand commonhold contributions to clear the debts of the association.[14] It is unclear how far the liquidator could sell off part of the common parts, and it is unclear whether the court could require it as a condition of making a succession order. It is uncertain whether the court could require the unit owners, or the successor association, to clear, or to make contributions towards the debts of the insolvent association as a condition of its making a succession order.

19.27 What is, however, clear is that practitioners have become aware of the uncertainties. They therefore fear that the position of unit owners with an insolvent commonhold association may be worse than that of leaseholders where the freehold is leaseholder controlled by an insolvent FMC.

19.28 The Association of Leasehold Enfranchisement Practitioners ("ALEP") remarked that, in spite of their acceptance of the advantages of commonhold over enfranchised leasehold, their members would be unable to recommend conversion from enfranchised leasehold to commonhold to their clients unless and until the issues arising from the potential insolvency of the commonhold association were fully and properly resolved.

19.29 This view contrasts strongly with the response of Martin Wood (solicitor). He did not think that the position of the commonhold association when faced with insolvency differed materially from that of an FMC, and suggested that too much was being made of the difference between the two bodies.

19.30 We are not aware of other consultees who have down-played the distinction between the effect of insolvency upon an FMC and the uncertainties over how it may apply to commonhold associations. We outlined what we thought were their respective positions in the Consultation Paper, and set out a more detailed analysis of what we believed to the position of an FMC in Appendix 5. No consultee suggested that what we described in Appendix 5 was incorrect. We therefore maintain the view that commonhold will need to offer unit owners a level of limited liability which is comparable with that offered to leaseholders who control the freehold of their block. Our objective must be to introduce reforms which remove the doubts that have arisen in relation to the position under the current law, and ensure that unit owners enjoy fully-limited liability.

19.31 We think that the recommendations which we make from 19.53 below will both clarify the position, and make commonhold more acceptable.

### Use of the company voluntary arrangement

19.32 In the Consultation Paper we raised the issue of whether a commonhold association which was faced with financial difficulties might make use of a company voluntary arrangement ("CVA").[15] We outlined how a CVA might work, and what the advantages of such an arrangement might be, both for a commonhold association and its creditors. We could see no reason, in principle, why a commonhold association might not make use of the CVA procedure, and we thought it likely that a commonhold

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14 CP, paras 7.32 to 7.33.

15 CP, paras 7.50 to 7.52.

association would fulfil the qualifying criteria for any CVA to include a moratorium on enforcement of its debts. We invited consultees' views on two issues:

(1) whether they were aware of any particular difficulties in applying CVAs to commonhold associations; and

(2) whether the CVA procedure needed any adaptation to make it more relevant and effective in dealing with commonhold associations in financial difficulties. [16]

### Consultees' views

19.33 In view of the specialised nature of the question, we received fewer responses to this question than to the more general questions in the Consultation Paper. Of those who did respond to either part, a significant minority either stated that they did not know, or did not understand the question.

19.34 A leaseholder, and the Leasehold Advisory Service ("LEASE"), both thought that a lack of knowledge or experience of company law on the part of a commonhold association's directors would mean that they might fail to appreciate that the association was in such difficulties that it should consider a CVA. The directors might also be unaware that a CVA could be of assistance.

19.35 Echoing this view, one leaseholder thought that the procedure should be adapted to take account of the directors' lack of knowledge of company law. Another leaseholder thought the procedure should be made more flexible, and one consultee suggested that it could be made more "streamlined", but without providing specific suggestions.

19.36 Most consultees with experience of the CVA procedure thought that it might be useful, but they could not suggest any specific adaptations. Several suggested that training and/or guidance on such matters should be given to directors of commonhold associations.

19.37 Places for People Group Ltd (developers) stressed that, although insolvency procedures such as the CVA were in theory available for FMCs, in practice it was rarely commercially viable to engage an insolvency practitioner to formulate and implement a CVA. They took the view that a similar problem would be encountered if a commonhold association wished to enter into a CVA.

### Discussion

19.38 Consultees' responses suggest that the CVA procedure could be useful to a commonhold association in financial difficulties. However, in view of the associated costs, a CVA is likely to only be an option for larger developments. Consultees' responses have not led us to believe that any amendments to the CVA procedure are necessary to make it more suitable for commonhold associations. We do not therefore make any recommendation in relation to the application of CVAs to commonhold associations.

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[16] CP, Consultation Question 31, paras 7.68 to 7.69.

### The appointment of a "commonhold administrator"

19.39 In the Consultation Paper we expressed concern that a commonhold association might become subject to the insolvency regime because it was unable to meet a statutory demand,[17] in circumstances in which it could be restored to financial health by demanding further contributions from unit owners. The consequences for unit owners and their lenders if the commonhold association were wound up, and the units were left as flying freeholds, would, as noted above, be particularly serious. We suggested that a commonhold association should never be wound up if there was a reasonable prospect of its being able to pay its debts.[18] We therefore made two interrelated provisional proposals.[19] We provisionally proposed:

(1) if a petition were presented for the winding-up of a commonhold association, the Insolvency Court should, as a first step, appoint a commonhold administrator; and

(2) that the commonhold administrator would review the financial position of the commonhold association and would petition for its winding-up only if he or she took the view that it was "irretrievably insolvent". The test would be whether the association could be returned to solvency within a set period. We did not propose any particular period, though the period of two years was given as an example.[20]

#### Consultees' views

19.40 It is convenient first to examine our provisional proposal that the test for making a commonhold association insolvent should be whether it is "irretrievably insolvent". Although we did not suggest how this test should be defined, we noted the definition in the 1990 Draft Bill.[21] The vast majority of the responses agreed with our proposal, with very few answering "other" and even fewer indicating that they disagreed.

19.41 Although a significant majority were in favour of having a more stringent threshold for a commonhold association to be wound up than would apply generally, a few of those who were in favour did, notwithstanding, express reservations. ARMA thought that a commonhold administrator would have a financial interest in continuing the period of administration for as long as possible, and only then petitioning for liquidation.

19.42 Letitia Crabb (academic), who opposed the proposal, made the point that it would reduce the scope of creditors' remedies, and would set commonhold associations apart from limited companies generally.

19.43 Others who opposed the proposal, or who answered "other", put forward a variety of views. These ranged from thinking that it was wrong for commonhold associations to be treated differently from other companies, that it should not be possible for a

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17 A statutory demand is a written demand for the payment of a debt.

18 See CP, para 7.53 to 7.55.

19 CP, Consultation Question 32, paras 7.70 to 7.71.

20 See CP, para 7.54(3), n 68.

21 See CP, para 7.53(2), n 67.

commonhold association to be wound up at all, or that an entirely bespoke insolvency regime was required for commonhold associations.

19.44 The Property Litigation Association ("PLA") expressed doubts as to what "irretrievably insolvent" would actually mean.

19.45 Our provisional proposal that appointing a commonhold administrator should be a preliminary step to a commonhold being wound up attracted almost universal support, with hardly any against it, and a very few answering "other".

### Discussion

#### "Irretrievably insolvent"

19.46 Consultees views prompted us to consider the feasibility of our provisional proposal. The commonhold association (whether it remained under the control of the directors, or was subject to the control of an administrator) would continue to have the right to demand commonhold contributions from unit owners. Therefore, virtually any commonhold association could, at least in theory, be restored to solvency if contributions were set at a high enough level for a sufficiently long period. Some other formulation of the threshold would be required. Setting a period within which the association should be returned to solvency would take no account of the level of the debts, or of the financial resources available to the individual unit owners. On reflection, it was not apparent to us how "irretrievably insolvent" should be defined.

19.47 "Irretrievably insolvent" is already used to describe the test for the process whereby a company which is in administration can move directly from administration into winding-up.[22] This usage describes a different state of affairs. The assets and liabilities of the company are known, and it is clear that the company will not be able to "trade its way out" of its position. It would be inappropriate therefore to use it to describe a rather different situation within a commonhold association. There will never be a scenario where a commonhold is restored to "profitability". The question would be what level of increased contributions the unit owners could reasonably afford. This would be a difficult question to answer in a small commonhold development, and an impossible exercise to carry out in a commonhold of potentially hundreds of unit owners.

19.48 The fact that our proposed term is already used to describe another procedure is not a sufficient reason for us not to adopt a higher threshold for the insolvency of commonhold associations, if we think it appropriate. Some other term could be given to it. However, consultees who were unhappy with what we described in the Consultation Paper as "irretrievable insolvency" did not suggest any alternative higher test for the insolvency of a commonhold association.

19.49 The recommendations we make from paragraph 19.53 below seek to ensure that unit owners in a commonhold are, insofar as possible, protected from the worst consequences of insolvency. Our recommendations on the process of a winding-up will ensure that the vast majority of commonhold associations are protected from the most severe consequences of insolvency. We are therefore of the view that

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22 Insolvency Act 1986, sch B1, para 84(1); and see I Fletcher, *Insolvency* (5th ed 2017).

introducing an additional test of "irretrievable insolvency" would introduce additional and unnecessary complexity into the commonhold scheme.

19.50 We have therefore concluded that we should not set a threshold before a commonhold association can be wound up which is higher than that which applies under the general law. Instead, the tests applied by the general law of insolvency should be used.

### The appointment of a commonhold administrator

19.51 The proposal to require an administrator to be appointed as a preliminary step to winding-up a commonhold association was predicated on the basis that commonhold associations would be treated differently from other companies in relation to insolvency. As we have concluded that the same test of insolvency should apply, the appointment of an administrator loses much of its justification. A number of other difficulties with that proposal have also come to light.

(1) Our provisional proposal would have required the appointment of an administrator for a potentially lengthy period while the association was restored to solvency. On reflection, this requirement did not seem a very realistic proposition. We have expressed reservations as to whether it would be economically viable for a licensed insolvency practitioner to formulate and put into effect a CVA for a commonhold association.[23] This would be a discrete task, likely to take a fairly short period. Having an administrator – who would also have to be a licensed insolvency practitioner – run a commonhold association for any substantial length of time raises similar issues of cost. The administrator would be fulfilling the role of the directors. As he or she would not be a specialist in property management, he or she would need to continue to engage professional managing agents. Having a licensed insolvency practitioner run a commonhold association for any lengthy period would be likely to be an expensive exercise.

(2) Since the idea of the "commonhold administrator" was proposed in the 1990 and 1996 Draft Bills, insolvency law has been amended and developed. The effect of the Insolvency Act 2000 and the Enterprise Act 2002, in particular, is that administration is more generally available. Administration can be used to avoid winding-up any limited company, if the company can be salvaged and restored to solvency. In an appropriate case, therefore, administration should be available to commonhold associations, without the need for special provision to be made for it.

(3) The proposals that we make below (see paragraph 19.88 onwards) relating to the making of a succession order and the appointment of a successor association should mean that the severe consequences that result from there being no commonhold association will occur very rarely. In some cases, it may therefore be appropriate that a commonhold association be wound up and that a successor association should take over. This procedure may offer a way forward that is more practicable, than that efforts should be made in an

[23] See para 19.37 above.

unrealistic attempt to keep alive an association with pressing financial difficulties.

19.52 In light of these factors, we have decided not to recommend the appointment of an administrator.

### Clarifying the process and extent of liquidation

19.53 We have noted at paragraph 19.18 above19.13 above the importance of there being, so far as possible, a commonhold association in existence at all times. We recognise that this aim is difficult to reconcile with the fact that, as a company with limited liability, it must be capable of being wound up if insolvent. The 2002 Act attempted to "square the circle" by providing that, if a commonhold association were to be wound up, it should be possible for the court to make a "succession order" within the insolvency proceedings. This order would allow a new commonhold association to assume the role of the dissolved association. We did not identify any approach that we thought preferable to the succession order, and so we asked questions in the Consultation Paper on the basis that the existing "succession order" procedure would continue.

19.54 Not all consultees agreed with this approach. Some suggested that we should provide that it should not be possible for a commonhold association to be wound up at all. This suggestion would undermine a basic assumption of company law in England and Wales. It would also have the effect that a commonhold association faced with the sort of "catastrophic loss" claim that we described in the Consultation Paper would find itself encumbered with a judgment debt which it might take years to clear. [24] It is not clear whether those who suggested that a commonhold association should never be wound up fully appreciated the difficulties that this would cause for unit owners.

19.55 Other consultees suggested that we should look at other corporate bodies which, for various reasons, cannot be wound up in the same way as ordinary limited companies. Bodies such as utility companies, registered providers of social housing, and Further Education Colleges were mentioned. However, in cases such as these the position is that, if they are insolvent then, broadly speaking, their assets and undertaking are taken over by a body which has similar functions. One commonhold association would rarely be in a position where it could take over the functions of another. Further, it would very rarely have any incentive to do so. We do not therefore think these models are likely to be of relevance.

19.56 We maintain the view that there is no viable alternative to retaining the general approach of the 2002 Act, and to provide that a successor association might take over, for the future, the functions and future responsibilities of the insolvent association.

19.57 We therefore raised various issues in the Consultation Paper which were intended to clarify the scope and detail of the liquidation process.[25]

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[24] See CP, paras 7.14 and 7.19.

[25] CP, Consultation Questions 33 and 34, paras 7.72 to 7.77.

(1) We provisionally proposed that, if a liquidator was appointed in respect of an insolvent commonhold association, then he or she would not be able to demand further contributions from the unit owners in order to reduce the indebtedness of the association. We also provisionally proposed that this restriction would extend to the liquidator not demanding a further "round" of contributions from unit owners to make up any shortfall from an earlier "round" if certain unit owners were bankrupt. This would also extend to the situation where there was clearly no point in attempting to recover contributions from them.

(2) We provisionally proposed that the law should be clarified to make it clear that there is a presumption that, if a commonhold association is wound up because of its insolvency, a successor association should be appointed. We asked whether consultees agreed with that.

(3) We invited consultees' views on whether there were any circumstances in which it would not be appropriate to appoint a successor association; and, if so, what those circumstances would be.

(4) We asked consultees whether they agreed with our provisional proposal that the court should have discretion as to whether to impose conditions on the making of a succession order.

(5) We invited consultees' views on what conditions might be imposed; and, if the court's discretion was to be structured, what factors the court should be required to take into account in deciding upon those conditions.

19.58 The first of these proposals relates to the powers of a liquidator to call for contributions from the commonhold unit owners. The other issues all relate to the succession order procedure.

### Powers of a liquidator to call for further contributions from unit owners

#### Consultees' views

19.59 The vast majority of the consultees who responded agreed with our provisional proposals that prevent a liquidator requiring unit owners to make further contributions. In particular, bodies representing the legal profession, leaseholders, and those representing leaseholders were in favour of our proposals. Views of law firms were more evenly divided. Opposition to our proposals came mainly from landlords, ARMA, and some individual consultees.

19.60 Most of those in favour simply stated that it was necessary to preserve the limited liability of unit owners, and necessary to make commonhold more attractive to purchasers.

19.61 Letitia Crabb stressed that this restriction on unit owners' liability was:

> made necessary by the dual status of unit holders as members of a company and as consumers of the company's services. Their liability as members of the company is clear – to pay £1 by way of guarantee if the company is wound up.

19.62 She justified the restriction as:

a consumer protection measure necessary to promote the security of those who live in interdependent properties under the commonhold scheme. This could (depending on the view one took about the position of [leaseholders] in an insolvent winding-up of a leasehold scheme) give commonhold another advantage over leasehold.

19.63 Some of the few consultees who opposed our provisional proposals appear to have misunderstood them. One consultee expressed the view that unit owners should be responsible for their arrears: our proposal would not affect existing debts to the association. Other consultees also appeared to have misunderstood our proposal as meaning that unit owners should not be required to pay their own arrears. Other consultees, however, clearly did think it was wrong that unit owners should not be responsible for debts which their association had incurred. Consensus Business Group (landlord) seemed opposed to the principle of the commonhold association having limited liability at all. ARMA was concerned about the possibility of a commonhold association sheltering behind limited liability so as not to meet its debts.

19.64 Mark Chick (solicitor) opposed our proposal, but recognised the dilemma. He commented that "to make commonhold fully 'circular' the whole concept of limited liability should really be removed" but recognised that to do this would prevent the take-up of commonhold at all.

### Discussion and recommendations for reform

19.65 Consultation responses focussed on the issue of whether unit owners should be required to contribute to the debts of the commonhold association. Responses focussed less on the specific issue of whether it is ever appropriate for the liquidator to take the decision to levy further contributions. It would, for example, be possible to take the view that unit owners should not enjoy absolute limited liability, but that whether to demand further contributions should always be a decision for the court, and not for the liquidator. This would mean that the court, as a condition of making a succession order, could require that the unit owners should each be required to pay a set sum to the liquidator of the insolvent association. Alternatively, it would be possible to impose a condition that the successor association should be required to pay a set sum to the liquidator, and the association would then have to recover this sum from the unit owners.

19.66 The vast majority of consultees supported our provisional proposal that the liquidator should not be able to demand further contributions from the unit owners. Those who were opposed to it did not come up with any reasons in favour of making this a decision to be taken by the liquidator rather than the court. Again, that is because their objections focussed on the question of liability of the unit owners, rather than the specific question of whether the liquidator should be able to impose that liability. In the interests of clarity and predictability we consider that – if further contributions from unit owners are to be required at all – then it should be the court, and not the liquidator, which makes the decision, and imposes a condition to that effect on the succession order.[26]

[26] In paras 19.108 to 19.113 below we consider whether the court should be able to make it a condition of the grant of a succession order that the unit owners, or the successor association, should be required to

19.67 We noted in the Consultation Paper that, even if a liquidator could not require further contributions from the unit owners to clear the debts of the association, he or she would be entitled to recover arrears of contributions which had fallen due before the liquidation. He or she would also be entitled to require contributions to meet the ongoing essential expenditure of the commonhold.[27] We think that the liquidator should be able to demand contributions to meet essential expenditure until either a successor association took over, or the liquidation was completed, and the former units had ceased to be a commonhold.

19.68 We have concluded therefore that a liquidator should not be able to demand further contributions from the unit owners to reduce the indebtedness of the commonhold association. That being the case, the possibility of making a further "round" of demands for contributions falls away. We note, however, that a similar proportion of consultees supported our provisional proposal in this respect as supported our main proposal.

**Recommendation 109.**

19.69 We recommend that, if a liquidator is appointed to wind up a commonhold association, he or she should not be able to demand further contributions from the unit owners to reduce the level of indebtedness of the association beyond those already demanded by the directors.

19.70 We recommend that a liquidator should have the power to issue demands for any contributions that are required to meet ongoing essential commitments of the commonhold until a successor association is appointed, or the commonhold association is wound up without the creation of a successor association.

## Succession orders

### Consultees' views

19.71 Our provisional proposal that it should be clarified that, on the insolvency of a commonhold association, there is a presumption that a successor association should usually be appointed, received almost universal agreement. Those who supported our proposal tended to echo the reasons given in the Consultation Paper, stressing that a commonhold should not be left without an association, as management and communal maintenance were required at all times. Nevertheless, some consultees who supported our proposal thought that that any presumption should be rebuttable, and were concerned that there should be some incentive for commonhold associations to manage themselves responsibly.

contribute to the debts for which the insolvent commonhold association was liable. We recommend that it should not be possible for such a condition to be imposed.

27 This is explained further in the CP, para 7.62.

19.72 An anonymous residents' association expressed concern about what would happen if no owners were prepared to serve as directors of the successor association. They thought that it would be a real possibility in a retirement block.

19.73 Those who disagreed with our proposal were two landlords, the Property Bar Association, and one individual. Landlords were chiefly concerned that commonhold associations would make use of insolvency as a way of avoiding their debts. The Consensus Business Group (landlord) predicted that contractors would insist upon payment in advance from commonhold associations. This would mean that commonholds would get poor value for money from their contractors. The Property Bar Association expressed misgivings that our proposed presumption could mean that the underlying difficulties that resulted in the failure of the commonhold association would recur in the successor association.

19.74 Letitia Crabb opposed the idea of there being a presumption because she considered that the court should retain full discretion as to whether to make a succession order: "The succession order procedure is, arguably, a rescue procedure, not a rubber stamp exercise".

19.75 Some of those who answered "other" appeared to have misunderstood our proposal, as they were unclear how the successor association would be formed. For example, one consultee was concerned that it should be independent, and not run by a freeholder or developer.

19.76 We asked consultees for their views on when and in what circumstances it would *not* be appropriate for a successor association to be appointed.

19.77 Consultees such as the landlords who had disagreed with our proposal found it difficult to envisage circumstances in which it *would* be appropriate to appoint a successor association. They could not see how an association could become insolvent except through its own fault (for example, failure to insure, or failure to take proper professional advice). They could not, therefore, foresee circumstances where it would be appropriate to appoint a successor association.

19.78 Letitia Crabb suggested that a succession order could be futile unless those who had been involved in the insolvent association were no longer involved in it. She further suggested that if the successor commonhold association wanted the common parts, then it should be required to pay for them, as these are assets that would otherwise be available to creditors.

19.79 As already noted, the overwhelming majority of consultees supported the principle that there should be a presumption in favour of there being a successor association. Many of these consultees also considered the circumstances when it would not be appropriate for there to be a succession association. From this group a degree of consensus emerged as to the sort of factors which would militate against having a successor association, although there were different views as to where the threshold should lie for a successor association not to be appointed.

(1) Boodle Hatfield LLP (solicitors) thought that there should be no successor association if there had been malfeasance on the part of the directors of the

insolvent association and they were intended to be the directors of the new association.

(2) A number of consultees referred to "negligence, collusion or fraud" (or various variants on this theme) as disqualifying the commonhold from having a successor association.

(3) The PLA, ARMA and LEASE all thought there should be no successor association if insolvency was being used as a deliberate attempt to avoid the association's liability.

(4) Damian Greenish (solicitor) and the Society of Legal Scholars endorsed the factors that we had set out at paragraph 7.59 of the Consultation Paper, although the Society of Legal Scholars felt that, to prevent abuse, broader grounds of mismanagement should justify the appointment of an administrator.

19.80 A few consultees suggested factors which we had not considered in the Consultation Paper. Several consultees referred to the destruction of the building. [28]

19.81 Some consultees seem to have misunderstood the nature of a "successor association". Some seem to have assumed that because of the reference to its being "appointed by the court" that a successor association would perform some temporary function, until the commonhold could be returned to the control of the original commonhold association.[29] That is not in fact the case: a successor association is a permanent replacement for an insolvent commonhold association.

19.82 The overwhelming majority of consultees agreed with our further provisional proposal that the court should have discretion as to whether to impose conditions for a successor association to be appointed. The very few who did not agree with this proposal (that is, who either disagreed with it, or answered "other") comprised leaseholders, individual consultees, and an anonymous residents' association.

19.83 The conditions suggested by consultees that might be imposed tended to fall within one or more of the following categories.

(1) The two commercial freeholders who were not in favour of there being a presumption of the making of a succession order, and who agreed that the court should have a discretion whether or not to make one, thought a succession order should be refused if there was a deliberate attempt to evade responsibility for validly incurred liabilities.

(2) The single condition that was suggested most often, including by Westminster and Holborn Law Society, ARMA, LEASE and Irwin Mitchell LLP (solicitors),

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[28] The destruction of the building would normally lead to the unit owners considering the formal termination of the commonhold, which is discussed in Ch 20.

[29] The wording of the question may have contributed to this misunderstanding. Technically the successor association has to be set up by the unit owners. The court then makes a "succession order" permitting it to assume the role of the commonhold association in respect of the commonhold.

was that those who had been responsible for the insolvency of the original association should be barred from being directors of the successor association.

(3) Three consultees thought that conditions could be imposed (i) to require the directors to have professionals assist them; (ii) to require the commonhold association to maintain a reserve fund; and (iii) to require the association to take out appropriate insurance policies.

(4) The Guinness Partnership (housing association) suggested that the directors could be required to appoint an expert manager.

(5) Other consultees made general references to restricting the future business or financial activities of the successor association. At least one such comment may have been made under the misapprehension that a commonhold association is likely to become insolvent only if it is engaging in trading activities.

(6) Trowers & Hamlins LLP (solicitors) thought that conditions might be imposed requiring financial contributions from those responsible for the insolvency of the previous association.

19.84 The Leasehold Knowledge Partnership ("LKP") and the All-Party Parliamentary Group on Leasehold and Commonhold Reform (the "APPG") stated "it is to be assumed that the successor association is not to be allowed to absent itself from debts of the predecessor". In fact, the opposite is the case; we suggested in the Consultation Paper that the ability of the court to impose conditions should not be used to undermine the general position that a successor association is not liable for the debts of its predecessor.[30] The Westminster and Holborn Law Society agreed with our view, on the basis that "such a condition would imperil ab initio its viability".

19.85 The PLA also thought that:

> The court might in certain circumstances require the payment of a deposit or other form of security in favour of a creditor of the commonhold association who is a creditor in respect of a liability that the previous commonhold association had sought to avoid or failed to pay.

but warned that "compulsory conditions" might make it impossible for the successor association to operate, with the result that the property could no longer be run as a viable commonhold.

19.86 Comments from a few consultees suggested that they were unsure of how the successor association procedure would work (see paragraph 19.81 above), and therefore what restrictions and conditions might be appropriate.

19.87 Berkeley Group Holdings PLC (developer) suggested that the court should be able to impose a condition that a successor association is required to continue to observe any

[30] See CP, para 7.58.

"place-making" provisions which had been included in the original CCS. A developer should therefore have standing to make any representations to that effect to the court.

## Discussion, and recommendations for reform

### Presumption in favour of a succession order

19.88 A number of consultees objected to the concept of a commonhold association being allowed to be wound up if insolvent, on the basis that it meant that it was offering the association, and therefore the unit owners, a way out of paying their debts. This criticism is a criticism of the principle of limited liability; it is not really an argument for the commonhold association not to have it.

19.89 A novel feature of insolvency law, as applied to commonhold associations, is the provision for the court to make a "succession order" allowing a "successor association" to take over the functions of an insolvent association. It should perhaps be recognised that this is only to institutionalise a phenomenon which has always been evident in the world of corporate insolvency: after an insolvent company has been wound up, those who were involved in it may choose to set up another, subject to a restriction on setting up a new company under a similar name. This, as we have noted, can be done after an FMC has been wound up or struck off.

19.90 Following the overwhelming support for our proposal, we recommend that that there should be a presumption in favour of the court making a succession order. This "presumption" should be a rebuttable presumption. The court would ultimately retain a discretion.[31]

19.91 Although the 2002 Act appears to lean in favour of the court making a succession order, it failed to offer guidance on whether any presumption extended to the making of a succession order *without conditions.* We noted in the Consultation Paper the considerable difference of opinion among commentators on this point.[32] How this difference of approach is resolved does, in practice, determine the extent to which unit owners enjoy fully-limited liability.

19.92 We would not expect the Insolvency Court to make a succession order until the liquidator had formed a view of the affairs of the association, and reported this to the court. It would also be necessary, in practice, for a successor association to be viable that the directors and unit owners of the insolvent association had co-operated with the liquidator in sorting out the affairs of the commonhold association.

### Sale of part of the common parts by the liquidator

19.93 In the Consultation Paper we suggested that the court might wish to impose a condition relating to the "sale off "of common parts which were considered to be

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[31] In the CP, we proposed that "a successor association should be appointed" (paras 7.72 to 7.75). On reflection, this terminology is imprecise. The court cannot, strictly speaking, appoint a successor association. The court can make a succession order only if the unit owners have already formed a company which fulfils the necessary criteria for it to be a commonhold association. The succession order will then enable the company to fulfil that role.

[32] See CP, paras 7.18, and 7.30 to 7.32.

surplus to the requirements of the commonhold.[33] We recognised that what one consultee referred to as the "basic common parts" – entrances, stairways, landings, and the main structure - would generally be unsaleable. In a few cases garden land, or leisure facilities, might be saleable. Perhaps the most likely scope for realising part of the common parts would arise in commonholds where attic space (for conversion) or airspace over the roof (for building additional storeys) might be sold.

19.94 The assets of a commonhold would come under the control of a liquidator on insolvency, and he or she would assume the functions of the directors, and of the unit owners (as members). It may therefore in principle be possible for the liquidator to put a sale into effect without the sanction of the court. Whether this is permissible depends on the view taken of the current law. A provision in the CCS would suggest that a unit may not be deprived of rights unless its owner, and any lender, has expressly consented in writing.[34] This would frequently have the effect of preventing a liquidator from selling part of the common parts. This provision may, however, conflict with the provision in the 2002 Act which provides that "nothing in a commonhold community statement shall prevent or restrict…the transfer by the commonhold association of its freehold estate in any part of the common parts".[35] On its literal interpretation, this section could have the effect that any sale of part of the common parts would automatically release any rights which unit owners had enjoyed over it.

19.95 We do not, in practice, need to resolve this possible inconsistency in the current law. Issues which are similar, but which present more difficulties, arise in the similar situation where a mortgage lender which has taken a charge over the common parts wishes to sell part of the common parts. We discuss the issues in greater detail in Chapter 15. The solution that we recommend would involve the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal") making orders to overcome the difficulties. The Tribunal would be able to dispense with the need for the consent of a unit owner (or a secured lender) to a change to the CCS which involved (a) the loss of the rights enjoyed by a unit over the common parts,[36] or (b) the loss of the rights of a unit to make use of a limited-use area.[37] We think that any practical difficulties arising on a sale by the liquidator of part of the common parts could be resolved in a similar way. However, as the court (that is, the Insolvency Court) would already be dealing with the matter, we shall recommend that the approval function, and the power to make any necessary orders, be given to the court.

19.96 It is also likely that any decision to sell off any of the common parts will necessitate the filing of an amended CCS. The liquidator would be in control of the association, and thus in a position to make these amendments. If, however, the consents of unit owners and their lenders are required, he or she would not be able to provide these consents. In Chapter 15 we recommend that, on a voluntary sale of part of the common parts, the approval of the Tribunal to the sale would remove the need for

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33 See CP, para 7.60.

34 Commonhold Regulations 2004, sch 3, para 4.8.5.

35 CLRA 2002, s 27(1)(a).

36 Commonhold Regulations 2004, sch 3, para 4.8.5.

37 Commonhold Regulations 2004, sch 3, para 4.8.6.

individual owners and their lenders to consent to the loss of rights over the common parts. A similar process would apply on a sale by a liquidator, except that the Insolvency Court (which would already be dealing with the matter), would supply any necessary consent to any sale of part of the common parts, including a limited use area. The court would thus have a measure of control over the sale process. The implementation of any sales might become a condition of the making of a succession order, although the consent of the court to a sale would be required even if – exceptionally – there was no application for a succession order.

19.97 Only two consultees specifically mentioned the sale off of parts of the common parts as a condition which might be imposed for the making of a succession order. One of these consultees would have required the successor association to purchase all of the common parts from the liquidator. This would not conform with our supposition that the "basic common parts" are simply too difficult to value and are, in effect, unsaleable. It does, however, raise the possibility that, if the liquidator wanted to sell garden land, or a leisure facility, or airspace, then the unit owners might wish to make a payment to the liquidator and, in effect, purchase them from the liquidator so that the successor association could continue to enjoy them. We can see no objection in principle to the unit owners being allowed to take this course of action. It would not leave the creditors any worse off, and it might be accomplished more quickly than a sale to a third-party. Again, it seems likely that the liquidator would wish to secure the approval of the court to such an arrangement.

19.98 Unit owners may argue with some justification that the value of the common parts is reflected in the value of their units, and so a sale of any of the common parts may affect the value of their unit.[38] It does, however, accord with the general principles of insolvency law that those parts of the common parts which are saleable should be sold. They are in law the assets of the commonhold association, not of the individual unit owners.

19.99 Those who have lent money on the security of a unit will also argue with some justification that the sale of part of the common parts may adversely affect the value of the unit which represents their security. As lenders are not members of the commonhold association, and their security is over a unit, it could be argued on that basis that they are not persons who are legally concerned with the liquidation. This argument may be technically correct, but it does not seem to reflect the reality of the situation. We discuss the position in more detail in Chapter 20 below.[39] There we recommend that mortgage lenders and other secured lenders should automatically have legal standing to make applications to the court during the termination process with a view to protecting their interests.[40] We recommend that the same principle should apply during any winding-up of a commonhold association.

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38 The sale of attic space and the airspace over the roof would seem generally likely to have the least effect on the value of other units. We suggested in the CP, para 7.60, that the owners of existing top storeys who would be affected by this might even be compensated for the disproportionately adverse effect on their units. This could be paid from the sale proceeds, before the balance was made available to the creditors of the insolvent commonhold association.

39 See paras 20.77 to 20.104, below.

40 See Recommendation 114.

19.100 In summary, therefore, the liquidator would be able to realise any of the saleable common parts of the commonhold. The approval of the court would almost always be necessary, to ensure that the liquidator could amend the CCS so as to remove rights over the parts of the common parts which were sold. The consent of the court would thus in this instance replace the need for the consent of the unit owners. The unit owners and lenders would be able to object if they considered that removing their rights so as to facilitate the sale caused them undue hardship. Refusal of consent to the amendment of the CCS would, in effect, prevent the sale of part of the common parts from taking place. Additionally, the disposal of part of the common parts might be a condition of the making of a succession order.

### Conditions as to the conduct of the successor association

19.101 More frequently consultees suggested conditions for the making of a succession order which could be characterised as relating to the future conduct of the successor association. These were summarised at paragraph 19.83 above. The condition that was most frequently suggested was that those who had been directors of the insolvent association should be barred from holding office in the successor association for a specified period.

19.102 In view of the limited pool of unit owners in smaller commonholds, it is recognised that it might be difficult to find unit owners who are able and willing to serve as directors of the successor association. This need not, we think, be an insuperable problem.

(1) Where the conduct of the directors of the insolvent association has not been culpable or negligent, the court might recognise the practicalities of the situation (particularly in a small commonhold) and impose no conditions.

(2) Where the court considers it appropriate – for example, because the court considers that the directors have been culpable or negligent in the insolvency – the court might impose a condition that certain named individuals should not be directors of the successor association. This might then have the effect that, if other unit owners were not able and willing to serve as directors, the successor association would have to appoint professional managing agents as directors. It seems acceptable to require the unit owners to bear the additional costs of having to have professional directors in these circumstances.

19.103 Although there is a procedure for the court to impose a ban on individuals who have been found to have committed misconduct from serving as directors, this operates as a ban on taking any directorship for a specified period.[41] The condition that we propose ought not to conflict with this. Whether or not to bar an individual from serving as director of a successor association could be dealt with by the Insolvency Court in a summary way appropriate to the circumstances, and it would not operate as a general ban.

19.104 Other consultees suggested a condition should be imposed that the successor association should appoint an expert manager, or otherwise engage professionals to assist them. Requiring a successor association not to re-appoint certain individuals as

[41] The provisions are contained in the Company Directors Disqualification Act 1986.

directors would, if no other unit owners were available, have the indirect effect of requiring the association to appoint professional directors, to very similar effect.

19.105 We have noted the suggestions that a successor association should be required to take out appropriate insurance policies, or hold specified reserve funds. Although the Insolvency Court might well commend these courses of action to a successor association, it is difficult to see how there could be ongoing supervision by the court to secure long-term compliance with such conditions. There would not appear to be any other appropriate body to exercise supervision. It does not seem appropriate for the court to impose conditions which cannot readily be enforced. We therefore do not recommend that conditions of this kind should be imposed.

### Existing provisions which may apply in the event of insolvency

19.106 It should be noted that directors of a commonhold association, like any company directors (including directors of an FMC), will be potentially liable if they engage in "fraudulent trading"[42] or "wrongful trading".[43] Although the heading of each section refers to "trading", and a commonhold association is not generally involved in trading, the wording of one section refers to carrying on "the business of the company…with the intent to defraud creditors,[44] and the other refers merely to being a director of a company when "there was no reasonable prospect that the company would avoid going into insolvent liquidation".[45] A liquidator can apply to the court for an order making directors liable for losses which the creditors of the company sustain due to their conduct. A successful application under section 213 or section 214 for a director to make a contribution to the company's funds may also result in the court, of its own motion, exercising its power to make a disqualification order against the director.[46] This would be a general disqualification order disqualifying the individual from serving as a director of any company for a specified period.

19.107 Although we do not think it is likely that the wrongful or fraudulent trading provisions will often apply to the directors of commonholds, they would seem to address at least some of the concerns expressed by those who have expressed misgivings that the insolvency of a commonhold could be used as a vehicle for fraud or sharp practice. To some extent, therefore, these provisions meet the concerns expressed by consultees such as Trowers & Hamlins LLP (see paragraph 19.83(6) above).

### Requiring a financial payment as a condition of making a succession order

19.108 Perhaps the most contentious condition which could be applied to the making of a succession order is that some financial payment should be made to the liquidator as a contribution towards the debts of the insolvent association. This contribution could take the form of requiring unit owners to contribute; or it could take the form of imposing a debt on the successor association.

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42 Insolvency Act 1986, s 213.

43 Insolvency Act 1986, s 214,

44 Insolvency Act 1986, s 213.

45 Insolvency Act 1986, s 214.

46 Company Directors Disqualification Act 1986, s 10.

19.109 Imposing the debt on the successor association is likely to be a more manageable option from the point of view of the liquidator. On the other hand, as Westminster and Holborn Law Society observed, it would imperil the successor association's viability from the outset.

19.110 Requiring each unit owner to make a financial contribution as a condition of making a succession order would create several practical problems. If an order for payment were made, but the condition did not extend to the actual payment of the debt, a liquidator would be faced with the task of recovering contributions from every unit owner. In a large commonhold that could be hundreds of individual owners. If the condition was that the contributions should actually be paid before the succession order could be made, then it might make a liquidator's task easier, but the making of the order could impose hardship on some unit owners. Some might be personally bankrupt, so it would be impossible to obtain payment from them. With others, attempting enforcement action might clearly be a waste of time and money. In practice requiring contributions to be made before the succession order is granted may be an impossible condition to fulfil.

19.111 Besides the practicalities, there is broader matter of principle at stake. Whether a condition requires payment from the successor association, or from the individual unit owners, it would be a fundamental departure from the principle of the limited liability of the unit owners as members of the company. On balance it seems to us best to preserve this principle of company law, especially when members of an FMC will continue to enjoy fully-limited liability. As we have explained above, we do not wish the position of commonhold unit owners on the insolvency of a commonhold association to be unfavourable compared to that of leaseholders in an FMC.

19.112 We accept some of the arguments of those who oppose the idea of allowing a successor association because of its likely side effects. The Consensus Business Group predicted that contractors dealing with commonhold associations would insist upon advance payments from the association because of the risk of it becoming insolvent. Berkeley Group Holdings PLC and an anonymous consultee mentioned that contractors might well require personal guarantees from directors. We heard anecdotal evidence at our consultation events that this practice is already common when contractors are dealing with leaseholder-controlled companies.

19.113 We accept that all this may mean that contractors may impose terms upon commonhold associations who deal with them that they would not impose on a landlord which was a substantial individual or company. We cannot, however, see why the terms should be any more onerous than the contractor would impose as a condition of dealing with a leaseholder-controlled company. With smaller contracts, requiring directors' personal guarantees may be appropriate. The expectation with larger contracts is that proper stage payments would be agreed in any event. As we are proposing safeguards to ensure that the designated reserve funds of commonhold associations are used only for their designated purposes, contractors may alternatively be satisfied by having sight of bank statements showing the balance held in the account.

### Reserve funds following a succession order

19.114 We note that following our recommendation in Chapter 14, designated reserve funds held by the commonhold will be held on statutory trusts. As a result, they are protected from general creditors on insolvency, as they are available only to discharge debts relating to the purposes for which they are held. Therefore, on the insolvency of a commonhold association its reserve funds will pass to a successor association.

### Summary of recommendations

19.115 We therefore recommend that the court, as a condition of granting a succession order, could impose:

(1) a condition as to the sale of part of the common parts; and/or

(2) a condition that named individual(s) should not serve as directors of the successor association for a period which the court would set. We accept that this might have the result that, in practice, professional directors would have to be appointed.

19.116 We also recommend that it should not be possible for the court to impose a condition as to the payment of a sum of money, either by the unit owners or the successor association. This would not affect any remedy that a liquidator might have against the directors under the provisions relating to fraudulent trading and wrongful trading.

**Recommendation 110.**

19.117 We recommend that there should be a rebuttable presumption that, on the insolvency of a commonhold association, the court will make a succession order enabling a successor association to fulfil the role of the insolvent commonhold association.

19.118 We recommend that the court should retain its broad discretion to impose conditions on the making of a succession order. These conditions could include:

(1) requiring the sale of part of the common parts; and/or

(2) requiring that named individuals should not be eligible to serve as directors of the successor association for a specified period or periods.

19.119 We recommend that if a condition as to the sale of part of the common parts should be imposed, the sale by a liquidator should automatically deprive the unit owners of their rights over the land sold, without the need for a unit owner (or a lender with a charge over a unit) to consent to such loss of rights.

19.120 We recommend that, if a liquidator wishes to sell part of the common parts of a commonhold, he or she should be able to do so without the consent of the owners (or of lenders with a charge over the units) to their loss of rights over the parts which are to be sold, provided that the court consents to the loss of such rights. (This provision would apply whether or not there is an application for a succession order).

19.121 We recommend that the court's discretion to impose conditions should not extend to making it a condition of the grant of a succession order that either the unit owners or the successor association contribute to the debts for which the insolvent commonhold association was liable.

19.122 We recommend that mortgage lenders and other secured lenders should automatically have standing to make applications to the court during the insolvency process with a view to protecting their interests.

# Chapter 20: Voluntary termination of commonholds

## INTRODUCTION

20.1 Commonhold enables the redevelopment of a building in a more structured manner than occurs with leasehold properties. Redevelopment of leasehold property often takes place in an ad hoc fashion which can disadvantage leaseholders. Leases may be acquired by a developer, or a group of people co-operating together, over a period of time, and pressure is then placed on the remaining leaseholders to sell. In contrast, a commonhold can take a single decision to terminate and sell the entire site. A decision to do so may be appropriate if the commonhold receives a lucrative offer from a developer, or where the building is beyond economic repair.

20.2 In this chapter, we make recommendations to:

(1) protect the rights of minority unit owners opposed to termination;

(2) protect the interests of mortgage lenders;

(3) address the position of tenants on voluntary termination;

(4) address how units are valued on termination and how funds are allocated to unit owners in the termination statement;

(5) protect unit owners' assets from the commonhold's creditors; and

(6) make provision for termination of a commonhold divided into sections.

## VOLUNTARY TERMINATION JURISDICTION

20.3 Under the current law, termination can proceed either with the unanimous consent of unit owners, or the consent of 80% of unit owners coupled with the approval of the court.[1] Where termination is not supported unanimously, it is for the court to determine the content of the termination statement, and to include any necessary terms and conditions.[2] In this section, we consider whether the level of support necessary to terminate should be changed, and whether applications should continue to be heard by the court, or the First-tier Tribunal (Property Chamber) in England and the Leasehold Valuation Tribunal in Wales (the "Tribunal").

### The level of support necessary for voluntary termination

20.4 We provisionally proposed to retain the thresholds in the current law, so that voluntary termination of a commonhold should be possible with either unanimous support, or the support of 80% of available votes and court approval.[3] Other common law jurisdictions

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1 CP, para 1.4 to para 1.34.

2 CLRA 2002, s 45.

3 CP, Consultation Question 87, para 15.88.

have similar minimum thresholds of support, and we believe that it is right that the threshold should be at the higher end given the seriousness of termination proceeding despite the opposition of some unit owners.

### Consultees' views

20.5 The vast majority of consultees agreed that voluntary termination of a commonhold should continue to be possible with either unanimous support or at least 80% of available votes coupled with court oversight.

20.6 A few consultees noted that unanimous support may be difficult or impossible to achieve in all cases, and that provision should therefore be made to facilitate termination where a majority are in support. The Property Bar Association (the "PBA") suggested that it was likely that resentment and challenges would arise if a very large majority are prevented from going ahead with terminating a commonhold.

20.7 However, a few consultees also had concerns that voluntary termination with less than unanimous support is contrary to the nature of freehold ownership. The joint response of some members of London Property Support Lawyers Group (the "joint response") suggested that a majority of unit owners should not be able to "override" the minority, and Martin Wood (solicitor) suggested that it would be "wrong to deprive the unit owners of their individual freedom of action to deal with their own property as they see fit".

20.8 Two consultees suggested that our provisional proposal reduces the bargaining power of unit owners and that sale prices would be lower than if unit owners conducted individual sales of their units. Martin Wood and Graham Webb (leaseholder) argued that requiring developers to buy up individual units, as they would need to do in a leasehold block, enables each unit owner could get the best possible price. In particular, it favours those who hold-out for a "ransom" price.

20.9 Martin Wood also suggested that our provisional proposal is in danger of breaching Article 1 of the First Protocol to the European Convention on Human Rights ("A1P1") and Article 8 of the European Convention on Human Rights.

### Discussion and recommendations for reform

#### The freehold nature of commonhold

20.10 The freehold nature of commonhold has many advantages compared to leasehold property. There are no external landlords, no onerous ground rents or permission fees and ownership of the property is not time-limited. Notwithstanding, there are inevitably constraints on the degree of autonomy each freehold unit owner can exercise where their unit forms part of a larger block. As commonhold is designed to provide freehold ownership in flats and other interdependent units, it needs to contain mechanisms that distribute decision making capacities. Commonhold would not work if every unit owner could simply do what he or she wishes, and the commonhold association was unable to make decisions that bind unit owners. As the authors of *Clarke on Commonhold*

have noted, “title to a commonhold unit brings with it rights, duties and responsibilities that are quite alien to a standard freehold title”.[4]

20.11 This does not diminish the freehold nature of commonhold. Instead, it reflects the reality that buildings owned and occupied by multiple individuals requires a system of collective management, and a mechanism to overcome stalemate where unanimity is not achievable. The prevalence of the wishes of the majority seems to us to be the most desirable principle, and, we suspect, is in keeping with most people’s expectations. Enabling a large majority of unit owners to seek termination where unanimity is impossible prevents intractable disputes concerning the future of the commonhold. It also avoids the scenario where one or a small number of owners may hold-out for a ransom price from their fellow unit owners.

20.12 We do not therefore believe that termination by majority is inconsistent with the freehold nature of commonhold. Our provisional proposal does not diminish the unit owner’s autonomy, but rather, in keeping with the dynamics of commonhold, pools that autonomy with other unit owners. We agree that it is important that minority unit owners should be protected, and believe that court oversight, and discretion to refuse termination, or to attach conditions to the termination statement, is sufficient protection. We address this in greater detail below at paragraph 20.22 to 20.44.

### Bargaining power

20.13 While it may be the case that some unit owners will be unable to hold-out for a ransom price if a developer wishes to acquire the entire commonhold, we believe that the current law strengthens the bargaining power of unit owners overall in comparison to leasehold properties.

20.14 First, as the Consultation Paper suggests, redevelopment of leasehold property currently takes place in a fashion that is unfavourable to leaseholders.[5] Commonhold provides an opportunity to deal with redevelopment in a more structured manner, enabling the owners of the flats to decide the future of the building. In a leasehold property, an investor may buy up leases one by one. It is possible that different prices are paid even where units are comparable. Flat owners potentially negotiate with no knowledge about other offers. This favours the developer and leaseholders who hold-out for a ransom price. Commonhold enables the unit owners to act as a single group. We suggest that this is likely to enhance the bargaining power of unit owners rather than reduce it, and provide greater equality as to the price received by unit owners.

20.15 Second, a prudent developer may avoid the risk of a ransom price by taking an option to purchase at a pre-agreed price, reducing the ability of any single owner holding out for an inflated price.

20.16 Finally, case law suggests that, in the circumstances where a developer owns the freehold and most of the leases, repairs are not undertaken, and the remaining

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4 *Clarke on Commonhold*, para 2[2].

5 CP, para 15.2.

leaseholders may face pressure to sell.[6] While leaseholders can refuse, the reality is they are trapped: no prudent third-party purchaser would be likely to buy the lease.

### Human rights considerations

20.17 A1P1 gives every person the right to peaceful enjoyment of his or her possessions. It protects against loss of enjoyment and control of property (for example, limiting a landowner's power in the interests of conservation[7]) and for deprivation of property (where, for example, property is taken from the owner). A1P1 is not an absolute right, and some interference may be justified if an action or legislative provision is in the public interest and prescribed in law. Proportionality has emerged as the standard against which to assess whether an interference with A1P1 strikes an appropriate balance between the public interest underlying the provision and the right of the individual. There must be proportionality between the legitimate aim being pursued by the interference with rights under A1P1 and the measures taken to secure it.[8]

20.18 We do not agree with the suggestion that our provisional proposal would unlawfully infringe unit owners' rights under A1P1. First, as we note above, the nature of commonhold requires the pooling of decision making among unit owners.[9] Commonhold simply could not work if unanimity were required in respect of every decision. Majority rule is a proportionate means of ensuring that commonhold functions. Second, and relatedly, commonhold functions through a company law structure which is inherently based on the principle of majority rule. In that respect, the rules by which commonhold makes decisions is not unique. Finally, other jurisdictions in which A1P1 operates, and which have similar schemes to commonhold, contain similar provisions for voluntary termination.[10] These have not been held to be in breach of A1P1.

20.19 Separately, Martin Wood suggested that voluntary termination where some owners oppose the resolution is liable to challenge under Article 8 of the European Convention on Human Rights. Article 8 provides a qualified right to right to private life, family life, home and correspondence. While the legislation governing the voluntary termination of commonholds may engage Article 8 rights, interference may be justified if it is prescribed in law and is necessary to protect the rights of others and economic well-being.[11] If unanimity were required it would likely be impossible to exercise the right to terminate in the majority of cases. Majority rule is therefore a proportionate means of ensuring that unit owners' right to terminate the commonhold can be effectively exercised. Furthermore, as termination is integral to the effective redevelopment of the commonhold site, majority rule is also a proportionate means of protecting economic well-being.

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6 Eg *Bluestorm Ltd v Portvale Holdings Ltd* [2004] EWCA Civ 289, [2004] 2 EGLR 38.

7 *R (Trailer and Marina (Leven) Ltd) v Secretary of State for the Environment, Food and Rural Affairs* [2004] EWCA Civ 1580, [2005] 1 WLR 1267 at [47].

8 *Fredin v Sweden (No 1)* (1991) 13 EHRR 784 at [51].

9 See para 20.10 to 20.12, above.

10 See Commonhold: A Legislative History.

11 European Convention on Human Rights (1950), Article 8(2).

20.20 Article 8 is also engaged where the court is asked to make an order for the sale of property against the owner's wishes.[12] The European Court of Human Rights and the Supreme Court of the United Kingdom have stressed that Article 8 requires procedural safeguards. The court must be able to assess the proportionality of granting an order that interferes with Article 8 rights.[13] However, Article 8 does not apply in cases where no public authority is involved. [14] It is therefore highly unlikely that Article 8 could be utilised to resist voluntary termination where no public authority is involved. If Article 8 was engaged, we believe that providing the court with discretion to determine whether or not an application should proceed (discussed below) would satisfy the procedural protections Article 8 requires, as the court could assess the proportionality of granting an order.

20.21 We therefore consider that no change should be made to the level of support necessary for voluntary termination.

### The court's discretion in voluntary termination

20.22 Currently, the court does not have any discretion to assess the effect of termination on the dissenting minority. It cannot refuse the termination application altogether if it considers that it is necessary to do so to protect the minority. We believe that this limited role does not offer substantive protection to minority interests.[15] We therefore provisionally proposed that the court should have discretion to decide whether to allow voluntary termination to take place, as well as the terms on which it may do so.[16] This would enable the court to protect the dissenting minority, either by imposing terms or conditions in the termination statement, or deciding that termination should not proceed.

20.23 We also invited consultees' views on the nature of the court's discretion in voluntary termination.[17] Specifically, we asked whether it would be useful to include factors to guide the court's discretion, and whether the following factors should be taken into account:

(1) whether termination was being proposed because rebuilding was not possible, or it would be uneconomic to repair the building, or because an offer to purchase it was financially attractive;

(2) exceptional hardship to a unit owner or a member of their family because of serious health problems;

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12 *Zehentner v Austria* [2009] 52 EHRR 22.

13 *Manchester City Council v Pinnock* [2011] UKSC 6, [2011] 2 WLR 220; *Hounslow LBC v Powell* [2011] UKSC 8, [2011] 2 AC 186.

14 The Supreme Court has declined to extend the operation of Article 8 so that it applies horizontally: *McDonald v McDonald* [2016] UKSC 28, [2017] AC 273. The court held that the respective rights of landlord and tenant established in statute represented the state's assessment of how the tenant's Article 8 rights should be balanced with the landlord's right to recover possession. In these circumstances, Article 8 cannot justify an order other than that required by the parties' relevant statutory and contractual rights.

15 See further CP, para 15.49.

16 CP, Consultation Question 87, para 15.89.

17 CP, Consultation Question 87, para 15.90.

(3) the fact that an individual unit had been extensively adapted to take account of a disability;

(4) the fact that the termination was supported principally by unit owners who were investor landlords (or who might be associates of the developers) and mainly opposed by unit owners who were owner-occupiers;

(5) financial hardship to a unit owner who was objecting. This might include that a unit owner was in negative equity, and would remain liable on their personal covenant; or an owner would have difficulty in obtaining another mortgage; and

(6) whether suitable alternative accommodation formed part of the package being offered, or would otherwise be available.

20.24 We also invited consultees' views on whether the court should be directed to consider the amount of support there is for voluntary termination over and above the 80% required, and whether other factors should be included.[18]

### Consultees' views

#### The principle of discretion

20.25 The vast majority of consultees supported our provisional proposal that in voluntary termination proceedings the court should have discretion to decide whether to allow the voluntary termination to take place, as well as the terms on which it may do so. The joint response suggested that it is important that the court has the discretion to protect minority interests.

20.26 However, a few consultees suggested that the discretion should be limited.

#### Factors guiding the court's discretion

20.27 Many consultees suggested that it would be useful to provide factors to guide the court's discretion, that the factors listed in the Consultation Paper should be taken into account, and that the court should be directed to consider the level of support for voluntary termination over and above 80%.

20.28 However, a few consultees expressed concern that such a list may not cover all situations, and suggested that the list be non-exhaustive. For example, Berkeley Group Holdings PLC (developer) preferred an open-ended discretion, arguing that "[a] list of factors can never be exhaustive and cover all issues and situations which may arise". They instead suggested that the court should have "flexibility as to the matters which should be taken into account". Damian Greenish (solicitor) suggested that the court have a "general discretion", but that it have regard to the factors outlined in paragraph 15.52 of the Consultation Paper.

20.29 While many consultees considered that the court should be directed to consider the level of support over and above 80%, Damian Greenish suggested that if an application is supported by more than 80% of unit owners, there "should be a

[18] CP, Consultation Question 87, para 15.90.

presumption of approval subject to being satisfied as regards the factors mentioned: i.e. the onus of proof would be on the objectors".

20.30 A few consultees suggested other factors that the court take into consideration. The Association of Residential Managing Agents ("ARMA") suggested:

> Investment into the minority units. For example, if there were five flats and four had been, intentionally or not, left in a very poor state of disrepair whereas the fifth had just been refurbished to a high extent.

20.31 The PBA suggested that the court consider "what the alternatives will be if the termination occurs".

## Discussion and recommendations for reform

### The nature of the discretion

20.32 We do not agree with the suggestion that the court should operate on the basis of a presumption that an application will be granted. As the Consultation Paper outlined, discretion would provide the court with the ability to determine whether "termination was appropriate in all the circumstances of the case", enabling the court to protect the minority opposed to the application.[19] A presumption that termination will proceed significantly changes the nature of our provisional proposal. It places the burden of proof on the objectors, and would require that the court be convinced that an application should not proceed. We do not believe that this is the appropriate starting point to protect the minority.

20.33 Instead, we recommend that the court should balance the interests of the parties in determining whether termination is appropriate in all the circumstances of the case and make such an order as it sees fit. This enables the court to decline termination, or attach conditions to the termination statement, if it considers it necessary to do so to protect the minority. This creates a similar starting point to the court's discretion in applications under section 14 of the Trusts of Land and Appointment of Trustees Act 1996 ("TOLATA 1996").

20.34 Under section 14, any person with an interest in a trust of land may make an application to the court for an order concerning various matters including the exercise by the trustees of any of their powers (such as selling the property). There is no presumption that the order will be granted. Instead, the court may make such order "as the court thinks fit" having regard to the relevant factors in the case.[20] Section 15 of that Act outlines a non-exhaustive list of matters to which the court is to have regard. The court is required to balance the interests of the parties with reference to the relevant factors of the case, and the court may give particular factors such weight as the court sees fit.[21] This provision has become an effective tool to determine disputes in relation to trusts of land.

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19 CP, para 15.51.

20 Trusts of Land and Appointment of Trustees Act 1996, s 14(2).

21 *White v White* [2003] EWCA Civ 924, [2004] 2 FLR 321.

20.35 In the context of commonhold, this approach would require the court to balance the interests and concerns of the minority with the interests and concerns of the majority. This offers substantive protection to the minority as it enables the court to decline termination, or attach conditions to the termination statement, if it considers it necessary to do so to protect the minority.

20.36 For example, the court might refuse termination where a minority are in negative equity, have specially adapted units and the proceeds of sale would not cover the costs of adapting a new home with the same equipment, and there is no pressing need to terminate at the time of application.

### Factors guiding the court's discretion

20.37 We believe that there is value in providing factors to which the court have regard in exercising its discretion in voluntary termination applications. The factors in the Consultation Paper are, we suggest, likely to be pertinent in balancing whether termination is appropriate in all the circumstances of the case. Specially adapted units, negative equity, exceptional hardship because of health reasons and financial difficulty are all factors that, if present, might suggest that termination would be particularly onerous on the minority. These factors can be balanced with the reason behind the vote to terminate (whether the building was beyond economic repair, or in response to a lucrative offer), whether the vote was led mainly by investors rather than owner-occupiers, and whether suitable alternative accommodation formed part of the package to the minority. It is for the court to afford whatever weight to each factor as it sees fit and to determine whether termination is appropriate in all the circumstances of the case. The factors do not rank in priority, and nor is it intended that they limit or constrain the exercise of the court's discretion.

20.38 In addition, we provisionally proposed that the court have regard to the level of support for voluntary termination over and above the 80% threshold. As noted in the Consultation Paper, voluntary termination is distinct from applications made under TOLATA 1996, and a direct comparison should not be drawn.[22] There are, however, similarities in that the court is often required to determine whether or not a property should be sold when owners, or those with an interest in the property, disagree. TOLATA 1996 provides that in a dispute between co-owners the court consider the wishes of the majority by value as a relevant factor.[23] This will not always be appropriate, and a court may decide that it is of no significance to its reasoning, but the court is entitled to consider this if it wishes to do so.

20.39 We think that it should be open to the court to consider the level of support for voluntary termination over and above the 80% threshold in voluntary termination applications. This is not to suggest that the wishes of the minority should be overridden where an application has a very high level of support. Rather, we believe it should be open to the court to have regard to the level of support in its balancing exercise, and to afford whatever weight to this as it deems appropriate. For example, if a proposed termination was supported by 95% of unit owners but opposed by 5% of owners because they would be left in negative equity, it would be open to the court to

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22 CP, para 15.54.

23 TOLATA 1996, s 15(3).

accord a very high majority weight in its balancing exercise. A very high level of support might tip the balance in favour of those supporting the termination, but it is ultimately for the court to make the order it deems appropriate in all the circumstances of the case.

20.40 We agree with consultees' concerns over the limitation of an exhaustive list of factors. We therefore recommend that the list of factors to which the court is to have regard in determining an application is non-exhaustive. This enables the court to consider other factors it considers relevant.

20.41 The PBA proposed that the court consider what the alternatives will be if termination occurs. As we recommend that the court must conduct a balancing exercise and make an order it sees fit, consideration of the effect of both granting and not granting termination is inherent to this balancing exercise. We do not believe this needs to be defined as a further, independent factor.

20.42 ARMA proposed that the court consider the level of investment in the minority units and whether other units had deliberately been left to dilapidate. Our recommendation includes a non-exhaustive list of factors which the court should have regard to. It would therefore be open to the court consider further factors that it considers relevant in the circumstances of the case.

**Recommendation 111.**

20.43 We recommend that on an application for voluntary termination the court should have discretion to decide whether to allow the voluntary termination to take place, as well as the terms on which it may do so.

20.44 We recommend that on an application for voluntary termination, the court should make any order which it thinks fit. In determining an application, factors to which the court should have regard include:

(1) whether termination was being proposed because rebuilding was not possible, or it would be uneconomic to repair the building, or because an offer to purchase it was financially attractive;

(2) exceptional hardship to a unit owner or a member of their family because of serious health problems;

(3) the fact that an individual unit had been extensively adapted to take account of a disability;

(4) the fact that the termination was supported principally by unit owners who were investor landlords (or who might be associates of the developers) and mainly opposed by unit owners who were owner-occupiers;

(5) financial hardship to a unit owner who was objecting. This might include that a unit owner was in negative equity, and would remain liable on their personal covenant; or an owner would have difficulty in obtaining another mortgage;

(6) whether suitable alternative accommodation formed part of the package being offered, or would otherwise be available; and

(7) the amount of support there is for voluntary termination over and above the 80% required.

### Voluntary termination jurisdiction

20.45 We provisionally proposed that an application for voluntary termination should continue to be heard by the court, rather than the First-tier Tribunal (Property Chamber) in England or the Leasehold Valuation Tribunal in Wales (the "Tribunal").[24]

#### Consultees' views

20.46 The vast majority of consultees agreed with our provisional proposal that an application for voluntary termination should be heard by the court rather than the Tribunal. The joint response suggested that "the issues at stake are of sufficient gravity to warrant this".

20.47 However, a few consultees disagreed. Simon Davies (leaseholder) argued that using the court would add complexity and cost. Keith Collier (leaseholder) suggested that the cost of applying to the court may not be appropriate for very straightforward cases of voluntary termination. Christopher Jessel (solicitor) argued that applications should be heard by the Tribunal as "the Tribunal will develop a competence and jurisdiction. There can be an appeal to the court on a point of law".

#### Discussion

20.48 While we recommend that many disputes which may arise in commonhold should be heard by the Tribunal, we believe that that voluntary termination applications must continue to be heard by the court. Voluntary termination applications engage issues of company law and insolvency law. The Insolvency Court is better equipped to deal with these issues than the Tribunal. Furthermore, if termination is not supported by a majority of unit owners, it may be necessary to order the sale of the property against some owners' wishes. Orders for possession are currently only made by the court.

20.49 The suggestion that the Tribunal determine applications for voluntary termination with an appeal route to a court on a point of law is not possible under the current court structure. Appeals against the First Tier Tribunal's decisions are heard by the Upper Tribunal, and thereafter by the Court of Appeal. In any case, as we note above, we believe that the court is the appropriate forum given the seriousness of the issue, and because of the possibility that technical accounting issues may arise. It does not follow that a court application is necessarily more complex than an application to the Tribunal. It will, however, be more expensive, as consultees point out.

20.50 Finally, we do not believe there are any advantages to creating two routes of application which would enable straightforward cases to be determined by the

[24] CP, Consultation Question 87, para 15.92.

Tribunal and complex cases determined by the court. It is difficult to categorise cases as simple or complex before they are heard. A court application will be necessary if fewer than 100% of unit owners support termination, or if the liquidator is not satisfied with the termination statement. In both scenarios there may be complexities that are not apparent at the outset. For example, a case may involve complex issues of accounting and company law, in which case the Tribunal is not the appropriate forum. Misclassification of a complex case would ultimately add delay and cost if it then had to be referred to the court.

20.51 In any case, we consider that an order of sale of a freehold property against the owners' wishes should always be made by a court. For these reasons, we do not consider any change to the current law is necessary.

### Final terms of the termination statement

20.52 The court has no discretion in voluntary termination applications. It therefore has no ability to dismiss the application if the final terms of the termination statement are not acceptable to the majority.[25] We invited consultees' views on whether increasing the role of the court would sufficiently address the issue of the final terms of the termination statement not being acceptable to those who supported the termination resolution.[26] We suggested that this would operate by the judge indicating the form of his or her order and then adjourning the hearing. The majority would then have the option to decide whether to proceed, or withdraw the application on such terms as the judge saw fit.

#### Consultees' views

20.53 Many consultees suggested that increasing the role of the court would sufficiently address the issue of the final terms of the termination statement not being acceptable to those who supported the termination resolution. ARMA, for example, observed that

> Given that the majority would have the option to review the impact of the courts amendments to the final terms and subsequently opt to either accept and continue or seek permission or to withdraw their application this would seem to protect the minority and give the majority an option.

#### Discussion

20.54 There was widespread agreement with our provisional proposal that judicial discretion would provide an effective way for unit owners to withdraw their support if the terms of the termination statement are unacceptable.

20.55 We believe that it would be problematic if those in support of termination had no mechanism to withdraw their support if the final terms of the termination statement were unacceptable. For example, the nature of a condition attached to an order may cause the applicants to withdraw support and continue the commonhold. However, under the current law, the court is obliged to order termination after finalising the termination statement.

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25 See CP, para 15.50.

26 CP, Consultation Question 87, para 15.91.

20.56 Providing discretion would offer an effective way to deal with this problem. After finalising the termination statement, the court could indicate to the parties the nature of the order it is willing to make. If the support of unit owners falls away in the light of the terms, the court could simply discharge the proceedings. Our recommendation above, that the court should have discretion to decide whether to allow the voluntary termination to take place, as well as the terms on which it may do so, will therefore provide a solution where the final terms of the termination statement not being acceptable to those who supported the termination resolution.[27]

## THE INTERESTS OF MORTGAGE LENDERS ON VOLUNTARY TERMINATION

20.57 The support of lenders is vital to the success of commonhold. We understand that lenders have legitimate concerns over the value and protection of their security during the termination process. We asked a series of questions in the Consultation Paper to address these, which we now consider in turn.

### The priority of the mortgage during termination and the position of a unit which is in negative equity

20.58 Concerns have been raised over the status and priority of mortgage charges secured on units during termination. The priority of a mortgage determines the point at which a lender will be paid after the sale of the property. If a lender does not have priority, other parties with an interest in the property may be entitled to be paid before the lender, and there is a risk that all the proceeds of sale will be distributed before the lender is repaid. We asked two questions concerning lenders' priority.

20.59 First, the termination process requires that the commonhold units are transferred to the commonhold association, which is under the control of the liquidator once termination has been approved, in order for the commonhold title entries to be removed.[28] We noted in the Consultation Paper section 28 of the Land Registration Act 2002 ensures that any mortgages secured on the units continue to take effect following a transfer of the units to the commonhold association, and requires the liquidator to repay lenders before passing the proceeds of sale to the unit owners.[29] However, there has been criticism of the lack of explicit confirmation of this protection.[30] We therefore provisionally proposed that this protection should be made more explicit to provide lenders with confidence in commonhold.[31]

20.60 Second, we noted that under the current law there is a risk that, upon termination, unit owners may be obliged to repay the debts of neighbouring units which are in "negative equity" – that is, the amount they owe exceeds the value of their unit.[32] Lenders who finance commonhold impose a requirement that the termination statement provides that "unit holders will ensure that any mortgage secured on their unit is repaid on

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27 See para 20.43, above.

28 See para 15.4 onwards of the CP for an overview of the voluntary termination process.

29 CP, para 15.64. We have referred to "mortgages" for simplicity, however s 30 of the Land Registration Act 2002 also protects the priority of registered charges and equitable charges subject to a notice in the register.

30 Land Registration Act 2002, s 28. See para 15.65 of the CP for further discussion.

31 CP, Consultation Question 90, para 15.101.

32 CP, para 15.72. See Glossary.

termination". Such funds would come from the sale of the commonhold site, and therefore at the expense of other unit owners. We provisionally proposed that it should be clarified that any shortfall should be met personally by the unit owner – and not covered by other unit owners.[33]

### Consultees' views

#### Clarifying lenders' priority

20.61 There was almost universal agreement with our provisional proposal to clarify that mortgage lenders and other secured lenders will retain their secured interest in the commonhold units until the commonhold in its entirety is sold. Several consultees suggested that our proposal was essential to fostering lender confidence and making commonhold viable.

20.62 However, Trowers & Hamlins LLP (solicitors) disagreed, suggesting that reform is unnecessary as the current law fully protects lenders' priority. They also expressed concern that the law on discharge of charges should not differ in respect of commonhold.

20.63 HM Land Registry agreed with our provisional proposal. HM Land Registry also noted that to give effect to a voluntary termination the Registrar needs to be satisfied that the statutory procedures have been complied with, the necessary consents have been obtained and, if necessary, the court has approved the application. HM Land Registry suggested the creation of a new bespoke form or statement of truth to assist with this.

#### The position of the unit which is in negative equity

20.64 Our proposed clarification that any shortfall should be met personally by the unit owner – and not covered by other unit owners – attracted near universal agreement. Susan Wood (leaseholder) observed that "it would be quite inequitable to expect owners of other units to meet what amounts to the financial problems of an individual". Similar views were expressed by a few other consultees.

20.65 One consultee pointed out that commonhold would be unworkable if unit owners were liable for the mortgages of others.

20.66 Paul MacAinsh expressed concern that termination while a unit owner is in negative equity will likely lead to bankruptcy and that termination should be prevented unless the debt is paid.

### Discussion and recommendations for reform

20.67 We agree that under the current law the priority of a lender's interest on voluntary termination is protected by section 28 of the Land Registration Act 2002. Upon the transfer of the units to the commonhold association, section 28 ensures that any mortgages secured on the units continue to take effect until the liquidator uses the proceeds of sale to repay the lenders. We therefore consider that lenders should be in no doubt that the current law protects the continuation of their interests upon voluntary termination.

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33 CP, Consultation Question 90, para 15.103.

20.68 However, we consider that there is insufficient clarity in how the liquidator distributes the proceeds of sale among mortgage lenders following a voluntary termination of a commonhold. Under the current law, if a unit is in negative equity, a lender may be able to recover the shortfall between the proceeds of sale allocated to the unit and the outstanding loan from other unit owners. That potential arises because the units are transferred to the commonhold association during the termination process. Mortgage lenders who have lent on units therefore become creditors of company property, and "company property" consists of all the commonhold units and the common parts. While the termination statement outlines how the proceeds of sale are to be divided among owners, before applying the funds in the proportions specified, the liquidator must use the proceeds of sale as a whole to satisfy the company's debts – even though those funds are to be divided between unit owners in agreed proportions. The liquidator cannot avoid this outcome. The result is that lenders must be paid from the proceeds of the entire site, despite that fact that they lent on a single unit.

20.69 We agree that it is unfair to expect unit owners to meet the financial obligations of other unit owners on termination. In our view, neither lenders nor unit owners would welcome this possibility. We do not think the position in commonhold should be any different to lending on other residential property. Any doubt around this issue is likely to diminish the confidence of lenders and consumers in commonhold. We therefore recommend that if a unit is subject to negative equity, any shortfall should be met personally by the owner of the unit, and should not be covered by other unit owners.

20.70 To achieve this outcome, there should be no possibility that a lender has a claim against the proceeds of sale of the entire site. We therefore consider that, after the liquidator has satisfied any debts incurred by the commonhold association prior to the termination, the proceeds of sale must be apportioned in accordance with the termination statement.[34] Once divided, the liquidator must then pay mortgage lenders from the portion of funds allocated to the respective units on which they have lent. This would prevent the liquidator from using funds otherwise owed to other lenders to satisfy loans on units in negative equity.

20.71 Following our recommendations, lending on commonhold units will operate in the same manner as other freehold and leasehold property: upon the termination and sale of a commonhold, funds due to an owner are first applied to the owner's mortgage lender(s), and the balance is paid to the owner. There is no risk that that money is taken to pay the lenders of other unit owners.

20.72 We recognise that a difficulty arises from our recommended approach. In preventing the liquidator from using funds allocated to other units to discharge mortgages on units which are in negative equity, such mortgages will continue to take effect against the unit and, if registered at HM Land Registry, would be enforceable against a purchaser. In these circumstances, the owner in negative equity, or his or her

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[34] A commonhold association may only begin the voluntary termination process if the directors conduct a full inquiry into the association's affairs and form the opinion that the association will be able to pay its debts in full, together with interest, within 12 months of the winding-up resolution (CLRA 2002, s 43). If it emerges that the association is in fact insolvent and cannot pay all of its debts then, following our recommendation at para 20.70 below, the value of the units would not be available to meet the claims of the association's creditors. There is therefore no risk that that the funds apportioned to individual units could be used to satisfy the debts of the association.

mortgage lender, may be in a powerful position. Either party could insist that other unit owners repay the loan, as purchasers of the site will insist on taking the land free of any mortgages, and the continuation of a single mortgage could frustrate the sale. Our policy of ensuring that negative equity is not paid by other owners may therefore be undermined.

20.73 We think a fair solution is to provide a mechanism for the liquidator to apply to HM Land Registry to discharge such mortgages. In the unlikely event that termination is approved and a unit or units are in negative equity, we recommend that after the liquidator has applied the funds in accordance with the termination statement, he or she should then be able to apply to HM Land Registry to discharge any mortgages that were not satisfied by the proceeds of sale. We acknowledge that this enables a mortgage to be discharged without the loan being fully repaid. However, the lender could still pursue the borrower under the terms of the contract.[35] In our view, this is preferable to the status quo, which prejudices all lenders on a commonhold by allowing the lender on a unit which is in negative equity to be paid with funds properly owing to other lenders. We think that this mechanism will be rarely used – it is extremely unlikely that a voluntary termination will be approved if a number of units are in negative equity.

20.74 Finally, we recommend an amendment to current practices at HM Land Registry so as to provide further reassurance to lenders (and to HM Land Registry) during the termination process that the termination is conducted properly and the necessary procedures have been followed. HM Land Registry suggested the creation of a new bespoke form or statement of truth to assure the Registrar that the statutory procedure has been complied with, that any necessary consents have been obtained, and, if relevant, a court order has been acquired. Requiring the liquidator to complete this statement of truth this would enable lenders (and, potentially, HM Land Registry) to take action against the liquidator if he or she failed to follow the termination process correctly and prejudiced a lender's interest, or caused loss to HM Land Registry.

**Recommendation 112.**

20.75 We recommend that if a unit is subject to negative equity, any shortfall should be met personally by the owner of the unit, and should not be covered by other unit owners.

20.76 We recommend the creation of a new bespoke form or statement of truth to assist HM Land Registry in confirming that a liquidator has complied with all necessary statutory requirements in conducting a voluntary termination.

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35 Where a freehold or leasehold property is subject to a mortgage and sold by the lender (eg under the lender's power of sale), it may be the case that the money from the sale does not cover the loan. In those circumstances, the buyer will expect the mortgage to be discharged. However, the mortgage lender will retain its right to pursue the borrower under the terms of the contract that gave rise to the loan. The outcome in commonhold would, therefore, be similar to the outcomes that now arise in leasehold and other freehold property.

### Lenders' standing during the termination process

20.77 Lenders have an interest in how the termination process is conducted. They may wish to raise concerns about issues that affect the value of their security or the funds that will be available to repay the mortgage, such as an improper valuation, or the manner in which the liquidator is conducting the termination. However, lenders would appear to have no clear standing to make applications to the court to protect their interests during the termination process.[36] The termination process requires that the commonhold units are transferred to the commonhold association, at which point it will be under the control of the liquidator.[37]

20.78 Once the association owns both the commonhold units and the common parts, lenders on commonhold units become secured creditors of the commonhold association. At this point, lenders have standing to apply to the court on issues defined by the Insolvency Act 1986 and the Insolvency Rules (England and Wales) 2016, but no general right to challenge how the termination is being conducted, and at no stage before the association is the registered proprietor of the units. If lenders had concerns about how the termination was being conducted, they would likely wish to raise these once they arise, rather than wait until relatively late in the termination process.

20.79 We therefore provisionally proposed that mortgage lenders and other secured lenders should have legal standing to make applications to the court during the termination process with a view to protecting their interests.[38]

#### Consultees' views

20.80 Our provisional proposal attracted almost universal approval. The joint response suggested that our proposal would offer further security and reassurance to lenders.

20.81 UK Finance also welcomed our proposal, but queried what the position would be for mortgagees in possession.[39]

20.82 Trowers & Hamlins LLP supported our proposal, and suggested that it extend to all parties with the benefit of a charge over a property, rather than just lenders.

#### Discussion and recommendations for reform

20.83 We agree that lender support is vital to the success of commonhold, and that it is important to provide mechanisms to protect the interests of lenders on termination. We also agree that the recommendation should encompass all legal and equitable chargees.

20.84 UK Finance queried the position and rights of mortgagees in possession. A lender who takes possession has a number of powers, rights and liabilities previously held by the borrower. A mortgagee in possession is entitled to rents arising from tenancies in

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36 CP, para 15.70.

37 CP, paras 15.4 to 15.33 for an overview of the voluntary termination process.

38 CP, Consultation Question 90, para 15.102.

39 A "mortgagee in possession" refers to the situation where a lender has exercised its right to take possession under the mortgage.

respect of the property, to grant leases, to enforce the benefit of leasehold covenants and to carry on a business conducted on the mortgaged property. A mortgagee in possession of a commonhold unit is also entitled to vote in place of the unit owner.[40] We do not believe that the right of a mortgage lender to apply to the court during the termination process should be affected by taking possession. The lender could therefore apply to court to challenge the way in which the termination is being conducted, whether or not they are in possession of the unit.

**Recommendation 113.**

20.85 We recommend that mortgage lenders and other secured lenders should automatically have standing to make applications to the court during the termination process with a view to protecting their interests.

## Other ways to protect mortgage lenders

20.86 Lenders are concerned about the value of their security during the interval between the passing of the termination resolution and the sale of the commonhold site. During this period, there is little point in a lender exercising its power of sale as the units will be difficult, if not impossible, to sell individually.[41] We invited consultees' views as to any other ways in which the interests of mortgage lenders and other secured lenders may require protection on the voluntary termination of a commonhold.[42]

### Consultees' views

20.87 A few consultees suggested that there should be a defined notice period for lenders during voluntary termination to ensure that they have sufficient time to exercise their rights.

20.88 The PBA considered that there should be a right to step in and pay or otherwise perform the unit owner's obligations and to vote in place of the owner. A few other consultees considered that lenders should be able to exercise the vote on termination in place of the unit owner.

20.89 UK Finance stated:

> [We] continue to have concerns about the position of lenders overall. There is a potential for liquidator costs to take up a significant proportion of available funds and the lack of a first charge over the property could mean lenders do not realise their security. This means that the lender's position is still not clear or secure. Concerns remain over the position of lenders during the potentially prolonged period between the decision to terminate and eventual sale - especially the likelihood that mortgage arrears could accrue at a time when units had become difficult or impossible to sell individually.

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40 Commonhold (Amendment) Regulations 2009, sch, art 33.

41 CP, para 15.68.

42 CP, Consultation Question 90, para 15.104.

20.90 Three consultees suggested that one conveyancer could be instructed to act for multiple unit owners to save cost and synchronise the termination and discharge of charges so as to be contemporaneous.

20.91 The joint response suggested that:

> There should be a statutory requirement that notice of a proposal for the voluntary termination of commonhold and advance notice of any related meetings and proceedings must be given within a specified time to all affected mortgage lenders and other secured lenders to ensure that they have sufficient notice to exercise their statutory and contractual rights, if they choose to do so.

### Discussion and recommendations for reform

#### Voting instead of unit owners and performing their obligations

20.92 Upon taking possession, a lender assumes many of the powers of the owner. In these circumstances, it is appropriate that the lender assumes the voting rights of the owner: it is unlikely that the borrower will occupy the unit again, and the lender will sell the unit, not the borrower. However, enabling a lender to vote on termination and other matters where a unit owner remains in possession provides the lender with a significant degree of control over the unit normally reserved for the most serious of circumstances. Our comparison of commonhold law suggests that Australia is the only jurisdiction that requires lender consent for voluntary termination.[43]

20.93 A mortgage charge is a method of securing a debt, enabling the lender to take possession and sell to realise that security. We believe that enabling a lender to exercise powers it normally enjoys only by virtue of possession provides the lender with a high degree of control over the management of the commonhold unit that is not commensurate with the nature of its interest. We also consider it unlikely that a lender would wish to exercise voting rights and be involved in managing the commonhold where it has not taken possession.

20.94 While it is possible that termination may be conducted in a way that is prejudicial to a lender, providing voting rights would not necessarily solve this. For example, voting rights would not help the lender where the liquidator has not achieved a proper valuation of the site, resulting in the proceeds of sale failing to discharge the mortgages. We believe that providing lenders with standing to apply to court during the termination process with a view to protecting their interest provides protection in a more effective and proportionate manner.[44] This position strikes an appropriate balance between unit owners' autonomy and the protection of lenders' legitimate interests.

#### Notification of voluntary termination

20.95 We agree that lenders require notification of termination if they are able effectively to exercise their rights. We recommend above above that lenders should automatically have legal standing to make applications to the court during the termination process with a view to protecting their interests. However, under the current law, there is no

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43 See Commonhold: A Legislative History.

44 Discussed at para 20.77 above.

mechanism which requires that lenders are informed of a termination either by unit owners, the commonhold association, the liquidator or HM Land Registry. While a lender may insist in its standard terms that they are informed of a prospective termination, we believe that notification should be required by statute as an additional safeguard.

20.96 While the joint response suggested that notification should occur when termination is proposed, we do not consider that is the appropriate time. The lender does not have voting rights at such a meeting, and it would in practice require additional notification of the vote's outcome. As we note above, we do not consider that a lender's interest extends to participation in the management and decision-making structures of the commonhold. We therefore recommend that upon passing a termination resolution the commonhold association be obliged to notify any secured lenders. This enables any lender to utilise their standing to protect their interest before winding-up occurs.

### Liquidator's remuneration

20.97 UK Finance noted that the liquidator's remuneration may diminish the funds available to redeem any mortgages. The liquidator is entitled to pay his or her own expenses before making payments to lenders.[45] There is therefore potential for the liquidator's remuneration to diminish the funds available to redeem any mortgages secured on the commonhold units. We understand that lenders would be particularly concerned where their loan amounts to a high proportion of the value of the unit, or the unit is in negative equity. In this context, the liquidator's remuneration will take priority over the lender's charge, and lenders may receive less than the value of their security when the commonhold is sold.

20.98 The level of the liquidator's remuneration takes on a significant role in this context. Under the current law, members of the commonhold association may challenge the level of the liquidator's remuneration as unreasonable, and apply to court for a new determination.[46] A secured creditor of the company may also make an application. In determining whether remuneration is excessive, the court is guided by a practice direction, which is designed to ensure "remuneration of an appointee which is fixed and approved by the court is fair, reasonable and commensurate with the nature and extent of the work properly undertaken".[47] The court is required to conduct a balancing exercise guided by the practice direction, and may reduce the remuneration if it considers the level excessive.

20.99 The current law therefore offers unit owners protection from excessive remuneration from the beginning of the termination process. However, lenders would have no standing to challenge the level of remuneration until the commonhold association is entitled to be registered as the proprietor of both the units and the common parts, at which stage the lender becomes a secured creditor of the association.[48] This is

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45 Insolvency Act 1986, s 115.

46 A challenge may be made either by members who collectively hold 10% of the available voting rights, or a single member with the permission of the court: Insolvency Rules (England and Wales) 2016, r 18.34(2)(c).

47 *Practice Direction: Insolvency Proceedings* [2018] Bus LR 2358 at [3.2].

48 Once this happens, the mortgage lender is a secured creditor of company property, and secured creditors are entitled to apply to court to challenge the level of remuneration (Insolvency Rules 2016, Rule 18.34).

relatively late in the termination process. If there is any prospect that excessive remuneration would result in the lender receiving less than the value of their security, lenders would likely wish to challenge the level of remuneration once it has been determined.

20.100 It would also be anomalous if a lender could apply to court at any time during the termination process with a view to protecting their interests, as we have provisionally proposed, but the right to challenge remuneration must wait until the termination process is almost complete. We therefore recommend that lenders are entitled to challenge the reasonableness of the liquidator's remuneration at any time during the termination process.

### Interval between termination and sale

20.101 We recognise that lenders have a legitimate concern over the interval between termination and eventual sale. If a borrower is in arrears during this time, the lender cannot effectively exercise its power of sale – it would be very difficult to find a purchaser wishing to buy a unit in a commonhold that will be terminated.

20.102 While a temporary delay to the effective exercise of the lender's power of sale is undesirable, we do not see that there is a practical legal solution to overcome this. While we appreciate that a lender may wish to act when arrears and interest are accruing, the lender does not face any possibility of ultimately losing their security. The termination process does not last indefinitely, and once termination and sale are complete, the lender is entitled to be paid the outstanding mortgage debt. If a termination were abandoned and the commonhold continues, the lender's power of sale once again becomes a viable solution.

20.103 Similar problems and risks that might undermine the viability of the power of sale exist in respect of other freehold and leasehold property which lenders currently accommodate in their business practices. For example, a property may become uninhabitable for a long period of time due to fire damage. Mortgage arrears may accrue, and the lender's power of sale would not help as the damage has likely reduced the value of the property below that of the security. In both leasehold and commonhold, lenders are best protected by leaseholders and unit owners being adequately insured, including insurance which covers alternative accommodation. There is then no reason why ongoing mortgage instalments cannot be paid.

20.104 More broadly, lenders face risks in both freehold and leasehold property that undermine the value of their security which will likely not exist in commonhold. For example, if a building is allowed gradually to fall into disrepair because the landlord plans to redevelop, the value of the flat may be diminished and no longer offer a lender the degree of security that they hoped it would. This is unlikely to occur in commonhold as there is no outside landlord, and if the state of the building did deteriorate, termination offers a structured process through which to address it.

### Single conveyancer

20.105 As the liquidator becomes the registered proprietor of both the commonhold association and the units during the termination it is very likely that he or she would instruct a single conveyancer in the manner suggested by consultees. We do not believe that it is necessary to make a recommendation to this effect. In most cases we

believe that a lender would have no reason to object to a single conveyancer, but we do not discount the possibility of there being circumstances in which a lender may wish to appoint its own conveyancer. In those circumstances, it would be entitled to do so.

**Recommendation 114.**

20.106 We recommend that commonhold associations should be required to notify mortgage lenders and other secured lenders on passing a termination resolution.

20.107 We recommend that mortgage lenders and other secured lenders should have standing to challenge the reasonableness of a liquidator's remuneration at any time during the termination process.

## THE POSITION OF TENANTS ON VOLUNTARY TERMINATION

20.108 Tenants of unit owners are impacted by the termination of a commonhold, and in many cases of voluntary termination, tenants will be a factor to consider in a commonhold's decision making. For example, termination for the purposes of selling the site is likely to be difficult if vacant possession cannot be achieved. In most cases, unit owners who are landlords will be able to end a tenancy to give effect to a decision to terminate. As we noted in the Consultation Paper, landlords who have granted an assured shorthold tenancy are likely to consent to voluntary termination if it takes effect at the end of the tenancy. Registered social providers are likely to do so on the basis that they can offer alternative accommodation to their tenants.[49] Business tenants who are protected by Part II of the Landlord and Tenant Act 1954 will be entitled to compensation for termination of their lease under section 37. Likewise, a unit owner will only consent if they are in a position to compensate those tenants.

### Recovery of possession if the commonhold association intends to demolish or reconstruct

20.109 Various statutory provisions entitle a landlord to recover possession or refuse a lease extension if he or she can demonstrate an intention to demolish or redevelop the building.[50] The nature of commonhold is that these decisions will usually be taken by the commonhold association rather than the unit owner. However, a decision of the commonhold association to demolish or redevelop does not entitle a unit owner who has a tenant from relying on these statutory provisions to recover possession.

20.110 We therefore provisionally proposed that if any statute provides that a landlord should be entitled to recover possession of a property if he or she can prove an

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49 CP, para 15.47.

50 CP, para 15.47.

intention to demolish or reconstruct the building, such a requirement should also be satisfied if it can be proved that a commonhold association has that intention.[51]

### Consultees' views

20.111 The vast majority of consultees agreed with our provisional proposal that if a statute provides that a landlord can recover possession if he or she demonstrates an intention to demolish or reconstruct a building, such a requirement should be satisfied if a commonhold association has that intention. Westminster and Holborn Law Society suggested "that a business lease can make provision for such an event, and it will doubtless be standard practice for a business lease of a commonhold unit to make such provision".

20.112 However, a few consultees misunderstood this provisional proposal to mean that the commonhold association could recover possession from the unit owner if it could demonstrate an intention to demolish or reconstruct the building and opposed it on that basis. This is not the case. Instead, our provisional proposal would enable a unit owner who is a landlord, and entitled by statute to recover possession if they had an intention to demolish or reconstruct the building, to recover possession if the commonhold association had this intention.

### Discussion and recommendations for reform

20.113 As decisions about demolition and reconstruction are likely to be taken by the commonhold association, we believe it is right that a unit owner who is entitled by statute to seek possession or refuse a lease extension if he or she can prove an intention to demolish or reconstruct the building should be able to do so if the commonhold association has that intention. Otherwise, a landlord of a commonhold unit may have no lawful means of recovering possession to give effect to a commonhold association's decision to demolish or reconstruct the building.

20.114 We believe that it is necessary to extend our provisional proposal to cover the rare situation in which a residential landlord could rely on section 12 of the Landlord and Tenant Act 1954 to recover possession if they "propose" to demolish or reconstruct the building. Our current proposal would only entitle a landlord to rely on a provision that entitles them to recover possession where they *intend* to demolish or reconstruct, and there is a subtle difference in how intention and proposals are evidenced for the purpose of the statutory provisions.[52] While it is very unlikely to occur in practice, it is possible that a lease protected under Part I of the 1954 Act could take effect against a

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51 CP, Consultation Question 89(1), para 15.96. Extensions of commercial tenancies granted under Pt II of the Landlord and Tenant Act 1954 can be refused under s 30(1)(f) if the landlord can demonstrate an intention to demolish or redevelop the building (or a substantial part of it). In the residential context, landlords of assured tenancies can seek possession under ground 6, sch 2, Housing Act 1988 if they intend to demolish or reconstruct. Secure tenancies under the Housing Act 1985 can be terminated under Ground 10, sch 2. for the same reason, but the court must be satisfied that suitable alternative accommodation is available.

52 If proposing work, the landlord does need not have a fixed and settled intention, but instead needs to demonstrate preparatory work (eg obtaining planning consents): *Trustees of the Magdalen and Lasher Charity, Hastings, and Others v Shelower* (1968) 19 P & CR 389. In contrast, an intention to demolish or redevelop requires demonstrating a fixed and settled intention – demonstrated, for example, by a schedule of works: *S Franses Ltd v Cavendish Hotel (London) Ltd* [2018] UKSC 62, [2019] AC 249.

commonhold unit following conversion from leasehold.[53] We believe that in these circumstances a landlord who is entitled to recover possession under section 12 of the 1954 Act if he or she proposes to demolish or reconstruct the building should be able to rely on such a provision if the commonhold association makes that proposal.

**Recommendation 115.**

20.115 We recommend that if any statute provides that a landlord can recover possession or refuse a lease extension if he or she intends or proposes to demolish or reconstruct the building, such a requirement should also be satisfied if it can be proved that a commonhold association has that intention or makes that proposal.

## Further provision to address the position of tenants

20.116 We also invited consultees' views as to what further provision, if any, should be made to address the position of tenants on voluntary termination of a commonhold.[54]

### Consultees' views

20.117 The Leasehold Advisory Service ("LEASE") suggested that tenancies should automatically be terminated upon voluntary termination. Keith Collier suggested the opposite.

20.118 A few consultees argued that tenants should be compensated if a commonhold is terminated.

20.119 The Guinness Partnership (housing association) called for further consultation specifically with social housing tenants on our proposals for voluntary termination.

20.120 Christopher Jessel suggested that "if a termination decision is to override contractual or statutory rights of a tenant the tenant should be entitled to compensation and should be entitled to make representations to the court or Tribunal".

### Discussion and recommendations for reform

#### Automatic termination of tenancies

20.121 Termination of a commonhold may not be viable if the commonhold site cannot be sold with vacant possession. Automatic termination of tenancies (as suggested by LEASE) would enable landlords easily to recover vacant possession, particularly where a tenancy enjoys statutory protection. We do not, however, believe that a recommendation is needed to address this. In a comparable leasehold arrangement, landlords would face the same difficulties in ending protected tenancies. There is no

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53 Pt I of the 1954 Act provides security of tenure to long leaseholders on the expiry of the term, and regulates the ability of the landlord to recover possession. However, the development of enfranchisement rights has ensured that leases will be extended rather than fall to be protected by Pt I of the 1954 Act. Furthermore, the class of lease eligible for protection under Pt I has been reduced. Leases granted after 1 April 1990, and leases granted before 1 April 1990 but which expire on or after 15 Jan 1999 are protected by sch 10 of the Local Government and Housing Act 1989 upon the expiry of the term rather than Pt I of the 1954 Act.

54 CP, Consultation Question 89, para 15.97.

mechanism that enables a leaseholder, who has granted a tenancy subject to statutory grounds for possession, to end the tenancy because he or she wishes to sell to a developer. This is a problem that landlords currently face and resolve, and there is not a convincing reason why security of tenure should differ between leasehold and commonhold units.

20.122 Similarly, we do not see why commonhold should be singularly more beneficial to tenants than would be the case in another arrangement. Tenants are not entitled to consultation and compensation if a landlord seeks possession with a view to selling his or her property. We also do not agree with the suggestion that tenants should be able to apply to the court to oppose termination. Termination has no effect on the status of a tenancy. Instead, a tenancy must be terminated in accordance with the terms of that tenancy. If a tenancy were not terminated, and the commonhold was sold, the tenancy would take effect against the purchaser following termination.[55] They are, therefore, distinct legal processes – albeit that possession will likely be sought as a precursor to the sale. To provide tenants with standing to resist termination of the commonhold would constitute a significant alteration of tenants' rights which we do not consider is justified merely by the fact that the tenancy exists within commonhold.

### Potential of tenancies to frustrate termination

20.123 In Chapter 18 we recommend that, in certain circumstances, a commonhold association should be able to apply to court for the sale of a defaulting unit owner's unit, in order to recover arrears of commonhold contributions from the proceeds of that unit's sale.[56] Consultees drew our attention to the possibility that a unit owner could create a tenancy agreement in an attempt to frustrate the sale of his or her commonhold unit. A tenancy granted to a family member, for example, would take effect against any purchaser, reducing the likelihood of finding a purchaser to take the unit. While we consider the risk low, we make provision in that chapter to address the possibility by providing the court with discretion to end such a tenancy.

20.124 We consider that the possibility may also arise in termination. If a unit owner opposed the termination, then he or she may attempt to create a tenancy, which would take effect against any purchaser, in order to frustrate sale of the site. If a termination is sought with a view to selling the site for redevelopment, the inability to sell the site with vacant possession would likely deter a developer from proceeding. While it is unlikely to occur, we consider that the possibility should be addressed. We therefore recommend that the court has the discretion to order that a tenancy does not bind a purchaser upon termination and sale of the commonhold if the unit owner has created the tenancy in order to frustrate the termination and sale of the site.

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55 Land Registration Act 2002, s 29(2)(a)(ii).

56 Para 18.22 onwards.

**Recommendation 116.**

20.125 We recommend that the court should have discretion to order that a tenancy does not bind the purchaser on termination of the commonhold where the tenancy has been created in an attempt to frustrate the termination of the commonhold and sale of the site.

## THE VALUATION OF COMMONHOLD UNITS AND TERMS OF THE TERMINATION STATEMENT

### Specifying the share of proceeds of termination in the CCS

20.126 The termination statement specifies how the proceeds of termination are to be divided among unit owners. The current law enables the commonhold community statement (the "CCS") to specify the share each unit owner will receive on termination, or specify some method of ascertaining it. In the Consultation Paper, we noted that this has the advantage of reducing disagreement as unit owners know their position when buying into the commonhold. However, it is not mandatory for the CCS to specify either the share or how it is to be determined, and instead this can be left to be determined when members vote to terminate. We provisionally proposed no change to this position.[57]

#### Consultees' views

#### Not mandatory to specify shares in the CCS

20.127 The vast majority of consultees agreed that the CCS should not be required to specify the share of the proceeds of termination that each unit owner is to receive on termination.

20.128 One consultee noted that units may be in a very different state from when the building was constructed. Any pre-determined shares would not therefore fairly distribute the value of respective units to unit owners.

20.129 However, some consultees opposed our proposal on the basis that it would reduce transparency and certainty for unit owners, add delay to the termination process, and potentially lead to disputes and litigation. The joint response argued that:

> In our view the CCS should be required to set out basic principles/ assumptions as to how the share of each unit owner in the proceeds of termination should be ascertained. Leaving this to be decided at the point when a termination has been proposed would, in the real world (a) be highly likely to create tensions if not arguments between neighbours, particularly if the proposal to terminate is already controversial; and (b) potentially take much longer.

[57] CP, Consultation Questions 91, paras 15.117 to 15.118.

20.130 Christopher Jessel suggested that it should be mandatory to specify the share of the proceeds of termination that each unit owner is to receive on termination (or some method of ascertaining the share). He argued that:

> It needs to be clear who owns what on termination. Otherwise the freehold will be held in unknown proportions. In effect the result of termination is that the fee simple in each unit is determinable. Even if this does not create a trust of land it is necessary to be clear in what proportions the fee simple vested in the association after dissolution is held.

### Possible to specify shares in the CCS

20.131 The vast majority of consultees agreed that it should be possible, but not mandatory, for the unit owners to specify the share of the proceeds of termination that each unit owner is to receive on termination (or some method of ascertaining it) in the CCS. ARMA considered that where the shares had been specified unit owners would need a method to challenge the share.

### Discussion

20.132 We do not agree that specifying the distribution of shares in the CCS will necessarily avoid disagreement. The only way to reduce the scope for disputes would be to recommend that the shares specified in the CCS are final. While this would reduce disputes, we do not believe this is desirable for the reason given above: the longer a commonhold endures, it becomes less likely that predetermined termination shares will be fair or accurately reflect the value of units.

20.133 We therefore think that the current law strikes the appropriate balance. The CCS can, but does not have to, specify the shares unit owners will receive on termination. While there is a risk that any pre-determined allocation later fails to accurately reflect the value of individual units, the current law addresses this: unit owners may apply to the court to disapply a term of the CCS governing termination shares. On the other hand, unit owners, or, more likely, the developer, can leave termination shares to be determined when a commonhold terminates.

## Disapplying a term of the CCS governing termination shares

20.134 We suggested throughout the Consultation Paper that most disputes that arise in commonhold should be determined by the Tribunal. We provisionally proposed that an application to disapply a provision in the CCS which determines the distribution of proceeds of sale on termination be made to the Tribunal rather than the court.[58] We suggested that the value of the units will be in question and the Tribunal has expertise to determine such disputes.

20.135 We invited consultees' views on whether guidance should be given to the Tribunal or court as to how it should exercise its discretion, and if guidance should be provided, what factors should be taken into account.[59] In the Consultation Paper, we suggested the following examples:

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58 CP, Consultation Question 91, para 15.119.

59 CP, Consultation Question 91, para 15.120.

(1) how long ago the advance determination was agreed;

(2) what the circumstances were when the advance determination was agreed; and

(3) how circumstances have changed since the advance determination was agreed.[60]

### Consultees' views

20.136 The vast majority of consultees agreed with our provisional proposal that an application to disapply a provision in the CCS be made to the Tribunal rather than the court. However, ARMA raised concerns about the splitting of jurisdiction in voluntary termination proceedings.

20.137 Just under half of consultees who responded to the question suggested that guidance should be provided to the Tribunal or court in how to exercise its discretion. A few consultees expressed concern that guidance may limit the exercise of discretion, and preferred an open-ended discretion. A few consultees suggested other factors to guide the court or Tribunal.

20.138 ARMA suggested the following factors:

(a) how long ago the CCS distribution was set;

(b) how many of the original signatories to the CCS are still owners and what their preference is re termination;

(c) what circumstances have changed since that date e.g. loss of views;

(d) what relative investment has been made into each unit such as new kitchens or alterations to the layout; and

(e) has the mechanism used to originally determine the relative share changed? A mezzanine floor would have changed the internal square footage if the latter was a measure originally used.

20.139 Trowers & Hamlins LLP suggested that

> The Tribunal or the Court should decide on a just and equitable basis having regard to the value of the respective units immediately before any relevant damage or destruction or the decision to terminate if there is none.

20.140 One confidential consultee suggested that there should be a presumption of equal division.

### Discussion and recommendations for reform

20.141 We believe that the Tribunal has the relevant expertise to deal with these applications as the comparative value of different units will be at issue. Moreover, it is

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[60] CP, para 15.108.

consistent with our provisional proposals for almost all disputes within commonholds to be decided by the Tribunal.

20.142 We accept that there is a division in that we provisionally proposed that applications to terminate with less than 80% support of unit owners be heard by the court, and that applications to disapply a term of the CCS governing termination be heard by the Tribunal. While we agree that it is desirable to keep commonhold disputes within the jurisdiction of the Tribunal, the respective expertise of the court and the Tribunal justify divergence. The expertise of the Insolvency Court is appropriate for overseeing the termination process, and the expertise of the Tribunal is appropriate for valuation issues. In addition to recommending that disputes over terms of the CCS governing valuation are heard by the Tribunal, we recommend below that valuation disputes generally should be heard by the Tribunal.[61]

20.143 We agree with concerns that an exhaustive list of factors limits the Tribunal's discretion. We therefore recommend that the list outlined at paragraph 15.108 of the Consultation Paper form a non-exhaustive list of factors to guide the Tribunal's discretion, providing it with flexibility to consider other relevant matters. For that reason, we do not believe it is necessary to expand the list of factors. Furthermore, the third factor in our provisional proposal – how circumstances are alleged to have changed since the advance determination was agreed – is wide enough to cover the additional factors suggested by consultees.

20.144 A presumption of equal division is problematic. While the Tribunal may decide that a term should not apply, it does not follow that a party is seeking equal division. Indeed, they are likely making such an application because they feel they are entitled to more than the original terms provide. Similarly, we do not see a convincing reason to adopt a "just and equitable" division in the event of the building's destruction. If the CCS contains valid terms governing the distribution of funds on voluntary termination, these should apply unless challenged by a unit owner. If for some reason the terms are not appropriate in the event of the destruction of a building, it would be for a unit owner to make an application to disapply the relevant terms.

**Recommendation 117.**

20.145 We recommend that applications to disapply a provision in the CCS which determines the distribution of proceeds of sale on termination should be heard by the Tribunal.

20.146 We recommend that the Tribunal, when determining an application to disapply a provision in the CCS determining the proceeds of sale on termination, should take into account all matters that appear to it to be relevant. Those matters should include:

(1) how long ago the advance determination was agreed;

[61] CP, para 15.114. Discussed below at para 20.152.

(2) what the circumstances were when the advance determination was agreed; and

(3) how circumstances have changed since the advance determination was agreed.

## The Tribunal and valuation

20.147 We invited consultees' views on whether all issues involving the valuation of commonhold units on termination should be referred to the Tribunal (and, if so, whether that would cause any unnecessary delays); and on whether, if valuation issues are referred to the Tribunal, the Tribunal should be able to appoint a single valuer.[62]

### Consultees' views

20.148 Just under half of consultees responding to this question considered that all issues involving valuation arising during voluntary termination should be referred by the Insolvency Court to the Tribunal. Berkeley Group Holdings PLC suggested that "the Tribunal has experience of residential valuation issues and will have a well-tested body of practice in making decisions regarding commonhold matters". ARMA considered that our provisional proposal will cause delays but that this is justified as the Tribunal is the appropriate forum to determine valuation issues.

20.149 Just under half of consultees responding to this question considered that the Tribunal should be able to appoint a single valuer when determining valuation disputes rather than hearing experts appointed by the parties.

20.150 A few consultees considered that all valuation issues should go to the Tribunal and that the tribunal should be able to appoint a single valuer.

### Discussion and recommendations for reform

20.151 We agree that although it may cause delay for the court to refer valuation issues to the Tribunal, the Tribunal is best placed to resolve these disputes. Appointing a single valuer has the advantage of providing the Tribunal with expert insight from one source rather than a range of experts appointed by each party. This seems particularly appropriate when the purpose of the valuation of individual units is to calculate the proportion of the net sale proceeds that each unit owner will receive. It is therefore essential that the valuation of each unit is calculated on the same basis and using the same assumptions.

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62 CP, Consultation Question 91, paras 15.121(2) to 15.121(3).

**Recommendation 118.**

20.152 We recommend that disputes on valuation issues should be referred as a discrete matter to the Tribunal and that the Tribunal should be able to appoint a single valuer to provide expert evidence.

## Valuation of a destroyed commonhold

20.153 We provisionally proposed that, if a commonhold is substantially destroyed, but remains solvent, then for the purposes of the termination statement the units should be valued on the basis of the best estimate that can be made of their pre-damage value.[63]

20.154 We also invited consultees' views as to any other issues that might occur in the valuation of units if all or some of them have been partly or entirely destroyed, and any suggested solutions.[64]

### Consultees' views

20.155 Almost all consultees agreed with our provisional proposal that if a commonhold is substantially destroyed, but remains solvent, then for the purposes of the termination statement, the units should be valued on the basis of the best estimate that can be made of their pre-damage value. One consultee pointed out that valuation is an important element of establishing each unit owners' share of insurance proceeds.

20.156 Consultees submitted a range of views on other issues that might occur in the valuation of units if all or some of them have been partly or entirely destroyed.

20.157 One confidential consultee suggested that percentage contributions to commonhold contributions should be considered.

20.158 Christopher Jessel considered that destruction by negligence or criminal activity of a unit owner should be considered in distributing the proceeds and raising separate claims.

20.159 Berkeley Group Holdings PLC suggested that unless it is impossible due to circumstances beyond its control, a commonhold association should be required to rebuild.

### Discussion and recommendations for reform

#### Valuation of destroyed commonhold

20.160 We agree that valuation of a destroyed commonhold has important implications for any insurance claim and that its pre-damage value is the most appropriate guide. While valuation of a destroyed commonhold will have to be conducted on the available evidence of its pre-damage value (such as plans), we believe that this should prove

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63 CP, Consultation Question 91, para 15.122.

64 CP, Consultation Question 91, para 15.123.

sufficient for the purposes of determining the value of each unit. A similar valuation and calculation would have to be adopted in the event of the destruction of a leasehold block in order to determine the distribution of the proceeds of the insurance claim among the landlord and the various leaseholders.

### Contributions to commonhold contributions

20.161 Commonhold contributions are made in respect of services, maintenance of the site and other purposes. While differing units may have different obligations attached to them, such obligations do not illustrate the value of the units, and we do not believe that this offers a basis on which to calculate the value of units following substantial damage or destruction.

### Negligence or criminal activity responsible for destruction

20.162 Christopher Jessel suggested that negligence or criminal activity by a unit owner which causes destruction should be taken into account in distributing insurance money. We think that there are more appropriate means to address the negligence or criminal activity of a unit owner which causes damage. As the consultee pointed out to us, unit owners could take action through the courts if this were to occur. The unit owner may also face a charge of criminal damage and a compensation order. We also consider that lenders would be unfairly prejudiced if criminal or negligent action of a unit owner affected the payment of insurance. A negligent or criminal act by a unit owner which precluded the unit owner from receiving proceeds of sale is a significant erosion to the value of the mortgage lender's security, as it may erode the available funds to redeem the mortgage.

### An obligation to rebuild

20.163 The current prescribed CCS imposes a requirement to use the proceeds from an insurance policy in respect of the common parts to rebuild in the event of the destruction of the commonhold.[65] However, this requirement can be overridden if the commonhold instead decides to terminate. Modification of this position would constitute a significant restriction of a commonhold's autonomy.

**Recommendation 119.**

20.164 We recommend that if a commonhold is substantially destroyed, but remains solvent, then for the purposes of the termination statement, the units should be valued on the basis of the best estimate that can be made of their pre-damage value.

## Supplemental commonhold insolvency rules

20.165 Voluntary termination of commonholds is governed by the general law of insolvency. When the 2002 Act was passed, it was anticipated that Commonhold Insolvency

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65 Commonhold Regulations 2004, sch 3, para 4.4.2. In Ch 12, we consider that it is necessary to maintain this requirement in respect of horizontally divided buildings for the purposes of insurance: see para 12.112.

Rules would be created, but no Rules were ever created.[66] We invited consultees' views as to whether the existing rules of the Insolvency Court would be adequate to deal with valuation issues which may arise on the voluntary termination of a commonhold, or need to be supplemented by Commonhold Insolvency Rules.[67]

### Consultees' views

20.166 Just over half of consultees considered that there was a need for supplementary Commonhold Insolvency Rules. Most consultees who considered that bespoke rules are not needed did not offer reasons why. However, one confidential consultee suggested that as the commonhold association is a conventional company, there is a range of adequate tools in the existing company law.

### Discussion

20.167 Commonhold Insolvency Rules offer the advantage of tailoring the application of insolvency law to the winding-up of commonhold associations. For example, in this chapter, we recommend that if a unit is in negative equity, it should be clarified that any shortfall should be met personally by the owner of the unit, and should not be covered by other unit owners. We also recommend that a lender has the right to challenge the level of the liquidator's remuneration at any stage during the termination process. These are the kinds of rules that would be appropriate in a supplementary regime of Commonhold Insolvency Rules.

20.168 However, supplemental rules add an additional framework for practitioners and owners to understand. The 1990 and 1996 draft Bills on commonhold failed to be taken up partly because their entirely bespoke insolvency provisions rendered them unwieldy. It should be noted, however, that these draft Bills were based on a bespoke corporate form, which crated an additional layer of complexity.[68]

20.169 We believe it would be useful for there to be some specific rules for the winding-up of commonholds. This could take effect by listing in regulations provisions of insolvency law that do not apply to commonhold and providing specific commonhold rules in their place. This would help address suggestions by consultees that insolvency provisions are complex and need to be made accessible to lay directors of commonhold associations. Under the current law, the Secretary of State has the power to create such rules.[69] We do not, however, think it is necessary to outline Commonhold Insolvency Rules at this stage – particularly as we do not have experience of issues that may arise during termination. It may be the case that as commonhold is taken up, future issues and problems arise that could be remedied via Commonhold Insolvency Rules. We therefore suggest that the need for specific insolvency rules be considered before the implementation of this Report, and that they are kept under review as and when issues emerge.

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66 CP, para 15.112.

67 CP, Consultation Question 91, para 15.121(1).

68 See Commonhold: A Legislative History.

69 CLRA 2002, s 64.

## PRESERVING THE VALUE OF THE COMMONHOLD UNITS

### The conversion of a voluntary termination into a creditors' winding-up

20.170 Concern has been raised over the possibility of a voluntary termination being converted into a creditors' voluntary winding-up.[70] The 2002 Act makes provision for a commonhold association to be wound up either voluntarily by its members or compulsorily by an order of the court. In both cases creditors have no access to the value of the commonhold units. However, the Insolvency Act 1986 makes provision for a third way – a creditors' voluntary winding-up.[71] A creditors' voluntary winding-up enables an insolvent company to begin liquidation rather than wait for creditors to petition the court to wind the company up. The company's assets are then distributed among its creditors. If a commonhold was subject to a creditors' voluntary winding-up, the unit owners face a serious risk – unlike in the case of a voluntary winding-up or a compulsory court ordered winding-up, the value of the units will be available to the commonhold association's creditors.

20.171 While it is not possible for a commonhold association to instigate a creditors' voluntary winding-up, it is possible for a members' voluntary termination to be converted into a creditors' voluntary liquidation if, after passing the termination resolution, it becomes clear that the commonhold association is in fact insolvent.[72] We provisionally proposed that if a voluntary termination should begin, but it subsequently turns out that the commonhold is in fact insolvent and the voluntary termination becomes a creditors' voluntary winding-up, the same protections should apply as if the process had begun as an involuntary insolvency, preventing creditors accessing the value of the units.[73] The value of the commonhold units would therefore be protected from the claims of creditors.

#### Consultees' views

20.172 The vast majority of consultees agreed with our provisional proposal that the value of the units should be protected if a voluntary termination is converted to a creditors' voluntary liquidation. The joint response suggested that our proposal is fair for unit owners, and offers security to lenders. One confidential consultee pointed out that insolvency of the commonhold association should not jeopardise the equity of unit owners.

#### Discussion and recommendations for reform

20.173 We agree with the consensus of consultees and recommend that if a voluntary termination is converted to a creditors' voluntary liquidation the same protections should apply as if the process started as an involuntary winding-up. This will ensure that in the unlikely event a voluntary termination becomes a creditors' voluntary liquidation, creditors' claims would be limited to the commonhold association's current balances, any relevant reserve fund balances, any debts owed to the association and

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70 CP, para 15.73.

71 Insolvency Act 1986, ch IV.

72 Insolvency Act 1986, ss 95 and 96.

73 CP, Consultation Question 92, para 15.126.

the value of the common parts. The value of the commonhold units would be preserved for unit owners.

20.174 This is in line with our provisional proposals in Chapter 19, which maintain that the value of commonhold units should not be available to meet the association's debts, and provides security for both unit owners and secured lenders.

**Recommendation 120.**

20.175 We recommend that if the process of voluntary termination should begin, but it subsequently turns out that the commonhold association is in fact insolvent, the same protections should be given to the assets of the individual unit owners and to any applicable reserve funds as would have applied if the process had begun as an involuntary insolvency.

### Preserving the value of units if a commonhold is destroyed

20.176 We invited consultees' views as to whether the value of the individual units should be preserved for the unit owners if the commonhold is substantially destroyed; and, if so, how this can be achieved.[74]

20.177 This question addressed the scenario where a building has been destroyed, the commonhold association is insolvent and the building is underinsured.[75] The value attributed to the units and the value attributed to the common parts takes on significance in this situation. When the commonhold association is solvent, unit owners are entitled to a share of the value attributed to the common parts. In contrast, where the commonhold association is insolvent, any value attributed to the common parts will be available to the creditors. In the event of underinsurance or void insurance, unit owners will be unable to recoup the total value of their unit, and any value attributed to the common parts cannot be used to supplement their share.

#### Consultees' views

20.178 Letitia Crabb (academic) suggested that:

> The wreck could be valued and that meagre value apportioned between the units and the common parts. That apportioned to the common parts and any balances in bank accounts or amounts owed to the common association should be available to creditors. The proposal to introduce restricted liability and the events which have occurred should prevent continuing assessments.

20.179 ARMA and LEASE agreed that the value of units should be preserved relative to other units for calculating the division of proceeds.

20.180 Christopher Jessel referred to freestanding buildings on a commonhold, noting that these were less likely to be destroyed. He considered that, where this was the case,

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74 CP, Consultation Question 92, para 15.127.

75 CP, para 15.125.

the unit owner should be entitled to the value of its building plus a share of any value in the commonhold association. He noted that where the destroyed units were flats, valuing airspace would be difficult, and said that, in that case, the unit owner should simply get a share in the site.

### Discussion

20.181 No consultee offered suggestions as to how the value of the individual units could be preserved for unit owners in the event the building was destroyed. We suggested in the Consultation Paper that the value of the common parts could be attributed to the unit owners rather than the association's creditors. However, only one consultee addressed this, and disagreed with the suggestion. We therefore make no recommendation.

## VOLUNTARY TERMINATION WHERE A COMMONHOLD IS DIVIDED INTO SECTIONS

20.182 In the Consultation Paper, we suggest that mixed-use commonholds will become increasingly common.[76] We provisionally proposed the use of "sections" to enable differing parts of a commonhold to self-manage.[77] Sections would enable a commonhold to separate out different interests and provide various groups with a degree of self-governance. This may be appropriate, for example, in mixed-use commonholds where the priorities and interests of residential units may differ from commercial units.[78] However, the current law is modelled on the assumption that a single vote to terminate will be taken across an entire commonhold. In Chapter 8, we make recommendations for commonholds to have sections based on the scheme we put forward in the Consultation Paper.

20.183 With the possibility of sections in mind, in the Consultation Paper we provisionally proposed that where a commonhold is divided into sections, any vote on voluntary termination would need to be taken in sections, and whether it was unanimous or received at least 80% support would have to be determined by section. For a termination to proceed, each section would have to achieve a majority of at least 80% support.[79] This is in keeping with the principle of delegated control that underlies the sections approach – a particular section could prevent the termination of a commonhold if its members did not agree with it.

### Consultees' views

20.184 The vast majority of consultees supported our provisional proposal. Professor James Driscoll considered the proposal to be "essential" for fairness. An anonymous consultee also suggested it was "fair and even".

20.185 However, several consultees indicated in their comments that they understood our provisional proposal as suggesting that a section would be able autonomously to vote

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76 CP, para 15.38.

77 CP, para 5.39.

78 CP, Ch 5.

79 CP, Consultation Question 88, para 15.93.

to terminate and remove itself from the commonhold, and supported it on that basis. For example, ARMA noted that:

> the resulting impact on the other sections will also need to be taken into account, particularly where financial contributions are made to the common areas. If the commonhold association for a section is dissolved and the land sold for redevelopment will the purchaser be obliged to continue to pay contributions at the required level to the commonhold for shared facilities such as the upkeep of gardens, gates and roads.

20.186 Christopher Jessel similarly cautioned that "a decision by one section could affect the owners of units in other sections, such as the cost of maintenance of a shared facility". One anonymous consultee also noted that the termination of a section could adversely impact other unit owners, and the entire commonhold should therefore have a say on such a proposal.

20.187 The joint response suggested that "determination by section would be workable in principle when each section is in a separate building but we consider that it could be problematic and very complicated where the sections are within the same building". The City of London Corporation also noted that:

> Determination by section could work where each section is a separate building, but could be problematic where the sections are in the same building. How would it work if the commercial section on the ground floor voted for termination, but the upper residential section did not?

20.188 Similarly, those who disagreed with our proposal indicated in their comments that they understood the proposal to mean that a section could terminate and remove itself from a commonhold. Consensus Business Group (landlord) stated that:

> We do not agree with the proposal that individual sections could have the ability to terminate their part of the commonhold association, this would lead to lacunas in management which would likely lead to chaos and potentially very serious consequences that could affect aIl unit holders.

### Discussion and recommendations for reform

#### Procedure for terminating where a commonhold is divided into sections

20.189 We agree that our provisional proposal is necessary for fairness: it would be contrary to the delegated control that underlies sections if a crucial decision in respect of the commonhold could be taken against a section's wishes. We therefore recommend that where a commonhold is divided into sections, two votes are necessary to approve termination (although both may take place at the same time). First, termination must be approved by the commonhold association as a whole. It will not always be the case that every part of the commonhold sits within a section. In those circumstances, restricting the vote to sections would exclude some unit owners. More fundamentally, under the 2002 Act, the decision to terminate must ultimately be taken by the

association.[80] It is therefore necessary that the association as a whole approves the proposal – even in cases where all parts of the commonhold sit within sections.

20.190 Second, termination must be approved by each individual section. Termination may only proceed if more than 80% of all unit owners support the first vote, and 80% of unit owners in each and every section support the second vote. A single section may therefore prevent termination. We consider that this is the correct outcome as it reflects the principle of delegated control underpinning the section model. However, if this were to occur, our recommendation in respect of partial termination would provide the parts wishing to terminate with a route to doing so while leaving the objecting section(s) as part of the commonhold.[81]

### Termination of part

20.191 The fact that several consultees shared a different interpretation of the question may suggest that our provisional proposal should be modified to take account of these views. While we did not provisionally propose that a section could decide to terminate and remove its units from the commonhold, we can see the advantages of such a provision – particularly in respect of mixed-use commonholds. Commercial buildings are likely to become obsolete before residential buildings, and it may prove problematic if commercial owners cannot remove their units from the commonhold if the units require redevelopment. We therefore believe that consultees have highlighted an important aspect concerning the viability of mixed-use developments, and that there should be provision for part of a commonhold to be terminated for the purpose of redevelopment.

20.192 There is no specific provision to remove units from a commonhold under the current law. However, it could be achieved through creative use of the 2002 Act. A commonhold association has the power to sell part of the common parts.[82] It also has the power to re-designate units as common parts.[83] A commonhold could therefore re-designate units as common parts, and then sell the relevant part to a third-party free of the commonhold obligations. However, as a commonhold cannot distribute profits among its members, it would likely be necessary to establish a company limited by shares to conduct the sale and distribute the proceeds.[84]

20.193 We do not believe that this is a satisfactory approach. It is unwieldy and complex, and we believe that it is necessary to provide a simpler procedure that would enable a section to be removed from the commonhold for the purposes of redevelopment.

20.194 Provision of such a procedure would be consistent with a number of other jurisdictions. For example, in New Zealand it is possible for land to be added or removed from the unit title scheme by special resolution (75% of those who attend the vote), and objecting unit owners may apply to court to oppose the addition or removal.

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80 CLRA 2002, ss 44(1) and 45(1).

81 See para 20.190 below.

82 CLRA 2002, s 27(1)(a). This must be approved by a special resolution of the commonhold association.

83 CLRA 2002, s 30. In addition to the owners' and any lenders' consent, the proposal to re-designate units as common parts would require a special resolution of the commonhold association.

84 Commonhold (Amendment) Regulations 2009, sch, art 72. See *Clarke on Commonhold*, 18[9] and 6[2].

Similarly, in Canada it is possible to sell common property or a unit and remove it from the strata corporation, but with the unanimous consent of all owners.

20.195 However, not all jurisdictions make provision for partial termination. It does not appear to be possible to remove units from a condominium scheme in the United States, but a condominium made up of individual houses may provide in its termination statement that the common parts will be sold but the houses kept by their current owners.[85] There is no provision to remove units in South Africa and in the Australian state of New South Wales there is no mechanism to remove land from a unit title scheme.

20.196 We have come to the conclusion that partial termination is important for the viability of mixed-use developments and that an ability to do so should exist in this jurisdiction. In devising how the power should operate, we have taken into account both the concerns of consultees and the experience in practice of partial termination in other jurisdictions, which we discussed with members of our international advisory group. We therefore recommend that partial termination is subject to the following conditions.

20.197 First, partial termination should only be possible where the terminating part consists of a single building or buildings. It would therefore not be possible (for example) to terminate floors five to ten within a building of a commonhold. We agree with consultees' concerns that to provide for termination of part of a single building would prove very complicated, with no provision in place to enforce positive obligations between the commonhold and terminated part.

20.198 Second, partial termination should only be possible for the purposes of redevelopment. It should not be a route for a part of a commonhold to remove itself so as to escape the obligations that a commonhold may impose. The fact that independent buildings sit within a commonhold suggests a level of interdependence between the buildings, such as the provision of shared services. We hope that this condition provides assurance to commercial owners that it is possible to terminate and redevelop if necessary, but without undermining the central purpose of commonhold: to provide a scheme of management for interdependent freehold titles.

20.199 Third, we recommend that partial termination is subject to the approval of both the remaining unit owners and the unit owners in the terminating part. As partial termination has the potential to significantly impact the remaining unit owners, a balance needs to be struck between those wishing to terminate and those remaining. The extent of that impact will vary from case to case. For example, commonhold contributions will likely need adjusting following the removal of units, potentially placing a higher burden on the remaining units. Furthermore, a particular part may add value to the scheme, such as leisure facilities, and its loss may cause the value of the remaining units to diminish. Such drastic changes should not be made without the consent of those affected. Requiring that the remaining units must consent puts the onus on the terminating part to negotiate a suitable arrangement with the remaining units. However, under the current law, a commonhold association is prevented from distributing profits to its members.[86] The ban on distribution does not seem

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85 Commonhold: Comparative Research, para 5.92(2).

86 Commonhold (Amendment) Regulations 2009, sch, art 72.

appropriate or necessary when there has been a termination of part, as we cannot see that there is scope for abuse. We therefore recommend an exception in the case of partial termination to enable the association to pay any profits from the termination to its members.

20.200 Finally, we believe that the existing threshold for voluntary termination is the appropriate threshold of support – partial termination would therefore be dependent on the support of all unit owners in the commonhold, or at least 80% plus court approval; and the unanimous support of unit owners in the part, or at least 80% plus court approval.

20.201 The procedure for section termination would therefore work in the following way.

(1) The part wishing to terminate must vote on the proposal and the resolution must attract at least 80% support. The vote must include: the principle of supporting termination, the establishment of a company, and name directors of the company. If the vote is passed, those who vote in favour must become members of the company. As a company will be needed to purchase the common parts, we think it should be formed at this stage, and be used to contract with the commonhold association for the remaining stages.

(2) The part, via the company, makes a proposal of termination to the commonhold association. Such a proposal would likely include provision for purchasing the relevant common parts, whether the terminating section is entitled to any of the reserve funds, and the terms of any developer, including any development rights that would need to be given to the purchaser.

(3) The proposal is put to a vote of the commonhold association (including the unit owners in the terminating part). The resolution requires either unanimous support of unit owners or at least 80% support, plus the approval of the court.

(4) The proposal is then put to a vote of the part, and requires either unanimous support or at least 80% support of unit owners in the part, plus the approval of the court.

(5) Once both resolutions are approved, the individual units and common parts can be sold to the purchaser free of the commonhold title entries.

(6) A new CCS must be registered reflecting the amended commonhold.

**Recommendation 121.**

20.202 We recommend that where a commonhold is divided into sections, any vote on voluntary termination should be taken in sections, and whether it was unanimous or received at least 80% support should be determined by section.

20.203 We recommend that it should be possible to terminate part of a commonhold, and the relevant part sold free of the commonhold title entries, subject to the following conditions:

(1) a part must comprise one or more entire buildings;

(2) a proposed partial termination must be approved unanimously by the remaining unit owners, or 80% of remaining unit owners plus the approval of the court; and

(3) a proposed partial termination must be approved unanimously by members of the terminating part, or 80% of members plus the approval of the court.

20.204 We recommend a change to the commonhold articles of association so that profits may be distributed to members of a commonhold association following termination of part.

## RECONSTITUTION OF A COMMONHOLD

20.205 Where a commonhold is not divided into sections, we provisionally proposed that it should be possible for part of the commonhold to be reconstituted following voluntary termination.[87] Our provisional proposal would enable the commonhold to be terminated, and a "new" commonhold established for the remaining parts. We suggested that reconstitution may address the problem in a mixed-use commonhold where part of the commonhold wishes to terminate.[88] However, as we outline above, we make recommendations for a bespoke procedure for termination of part in the light of consultees' views.[89] As that recommendation addresses the issue of termination of part more directly than reconstitution, we do not consider that it is necessary to make provision for reconstitution.

87 CP, Consultation Question 88, para 15.94.

88 CP, para 15.58.

89 See para 20.191 above.

# Part VIII: Summary of our recommendations

# Chapter 21: Recommendations

**Recommendation 1.**

21.1 We recommend that it should be possible to convert to commonhold if either:

(1) the freeholder consents; or

(2) the leaseholders carry out a collective freehold acquisition claim as part of the process of converting to commonhold.

21.2 We recommend that the circumstances in which leaseholders may acquire the freehold on conversion to commonhold without the freeholder's consent should be kept under review.

**Paragraph 4.39**

**Recommendation 2.**

21.3 We recommend that conversion to commonhold should be possible without the unanimous agreement of the leaseholders.

**Paragraph 4.51**

**Recommendation 3.**

21.4 We recommend that leaseholders who are eligible to participate in a collective freehold acquisition claim should have a statutory right to participate in a decision to convert to commonhold and take a commonhold unit on conversion.

**Paragraph 4.63**

**Recommendation 4.**

21.5 We recommend that, to convert to commonhold, eligible leaseholders of at least 50% of the flats in the building must support the decision to convert.

**Paragraph 4.90**

**Recommendation 5.**

21.6 We recommend that, on conversion to commonhold, any tenancies which are not held by individuals who are eligible to participate in a collective freehold acquisition claim, should continue automatically on conversion and that the consent of such tenants should not be required in order to convert to commonhold.

**Paragraph 4.98**

**Recommendation 6.**

21.7 We recommend that Government work with lenders to facilitate the automatic transfer of charges from the leasehold title to the commonhold unit title on conversion.

**Paragraph 4.116**

**Recommendation 7.**

21.8 We recommend that, if conversion Option 1 is adopted, non-consenting leaseholders should be provided with a statutory right to buy the commonhold title in respect of their unit following the conversion to commonhold.

**Paragraph 5.19**

**Recommendation 8.**

21.9 We recommend that, if conversion Option 1 is adopted, non-consenting leaseholders' statutory right to buy their commonhold unit should replace their existing statutory right to a lease extension.

21.10 We recommend that it should not be possible for leaseholders to carry out a collective freehold acquisition or a right to manage claim once conversion has taken place.

**Paragraph 5.35**

**Recommendation 9.**

21.11 We recommend that, if conversion Option 1 is adopted, on the transfer of a leasehold property owned by a non-consenting leaseholder, the transferee should be required to purchase the commonhold title, as well as the leasehold interest.

21.12 We recommend that a person who receives a leasehold property by operation of law should not be required to buy the commonhold title.

**Paragraph 5.48**

**Recommendation 10.**

21.13 We recommend that, in order to finance the share of the freehold value attributable to flats which are held by non-consenting leaseholders, any of the methods available to finance a collective freehold acquisition should also be available where leaseholders are acquiring and converting to commonhold under conversion Option 1.

21.14 We recommend that, if conversion Option 1 is adopted, the commonhold association's articles of association should permit the association to distribute ground rent and premiums received from non-consenting leaseholders to its members.

**Paragraph 5.80**

**Recommendation 11.**

21.15 We recommend that, if conversion Option 1 is adopted, the participating leaseholders should be able to require the freeholder to take the commonhold unit in respect of any flats which have not been let to a leaseholder who is eligible to participate in the conversion. Additionally, the freeholder should be able to require that he or she be granted the commonhold unit in respect of such flats (rather than being able to require a leaseback, as is presently the case).

21.16 We recommend that the freeholder should automatically become the unit owner in respect of any flats let to statutorily-protected non-qualifying tenants and shared ownership leaseholders on conversion.

21.17 We recommend that, where some or all of the participating leaseholders finance the shares of the freehold value attributable to flats in respect of which there is not an eligible leaseholder (and so do not require the freeholder to take the units and

the freeholder does not request the units) the commonhold units should be owned by the commonhold association as a default rule.

**Paragraph 5.95**

**Recommendation 12.**

21.18 We recommend that, if conversion Option 2 is adopted, Government should provide equity loans to non-consenting leaseholders to cover their share of purchasing the freehold. Government should also offer such loans to participating leaseholders on a voluntary basis.

**Paragraph 5.146**

**Recommendation 13.**

21.19 We recommend that, if Option 2 is adopted, the participating leaseholders should be able to require the freeholder to take the commonhold unit in respect of any flats which have not been let to a leaseholder who is eligible to participate in the conversion. Additionally, the freeholder should be able to require that he or she be granted the commonhold unit in respect of such flats (rather than being able to require a leaseback, as is presently the case).

21.20 We recommend that the freeholder should automatically become the unit owner in respect of any flats let to statutorily-protected non-qualifying tenants and shared ownership leaseholders on conversion.

21.21 We also recommend that, where some or all of the participating leaseholders finance the shares of the freehold value attributable to flats in respect of which there is not an eligible leaseholder (and so do not require the freeholder to take the units and the freeholder does not request the units) the commonhold units should be owned by the commonhold association as a default rule.

**Paragraph 5.156**

**Recommendation 14.**

21.22 We recommend that those wishing to convert to commonhold must either:

(1) prepare the CCS in accordance with conditions which should be prescribed by Regulations; or

(2) make an application to the Tribunal as part of the process of converting to commonhold.

21.23 We recommend that, if the participating leaseholders elect to apply to the Tribunal, the Tribunal should authorise the conversion unless the terms of the CCS do not adequately protect the individuals who will take a unit on conversion, and individuals who might take a unit in the future under our recommendations to phase out leasehold interests.

21.24 We recommend that, if the terms of the CCS, as presented to the Tribunal, do not adequately protect these individuals, the Tribunal may suggest revisions to the CCS. Participating leaseholders may choose to accept these revisions and proceed with the conversion, or reject the suggestions and not proceed. Any individual who will or might take a unit should be able to make representations to the Tribunal.

21.25 We recommend that, unless the Tribunal has authorised a departure from the prescribed statutory conditions:

(1) any terms of the CCS which were approved before the individual in question became a unit owner, and which place more extensive obligations or restrictions on the unit owner than those which existed under the lease terms, should not be enforceable against that unit owner; and

(2) a unit owner who had certain rights in his or her lease over the land that will form the commonhold but has not been provided with equivalent protections in the CCS, should have the right to apply to the Tribunal. The Tribunal may order that the terms of the CCS should be amended to protect that owner's right, or may award the payment of compensation for the loss of that right.

**Paragraph 5.197**

**Recommendation 15.**

21.26 We recommend that all eligible leaseholders should be required to take a commonhold unit on conversion (which we call "conversion Option 2"), but only if:

(1) Government provides an equity loan to non-consenting leaseholders to cover their share of purchasing the freehold, and offers such loans to consenting leaseholders on a voluntary basis; and

(2) Government works with lenders to ensure that charges over leasehold flats can transfer automatically to the commonhold units on conversion.

21.27 If the actions listed at (1) and (2) above are not feasible, non-consenting leaseholders should retain their leasehold interests on conversion (which we call "conversion Option 1") but:

(1) non-consenting leaseholders should have the option to buy the commonhold title in respect of their unit at a later date;

(2) the new right to buy the commonhold unit should replace leaseholders' existing rights to a lease extension; and

(3) incoming purchasers should be required to buy the title to the commonhold unit in addition to the leasehold interest.

**Paragraph 6.57**

**Recommendation 16.**

21.28 We recommend that it should be possible for leaseholders to acquire the freehold through a collective freehold acquisition claim, and convert to commonhold, by following a streamlined "acquire and convert" procedure.

**Paragraph 7.17**

**Recommendation 17.**

21.29 We recommend that a prescribed Claim Notice to "acquire and convert" should be produced for leaseholders who need to acquire the freehold compulsorily as part of the process of converting to commonhold. We further recommend that a prescribed "Conversion Notice" should be produced for leaseholders who do not need to acquire the freehold as part of the conversion to commonhold. In this recommendation, "the Notice" refers either to the Claim Notice to acquire and convert or the Conversion Notice as appropriate.

21.30 We recommend that leaseholders should indicate their consent to the conversion to commonhold (and the collective freehold acquisition claim, where leaseholders are also acquiring the freehold compulsorily) by signing the Notice.

21.31 We recommend that once the Notice has been signed, leaseholders should not be able to withdraw their individual consent to the conversion. Leaseholders should make a collective decision no longer to pursue the claim.

21.32 We recommend that leaseholder consents to the conversion should not lapse automatically after a certain period of time and that it should not be possible for leaseholders to provide their consent to the conversion on a conditional basis.

21.33 We recommend that, should mortgage lender consent be required to the conversion, lenders should evidence their consent by completing a deed of substituted security to transfer their charge to the commonhold unit.

21.34 We recommend that, in addition to the freeholder, it should be possible for the commonhold association (as nominee purchaser) to apply to HM Land Registry to create a new commonhold. Those applying to HM Land Registry (whether the freeholder or the nominee purchaser) should submit the following documents alongside application form CM1:

(1) the transfer deed, transferring the freeholder's land to the commonhold association;

(2) the CCS and accompanying plans;

(3) a copy of the Notice (which provides evidence of leaseholder consents and lists the individuals who will take a unit on conversion);

(4) any deeds of substituted security;

(5) a statement of truth confirming that the necessary consents have been obtained;

(6) the commonhold association's certificate of incorporation and articles of association; and

(7) a certificate by the directors of the association that the CCS and articles of association comply with the commonhold legislation and regulations. The certificate should also confirm that the CCS satisfies the statutory conditions which are aimed at protecting those who have not agreed to the conversion, unless a copy of the Tribunal order approving the terms of the CCS is supplied.

21.35 We recommend that, where the freehold of the building is controlled by the leaseholders through a freehold management company (an "FMC"), the freehold should be transferred to a new commonhold association as part of the process of conversion to commonhold (rather than the FMC changing its articles to become a commonhold association, where this is possible).

21.36 On receipt of the documents above, HM Land Registry should register the land as a freehold estate in commonhold land. HM Land Registry should also register the commonhold association as the freehold owner of the common parts and those leaseholders identified as taking a unit on conversion should be registered as the freehold owners of their unit or units under separate title numbers.

**Paragraph 7.84**

**Recommendation 18.**

21.37 We recommend that commonholds with sections (which are not individual corporate bodies) should be introduced as a management structure, to make commonhold workable for more complex developments.

**Paragraph 8.30**

**Recommendation 19.**

21.38 We recommend that it should be possible for sections to be created:

(1) at the outset, by the developer;

(2) at the outset, on conversion from leasehold to commonhold; or

(3) at a later date, by the commonhold association.

**Paragraph 8.39**

**Recommendation 20.**

21.39 We recommend that for a commonhold association to create sections at a point after the commonhold has been set up:

(1) the decision should be approved by a special resolution of the commonhold association; and

(2) separately, 75% of all the votes held by unit owners who would be part of the new section should be cast in favour of creating the section.

**Paragraph 8.46**

**Recommendation 21.**

21.40 We recommend that unit owners should have a right to apply to the Tribunal under our recommended minority protection provisions.

**Paragraph 8.55**

**Recommendation 22.**

21.41 We recommend that qualifying criteria for sections should be introduced, so that sections can only be created to separate out the interests of:

(1) residential and non-residential units; or

(2) different non-residential units, which are used for significantly different purposes; or

(3) different types of residential units; or

(4) separate buildings in the same development; or

(5) other premises falling within the commonhold which, on an application by the developer or commonhold association, and in the interests of practicality and fairness, the Tribunal decides should form a separate section.

21.42 We recommend that the Tribunal should not be able to decide that a separate section should be set up on the basis of differences in the identity of unit owners or different tenure types. New sections should instead be justified by some difference in the nature of the units.

21.43 We recommend that any decision of the Tribunal that a section has been set up where none of the criteria have been met will require a change in the structure of the commonhold from that date, but will not render the section void from the outset.

**Paragraph 8.72**

**Recommendation 23.**

21.44 We recommend that it should be possible for sections to consist of a single unit.

**Paragraph 8.77**

**Recommendation 24.**

21.45 We recommend that to combine two or more sections:

(1) the decision should be approved by a special resolution of the commonhold association; and

(2) separately, each of the sections which will be combined should individually meet the requirement that 75% of all the votes held by all the unit owners in that section must be cast in favour of combining the sections.

21.46 We recommend that unit owners should have a right to apply to the Tribunal under our recommended minority protection provisions if a decision to combine two or more sections is approved.

**Paragraph 8.86**

**Recommendation 25.**

21.47 We recommend that there should not be any criteria which must be met before two or more sections in a commonhold can be combined.

**Paragraph 8.90**

**Recommendation 26.**

21.48 We recommend that it should be optional for a section to have a section committee.

**Paragraph 8.99**

**Recommendation 27.**

21.49 We recommend that it should be for the directors of a commonhold association to decide whether powers are delegated collaterally or exclusively to a section committee.

(1) We recommend that if a delegated power does not state how it has been delegated, it should be presumed to have been delegated collaterally.

(2) We recommend that the CCS should provide that, regardless of the wording of a delegated power, the directors retain the ability to exercise that delegated power if it is reasonable to do so. The provision should require the directors to serve a notice on the section committee which identifies the reason(s) why the directors intend to exercise the delegated power, and confirms the directors' intention to exercise the power unless the committee remedies the problem(s) identified by the directors within 14 days. If the directors are seeking to exercise the delegated power because an

emergency has arisen, they should be able to step in immediately upon serving notice of their intention.

(3) We recommend that guidance should be created which explains the advantages and disadvantages of collateral and exclusive delegation and recommending that collateral delegation be used in most circumstances.

**Paragraph 8.107**

**Recommendation 28.**

21.50 We recommend that the directors of a commonhold association should be able to revoke or alter the powers delegated to a section committee as they wish, subject to the following requirements:

(1) the directors should only be able to revoke or alter the delegated powers where reasonable to do so; and

(2) the directors should be required to give 14 days' notice to the section committee that they intend to revoke or alter a power delegated to that section committee, unless the directors are seeking to revoke or alter the delegated power in an emergency.

**Paragraph 8.113**

**Recommendation 29.**

21.51 We recommend that developers should be able to reserve such rights in the CCS as they consider appropriate for the particular development. However, a developer should only be able to exercise development rights:

(1) for a permitted statutory purpose; and

(2) in accordance with certain statutory limitations which protect unit owners against unreasonable effects of development rights.

**Paragraph 9.34**

**Recommendation 30.**

21.52 We recommend that a developer should only be able to exercise any development rights reserved in the CCS for a purpose which is the pursuit of the development business of the developer.

21.53 We recommend that "development business" should be defined as including:

(1) the completion of a development; and

(2) the marketing and sale of units within a development.

**Paragraph 9.39**

**Recommendation 31.**

21.54 We recommend that the exercise of development rights should be subject to the following limitations:

(1) A developer must not exercise rights in a way which would interfere unreasonably with unit owners' enjoyment of their units or their ability to exercise rights granted by the CCS.

(2) A developer must not make any of the following changes without first obtaining the written consent of the unit owner affected:

(a) changing the boundaries of a unit;

(b) removing a unit from the list of authorised users of a limited use area;

(c) where a unit owner is the only authorised owner of a limited use area, reducing the extent of that limited use area, or adding in more users; or

(d) altering rights over a commonhold unit.

(3) Any damage caused to the commonhold land by the developer should be remedied as soon as reasonably practicable.

**Paragraph 9.54**

**Recommendation 33.**

21.55 We recommend that the development rights reserved in the CCS should not be added to or amended without the unanimous agreement of the developer and the unit owners.

**Paragraph 9.62**

**Recommendation 34.**

21.56 We recommend that there should not be any specific statutory provisions for the appointment of developers' directors. Instead, a developer's ability to appoint directors will depend on the number of votes it owns in the commonhold association.

**Paragraph 9.83**

**Recommendation 35.**

21.57 We recommend that the "without unit owners" registration procedure should be removed and there should be a single process for registering commonholds at HM Land Registry for existing and new developments.

**Paragraph 9.92**

**Recommendation 36.**

21.58 We recommend that "anti-avoidance" provisions should be introduced to ensure that a developer does not attempt to secure a greater degree of control by:

(1) taking powers of attorney from the purchasers of commonhold units (or seeking to control votes in any other way); or

(2) attempting to control how unit owners vote by inserting terms in the purchase contracts.

**Paragraph 9.98**

**Recommendation 37.**

21.59 We recommend that it should be possible for a CCS to impose restrictions on the use or occupation of units and on lettings of less than six months.

21.60 We recommend that it should not be possible for a CCS to restrict the short-term letting of units by certain bodies who are responsible for the provision of temporary or emergency accommodation and that the Secretary of State be given the power to determine whether additional categories of unit owner should benefit from such an exemption in future.

**Paragraph 10.44**

**Recommendation 38.**

21.61 We recommend that event fees should be prohibited within commonhold, subject to an exemption for specialist retirement properties.

**Paragraph 10.61**

**Recommendation 39.**

21.62 We recommend that wherever the model CCS requires an ordinary resolution to approve an amendment to the local rules in a CCS under the current law, this voting majority should be raised to a special resolution.

**Paragraph 10.91**

**Recommendation 40.**

21.63 We recommend that unit owners should have a right to challenge amendments to a CCS in the Tribunal.

**Paragraph 10.99**

**Recommendation 41.**

21.64 We recommend that a commonhold association may only:

(1) add additional authorised users to a limited use area that previously had only one authorised user; or

(2) reduce the extent of such a limited use area

with the express written consent of the sole authorised user and his or her lender.

**Paragraph 10.104**

**Recommendation 42.**

21.65 We recommend that it be clarified that tenants of commonhold units are bound by all rules in Part 4 of the model CCS and by any local rules that are drafted to bind tenants. We recommend that it be further clarified that any amendment to these provisions bind existing tenants of commonhold units.

21.66 We recommend that local rules that are expressed to bind tenants of commonhold units should not be capable of being added to a CCS if there is already an equivalent prescribed obligation in the model CCS that is not expressed to bind tenants.

21.67 We recommend that form 13 is updated to better inform prospective tenants that they are subject to the terms of a CCS as it stands, and any subsequent amendments.

**Paragraph 10.113**

**Recommendation 43.**

21.68 We recommend that any provision in the model CCS relating to use should be enforceable against a licensee or other occupier.

21.69 We recommend that a local rule in a CCS drafted so as to apply to licensees should be enforceable against licensees and other occupiers.

**Paragraph 10.118**

**Recommendation 44.**

21.70 We recommend that the mandatory provisions applicable to all commonholds contained in the Commonhold Regulations should not be reproduced in a CCS.

21.71 We recommend that the directors of commonhold associations should be under a duty to make updated copies of the mandatory provisions available to unit owners, in print or electronic form, if the Commonhold Regulations are amended. Any unit

owner selling his or her unit should provide a copy of the most up-to-date mandatory provisions to prospective purchasers along with a copy of the CCS.

**Paragraph 10.136**

**Recommendation 45.**

21.72 We recommend that it should be possible to add schedules to a CCS to collate the rights and obligations applicable to different sections.

**Paragraph 10.143**

**Recommendation 46.**

21.73 We recommend that there should be an exception to the prohibition of residential leases exceeding seven years, and leases granted at a premium, for shared ownership leases which contain the fundamental clauses prescribed by Homes England in England or the Welsh Government in Wales.

**Paragraph 11.19**

**Recommendation 47.**

21.74 We recommend that it should be a term of any model shared ownership lease designed or adapted for use in commonhold to require the shared ownership leaseholder to comply with all the terms of the CCS.

**Paragraph 11.31**

**Recommendation 48.**

21.75 We recommend that, where shared ownership leases are granted in new commonholds or in buildings which have converted to commonhold, shared ownership leaseholders should be able to exercise:

(1) all the voting rights associated with the unit in place of the shared ownership provider (the "Provider"), apart from a decision to terminate the commonhold, which should be exercised jointly with the Provider. If either party is opposed to termination, the vote should be cast negatively; and

(2) the minority protection rights available to unit owners, in place of the Provider.

**Paragraph 11.50**

**Recommendation 49.**

21.76 We recommend that the statutory rights associated with leasehold, including the rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount, should not apply to service charges in shared ownership leases granted in new commonholds or in buildings which have converted to commonhold. The shared ownership leaseholder will instead have the same rights to vote on the costs budget and challenge commonhold contributions as unit owners.

21.77 We recommend that the right to challenge service charge costs should remain in respect of any service charge costs which are incurred by the Provider in excess of the costs demanded by the commonhold association.

**Paragraph 11.61**

**Recommendation 50.**

21.78 We recommend that, if a shared ownership lease is granted in a new commonhold or in a building which has converted to commonhold, the shared ownership leaseholder should acquire the freehold title of the unit and become a member of the commonhold association on staircasing to 100%.

**Paragraph 11.73**

**Recommendation 51.**

21.79 We recommend that where a shared ownership provider (the "Provider") takes a commonhold unit on conversion to commonhold, the Provider may delegate some or all of its voting rights associated with the unit to a shared ownership leaseholder of the unit.

21.80 We recommend that where a Provider's voting rights associated with a unit have been delegated in full to a shared ownership leaseholder following conversion to commonhold:

(1) the shared ownership leaseholder's statutory rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount should no longer apply; and

(2) the minority protection rights available to unit owners will be available to the shared ownership leaseholder, in place of the Provider.

21.81 We recommend that the voting rights associated with a unit should be considered to be delegated "in full" only if the shared ownership leaseholder may exercise all the votes associated with the unit in place of the Provider, apart from a decision to terminate the commonhold, which should be exercised jointly with the Provider. If either party were opposed to termination, the vote should be cast negatively.

21.82 We recommend that, where a Provider delegates its voting rights associated with a unit in full to a shared ownership leaseholder following conversion to commonhold, the shared ownership leaseholder's right to challenge service charges should remain in respect of any service charge costs which are incurred by the Provider in excess of the costs demanded by the commonhold association.

**Paragraph 11.93**

**Recommendation 52.**

21.83 We recommend that, where a shared ownership lease is granted before a conversion to commonhold, the shared ownership leaseholder of a commonhold unit should remain a leaseholder after staircasing to 100%, but the provisions relating to shared ownership should fall away. After staircasing to 100%:

(1) the shared ownership leaseholder should have a statutory right to buy the commonhold title to his or her unit;

(2) the shared ownership leaseholder's new statutory right to buy the commonhold title to the unit should replace his or her existing enfranchisement rights; and

(3) where the shared ownership leaseholder wishes to sell his or her interest, the incoming purchaser should be required to buy the commonhold title, rather than the leasehold interest.

**Paragraph 11.109**

**Recommendation 53.**

21.84 We recommend that an exception to the prohibition of residential leases exceeding seven years, and those granted at a premium, should be made for lease-based home purchase plans regulated by the Financial Conduct Authority.

**Paragraph 11.145**

**Recommendation 54.**

21.85 We recommend that where home purchase plan leases are granted in new commonholds or in buildings which have converted to commonhold, home purchase plan customers should be able to exercise:

(1) all the voting rights associated with the unit in place of the home purchase plan provider, apart from a decision to terminate the commonhold, which should be exercised jointly with the home purchase plan provider. If either party is opposed to termination, the vote should be cast negatively; and

(2) the minority protection rights available to unit owners, in place of the home purchase plan provider.

**Paragraph 11.160**

**Recommendation 55.**

21.86 We recommend that the statutory rights associated with leasehold, including the rights to challenge service charge costs and to be consulted on works and contracts exceeding a certain amount, should not apply to service charges in home purchase plan leases granted in in new commonholds or in buildings which have converted to commonhold. The home purchase plan customer will instead have the same rights to vote on the costs budget and challenge commonhold contributions as unit owners.

21.87 We recommend that the right to challenge service charge costs should remain in respect of any service charge costs which are incurred by the home purchase plan provider in excess of the costs demanded by the commonhold association.

**Paragraph 11.161**

**Recommendation 56.**

21.88 We recommend that, for home purchase plan leases granted in in new commonholds or in buildings which have converted to commonhold, once the home purchase plan customer has met his or her obligations to the home purchase plan provider, he or she should be transferred the commonhold title of the unit and become a member of the commonhold association.

**Paragraph 11.164**

**Recommendation 57.**

21.89 We recommend that the procedure for the election of directors of a commonhold association should be simplified, so that the prescribed articles of association provide that directors should be elected by an ordinary resolution, which should generally be passed at a general meeting, but which might be passed by the written resolution procedure. We further recommend that directors may also be co-opted by the existing directors.

21.90 We recommend that a commonhold association's board of directors should be subject to an annual election.

**Paragraph 12.10**

**Recommendation 58.**

21.91 We recommend that, if a commonhold association cannot find unit owners able and willing to serve as directors, and is also unwilling to appoint professional directors, it should be possible to make an application to the Tribunal for professional directors to be appointed, who would then be paid by the association.

21.92 We recommend that the following parties should be entitled to apply for directors to be appointed:

(1) unit owners;

(2) permitted leaseholders;

(3) non-consenting leaseholders, under conversion Option 1;

(4) mortgage lenders and other secured lenders; and

(5) developers exercising development rights.

21.93 We recommend that the rights of permitted leaseholders and non-consenting leaseholders under this provision should replace their right to apply for a receiver and manager to be appointed under Part II of the Landlord and Tenant Act 1987.

21.94 We recommend that anyone who makes an application to the Tribunal under this provision should normally be paid their reasonable costs by the commonhold association.

**Paragraph 12.32**

**Recommendation 59.**

21.95 We recommend that, if there is a persistent failure by the directors of a commonhold association to comply with the CCS in some material respect, the Tribunal or the court should have the power to appoint a director who would replace any existing directors. Upon the appointment of a director, unit owners would be unable to resolve to remove that director, or to elect further directors.

21.96 We recommend that the following parties should have standing to make an application for the appointment of a director:

(1) unit owners;

(2) permitted leaseholders;

(3) non-consenting leaseholders, under conversion Option 1;

(4) mortgage lenders and other secured lenders; and

(5) developers exercising development rights.

21.97 We recommend that applications for the appointment of a director should be made initially to the Tribunal, but that, if the application should require remedies which are beyond the scope of the Tribunal to grant, the Tribunal should have power to transfer the application to the court.

21.98 We recommend that the director appointed by the court or the Tribunal should remain in place until the court or Tribunal granted an application to remove or replace the appointed director. Anyone who might have applied originally for the appointment of a director, and additionally the appointed director, should have standing to make the relevant application

21.99 We recommend that the Tribunal or the court should have power to make supplementary orders so as to ensure that the powers of the appointed director cannot be frustrated by the unit owners.

21.100 We recommend that, if the unit owners passed a special resolution requiring the appointed director to take, or not to take, any specified action, the appointed director should have the power to annul it.

21.101 We recommend that, if the appointed director annuls a resolution of the commonhold association, a unit owner, or any other party with standing to make an application for the appointment of a director, may apply to the Tribunal to confirm the resolution. The Tribunal should then have the power to let the annulment stand, to confirm the resolution, or to make such other order and on such terms as it sees fit.

21.102 We recommend that so long as there is a director appointed by the court or the Tribunal, the director should consult with the unit owners before setting the contributions to shared costs and reserve fund(s), but there should be no requirement that the unit owners approve the level of contributions. Instead, if the owners voted to reject the proposed level of contributions, anyone who had voted in favour of the rejection should be entitled to apply to the court or the Tribunal to determine the appropriate level of contributions.

**Paragraph 12.64**

**Recommendation 60.**

21.103 We recommend that, if unit owners impose the obligation to insure the commonhold units on a commonhold association, the association should be obliged to repair, reinstate or rebuild (as appropriate) the whole of a horizontally-divided building – including the parts of the commonhold owned by the unit owners.

**Paragraph 12.117**

**Recommendation 61.**

21.104 We recommend that commonhold associations should supply a copy of the buildings insurance policy and schedule, or sufficient details of it, to all unit owners when they acquire a unit, and whenever the terms of the policy change.

21.105 We recommend that commonhold associations should be required to confirm to unit owners and their mortgage lenders that the insurance is in existence on demand.

21.106 We recommend that these obligations may be satisfied either by publishing the relevant documents online or distributing hard copies. However, hard copies must be supplied if a unit owner insists.

**Paragraph 12.126**

**Recommendation 62.**

21.107 We recommend that it should be compulsory for all commonhold associations to take out and maintain public liability insurance. The minimum level of cover, and permissible exclusions and excesses, should be prescribed from time to time by the Secretary of State. Different levels of cover might be prescribed for different sizes and types of commonhold.

**Paragraph 12.143**

**Recommendation 63.**

21.108 We recommend that the CCS should contain an express provision confirming that commonhold associations have the power to take out directors' and officers' insurance.

**Paragraph 12.152**

**Recommendation 64.**

21.109 We recommend that it should be possible for the repairing obligations required by the CCS to be supplemented by a local rule requiring a higher standard of repair.

**Paragraph 12.160**

**Recommendation 65.**

21.110 We recommend that the provision in the CCS requiring the repair of the common parts should be extended to impose an obligation "to renew, and where necessary to replace": that is, the replacement of "like with like" if something should be beyond economic repair.

21.111 We recommend that these amendments should also apply to unit owners, so far as any obligations to repair are imposed on them by the CCS.

**Paragraph 12.174**

**Recommendation 66.**

21.112 We recommend that matters relating to the internal repair of units in horizontally-divided buildings should be left to local rules.

21.113 We recommend that the CCS should require, as a minimum, that owners of horizontally-divided units keep all "relevant services" in repair, and that an owner should not allow a unit to fall into such a state of disrepair so as adversely to affect another unit or the common parts.

**Paragraph 12.193**

**Recommendation 67.**

21.114 We recommend that matters relating to the internal and external repair of units in vertically-divided buildings should be left to local rules.

21.115 We recommend that the CCS should requires, as a minimum, that owners of vertically-divided buildings should not allow a unit to fall into such a state of disrepair so as adversely to affect another unit or the common parts.

**Paragraph 12.206**

**Recommendation 68.**

21.116 We recommend that minor alterations to the common parts which are incidental to internal alterations made by a unit owner to his or her own unit should not require the consent of the commonhold association by an ordinary resolution. Instead, the granting of consent to such proposals should be delegated to the directors.

21.117 We recommend that any unit owner should be able to challenge a decision by the directors of a commonhold association under this recommendation before it is acted on, in which case the decision would have to be made by the unit owners by ordinary resolution.

**Paragraph 12.227**

**Recommendation 69.**

21.118 We recommend that commonhold associations should have the right, within six months of the unit owners taking effective control of the association, to give not less than 12 months' notice to contractors of their desire to cancel a long-term contract which had been entered into by the developer, or by the commonhold association when it was under the control of the developer. This statutory right should not affect any rights of cancellation that may arise under the terms of contract.

21.119 We recommend that the developer should be required to notify unit owners when they have taken effective control of the commonhold association, and must disclose the existence of any long-term contracts to which the commonhold association is a party.

21.120 We recommend that a contractor should be able to apply for a ruling from the Tribunal that a contract is fair before entering into a long-term contract which involves significant up-front capital expenditure. If the Tribunal rules accordingly, the long-term contract should be exempt from subsequent cancellation when the unit owners take effective control of the commonhold association.

21.121 For the purposes of this recommendation, a "long-term contract" should be defined as a contract which must run for more than 12 months; and the association should be considered to have come under the effective control of the unit owners when they are able to exercise 75% of the available voting rights, providing that the units have been sold to "arms-length" purchasers of the units.

**Paragraph 12.255**

**Recommendation 70.**

21.122 We recommend that the proposed contributions to shared costs should require the approval of the unit owners as members of the commonhold association by ordinary resolution.

21.123 We recommend that a commonhold association should be able to dispense with the requirement to approve proposed contributions to shared costs by passing an ordinary resolution to that effect. This resolution could be in general terms, or subject to conditions, and could be of indefinite or finite duration. It could be rescinded at any time by another ordinary resolution.

21.124 We recommend that improvements to the common parts should require the approval of unit owners by ordinary resolution.

**Paragraph 13.29**

**Recommendation 71.**

21.125 We recommend that, if the directors' proposals as to the level of contributions should fail to secure approval, the level of contributions required in the previous financial year should continue to apply.

**Paragraph 13.38**

**Recommendation 72.**

21.126 We recommend that it should be possible to allocate to individual units within a commonhold different percentages that each unit must contribute towards different heads of cost.

**Paragraph 13.58**

**Recommendation 73.**

21.127 We recommend that the Secretary of State approves a Code of Practice on the allocation of proportionate financial contributions in residential, mixed-use and purely commercial commonholds.

**Paragraph 13.74**

**Recommendation 74.**

21.128 We recommend that unit owners should have the right not to have more than a reasonably proportionate share of the commonhold's expenditure allocated to his or her unit. We recommend that this right should apply to the allocation as a whole and to shares allocated under specific heads of costs.

21.129 We recommend that a unit owner's right not to have more than a reasonably proportionate share of the commonhold's expenditure allocated to his or her unit should apply both to the contributions initially allocated by the CCS, and to any allocations resulting from an amendment to the shares by a special resolution of unit owners.

21.130 We recommend that a commonhold association should only be able to amend the share of expenditure allocated to a unit to ensure that the share is reasonably proportionate.

21.131 We recommend that challenges to the share of expenditure allocated to a unit should be heard by the Tribunal. We recommend that, in making its determination as to whether the share of expenditure allocated to a unit is reasonably

proportionate, the Tribunal should be required to have regard to:

(1) the rights and services enjoyed by the commonhold units;

(2) the internal floor space of the commonhold units;

(3) any Code of Practice on the allocation of commonhold contributions;

(4) the voting rights allocated to the unit; and

(5) any other matter the Tribunal considers relevant.

21.132 We recommend that the Tribunal should be able to substitute its own determination of a reasonably proportionate share, or may refer the matter back to the commonhold association to produce a reasonably proportionate allocation.

**Paragraph 13.102**

**Recommendation 75.**

21.133 We recommend that it should be possible for the CCS to include, as a local rule, index-linked thresholds on the amount of expenditure which could be incurred annually on the costs of:

(1) alterations and improvements; and

(2) enhanced services.

21.134 We recommend that the relevant section of the model CCS should clearly indicate, by means of boxes which would have to be completed:

(1) whether a costs threshold applies to alterations and improvements, and if so, what the threshold amount is; and

(2) whether a costs threshold applies to enhanced services, and if so, what the threshold amount is.

**Paragraph 13.135**

**Recommendation 76.**

21.135 We recommend that if a proposed budget includes expenditure in excess of a costs threshold and the budget is approved by unit owners, any unit owner who objects to a threshold being exceeded should be entitled to refer to the Tribunal the question of whether the expenditure should be allowed. The application should be made under the minority protection provisions. The expenditure in excess of a threshold should not be incurred unless and until the Tribunal has approved it. The

remainder of the budget should be treated as approved.

21.136 We recommend that any application by a unit owner to challenge proposed expenditure in excess of a costs threshold should be made before it is incurred, and expenditure should not be open to challenge later. This principle should not affect any rights enjoyed by a unit owner or the association to challenge a director's actions on the basis that they amounted to a breach of a director's duty.

**Paragraph 13.148**

**Recommendation 77.**

21.137 We recommend that it should be possible to remove or vary a costs threshold only with the unanimous consent of the owners, or with the support of 80% of the available votes, and the approval of the Tribunal.

**Paragraph 13.156**

**Recommendation 78.**

21.138 We recommend that a court order or arrangement which discharges a unit owner's debts should not extinguish any arrears of contributions to the commonhold expenditure in respect of his or her commonhold unit.

**Paragraph 13.170**

**Recommendation 79.**

21.139 We recommend that the Commonhold Unit Information Certificate ("CUIC") should be amended to clarify that the buyer will still be liable for any contributions which fall due after its date of issue, including both (a) any regular contributions and (b) any further contributions which are not known as at the date of its issue.

**Paragraph 13.194**

**Recommendation 80.**

21.140 We recommend that the CUIC should continue to be conclusive once issued, and that it should not be amendable; but that the law should be clarified to ensure that if the buyer requests the issue of a new CUIC, the new CUIC can correct any mistake on the previous one.

**Paragraph 13.204**

**Recommendation 81.**

21.141 We recommend that a maximum fee for a CUIC to be issued should be set by regulations, and kept under review.

**Paragraph 13.215**

**Recommendation 82.**

21.142 We recommend that, if a commonhold association or its agent should fail to issue a CUIC within the prescribed time limit, there should be a continuing obligation to issue it, but that it should not be entitled to charge any fee for providing it (and any fee which has been pre-paid should be refunded).

**Paragraph 13.223**

**Recommendation 83.**

21.143 We recommend that it should be compulsory for all commonhold associations to have a reserve fund.

**Paragraph 14.11**

**Recommendation 84.**

21.144 We recommend that the proposed contributions to the reserve fund or funds should require the approval of the unit owners by ordinary resolution, and, if possible, at the same time the proposed contributions to the shared costs are approved.

**Paragraph 14.22**

**Recommendation 85.**

21.145 We recommend that the directors of commonhold associations should be able to set up such designated reserve funds as they see fit.

**Paragraph 14.43**

**Recommendation 86.**

21.146 We recommend that it should be possible for the members of a commonhold association to require, by ordinary resolution, that a designated reserve fund or funds should be set up.

**Paragraph 14.50**

**Recommendation 87.**

21.147 We recommend that reserve funds should be held on a statutory trust for the purpose for which they have been set up and, if that is no longer capable of fulfilment, then for the commonhold association.

21.148 We recommend that designated reserve funds should be protected from enforcement action by creditors, unless their claim relates to the specific purpose for which the designated reserve fund was set up.

21.149 We recommend that designated reserve funds should continue to receive equivalent protection if the commonhold association should be subject to insolvency proceedings.

21.150 We recommend that general (that is, undesignated) reserve funds should be held on a statutory trust for the commonhold association to comply with its obligations in the CCS in respect of the common parts.

**Paragraph 14.70**

**Recommendation 88.**

21.151 We recommend that it should be possible for a commonhold association to change the designation of an existing designated reserve fund, or to convert a general reserve fund into a designated one, by passing a resolution with the support of 80% of the available votes, and with, in all cases, the approval of the Tribunal.

21.152 We recommend in determining an application for the redesignation of a reserve

fund, the Tribunal should:

(1) in cases of less than unanimous support, apply the same test as if the application was made under the minority protection provisions; and

(2) in all cases, consider whether the redesignation is pursued to frustrate the claims of creditors or the effects of insolvency proceedings.

**Paragraph 14.84**

**Recommendation 89.**

21.153 We recommend that a commonhold association should be able to make an internal borrowing from a reserve fund, for the credit of either another reserve fund, or for the shared costs of the commonhold, by passing a resolution with the support of 80% of the available votes, and with, in all cases, the approval of the Tribunal.

21.154 We recommend in determining an application for an internal borrowing from of a reserve fund, the Tribunal should:

(1) in cases of less than unanimous support, apply the same test as if the application was made under the minority protection provisions; and

(2) in all cases, consider whether the borrowing is pursued to frustrate the claims of creditors or the effects of insolvency proceedings.

**Paragraph 14.95**

**Recommendation 90.**

21.155 We recommend that it should be possible for the commonhold association to grant a fixed charge over the whole or part of its common parts, or a floating charge, subject to the following levels of support:

(1) the unanimous consent of the unit owners; or

(2) 80% of the available votes of the unit owners, and approval is obtained from the Tribunal.

21.156 We recommend that, in all cases where there are mortgages secured on the units, the grant of the charge should require the approval of the Tribunal. Any unit

owner's mortgage lender or other secured lender should have an automatic right to be joined in the proceedings to set out any objections to the charge.

**Paragraph 15.55**

**Recommendation 91.**

21.157 We recommend that there should be no requirement for unit owners or their mortgage lenders to consent to the loss of rights under the CCS on the sale of part of the common parts by a lender in the exercise of its power of sale.

21.158 We recommend that, on the sale of part of the common parts by a lender in the exercise of its power of sale, there should be no requirement that either the buyer or the commonhold association simultaneously file an amended CCS at HM Land Registry. This would not, however, detract from the requirement for the commonhold association to regularise its position, and file an amended CCS as soon as possible thereafter.

21.159 We recommend that, if the commonhold association fails to register an amended CCS within a specified period, any unit should be entitled to apply to the Tribunal for all necessary amendments to be made to the existing CCS.

**Paragraph 15.71**

**Recommendation 92.**

21.160 We recommend that it should be possible for the commonhold association to sell part of its common parts, and at the same time to ensure that the rights granted to all units are modified, so that they can no longer be enjoyed over the land which is sold, provided that:

(1) it does so with the unanimous consent of the unit owners; or

(2) it does so with the consent of 80% of the available votes of the unit owners, and approval is obtained from the Tribunal.

21.161 We recommend that, in all cases where there are mortgages secured on the units, the sale should require the approval of the Tribunal. Any unit owner's mortgage lender or other secured lender should have an automatic right to be joined in the proceedings to set out any objections to the sale.

**Paragraph 15.86**

**Recommendation 93.**

21.162 We recommend that a commonhold association should not be able to prevent a unit owner or tenant taking further action in a dispute with another unit owner or tenant. Instead, the commonhold association should have a right, at its discretion, to notify the unit owner, or tenant, that it reasonably considers a claim to be frivolous, vexatious or trivial or that the matter complained of is not a breach of the CCS.

**Paragraph 16.15**

**Recommendation 94.**

21.163 We recommend that:

(1) the dispute resolution procedure makes clear that there is an expectation that the forms which accompany the procedure will be used; however

(2) a failure to use the forms, or forms to the same effect, should not in itself prevent a claim from progressing.

**Paragraph 16.23**

**Recommendation 95.**

21.164 We recommend that where the dispute resolution procedure has not been followed, in full or in part, any court or Tribunal, which subsequently considers the dispute, should be able to order the parties to take any steps it considers appropriate, or to disregard the non-compliance in accordance with its general case management powers.

**Paragraph 16.29**

**Recommendation 96.**

21.165 We recommend that:

(1) referral to an ombudsman should not be a mandatory part of commonhold dispute resolution procedure. Instead, it may be used, on an optional basis, instead of, or alongside, other forms of alternative dispute resolution; and

(2) membership of an ombudsman scheme be made optional for commonhold associations.

**Paragraph 16.45**

**Recommendation 97.**

21.166 We recommend that the commonhold dispute resolution procedure should be updated to refer specifically to the Housing Complaints Resolution Service, the Commonhold Regulator and the New Homes Ombudsman, once these bodies are established.

21.167 We recommend that a unit owner and commonhold association, as part of a pre-action protocol, should be expected to engage with these independent bodies in order to provide the certification they need to bring a claim to a court or tribunal and generally to apply their minds consistently to ADR throughout the litigation process.

**Paragraph 16.63**

**Recommendation 98.**

21.168 We recommend that:

(1) the Tribunal should have jurisdiction to hear disputes arising between commonhold associations, unit owners or tenants regarding duties arising in the CCS or from the commonhold legislation; and

(2) all applications should be made to the Tribunal. Where an injunction, or other order which is not available in the Tribunal is sought, the Tribunal should be able to refer all or part of the dispute to the court. After such a transfer, the court may exercise all the jurisdiction that the Tribunal could have exercised.

**Paragraph 16.73**

**Recommendation 99.**

21.169 We recommend that, if a specialist Housing Court is created which has jurisdiction over commonhold, the commonhold dispute resolution procedure should be moved from the CCS to a pre-action protocol.

**Paragraph 16.80**

**Recommendation 100.**

21.170 We recommend that the prescribed CCS should include a provision that, where a unit owner or tenant breaches the duties in the CCS, or commonhold legislation, the unit owner or tenant indemnifies the other unit owners, tenants and the commonhold association for losses they reasonably incur as a result of the breach.

**Paragraph 16.94**

**Recommendation 101.**

21.171 We recommend that Government consider creating a commonhold regulator.

**Paragraph 16.100**

**Recommendation 102.**

21.172 We recommend that unit owners should be given a right to apply to the Tribunal to challenge a vote of the commonhold association, if:

(1) the commonhold association has approved an amendment to the terms of the CCS;

(2) the commonhold association has approved the creation of a section (or sections);

(3) the commonhold association has approved the combination of two or more sections; or

(4) the commonhold association has approved a budget above a cost threshold for improvements and enhanced services set in the CCS.

**Paragraph 17.28**

**Recommendation 103.**

21.173 We recommend that, on an application for minority protection, the Tribunal should consider the following factors when deciding whether to grant a remedy to the applicant:

(1) whether the applicant had voted against the decision being complained of and, if so, whether the applicant voted for or against the decision;

(2) the impact and degree of impact of the decision on the applicant;

(3) the reason(s) the commonhold association had for voting for the decision being complained of;

(4) the terms of the CCS, taken as a whole; and

(5) any other relevant factors.

**Paragraph 17.61**

**Recommendation 104.**

21.174 We recommend that it should only be possible for a unit owner (or owners) to bring an application for minority protection within one month of the commonhold association giving notice of the resolution being complained of to unit owners.

21.175 We recommend that directors of the commonhold association should not be permitted to incur costs above a cost threshold set out in the CCS for a period of one month following the commonhold association's approval of a budget. That is to enable any unit owners opposed to the decision to bring a minority protection claim.

**Paragraph 17.66**

**Recommendation 105.**

21.176 We recommend that the Tribunal should be able either to annul a decision being complained of in a minority protection case or allow that decision to stand.

21.177 We recommend that the Tribunal should be able to attach conditions to a decision to allow a decision being complained of to stand.

**Paragraph 17.75**

**Recommendation 106.**

21.178 We recommend that a commonhold association should be able to apply to court for the sale of a defaulting unit owner's unit, in order to recover arrears of commonhold contributions from the proceeds of sale.

21.179 We recommend that the unit owner's insolvency should not prevent the association from making an application for the sale of the unit.

21.180 We recommend that a pre-action protocol should be created which sets out the steps with which the parties will be expected to comply (where reasonable and proportionate to do so) before applying to court for the sale of the property. We recommend that the protocol should include the following steps.

(1) The commonhold association should notify the defaulting unit owner that it is considering taking legal action to recover the arrears, and should provide the unit owner with a reasonable period of time in which to clear the arrears in order to avoid further action. The notice should set out the level of arrears outstanding and provide evidence that the sums have been correctly demanded by the association.

(2) The association should respond to reasonable requests for further information and provide any documents requested.

(3) The parties should take reasonable steps to discuss the reasons for the arrears, the unit owner's financial circumstances and proposals for repayment of the arrears. The decision to apply to court for an order for sale should be one of last resort and should not normally be started unless all reasonable attempts to resolve the situation have failed.

21.181 We recommend that the court should not order the sale of the unit unless it is reasonable and proportionate to do so, and at the time of the commonhold association's application:

(1) the outstanding commonhold contributions, plus interest, amount to £1,000 or more; or

(2) any amount of commonhold contributions and/or interest has been outstanding for over one year.

21.182 We recommend that commonhold associations should be required to notify any party with a charge secured over a defaulting unit owner's property (the "chargee") within a reasonable period of time of the commonhold contributions (plus interest) reaching the threshold at which an association would be able to seek an order for sale. An association should provide the chargee with 28 days in which to take steps to protect its security before the association applies to court for the sale of the unit. If an association fails to notify the chargee, and applies to court for the sale of the property, the court may decide to stay the court proceedings for 28 days to provide the chargee with an opportunity to take steps to protect its interest.

21.183 We recommend that, when deciding whether to make an order for sale, the court should consider all the circumstances of the case, including the factors currently considered by the court on an application to enforce a charging order. In addition to these factors, the court should consider:

(1) the commonhold association's and the defaulting unit owner's compliance with the pre-action protocol;

(2) the defaulting unit owner's past record in paying commonhold contributions;

and

(3) the effect of the arrears on the commonhold association (including the association's ability to cover the arrears without needing to make further demands from the unit owners).

21.184 We recommend that, if the court orders the sale of a commonhold unit, a receiver should normally be appointed to arrange the sale of the unit and distribute the proceeds of sale. We recommend that the chargee should be able to request to take over the conduct of the sale of the unit in place of the receiver. If the chargee's application is successful, it must distribute the proceeds of sale in accordance with the court's order.

21.185 We recommend that the court should determine the order of distribution of the proceeds of sale when making an order for sale. Unless otherwise directed by the court, the proceeds of sale should normally be applied in the following order.

(1) Any receiver appointed by the court should be paid his or her fees, and any costs and disbursements properly incurred in arranging the sale of the property should also be paid.

(2) The commonhold association should be repaid any outstanding amounts of commonhold contributions, plus any interest payable on the arrears and any costs awarded by the court.

(3) Any chargee should be repaid, such as a mortgage lender.

(4) Any remaining amount should then be returned to the defaulting owner.

21.186 We recommend that, as a general rule, any tenancies granted in respect of a unit should continue automatically on the sale of the unit. However, we recommend that the court should have discretion to order that a tenancy does not bind the purchaser on the sale of the unit in the following three circumstances:

(1) where the unit owner has created a tenancy agreement in an attempt to frustrate the sale of his or her commonhold unit;

(2) where the tenancy agreement was granted in breach of the terms of the CCS; and/or

(3) where the tenant has not complied with the diversion of rent procedure.

21.187 We recommend that the prescribed notice given to tenants on entering a tenancy agreement should be updated to inform tenants that their tenancy might be at risk on the sale of the commonhold unit in the three circumstances above.

**Paragraph 18.131**

**Recommendation 107.**

21.188 We recommend that there should be a statutory cap on the amount of interest that may be charged by a commonhold association on late payments of commonhold contributions which is linked to the amount of interest payable on judgment debts.

**Paragraph 18.150**

**Recommendation 108.**

21.189 We recommend that Companies House consider whether, when they are about to strike off a commonhold association for failure to comply with filing requirements, they might send letters of warning to the directors at their private addresses as well as to the registered office of the association.

**Paragraph 19.12**

**Recommendation 109.**

21.190 We recommend that, if a liquidator is appointed to wind up a commonhold association, he or she should not be able to demand further contributions from the unit owners to reduce the level of indebtedness of the association beyond those already demanded by the directors.

21.191 We recommend that a liquidator should have the power to issue demands for any contributions that are required to meet ongoing essential commitments of the commonhold until a successor association is appointed, or the commonhold association is wound up without the creation of a successor association.

**Paragraph 19.69**

**Recommendation 110.**

21.192 We recommend that there should be a rebuttable presumption that, on the insolvency of a commonhold association, the court will make a succession order enabling a successor association to fulfil the role of the insolvent commonhold association.

21.193 We recommend that the court should retain its broad discretion to impose conditions on the making of a succession order. These conditions could include:

(1) requiring the sale of part of the common parts; and/or

(2) requiring that named individuals should not be eligible to serve as directors of the successor association for a specified period or periods.

21.194 We recommend that if a condition as to the sale of part of the common parts should be imposed, the sale by a liquidator should automatically deprive the unit owners of their rights over the land sold, without the need for a unit owner (or a lender with a charge over a unit) to consent to such loss of rights.

21.195 We recommend that, if a liquidator wishes to sell part of the common parts of a commonhold, he or she should be able to do so without the consent of the owners (or of lenders with a charge over the units) to their loss of rights over the parts which are to be sold, provided that the court consents to the loss of such rights. (This provision would apply whether or not there is an application for a succession order).

21.196 We recommend that the court's discretion to impose conditions should not extend to making it a condition of the grant of a succession order that either the unit owners or the successor association contribute to the debts for which the insolvent commonhold association was liable.

21.197 We recommend that mortgage lenders and other secured lenders should automatically have standing to make applications to the court during the insolvency process with a view to protecting their interests.

**Paragraph 19.117**

**Recommendation 111.**

21.198 We recommend that on an application for voluntary termination the court should have discretion to decide whether to allow the voluntary termination to take place, as well as the terms on which it may do so.

21.199 We recommend that on an application for voluntary termination, the court should make any order which it thinks fit. In determining an application, factors to which the court should have regard include:

(1) whether termination was being proposed because rebuilding was not possible, or it would be uneconomic to repair the building, or because an offer to purchase it was financially attractive;

(2) exceptional hardship to a unit owner or a member of their family because of serious health problems;

(3) the fact that an individual unit had been extensively adapted to take account of a disability;

(4) the fact that the termination was supported principally by unit owners who were investor landlords (or who might be associates of the developers) and

mainly opposed by unit owners who were owner-occupiers;

(5) financial hardship to a unit owner who was objecting. This might include that a unit owner was in negative equity, and would remain liable on their personal covenant; or an owner would have difficulty in obtaining another mortgage;

(6) whether suitable alternative accommodation formed part of the package being offered, or would otherwise be available; and

(7) the amount of support there is for voluntary termination over and above the 80% required.

**Paragraph 20.43**

**Recommendation 112.**

21.200 We recommend that if a unit is subject to negative equity, any shortfall should be met personally by the owner of the unit, and should not be covered by other unit owners.

21.201 We recommend the creation of a new bespoke form or statement of truth to assist HM Land Registry in confirming that a liquidator has complied with all necessary statutory requirements in conducting a voluntary termination.

**Paragraph 20.75**

**Recommendation 113.**

21.202 We recommend that mortgage lenders and other secured lenders should automatically have standing to make applications to the court during the termination process with a view to protecting their interests.

**Paragraph 20.85**

**Recommendation 114.**

21.203 We recommend that commonhold associations should be required to notify mortgage lenders and other secured lenders on passing a termination resolution.

21.204 We recommend that mortgage lenders and other secured lenders should have standing to challenge the reasonableness of a liquidator's remuneration at any

time during the termination process.

**Paragraph 20.106**

**Recommendation 115.**

21.205 We recommend that if any statute provides that a landlord can recover possession or refuse a lease extension if he or she intends or proposes to demolish or reconstruct the building, such a requirement should also be satisfied if it can be proved that a commonhold association has that intention or makes that proposal.

**Paragraph 20.115**

**Recommendation 116.**

21.206 We recommend that the court should have discretion to order that a tenancy does not bind the purchaser on termination of the commonhold where the tenancy has been created in an attempt to frustrate the termination of the commonhold and sale of the site.

**Paragraph 20.125**

**Recommendation 117.**

21.207 We recommend that applications to disapply a provision in the CCS which determines the distribution of proceeds of sale on termination should be heard by the Tribunal.

21.208 We recommend that the Tribunal, when determining an application to disapply a provision in the CCS determining the proceeds of sale on termination, should take into account all matters that appear to it to be relevant. Those matters should include:

(1) how long ago the advance determination was agreed;

(2) what the circumstances were when the advance determination was agreed; and

(3) how circumstances have changed since the advance determination was agreed.

**Paragraph 20.145**

**Recommendation 118.**

21.209 We recommend that disputes on valuation issues should be referred as a discrete matter to the Tribunal and that the Tribunal should be able to appoint a single valuer to provide expert evidence.

**Paragraph 20.152**

**Recommendation 119.**

21.210 We recommend that if a commonhold is substantially destroyed, but remains solvent, then for the purposes of the termination statement, the units should be valued on the basis of the best estimate that can be made of their pre-damage value.

**Paragraph 20.164**

**Recommendation 120.**

21.211 We recommend that if the process of voluntary termination should begin, but it subsequently turns out that the commonhold association is in fact insolvent, the same protections should be given to the assets of the individual unit owners and to any applicable reserve funds as would have applied if the process had begun as an involuntary insolvency.

**Paragraph 20.175**

**Recommendation 121.**

21.212 We recommend that where a commonhold is divided into sections, any vote on voluntary termination should be taken in sections, and whether it was unanimous or received at least 80% support should be determined by section.

21.213 We recommend that it should be possible to terminate part of a commonhold, and the relevant part sold free of the commonhold title entries, subject to the following conditions:

(1) a part must comprise one or more entire buildings;

(2) a proposed partial termination must be approved unanimously by the remaining unit owners, or 80% of remaining unit owners plus the approval of the court; and

(3) a proposed partial termination must be approved unanimously by members of the terminating part, or 80% of members plus the approval of the court.

21.214 We recommend a change to the commonhold articles of association so that profits may be distributed to members of a commonhold association following termination of part.

**Paragraph 20.202**

(signed) Sir Nicholas Green, Chairman
Professor Sarah Green
Professor Nick Hopkins
Professor Penney Lewis
Nicholas Paines QC

Phil Golding, Chief Executive

26 June 2020

# Appendix 1: Terms of Reference

## THE LAW COMMISSION: RESIDENTIAL LEASEHOLD LAW REFORM

## TERMS OF REFERENCE

The project was announced in the Law Commission's *Thirteenth Programme of Law Reform* and in Government's response to its consultation *Tackling unfair practices in the leasehold market*.

The project will be a wide-ranging review of residential leasehold law, focussing in the first instance on reform to:

1. enfranchisement;

2. commonhold; and

3. the right to manage.

The Commission and Government are discussing other areas of residential leasehold reform that could be included in the project.

The Government has identified the following policy objectives for the Law Commission's recommended reforms:

### Generally

- to promote transparency and fairness in the residential leasehold sector;

- to provide a better deal for leaseholders as consumers;

### Enfranchisement

- to simplify enfranchisement legislation;

- to consider the case to improve access to enfranchisement and, where this is not possible, reforms that may be needed to better protect leaseholders, including the ability for leaseholders of houses to enfranchise on similar terms to leaseholders of flats;

- to examine the options to reduce the premium (price) payable by existing and future leaseholders to enfranchise, whilst ensuring sufficient compensation is paid to landlords to reflect their legitimate property interests;

- to make enfranchisement easier, quicker and more cost effective (by reducing the legal and other associated costs), particularly for leaseholders, including by introducing a clear prescribed methodology for calculating the premium (price), and by reducing or removing the requirements for leaseholders (i) to have owned their lease for two years before enfranchising, and (ii) to pay their landlord’s costs of enfranchisement;

- to ensure that shared ownership leaseholders have the right to extend the lease of their house or flat, but not the right to acquire the freehold of their house or participate in a collective enfranchisement of their block of flats prior to having "staircased" their lease to 100%; and

- to bring forward proposals for leasehold flat owners, and house owners, but prioritising solutions for existing leaseholders of houses;

### Commonhold

- to re-invigorate commonhold as a workable alternative to leasehold, for both existing and new homes.

### Right to manage

- to facilitate and streamline the exercise of the right to manage.

## (1) ENFRANCHISEMENT

Enfranchisement covers the statutory right of leaseholders to:

- purchase the freehold of their house;

- participate, with other leaseholders, in the collective purchase of the freehold of a group of flats; and

- extend the lease of their house or flat.

The project will consider the following issues:

1. *Qualifying criteria.* The Commission will review the qualifying criteria that must be satisfied to exercise the right to enfranchise, namely:

    a. the premises that qualify for enfranchisement;

    b. the leaseholders who can exercise the rights, including the two-year ownership requirement, and the proportion of tenants required to participate in a collective enfranchisement claim;

    c. the landlords to whom the enfranchisement legislation applies; and

    d. the leases to which the enfranchisement legislation applies.

2. *Valuation.* The Commission will seek to produce options for a simpler, clearer and consistent valuation methodology. The review will include consideration of:

    a. the existing valuation assumptions;

    b. the extent to which the ground rent (including any rent review clause) should feature in the valuation;

    c. the role of yield and deferment rates and whether they could be standardised;

d. the role of marriage value, hope value, and relativity, and the extent to which they should feature in the valuation;

e. whether to retain different valuation bases (as currently exist for enfranchisement of houses, depending on historic rateable values);

f. the valuation of the interest of any intermediate leaseholders.

3. *Procedure.* The Commission will consider reforms to make it easier, quicker and more cost effective to enfranchise. The review will include consideration of:

a. introducing a simplified enfranchisement procedure which is, so far as possible, consistent across all enfranchisement claims;

b. the form, content, effect, service, and assignment of notices by leaseholders and landlords in the enfranchisement process;

c. how to reduce or remove the requirement for leaseholders to be responsible for landlords' costs of responding to enfranchisement claims;

d. the nature and role of the nominee purchaser in collective enfranchisement claims;

e. giving effect to the right to enfranchise, including the conveyancing procedure, the terms of the transfer of the freehold or extended lease, leasebacks to the landlord, and the role of third party funders (in a collective enfranchisement claim);

f. the forum for, and facilitation of, the resolution of disputes and enforcement of the statutory rights;

g. problems that arise where there are missing, incapacitated, recalcitrant, or insolvent landlords; and

h. the termination or suspension of an enfranchisement claim, and its effect.

## (2) COMMONHOLD

Commonhold is a form of ownership of land which is designed to enable the freehold ownership of flats. There are various legal issues within the current commonhold legislation which affect market confidence and workability. The Commission will review those issues to enable commonhold to succeed.

The following legal issues will be considered:

1. *Creation of commonhold (including conversion).* The Commission will consider whether the procedure for creating and registering commonhold could be simplified and how it could be made easier for leaseholders to convert. In particular, the Commission will review whether, and if so how, it might be possible to convert to commonhold without the consent of:

a. the freeholder; and

b. all of the leaseholders.

2. *Improving flexibility.* The Commission will consider reforms to make the commonhold model more sophisticated and flexible to meet the needs of communities and developers, including:

    a. the creation of "layered" or "sub-commonholds" to deal with different parts of a commonhold scheme, especially in mixed-use developments; and

    b. allowing different costs to be shared between unit-holders in ways that will better reflect actual use of amenities and services.

3. *Corporate structure*. The Commission will consider whether the commonhold association, which owns and manages the common parts of the commonhold, should remain a company limited by guarantee or whether there might be a more appropriate corporate structure.

4. *Shared ownership.* The Commission will consider ways of incorporating shared ownership within commonhold.

5. *Developer rights and consumer protection.* Ensuring developers have sufficient power to complete the development whilst affording protection to unit-holders.

6. *Commonhold Community Statement.* The Commission will review the model CCS which sets out the rights and obligations of unit-holders and the commonhold association. In particular, the Commission will seek to ensure the CCS is flexible enough to meet the local needs of a scheme, and consider the circumstances in which it can be varied.

7. *Dispute resolution.* The Commission will consider ways of facilitating the resolution of disputes within commonhold.

8. *Enforcement powers.* The Commission will consider whether the enforcement powers of the commonhold association, for instance to enforce the payment of commonhold costs, are sufficient or whether these powers should be enhanced. The Commission will also consider whether there are sufficient safeguards in place to protect unit-holders from unreasonable demands for costs.

9. *Insolvency.* The Commission will consider whether any mechanisms could usefully be put in place to prevent a commonhold association from becoming insolvent, for instance whether it might be appropriate for an administrator to be appointed. The Commission will also consider the effect of insolvency on a commonhold association and review whether homeowners and lenders are adequately protected.

10. *Voluntary termination.* The Commission will review the procedure for the termination of a commonhold association by unit-holders and consider whether lenders' security is adequately protected.

The project will commence with the publication of a call for evidence. Other legal problems that emerge from that call for evidence will be included in the project by agreement with Government.

The Commission's review will complement Government's own work to remove incentives to use leasehold, and Government's work to address non-legal issues to re-invigorate

commonhold such as education, publicity and supporting developers, lenders and conveyancers. As part of its call for evidence, the Commission will invite consultees' views on (i) whether, and if so how, commonhold should be incentivised or compelled, and (ii) the non-legal issues that must be addressed to re-invigorate commonhold, and report on the outcome of that consultation, without making recommendations.

## (3) RIGHT TO MANAGE

The right to manage was introduced by the Commonhold and Leasehold Reform Act 2002. It is a right granted to leaseholders to take over the landlord's management functions through a company set up by the leaseholders for this purpose.

The Law Commission is asked to conduct a broad review of the existing right to manage legislation with a view to improving it. In particular, the Law Commission will:

1. consider the use currently made of the right to manage legislation and how far it meets the needs of users;

2. consider the case to improve access to the right to manage, including by modifying or abolishing existing qualification criteria; and

3. make recommendations to render the right to manage procedure simpler, quicker and more flexible, particularly for leaseholders.

# Appendix 2: List of consultees

1 West India Quay Residents' Association

A. L. Hughes & Co.

Aaron Kirkup

Abu Mansoor

Adam Webb

Aisling Rollason

AL Green

Alan Davis

ALEP (Association of Leasehold Enfranchisement Practitioners)

Alex [no other name given]

Alexander MacDonald

Alice Brown

Alison Fanning

Alison Jervis

Alma Borg

Alok Goyale

Amalia Liliana Castle

Amita Jaitly

Anchor Hanover

Andreas Bjork

Andrew Huntley

Andries Marits

Angela Bruce

Angela Jezard

Angela Turnbull

Angela Wong

Anil [no other name given]

Ann Williams

Anna Scoffin

Anne Cooper

Anne Dimopoulos

Antonia Batty

Antonia Marjanov

Any Pegnam

Archimedes Apronti

APPG (All-Party Parliamentary Group on Leasehold and Commonhold Reform)

ARCO (Associated Retirement Community Operators)

ARHM (Association of Retirement Housing Managers)

ARMA (Association of Residential Managing Agents)

Asela Kuruwita Arachchilage

Avril Pino

Barry Carpenter

Barry Smith

Barry Whyte

Battersea Reach Residents' Association

Beishan Sun

Belgravia Residents Association

Belinda Jimenez

Ben Gilbey

Berkeley Group Holdings PLC

Beverley Woodward

BIBA (British Insurance Brokers' Association)

Bijan Doostani

Blazej Marek

Boodle Hatfield LLP

Boris Vucicevic

Brenda Fearns

Brian Gallacher

Brian Quinn

Bridget Murphy

Brijendra Kumar Sahye

Bruce Vair-Turnbull

Bryan Wildman

Buckingham Court Residents' Association

Cadogan

Camilla Laird-Clowes

Canary Wharf Lettings Limited

Carmen [no other name given]

Carol Barber

Carol Bucknall

Carol Greenwood

Carolyn Kimble

Carrie Hobrough

Cassie Ilett

Catarina Nunes Walsh

Catherine Gale

Catherine Isbell

Catherine Williams

Celia Webber

Cem Dedeaga

Cenergist

Charlotte Burnup

Charlotte Neville

Chin Li

Chris Jones

Chris Longley

Chris Marshall

Chris Mitchell

Chris Pearce

Chris Whitmore

Christine Harrison

Christine McGrath

Christopher Harris

Christopher Jessel

Christopher Karl Myers

Churchill Retirement Living

CILEx (Chartered Institute of Legal Executives)

Cindie Casey

Claire Summerfield

Claire Woodcock

Clare Butchart

Clive Senior

Clutton Cox Conveyancing

Colette Boughton

Consensus Business Group

Cora Beeharry

Council for Licensed Conveyancers

Craig Alexander

Craig Grosscurth

D Wilcox

Damian Greenish

Damien Coyle

Daniel Hooley

Daniel McConville

Darren Fairhurst

Darren Molyneux

David [no other name given]

David Brown

David Dick

David Duncan

David Elder

David Flood

David Johnson

David May

David North

David Phillips

David Rincon

David Silvermam

David Yapp

Debbie Davies

Deborah Olszweski

Deborah Wilcox

Debra Harvey

Della Bramley

Denise Clark

Dennis House RTM Company Ltd

Des Kinsella

Dimi Peppas

Dominic Davis-Foster

Don Hale

Donald Hale

Douglas Haigh

Dr Agnes Kory

Dr Gabriel Schembri

Dr Nadezda Ranceva

Dr Selby Whittington

Edoardo Linington

Edyta Harrison

Elizabeth Charmian Spickernell

Ellen [no other name given]

Emma Hynes

Eric Larkins

Evelyn Webster

Fathy Kandil

Fidelma Lynchehaun

Fiona Biglin

FirstPort

FPRA (Federation of Private Residents' Associations)

Gabriel Netser

Gail Nelson

Gavin Allen

Gavin Buckley

Gemma Watson

Geoff Holmes

Geoffrey Baffoe-Djan

George Wilcox

Gerald Eve LLP

Gillian Birch

Gillian John

Gillian Weymouth

Gordon Clifton

Gordon Peters

Granville Stride

Graziella [no other name given]

Great Yarmouth Borough Council

Hakam Baban

Hanna Varabyova

Hannah Yates

Heather Keates

Helen and Keith Clark

Helen Austerberry

Helen Roberts

Hilary McDonagh

Hitesh Sangtani

HM Land Registry

HML Holding plc

Home Builders Federation

Home Owners Rights Network

Hugh Donaldson

Hyla Campbell

Iain MacFarlane

Ian Nicholson

Iram Ullah

Irwin Mitchell LLP

J Brown

Jack Murray

James Deeman

James Dow

Professor James Driscoll

James Taylor

James Wardhaugh

Jamie John Atkins

Jane Lahr

Jane Wood

Janet Johnson

Jason Dimopoulos

Jay Beeharry

Jay Maru

Jean Breakey

Jean Gaffin

Jeanette Allen

Jennifer Kroner

Jennifer Wood

Jenny Anderton

Jenny Roberts

Jeremy Bishop

Jim Kelly

Jo Darbyshire

Joe Ogden

John Davies

John Luke Williamson

John Rogers

John Smith

John Speakman

Johnny Levan-Gilroy

Joint response of some members of the London Property Support Lawyers Group

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Jonathan and Yvonne Boyd

Jose Antonio Martin

Joseph McGuigan

Josephine Rostron

Joy Dickinson

Judith Amanthis

Julia Burgess

Karen Conneely

Karen Tenzer

Karim Walji

Karl Layland

Kath Jones

Katherine Mickleson

Kathleen Curry

Kathryn Henderson

Kathryn McGouran

Kathy Sen

Katie Kendrick

Keith Collier

Keith Hince

Keith Mortimer

Keith Richardson

Kelly [no other name given]

Ken Moore

Kenneth Gaffney

Kevin Jackson

Kevin Murphy

Kieron [no other name given]

Kim Irving

Kirsty Marsden

Lauren Baldwin

Lawson Morton

LEASE (Leasehold Advisory Service)

Lee Dickinson

Leroy Forbes

Lesley Cooper

Lesley Johnson

Leslie Smee

Letitia Crabb

Liam Ormonde

Ling Leng

Linton Davies

Lionel Thomas

Lisa Moller

Living Services Ltd

LKP (Leasehold Knowledge Partnership)

Long Harbour and HomeGround

Lorimer Catherine

Lorraine Jimenez

Louise Hudspith

Louise Jones

Louise O'Riordan

Lu Xu

Lucas Burchard

Lucy Dent

Lucy Griffin

Lucy Shepherd

Lukasz Banaszczyk

Luke Scott-Berry

Lynn Myers

Lynne Martin

Malgorzata Wroblewska

Malgorzata Zymla

Margaret Donaldson

Margaret Moore

Mariyam Zaman

Mark Chick

Mark Wood

Martin Gillam

Martin Wood

Mary Arnold

Massimo Romano

Matt Ashley

Maureen Gillooly

Mayor of London

McCarthy & Stone Retirement Lifestyles Limited

Mehboob Neky

Melanie Malkin

Melanie West

Michael Cox

Michael Kelly

Michael King

Michael Tsoi

Michaela Oxley

Michelle Baharier

Mike Stone

Millbank Residents Company Ltd

Molly Ayton

Monica Cachon Suarez

Mortimer Crescent Tenants/Residents Association

Mr Andrew Hoyle

Mr Graham Webb

Mr Kenneth Mason

Mr Robin Wilson
Mr Smith
Mr William Doran
Mrs Angela Doran
Mrs Jacqueline Cummins
Mrs Julie Bryan
Mrs Karen Price
Mrs M Aldridge
Mrs Sally Mills
Mrs Marion Thompson
Natalie Carthy
Natasha Fisher
National Community Land Trust Network
National Leasehold Campaign
National Trust
Neha Sahni
Neil Pothecary
Neil Ryan
Neil Thacker
Nick Matthews
Nick Wilkins
Nicola Beswick
Nicola Etchells
Nicola Hughes
Nicola Tomlinson
Nigel Burkitt
Nigel Hulse
Nina Rautio
North View Fold Resident Group
Notting Hill Genesis
Orowa Sikder
Pamela Hughes
Pat Meyrick
Pat Suitor
Paul Buttner
Pal Fallows
Paul Gothard
Paul MacAinsh
Paul Potts
Paul Stevens
PegasusLife Group
Penny Atkinson
Pete Ward
Peter Johnson
Peter Kilbride
Peter Nicholson
Peter Robins
Peter Robinson
Peter Smith
Philip Bree
Philip Thomas
Phyllis Buchanan
Pietari Laurila
PLA (Property Litigation Association)
Places for People Group Ltd
PM Property Lawyers Limited
Property Bar Association
Rachel Kelly
Rama Mathanmohan
Ramilla Shah
Rashid Raja
Rebecka Steven
Residential Landlords Association
Richard Alan Dawe
Richard Barclay
Richard Barclay
Richard Miller
Richard Stokes
Richard Wellesley
Ridwan Choudhury
Rita Birch
Robert Montague
Robert Plumb
Robert Richardson
Roddy Yang
Rosemary Aikman Bull
Rosemary Marshall
Ross Cameron-Symes
Rowan Hodgson
Roy Chapman
Roy Mosley
S M Rendell
Sally Blues
Sally Kenkins
Sally Mills
Sandra Smith
Sarah Denbee
Sarah Johnston
Sathia Balakrishnan
Sean Taylor
Sergio [no other name given]
Sharon Clements
Sherek James
Shira Baram
Simon Cox
Siobhan Allen
Siobhan Miller
Sophie Hadaway
Staci Langford
Stella Roberts
Stella Ryan
Stephanie Russell
Stephen Bedford
Stephen Bonney
Stephen Collins
Stephen Desmond
Stephen Squires
Stone King LLP
Sudhir Singh
Susan Norris
Susan Osman
Susan Stuckey
Susan Wood
Svetlana [no other name given]

Tara Barker

Teresa Velasco

Terry Ballard

The British Property Federation

The Building Societies Association

The Charities' Property Association

The City of London Law Society

The Confederation of Co-operative Housing

The Conveyancing Association

The Guinness Partnership

The Law Society

The Leaseholder Association

The Portman Estate

The Property Ombudsman

The Society of Legal Scholars

Thomas Bygott

Thomas Gupta-Jessop

Tian Luo

Tiara Hardy

Tina Hart

Tony Baker

Tony Burke

Tracey Horton

Trowers & Hamlins LLP

Tudor Court Residents' Association

Tumini Wilcox

UK Cohousing Network

UK Finance

Utchay I

Utsav Boobna

Valerie Bidewell

Vanessa Da Cunha

Villandry Property Ltd

Wallace Partnership Group Ltd

Wandsworth Borough Council

Wasse Efimba

Westminster and Holborn Law Society

Will Jones

William Martin

Wojciech Zymla

Wong CK

Wrigleys Solicitors LLP

Xi Yen Tan

Yvonne Hunter

Zaman Ali

Zaneta Gontarczyk

The list of consultees set out in this Appendix excludes those who wished to remain anonymous or whose response to our consultation was intended to be confidential.

# Appendix 3: Summary of consultees' views about the steps necessary to reinvigorate commonhold

3.1 In the Consultation Paper, we explained that:

> Our Terms of Reference require us to make recommendations that would "reinvigorate" commonhold. We wish therefore to gauge consultees' overall reactions to the provisional proposals in this Consultation Paper.[1]

We went on to ask two, targeted questions.

### QUESTION ONE

3.2 The aim of our first question was to ascertain consultees' overall views on our provisional proposals set out in the Consultation Paper, and whether these proposals would be sufficient for developers to adopt commonhold for a "substantial number" of developments. The question offered three options, and consultees were asked which option best reflected their views.[2]

(1) The first option was, if our provisional proposals were adopted, would they be sufficient on their own for developers to use commonhold for a substantial number of developments?

(2) The second option was, if our provisional proposals were adopted, would they not in themselves be sufficient, but would they require financial incentives, either for developers, or for purchasers of commonhold units?

(3) The third option was, even if our provisional proposals were adopted with or without a package of financial incentives, would developers adopt commonhold only if they were prohibited from selling flats on a leasehold basis?

3.3 In response to this question:

(1) a few consultees thought that our proposals in themselves would be sufficient;

(2) marginally more consultees thought that our proposals would be sufficient, if combined with some form of financial incentives;[3] and

(3) the overwhelming majority of consultees (and particularly leaseholders, residents' associations and other individuals) thought that compulsion would be required.

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1 See CP, para 16.42.

2 See CP, Consultation Question 105, para 16.43.

3 Nearly half of those who favoured financial incentives were individuals, with the remainder coming from a range of categories of consultee.

3.4 Consultees who favoured compulsion and added comments to explain their views almost universally gave as their reason that leasehold was too financially advantageous for developers to abandon it voluntarily. These consultees stressed that leasehold offered developers – after having received the initial purchase price – the opportunity for further profits from ground rents, premiums for lease extensions, insurance commissions, and permission fees. Consultees explained that developers could also use associated companies as managing agents and for building works. One consultee mentioned the opportunity to augment developments by adding extra storeys.

3.5 One developer, Berkeley Group Holdings PLC, thought that the key issue was not the presence or absence of financial incentives to use commonhold, but the need for there to be flexibility, which they thought would be essential. One consultee commented that it would not be helpful to force developers to adopt commonhold and that ways to persuade developers that commonhold was a preferable model needed to be found.

3.6 The All-Party Parliamentary Group on Leasehold and Commonhold Reform and the Leasehold Knowledge Partnership both thought that incentives would be required, but that they would not necessarily need to be financial. Removing "additional income streams" from leasehold would diminish leasehold's appeal for developers, who would soon realise that a commonhold unit would attract a higher price than a leasehold one. Some members of the London Property Support Lawyers' Group explained in a joint response that eliminating ground rents would remove one incentive for developers to use leasehold, but developers would still not use commonhold unless the demand for it were there. They thought that the stance taken by lenders would dictate the outcome.

3.7 A range of suggestions were put forward by those organisations who favoured the use of financial incentives. For some it would be sufficient to "level the playing field" between leasehold and commonhold by removing the financial incentives for developers to use leasehold. Others favoured more active incentives, such as restricting assistance under the Help to Buy scheme to commonhold developments, or giving commonhold favourable treatment so far as Stamp Duty Land Tax is concerned.[4]

3.8 Professor James Driscoll favoured a hybrid of options 2 and 3, so that there could be financial incentives leading to a 'sunset clause' for leasehold.

## QUESTION TWO

3.9 In addition to the "closed" question which has just been discussed, we asked an open question, inviting consultees' views generally on the issues that were preventing the uptake of commonhold, and what could be done to promote its adoption.[5] A number of themes emerged.

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4 Land Transaction Tax in Wales.

5 See the CP, Consultation Question 106, paras 16.48 and 16.49.

3.10 **Continued availability of leasehold tenure**: the reason most commonly given for the low uptake of commonhold was the continued availability of leasehold. Many individual consultees, including leaseholders, the National Leasehold Campaign, and a few legal practices thought that developers' financial interests in retaining leasehold had inhibited the adoption of commonhold. A number of consultees called for the complete abolition of leasehold tenure.

3.11 The Law Society was concerned that the use of commonhold should not be made compulsory until it had proved itself as a viable form of tenure:

> the Society does have serious concerns, which should be relayed to Government, about the impact of immediate radical changes proposed to be made to the law of leasehold tenure of residential units, until commonhold tenure in reinvigorated form has been shown to have earned market approval and to have provided a viable form of home co-ownership which generally meets the market expectations in preference to leasehold ownership models. This response therefore considers the general impact of such changes and the fears of the Society of the ambitious scale and pace of the change proposed by the Government at a stage which, while being furthered, must be on an experimental basis if adverse effects of dramatic measures are to be avoided.

3.12 These concerns were echoed by the City of London Law Society, who added that implementation of the Law Commission's report "Making Land Work" would remove incentives for the creation of more leasehold.[6]

3.13 **Lack of awareness of commonhold**: the next most common reason given for the low uptake of commonhold was a lack of awareness of commonhold among the general population. Many consultees thought that a relaunch of commonhold would need to be accompanied by an extensive publicity campaign, with training courses for conveyancers. Some consultees thought that the advantages of commonhold should be explained to all existing leaseholders.

3.14 **Lack of knowledge among professionals**: a few individual consultees thought that a lack of knowledge of commonhold among legal and other professionals had contributed to the lack of uptake. A small number of legal practices referred to professional conservatism or inertia.

3.15 **More specific advertising of the tenure of flats**: a number of consultees thought that it would assist in the adoption of commonhold if estate agents were required to be more specific in their advertisements about the tenure of properties. One consultee thought that this should extend to a specific warning that leases would expire, unless the leaseholder paid for it to be renewed.

3.16 **Other reasons**: other reasons mentioned by consultees included developers not offering commonhold tenure and a significant number of lenders unwilling to lend on commonhold. It was also felt by some that the responsibilities that accompany commonhold management would not be appropriate for the residents of retirement

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6 Making Land Work: Easements, Covenants and Profits à Prendre (2011) Law Com No 327.

homes, and that leasehold provided a more suitable framework for liaison with well-being services and care providers.