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# Community Land Trusts

Disposal Models for Affordable Housing



An initiative of



# Community Land Trusts

## Disposal Models for Affordable Housing

### Introduction

The leaflet produced by Community Finance Solutions and Trowers & Hamlins entitled 'Community Land Trusts - Affordable Homes in Sustainable Communities' set out options for a Community Land Trust (CLT) to consider as to how it may dispose of affordable housing in ways which achieve a balance of permanent affordability, meeting local needs, meeting lenders' requirements and complying with the terms of planning agreements (Section 106 Agreements).

These models included 'Equity Purchase' (which utilised equity mortgages and pre-emption deeds) and 'Tenancy Plus' (which utilised short term tenancy agreements).

The purpose of this Briefing Note is to examine in more detail the implications of the use of equity mortgages and pre-emption deeds and to identify further possible methods of disposal including resale price covenants and declarations of trust.

### Equity Mortgages

The first decision for a CLT is whether it is prepared to dispose of its legal interest in its land. It is not, of course, possible to simultaneously both retain and dispose of a legal interest in land.

A CLT which wishes to retain its legal interest in a particular piece of land may consider using the 'Tenancy Plus' model.

If a CLT is prepared to make a disposal of its legal interest in the land, then under an equity mortgage scheme, the CLT will dispose of the freehold or long leasehold interest in a dwelling but will retain an equity stake of a percentage of the Open Market Value ('OMV') of the property. Under the terms of the equity mortgage, the CLT will be entitled to that same percentage of the OMV at the time of redemption of the equity mortgage (whether on sale or earlier redemption).

Thus, in a rising market, the CLT shares in equity growth. Moreover, the CLT's equity percentage may be adjusted to reflect the financial needs of the CLT and the terms agreed with the occupier.

The sum due to the CLT is 'secured' because the CLT holds a second legal charge on the dwelling, only ranking behind the first legal mortgage obtained by the occupier to fund his or her initial purchase. Redemption of the equity mortgage and re-payment to the CLT would take place at the time the occupier wishes to sell the property. An OMV is carried out at that time, in order to calculate the amount required to be paid to the CLT.

Redemption of the equity mortgage may also take place prior to such a sale. As a matter of public policy, all borrowers are entitled to redeem their borrowings if they so wish. Again, if such redemption is proposed, a valuation of the OMV at the time of redemption will form the basis of the calculation of the amount to be paid to the CLT.

Following redemption, the CLT will, for the time being, hold proceeds of sale rather than an equity stake in property.

### Pre-Emption Rights

The use of equity mortgages is always coupled with a pre-emption agreement, which gives the CLT a 'first refusal' to reacquire a dwelling when it is sold.

Even if an equity mortgage is redeemed by the occupier (prior to sale) the pre-emption agreement will remain in force. When the occupier subsequently chooses to sell;

- the dwelling must first be offered back to the CLT.
- the CLT may re-acquire the dwelling and if it chooses to do so it will pay full OMV for it.
- the CLT may also exercise its pre-emption right by directing a transfer to its next selected occupier - to whom the CLT may again offer an equity mortgage, and obtain a new pre-emption agreement.

Under rules against perpetuity, pre-emption rights may be unenforceable after a period of 21 years - although under flat leases the provisions forming part of the lease may continue for the full term of the lease. The 21 year period will re-commence on each subsequent disposal to future occupiers, upon the grant of a new pre-emption agreement.

Thus, the matters to be considered by the CLT are:

- (a) In the event that an occupier redeems the equity mortgage prior to sale, the CLT will then not hold equity in the property but cash; and if property inflation exceeds the return on the cash (ie interest rates) for that period, this may affect the CLT's ability to re-acquire the dwelling at OMV in the future, or the terms it is able to offer to the subsequent occupiers.
- (b) If the same occupier remains in occupation for longer than 21 years he or she may choose thereafter to dispose of the dwelling to a third party rather than to the CLT under the pre-emption agreement. This may, in reality, be unlikely, since an occupier can avoid incurring marketing costs by disposing to the CLT. There would still be a requirement to redeem any remaining equity mortgage. In such a case, the CLT will again receive cash and would then have to re-invest the cash in another property.

## Section 106 Agreements (s106 agreements)

Many CLT projects will be subject to s106 agreements, either as affordable housing as part of a larger scheme or (more likely) as a whole scheme on a rural exception site. Local authorities will usually seek to preserve affordability where possible, especially on a rural exception site where planning permission for residential development would not otherwise be granted.

However, it is also necessary that any obligations in s106 agreements meet the requirements of the lenders who provide funding for purchasers. Usually, such lenders will require an exemption from affordable restrictions which would allow them to dispose of a property in order to recover their funding in event of default. It is always very important to consider the terms of any s106 agreement applicable to the property.

In some cases, s106 agreements have provided for an equity mortgage scheme to be utilised, and have included exemptions which apply upon redemption of the equity mortgage (in the same way as exemptions which apply following final staircasing under a shared ownership lease).

Other s106 agreements seek to impose restrictions on re-sale values - for example, by stating that the property must never be sold for more than a percentage of OMV at the time of such sale. This percentage may reflect affordability judged by local income levels at the time of first disposal.

In such a case, it is important to establish that the initial sale by the CLT supported by an equity mortgage of at least a minimum percentage of OMV will comply with this s106 agreement requirement.

Similarly upon redemption of the equity mortgage, it is important to establish that when assessing OMV in order to calculate the redemption payment, the s106 agreement restriction is to be disregarded.

But even so, what is the position of the occupier? – s106 agreement obligation not to dispose of a property at a price greater than (say) 75% of OMV will simply suppress the value of the property to 75% of OMV. Under an equity mortgage scheme, the occupier has in effect had to fund an acquisition at 100% OMV (i.e. 25% by way of equity mortgage; 75% by private first mortgage) for an asset which he/she can only sell for 75% OMV.

So, the risk for the purchaser is that if the CLT does not exercise its right of pre-emption the disposal of the dwelling will not generate sufficient proceeds for the occupier to redeem both the first mortgage and the equity mortgage, due to the s106 agreement restriction. And since the private lender takes priority, the risk is that the CLT loses its equity share.

For these reasons, suppressing values by way of s106 agreement requirements is unlikely to be compatible with equity mortgage schemes - because such restrictions undermine the ability of the CLT and the occupier to access and share full OMV.

## Resale Price Covenant

Where there is such a s106 agreement restriction, a more appropriate model may be to dispose of housing subject to a resale price covenant. This is a relatively straightforward method of creating permanent affordability, whereby the dwelling is sold in its entirety to a buyer at a percentage of OMV and on resale the occupier must sell the property at no more than that same percentage. The CLT retains no equity share in the property but can enforce the resale covenant.

Such an arrangement can reflect a s106 agreement restriction on resale prices. The CLT simply disposes of the property at the restricted price, and imposes an obligation on the purchaser not to sell for more than the stated percentage of OMV at the time of subsequent sale.

This can be enforced by obtaining a new deed of covenant from each incoming purchaser; by imposing a restriction on title, which prohibits any disposal being registered by the Land Registry unless a certificate is produced by the CLT confirming compliance with the covenant; and by way of rent charge obligation (which gives the CLT additional remedies in the event of breach).

Neither staircasing nor redemption applies. The resale price covenant will apply permanently (unless the CLT, which holds the benefit of the covenant, chooses to release it).

Such a sale could also be coupled either with a pre-emption arrangement (as above) or a nomination arrangement which gives the CLT an opportunity to nominate the future purchasers.

Obligations may also be included to restrict occupation (e.g. to reflect particular s106 agreement requirements for occupation by 'Persons in Need' or persons with a 'Local Connection').

But unlike the Equity Mortgage arrangement, the CLT retains no equity stake in the property. The CLT will have received the proceeds of initial sale (e.g. 75% of OMV). If the CLT wished to subsequently re-acquire, it would have to do so at 75% of OMV at the time of re-acquisition.

Also relevant will be the need for the local planning authority to consider the inclusion of a mortgagee exemption provision on such s106 agreement requirements, and the CLT will need to consider whether this is to be reflected in the resale price covenant.



### **Co-ownership and Declaration of Trust**

Under a Declaration of Trust the CLT and the occupier can record the respective equity shares in a dwelling, which is jointly owned by them. This 'co-ownership' approach can apply to houses or flats.

The Declaration of Trust would allow the occupier to live in the dwelling, apportion repair responsibilities, and can provide for payment of an occupation 'rent' by the occupier to the CLT. It can give flexibility by providing for 'staircasing', by which the respective equity shares are adjusted.

In order to produce a capital receipt, the occupier would have to raise a mortgage, and it is necessary to address the question of liabilities of both parties in the event of default by the occupier on such mortgage. Since either joint owner can require a sale, the Declaration of Trust would include similar pre-emption arrangements whereby the CLT is given 'first refusal' to acquire the equity share of the departing occupier.

Co-ownership is commonly used for shared house purchase, but it would be necessary to agree with lenders the terms on which they are prepared to lend against such models and any restrictions which apply. For example, it is necessary to settle with lenders how far each of the joint owners is responsible for the mortgage; to what extent a lender can recover its lending and costs from the CLT's share; and whether the lender would be bound by any affordable housing provisions in a s106 agreement. The terms of any s106 agreement would have to allow for disposals by way of joint ownership under a Declaration of Trust.

### **Rental Models**

If a CLT wants to retain the freehold of the property in perpetuity it may select a 'Tenancy Plus' model which grants to the occupiers limited security and no right to acquire any freehold or long leasehold interest.

Provisions can be included entitling the tenant, on departing the property, to a payment to reflect the 'surplus' rent paid during his or her period of occupation (i.e. payments beyond the rent required to service borrowing and to manage and maintain the dwelling). Such payment may also include a share in the equity growth in the dwelling during the period of occupation - in order to provide the tenant with funds for a deposit to acquire another property.

Such a model will produce an income (by way of rent) but will not produce a capital receipt for the CLT. The CLT retains, instead, the asset value of the land (which could be used as security for borrowing).

### **Enfranchisement and Legislative Framework**

We are aware that some parties are promoting a change in the legislative framework governing affordable housing and in particular leasehold enfranchisement. As part of this endeavour it is proposed that there be an agreed statutory definition of a CLT which could then be utilised in extending to CLTs some of the statutory exemptions and benefits. See the proposed statutory definition of a CLT in box opposite. For example, shared ownership leases of houses granted by housing associations are currently exempted from statutory enfranchisement provisions (by Schedule 4A of the Leasehold Reform Act 1967). But among the requirements of this Act is the need to allow 'staircasing' to 100% (at which time the leaseholder will own the full interest in the property). Thus any 'shared ownership' type lease of a house granted by a CLT which restricts staircasing will not benefit from such exemptions, unless or until such exemptions are considerably widened.

## Proposed statutory definition of a Community Land Trust:

1. A Community Land Trust is a not-for-profit organisation which is an industrial and provident society, a company limited by guarantee or other incorporated body whose governing instrument contains provisions to the following effect:
  - (a) the primary purpose of the organisation is to hold land and other assets so as to promote the social, economic and environmental sustainability of a specified local geographic community through providing or facilitating the provision of affordable or other sub-market housing and/or other community-based facilities and services,
  - (b) the organisation will not dispose of its land and other assets save in the furtherance of its objectives to promote the sustainability of the local community as set out in (a) above,
  - (c) the membership of the organisation is open to persons or organisations living in or whose principal place of work or business is in the specified community it is established to serve (but may involve different classes of membership),
  - (d) the majority of the governing body is elected by the members of the organisation,
  - (e) the organisation is accountable to the local community through annual reporting or otherwise and is responsive to its needs and to representations made on its behalf, and
  - (f) it is an inclusive organisation, committed to enabling those who live and/or work, or need to live and/or work, in the community it is established to serve to benefit from the land or other assets it holds, without discrimination on grounds of race, religion, age, sex, disability, sexuality or any other matter that is not relevant to its work.

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March 2007

## Explanatory note regarding the proposed statutory definition of a Community Land Trust

This proposed definition tries to capture the essence of a Community Land Trust (CLT). The following brief commentary endeavours to explain the thinking. It will be understood that a definition of this kind has to have sufficient precision to pass muster with the parliamentary clerks and though there is obvious merit in keeping a definition of a CLT as flexible as possible, that objective is, to a degree, incompatible with the purposes of a statutory definition.

The proposed 'not for profit' principle reflects the fact that the CLT needs to generate confidence and be regarded as a safe haven for assets. It also needs to be robust and capable of entering into contracts and otherwise giving third parties reassurance that undertakings given by it can be relied upon. Hence the requirement for it to be an incorporated body. As far as the six constitutional provisions are concerned:

- (a) Sustainability is at the heart of the CLT concept and has the important advantage of being able to be linked with local authorities' well-being powers. The specific reference to housing is deliberate but it does not rule out other community-based activities.
- (b) This links to (a) and restrictions on disposal are key but this provision would allow for disposal provided the result was to further the objectives in (a).
- (c) Membership refers to shareholding or the equivalent membership arrangement for the body in question. The requirement for open membership ensures that the organisation is 'owned' by members of the community; but the reference to classes of membership allows for a suitable balance to be struck between different types of member. This is a common arrangement (in registered social landlords and others) to give appropriate weighting to different types of members.
- (d) This provision links to (c) and ensures that, in turn, the governing body or board has a community or similar mandate; but it leaves open the possibility that a minority of the board can be nominated by the local authority or other organisations.
- (e) This is designed to ensure that there are ways, outside the election or representation mechanisms, for the board to be held to account and envisages at least an annual opportunity for the community to ask questions of the CLT board and to be entitled to a board which listens and responds.
- (f) This links to (e) and, quite apart from being desirable in its own right, is designed to ensure that the CLT does not become self-regarding. In areas of such sensitivity as housing, it is vital that CLT adopts an inclusive approach.

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June 2007

## Recommendations

The individual circumstances of each CLT project will determine which method of disposal to adopt. The choice is dependent upon the terms of the s106 agreement with local authorities, and the CLT's funding arrangements with its lenders and the occupier's mortgagee's requirements. The CLT will need to consider its approach based upon the advantages/disadvantages of the disposal models:

In Summary:

### (a) Equity Mortgage

This method allows the CLT to retain an equity share and to share in the growth of the equity value of property. It is flexible in that equity can be redeemed in part; but the occupier has the right to redeem outright, after which the CLT would hold cash not equity. This could mean that the CLT might not afford subsequently to re-invest in a rising property market.

In the event of redemption of an equity mortgage, one solution is to immediately use the proceeds to reinvest in an alternative property, and to have a s106 agreement which recognises this. In addition, a lender can and will override the affordable housing provisions, if it sells as mortgagee in possession under an exemption in a s106 agreement.

The equity mortgage method is a useful solution in an urban or market town context where the CLT wishes to retain a share in the equity of the property. In such a case, the CLT can, if faced with redemption of the equity mortgage, acquire a similar property nearby and thus maintain its objective in meeting housing need locally.

### (b) Resale Price Covenant

This method achieves permanent affordability of the property. In addition, it can allow the CLT to nominate a buyer and this can be coupled with a right of pre-emption for the CLT. The drawback is that the CLT has no equity share in the property, because it is locked away in perpetuity, due to the imposition of the covenant and the s106 agreement requirements.

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The Resale Price Covenant method is straightforward, it does provide permanent affordability for the dwelling created and as such could be an appropriate solution for a rural exception site; particularly where the CLT's business model is not dependent on sharing in equity growth.

### (c) Declaration of Trust

This method has the advantage that the CLT has a continuing equity share. The respective equity shares can be adjusted where this is agreed (and permitted by the s106 agreement); but there is no right to redeem.

Enfranchisement is not an issue, because there is no lease.

In addition, rights of pre-emption can be included under the terms of the Declaration of Trust.

A drawback is that if the occupier defaults on the mortgage to their lender this may have implications for the CLT. This is a relatively new method of disposal and it remains to be seen how lenders will agree to be bound by the provision only to lend on the security of the occupier's share and how s106 agreement restrictions on sale prices will affect them.

The Declaration of Trust model allows the CLT to retain an equity interest in a property, whilst avoiding some of the issues relating to redemption of equity mortgages or limits on pre-emption rights. This model is equally applicable to urban/market town schemes and for village exception sites, but there is still the need to meet lenders' requirements and s106 agreement obligations, which will require this model to be tested in practice.

### Note

The information and commentary set out in this Briefing Note are not intended to be legally comprehensive and we recommend that no action be taken on matters referred to in this Briefing Note without first taking full legal advice.

ISBN 0902896997



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