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Can You Bear It?

The Impact of Residential Service Charge Legislation on Mixed Use Property

Owners of commercial property know that managing their property can be difficult enough, but that, worse, managing residential leasehold property can be a thankless task, fraught with risk not least as a result of the legislation that affects it. A failure to comply with the strict obligations imposed upon landlords of residential property can lead to significant financial loss and even criminal convictions.

As a consequence, many try not to undertake residential property management. But in recent years, it has been increasingly difficult to avoid – the planning system often encourages mixed use schemes and in most cases that means a sizeable residential element being included in developments.

A solution to the problem frequently adopted is to grant a head lease of the whole of the residential element of the scheme or of the residential parts of each building, so that the tenant under that lease manages the relationship with the individual flat tenants. But it is usually not possible to entirely separate things, and the developer will need or want to maintain some control, perhaps over the estate or the structure of the buildings, so that it can maintain the value of the other, commercial or leisure, interests. There will be a cost incurred in doing that, and usually a share of that cost will be passed on to the head tenant of the residential parts, who will pass it on down to the individual flat tenants.

The developer might think that, in organising the letting arrangements that way (ie by having only an indirect relationship with the owners of the individual flats), it will avoid many of the headaches associated with the management of residential leasehold property. Many of those “headaches” - such as the obligations to consult with tenants, to provide extensive information, and to manage service charge demands promptly - flow from the application of or need to comply with the residential service charge legislation, most of which is contained in the Landlord and Tenant Act 1985 (LTA 85).

Two important recent cases suggest that it is unlikely to be the position that the impact of the legislation can be avoided that way.

In Ruddy v Oakfern Properties Ltd ([2007] 3 EGLR 30), Oakfern, a headleaseholder, sought confirmation from the Court of Appeal that, where there was a headlease in place of the sort described above, the legislation did not apply. The question was whether the statutory definition of “service charge” (section 18 LTA 85) applied.

If it did, then, among other things, the service charges definitely had to be reasonable (there is an on-going debate about that issue in the context of commercial property), there would have to be consultation with tenants on charges where the qualifying criteria applied, an abbreviated time limit to raise demands would apply, and challenges to the service charges could be made to the Leasehold Valuation Tribunal (LVT).

The Court of Appeal said that the service charge definition did apply to the headlease.

Two key points were decided in that case: (i) that the headtenant was within the legislation and (ii) a sub-tenant was too, in the sense that he could make an application to the LVT direct against the freeholder (he could previously have made one against his immediate landlord, i.e. the headtenant).

At the time of the decision, some commentators suggested that Oakfern would cause difficulties in that many more developments would be affected by and their managers finding themselves with obligations that they were not set up to meet.

That Oakfern would have an impact on mixed use schemes has been borne out in two recent cases: Paddington Walk Management Ltd v Governors of Peabody Trust ([2009] 2 EGLR 123) and Paddington Basin Developments Ltd & ors v West End Quay Estate Management Ltd & anor (HCt 20 April 2010). Complex organisational arrangements created for the easier management of substantial mixed use developments in Paddington were held to fall within the requirements of the LTA 85.

Those cases should act as a warning to developers and managers of mixed use property. In both cases, costs were not recoverable by the landlords and/or their managers because agreements had been entered into without the required prior consultation. In one of the cases, another agreement was, on the basis of its own particular terms, held not to have required prior consultation, but, of course, might have done if it had been differently worded.

Close attention must be paid to the way in which costs that might directly or indirectly be borne by residential tenants are incurred, accounted for or demanded. Failure to do so can mean that the right to recover what can be very large items of expenditure might be severely curtailed or even extinguished, leaving the developer, landlord or management company bearing the vast bulk of the cost, and possibly becoming insolvent as a consequence.

The clear lessons are to (i) plan the leasehold and estate scheme carefully, (ii) set up an appropriate leasehold structure and (iii) make sure it is managed, or advice is given, by appropriately qualified personnel who understand the minutiae of the legislation and are used to dealing with the demands of residential property management.

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