HOUSING COMMUNITIES & LOCAL GOVERNMENT SELECT COMMITTEE ON LEASEHOLD REFORM

SUBMISSION

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1. Many areas need reform in the leasehold sector. This submission focuses solely on clarifying and identifying the problems in the current law on leaseholders' liability to pay their landlord's legal costs when they challenge service and administration charges.

2. It is difficult to navigate the technicalities of the law of service and administration charges without specialist legal advice. The cost of obtaining such legal advice often outweighs the amount of money at stake. Landlords are regularly entitled to charge those legal costs to leaseholders. By contrast, leaseholders rarely have the converse right.

3. I have experienced in practice and blogged about the inequality of arms of the long leasehold landlord and tenant relationship. I make this submission because I am concerned that the law relating to service and administration charges does not operate fairly partly by reason of that inequality.

4. The submission includes three brief example case studies and is made in my professional capacity as a barrister. It represents my views, but not those of any other member of Tanfield Chambers.

The lease

5. A lease is a contract. It is the agreement between the parties to it about the rights and obligations governing the leaseholder's occupation of property such as a flat or a house.

6. In a straightforward case, there will be two parties to the lease: the landlord, who is the person who is letting the property, and the leaseholder, the person taking the lease. "Leaseholder" can be used interchangeably with "lessee" and "tenant". There is no technical difference in meaning.

7. Increasingly, modern leases are tripartite: they include not only landlord and lessee, but also a third party, normally a company, that fulfills the management and service functions that would otherwise be performed by the landlord.

Situations where a landlord might incur legal costs

8. Not all legal costs involve going to court. A landlord or management company might incur legal costs in:

    a) Obtaining legal advice about the meaning of a lease such as whether it is entitled to take action such as improving the insulation to a building or changing the windows from single to double glazed;

    b) Writing letters to a leaseholder chasing payment of arrears;

    c) Deciding whether to grant consent to alterations; sub-letting; keeping pets etc., or

    d) Asking solicitors or a barrister to advise whether a leaseholder has breached the terms of the lease.

9. The amount of legal costs tends to be highest however where a landlord takes legal action in court or in the First-tier Tribunal (Property Chamber).

10. That action may be taken in relation to:

    a) Determining whether a service charge is payable, and if so, how much;

    b) Recovering arrears of payments such as ground rent or service charges;

    c) Establishing whether a leaseholder is in breach of covenant, or

    d) Forfeiting the lease if the leaseholder is in breach of the covenants under the lease.

11. In all or any of the above, it is increasingly common for a landlord or management company to look to the leaseholder(s) to pay those costs.

Structure of leases

12. Some legal costs may be payable by a leaseholder as part of the general services provided under the lease, that is, as part of the service charge.

13. Others may be payable directly by the leaseholder who has effectively caused the landlord to incur those costs. Those costs are known technically as variable administration charges.

14. It does not follow however that a leaseholder is obliged to pay the landlord's legal costs just because the landlord has incurred them. The lease must oblige the leaseholder to pay those costs, and each lease must be considered individually.

Costs as part of the service charge

15. The box below contains two non-exhaustive examples of relatively common structures for providing and paying for services.

> Type A
>
> Clause 1 contains a list of the services that the landlord must/may provide.
>
> Clause 2 contains a list of the services towards the costs of which a leaseholder is required to contribute. That list may be the same or different to the list of services that the landlord must/may provide.
>
> Type B
>
> Clause 1 requires/entitles the landlord to provide services listed in a schedule to the lease.
>
> Clause 2 requires the leaseholder to contribute towards the landlord's costs of providing the services in the schedule.

16. It is important to bear in mind that the landlord may be entitled to recover its legal costs, even if the words "legal costs" do not actually appear among the services that the landlord is obliged or entitled to perform and for which the leaseholder is obliged to pay. It is a question of interpreting the words in the clause and the lease overall against the background known to the parties when the lease was granted.

17. Older leases tend to lack the clarity of modern leases so far as the recovery of legal costs is concerned.

Costs as variable administration charges

18. A lease is likely to contain clauses that oblige a leaseholder to pay for specific actions taken by a landlord, often in relation to that leaseholder individually such as enforcing the terms of the lease, or in considering whether to grant consents.

19. These clauses are likely to oblige the leaseholder to pay all of the landlord's legal costs. Legal costs charged under those clauses are known technically as variable administration charges.

20. Some clauses will clearly set out the obligation to pay the landlord's costs of enforcing the terms of the lease. Others are less obvious.

21. The box below sets out two examples of wording that require such payment.

> The lessee covenants:
>
> "To pay the Lessor all expenses (including Solicitors' costs and Surveyors' fees) incurred by the Lessor incidental to the preparation and service of a notice under Section 146 of the Law of Property Act 1925 notwithstanding forfeiture is avoided otherwise than by relief granted by the Court"
>
> or
>
> "To pay all expenses including solicitors costs a surveyors' fees incurred by the Landlord incidental to the preparation & service of a notice under Section 146 of the Law of Property Act 1925 or incurred in contemplation of proceedings under Section 146 of the Act"

22. There can be a significant and disproportionate difference between the level of legal fees incurred under such clauses and the seriousness of the issue – for example the level of arrears – in relation to which the proceedings are contemplated or taken.

23. In order to understand why, some understanding of the law of forfeiture is needed.

Forfeiture

24. Most leases include a clause that entitles the landlord to forfeit the lease (also known as "re-entry") if the leaseholder is in breach of covenant.

25. Forfeiture is a draconian measure: if a lease is forfeit, it is extinguished, leaving the leaseholder with nothing.

26. Indeed, if there is a mortgage secured on the property, forfeiture destroys the lender's security, leaving the leaseholder with a significant debt to the lender.

27. For that reason, many landlords inform mortgage lenders of any alleged arrears or other breaches of covenant at the same time that they issue pre-action letters to leaseholders, knowing that the lender will be anxious to protect their security and will often pay any alleged arrears in order to do so.

28. The mortgage lender then adds that payment, along with any legal costs it has itself incurred, to the leaseholder's mortgage, as it is generally entitled to do under the terms of the mortgage.

29. For the reasons set out below, landlords and management companies increasingly rely on forfeiture clauses in leases in order to recover alleged arrears of payments from leaseholders.

Restrictions on the right to forfeit

30. Parliament has intervened on several occasions to try to reduce the likelihood of a landlord successfully forfeiting a long residential lease.

31. First, section 146 of the Law of Property Act 1925 prohibits a landlord from forfeiting a lease unless he has served on the leaseholder a notice (a "section 146 notice") detailing the leaseholders alleged breaches of covenant, including failure to pay service charges.

32. There is no requirement to serve a section 146 notice where the leaseholder has failed to pay rent.

33. Next, section 81 of the Housing Act 1996 prohibits a landlord from serving a section 146 notice based on arrears of service charges unless there has been a determination of the amount of service charge that the leaseholder must pay, or the leaseholder has admitted that the service charge is payable.

34. Even in leases where the service charge is "reserved", ie payable, as rent, a landlord must obtain a "section 81 determination" before serving a section 146 notice (see the judgment Sir Andrew Morritt in the Court of Appeal in *Freeholders of 69 Marina, St Leonards-on-Sea* [2011] EWCA Civ 1258).

35. Thirdly, sections 168 and 169 of the Commonhold and Leasehold Reform Act 2002 prohibit a landlord from serving a section 146 notice based on breach of a covenant (apart from payment of service charge, which is covered by section 81 of the Housing Act 1996 above), unless there has been a determination that the leaseholder is indeed in breach of covenant, or the leaseholder has admitted that s/he is in breach of covenant.

36. For the sake of clarity, a landlord need only obtain a determination under either section 81, Housing Act 1996 or section 168, Commonhold and Leasehold Reform Act 2002, not both.

Summary

37. The result of all of the above is that, if a landlord considers that a leaseholder has either failed to pay service charges or has otherwise contravened the terms of the lease, the landlord must follow one of two courses of action.

38. In relation to arrears of service charges, the landlord must:

    a) Obtain a determination that service charges are payable or an admission from the leaseholder to that effect (section 81, Housing Act 1996);

    b) Serve on the leaseholder a section 146 notice;

    c) Bring court proceedings for possession on the ground of forfeiture.

39. In relation to any other breach of covenant (eg sub-letting or unauthorised alterations), the landlord must:

    a) Obtain a determination that there has been a breach of covenant or an admission from the leaseholder to that effect (section 166, Commonhold and Leasehold Reform Act 2002);

    b) Serve on the leaseholder a section 146 notice;

    c) Bring court proceedings for possession on the ground of forfeiture.

40. The purpose of Parliament's intervention was presumably to give leaseholders the opportunity to dispute a landlord's right to forfeit a lease at an early stage, and to protect them from the unexpected or abusive exercise of that right.

The law of unintended consequences

41. In theory, the above fulfils Parliament's purpose.

42. Significant issues have however arisen in relation to the legal costs of following the procedure towards forfeiture, the main effect of which has been to confer on landlords an all but unassailable position of strength in relation to the costs of litigation.

43. First, as set out above, there are likely to be contractual entitlements to costs in the lease that are enforceable in all jurisdictions including the First-tier Tribunal and the small claims track in the county court.

44. Secondly, given the "no/low costs" jurisdictions of the First-tier Tribunal and court claims worth under £10,000, a landlord or management company can be reasonably confident that, even if their litigation is unsuccessful, it is unlikely that there will be any costs order made in favour of the leaseholder.

45. It is also worth noting, from a practical perspective, that claims for arrears of service charge tend to be dealt with as debt claims, and cases tend to be dealt with trainees or paralegals with little to no technical knowledge of what is a highly technical area of law.

First-tier Tribunal (Property Chamber) applications

46. It is often said that the First-tier Tribunal is a "no costs" jurisdiction.

47. Whilst that means that the First-tier Tribunal has no power to order one side to pay the other's costs (save where a party is found to have crossed the high threshold of having behaved unreasonably), it does not mean that legal costs in proceedings in the First-tier Tribunal cannot be recovered from the leaseholder by the landlord or the management company, depending on the wording of the section 146 clause.

48. As a result of the *69 Marina* case, landlords now routinely rely on section 146 clauses to charge leaseholders the legal costs that they incur in the First-tier Tribunal or in court.

County court claims

49. In contrast to the First-tier Tribunal, under section 51 of the Senior Courts Act 1981, the county court has the power to order one party to pay the other's legal costs of the claim, subject to the Civil Procedure Rules 1998 (the "CPR").

50. CPR rule 27.14 provides that in a small claim, ie, one in which the amount at stake is less than £10,000, the court "may not order a party to pay a sum to another party in respect of that other party's costs, fees and expenses" except for certain, limited costs.

51. However, in *Chaplair Ltd v Kumari* [2015] EWCA Civ 798, the Court of Appeal decided that where landlords bring county court claims for non-payment of service charges, they are also entitled to rely on section 146 clauses in leases, even if the amount that is claimed falls under the small claims threshold.

52. The three case studies that follow evidence the effect of that decision.

Case study 1

The landlord issues a claim for service charge arrears of £3,400.

The leaseholder defends the claim.

The court finds that £2,500 is payable and enters judgment for that amount.

The landlord claims – and is awarded – its costs of £9,500.

The leaseholder is therefore liable to pay a total amount of £12,000.

Case study 2

The landlord issues a claim for service charge arrears of £3,400.

The leaseholder defends the claim.

The court finds that £2,500 is payable and enters judgment for that amount.

The landlord claims legal costs of £9,500. The court reduces the amount to £3,000.

The leaseholder is therefore liable to pay £5,500 in service charges and costs.

The landlord puts the balance of its costs through the service charge, resulting in a £200 increase in the service charge payable by each leaseholder in the block. There is no RTA, and few leaseholders are owner occupiers, so no one challenges the increase because no one wants to challenge their individual £200 liability: the application fee to the First-tier Tribunal itself is £150.

Case study 3

The landlord issues a claim for service charge arrears of £3,400 and notifies the leaseholder's mortgage lender.

The leaseholder defends the claim. The lender applies to be joined to the claim so as to protect its security.

The court finds that £2,500 is payable and enters judgment for that amount.

The landlord claims legal costs of £9,500. The court reduces the amount to £3,000.

The leaseholder must therefore pay £5,500 in service charges and the landlord's costs.

The landlord puts the balance of its costs through the service charge, resulting in a £200 increase in the service charge payable by each leaseholder in the block. There is no RTA, and few leaseholders are owner occupiers. No one challenges the £200 per leaseholder increase: the application fee to the First-tier Tribunal itself is £150.

The lender adds its costs of the claim, some £3,000, to the leaseholder's mortgage account as it is entitled to do under the terms of the mortgage.

A dispute over £3,400 of service charges has therefore resulted in a liability to the leaseholder of £8,200, even before the leaseholder has incurred any legal costs him/herself.

Forfeiture for non-payment of (ground) rent

53. As noted above, a landlord is not obliged to serve a section 146 notice on a leaseholder if the reason for forfeiting the lease is non-payment of (ground) rent.

54. Parliament has again legislated however to prevent landlords from bringing claims for possession of leasehold property as soon as there are arrears of ground rent.

55. Section 166, Commonhold and Leasehold Reform Act 2002 obliges a landlord to serve a demand for rent in a prescribed form.

56. Section 167 of the same Act prohibits a landlord from forfeiting a lease unless the leaseholder has payment arrears of over £350, or the arrears have been payable for more than three years. The arrears may be a combination of service charges, ground rent and administration charges.

57. As there is no requirement to serve a section 146 notice for ground rent arrears, a landlord cannot rely on a section 146 clause to recover the costs of a claim based solely on ground rent arrears.

58. The First-tier Tribunal (Property Chamber) has no power to deal with ground rents.

59. In the county court however, section 138 of the County Courts Act 1984 provides that if the leaseholder pays all of the arrears and the costs of the claim before the first hearing date, the lease continues as if there had been no forfeiture. In principle therefore a landlord can issue a claim for possession of a leasehold property for non-payment of £500 of ground rent, and demand payment of legal costs of £1,000.

60. The financial risks of defending a claim to £1,000 of ground rent arrears are likely to be disproportionate to the amount of money at stake.

61. Those risks are likely to be most acute to the leaseholder if the landlord has the power to put its legal costs through the service charge.

Statutory controls of costs

62. There is some statutory regulation of contractual entitlements to legal costs, depending on the nature of the charge:

    a) In the court and First-tier Tribunal (Property Chamber): section 19 of the Landlord and Tenant Act 1985;

    b) In the court and First-tier Tribunal (Property Chamber): section 20C of the Landlord and Tenant Act 1985;

    c) Paragraph 5 and 5A of Schedule 11 to the Commonhold and Leasehold Reform Act 2002;

    d) In court: the Civil Procedure Rules 1998.

63. All of the above controls require litigation in order to be exercised. If a leaseholder seeks to do so, whether in the First-tier Tribunal (Property Chamber) or in court, the same problems are likely to recur as are set out above.

64. In short, it might be said that in litigation about service and administration charges, the leaseholder's best outcome – that s/he pays her own costs but the not the landlord's – is the landlord's worst.

65. In practical terms therefore, the leaseholder's ability to challenge service and administration charges in a meaningful way is, at best, compromised.

66. Action is needed to counter the effects of the Court of Appeal's judgments in *Freeholders of 69 Marina* and *Chaplair Ltd v Kumari*, so as to recalibrate landlord and leaseholder costs entitlements. In the interests of access to justice, one party should not be required to run the risk of paying the other's costs with no prospect of recovering their own.

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