Alternatives to service charges?

There is increasing evidence of frustration with the current law governing residential service charges. It is fragmented and difficult. The panoply of statutory control appeals to tenants, until they buy their own freehold, at which point they come to appreciate how difficult it can be to comply. *Daejan v Benson* is widely seen as a welcome development by landlords, but *Phillips v Francis* goes the other way and imposes even more onerous consultation requirements than was thought to be the case hitherto. The case for reform becomes ever stronger, but may never happen. In the meantime, are there alternatives?

Morshead Mansions Ltd is a lessee-owned company of which all lessees are now members. In *Morshead Mansions Ltd v di Marco* [2008] EWCA Civ 1371, the Court of Appeal decided that sums claimed via a member's call clause ("Article 16") in the Articles of Association were not a service charge, even if they were collected in order to defray service charge costs. That was something of a watershed ruling, but the Court of Appeal stated that they were not deciding whether, for example, the sums collected could in fact be spent on costs which would otherwise be service charge costs.

Last month, a further judgment was given involving the same parties [2013] EWHC 1068. I will not comment on the issues which Mann J was called upon to decide (and which may be taken further). What is interesting is that the judgment records what happened after the Court of Appeal decision. First, the company has ceased to make any service charge demands, and now funds itself solely through Article 16 demands. Secondly, the issues left open in the Court of Appeal were resolved in favour of the company (in the end, by consent) by an order of the county court. Art 16 money can be spent on the provision of services under the lease, ss.18-30 of the Landlord and Tenant Act 1985 do not apply, and the Art 16 money is not impressed with the statutory trust under s.42 of the Landlord and Tenant Act 1987.

The upshot is that a "Morshead Mansions clause" is an effective method for lessee-owned companies to take themselves out of the rigours of statutory control of service charges. Of course, it only works if all the lessees are, and are required to be, members. But for anyone setting up a service charge structure, it makes sense to include the clause, and a covenant in the leases which requires all tenants to be members. It makes good sense to follow this route for enfranchising groups of lessees setting up their nominee purchaser and granting themselves new leases after enfranchisement.

Operation of the clause depends on the necessary resolution passing a General Meeting. So such a clause preserves democracy within the lessee group, but prevents a minority from bringing the company low by withholding service charge, repeated LVT applications and so forth. One is tempted to wonder why some sort of similar arrangement could not be worked into the general statutory controls of service charges, applicable where the landlord and tenant are the same people wearing different hats.

To a developer who wishes to retain the freehold and a ground rent this may seem irrelevant. But logically, if it works for a landlord company, the same approach could also work for a third party management company under the leases. A tripartite structure involving a management company

is attractive to developers anyway, and a "Morshead Mansions clause" may lessen the likelihood of the landlord having to exercise step-in rights.

Moving away from the lessee-owned model, some large landlords taking a very long term view may consider a return to a form of service charge which does not vary with the relevant costs and hence is outside the ambit of the definition in s.18 LTA 1985 on which much of the legislative edifice is based. It has been suggested to me that analysis of historic costs may allow for a fairly accurate prediction of the *average* costs of maintenance including major works over (say) a 20 year cycle. Such information exists because the statutory controls and the lack of any limitation period on re-opening old service charge years in the LVT has forced landlords to keep better records. The annual cost can be linked to inflation or a building costs index. It seems likely that a provision for review or re-basing at (say) 20 year intervals, perhaps subject to expert determination in case of dispute, would not be caught by s.18 either.

Another possibility is making more use of estate rentcharges. A rentcharge is essentially a rent payment to someone who is not a landlord, charged on the land by Deed. Creation of new rentcharges was prohibited in 1977, subject to exceptions including a "variable estate rentcharge". That is a payment for the purposes of meeting the cost of services, maintenance, insurance and similar – it covers the same ground as a service charge. The payment must be "reasonable in relation to the covenant". In *Canwell Estate Co v Smith Bros Farms* [2012] EWCA Civ 237 the Court of Appeal interpreted this test as applying separately to each payment, thus effectively confirming a limited control similar to the reasonableness tests under s.19 LLTA 1985. But it is a simple, fair criterion; estate rentcharge payments are not subject to the general controls on service charges and are not within the jurisdiction of the LVT.

Rentcharges are attractive for freehold estates because the covenant to pay runs with the land, but it is clear that a rentcharge can also be created and secured on leasehold land. So a variable estate rentcharge could be used on leasehold estates to provide for upkeep of the estate common parts. The charge payments would not be made under the lease and hence not to a landlord (as defined in s.30 LTA 1985) so they would not be subject to the statutory regime. The benefit of a rentcharge – the right to receive the payments – is freely assignable by the "rent owner", so it can be assigned on by a liquidator in the case of insolvency.

Finally, there is Commonhold. Various defects in the legislation have led to a low take-up, but the regime does have an advantage which appears ever more significant: a commonhold assessment is not a "service charge" and is much more difficult to challenge. If the other defects could be sorted out, the absence of service charges just might make commonhold look an attractive option.

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