

# Lessees & Residents' Management Companies

## OVERVIEW

ARMA regularly receives calls from 'disgruntled' lessees about the management of their building. Very often it turns out that the lessee lives in a building owned or run by a company in which they are a shareholder. Legal Executive, Brian Jones, explains below how it all works.

The numbers are steadily rising of blocks of flats which are owned and/or managed by companies made up of the leaseholders. These are usually known as Residents' Management Companies ("RMCs") or Flat Management Companies ("FMCs"). This note will refer to RMCs, even though it can be a misnomer as there are a lot of lessees who do not reside in their flats.

Many RMCs own their freeholds but it is not exclusively such companies who can manage the blocks. Particularly in larger and more modern developments, the leases are frequently written on the basis that management will fall to the lessees, so that the RMC is a party to the contract between freeholder and lessee; otherwise, the leases may need to be varied or perhaps the RMC will be granted a head-lease or a lease over the common parts.

## TYPES OF COMPANY

Historically, RMCs will be simple companies limited by share with the lessees being the shareholders. Henceforth, under the Commonhold & Leasehold Reform Act 2002 ("the 2002 Act") they will have to be companies limited by guarantee if they have achieved their status by exercising the Right To Enfranchise ("RTE") or Right To Manage ("RTM") under the 2002 Act; otherwise, they will no doubt continue as before.

Guidance on setting up and running a company may be obtained from Companies House or the reader may wish to obtain a copy of the book 'Running A Management Company' written by Nigel Cox and available from the Jordans Property List.

As RMCs will not be substantial trading companies (usually) the formalities required will be limited, but they will still need a Memorandum & Articles of Association (including, crucially, an appropriate objects clause), a board of directors elected from the lessees, and to comply with basic company legislation. The latter can be demanding when it comes to the presentation and timing of company returns, and the company secretary thus has a vital role. It is not uncommon for managing agents to serve in this capacity. If they do, the agents must make themselves thoroughly familiar with the relevant legislation as the penalties for breaches can be severe, and company members will no doubt look for compensation from the agents.

## THE ROLE OF THE MANAGING AGENT

Whether or not the agent serves as company secretary, his role will be central to the management of the block. The board will expect the agent to carry out its wishes, and lessees will be in contact with the agent far more than the board. Managing agents therefore are often "piggy in the middle".

Agents would be well advised to try to avoid this scenario by pointing out clearly and regularly that:

- The party with the contractual duty to provide services is the RMC and its board.
- The agents' services to a particular property will be limited to those agreed with the board and for which a management fee is payable.
- The agents have no contract with lessees as a whole or individually.
- Any complaints by lessees concerning management issues must be directed to the board.
- Any unresolved complaints which the lessees decide to pursue should be taken up through the lessees' rights as shareholders to remove the directors, or proceedings against the RMC through the Courts or LVT (even though they are members of the company they are suing).
- No complaint lies to ARMA or another professional or trade body in respect of a managing agent carrying out the lawful and proper instructions from the RMC directors.

## RELATIONSHIP TO THE FREEHOLD

Assuming that the RMC does not own the freehold itself, then it will owe contractual duties to the freeholder. The extent of those duties will be set out in the leases, head-lease, or whatever is the form of contract between the parties. Inevitably, the RMC will be responsible to the freeholder for keeping the building in repair and insured. Apart from remedies available to the freeholder through the courts for breach of contract, it is conceivable that the freeholder could take the RMC to the LVT.

## DUTIES TO LESSEES

Again, the duties to the lessees will be set out in the leases, and can take two forms: either the RMC is a party to the leases with its covenants set out expressly; or the RMC will be directly responsible for performing the landlord's covenants (at least insofar as they relate to management matters).

Either way, the fact that lessees are also shareholders provides the RMC with no excuse for failing to perform its obligations (see below). In any event, there may well be lessees who are not members of the company. Contractual duties (such

as to repair, maintain, insure and account for service charge funds are combined with statutory duties including restricting service charges to reasonable amounts and consultation) are owed to all lessees by the RMC as though it were an institutional landlord; the law recognises no difference.

Consequently, it is essential that RMC directors (and those advising them) are familiar and up-to-date with Landlord & Tenant legislation (as well as the Companies Acts).

### WHAT ARE THE DISTINCTIONS BETWEEN A "SHAREHOLDER" AND A "LESSEE"?

There are both legal and practical reasons why these two creatures are separate and distinct from each other, even though they may be the same person(s).

A shareholder of the RMC will be entitled to take part in decision-making (albeit probably restricted to voting for the removal of the board) and will have a say at company meetings. If they think that the board has wrongfully exceeded its powers, they may take the company to Court under the Companies Acts. Their liability to the company and its creditors is limited to the extent of their shareholding (commonly £1). They cannot otherwise be forced to participate in the company.

A lessee however is contractually bound under his lease to abide by his covenants to the RMC, including the payment of service charges. Any breach of his covenants renders the lessee liable to Court action (possibly forfeiture of his lease) and/or an application to the LVT. These can be ignored (and often are) but the lessee cannot escape the consequences at the end of the day.

Meanwhile, if the lessee considers that the RMC is in breach of its covenants, or has acted or charged unreasonably, he may take the RMC to Court or the LVT under the Landlord & Tenant legislation. The lessee's rights are not fettered by the fact that he is also a member of the RMC.

This all makes sense practically because the requirements of a shareholder and a lessee can be entirely different – even opposite on occasions. From a legal point of view, the fundamental issue is that a shareholder's interest is entirely personal, whereas holding a lease vests the land (the flat) in the lessee for the time being: he is effectively a trustee of the land for the period of his ownership for his successors and assigns.

### DISTINCTIONS BETWEEN SERVICE CHARGES AND COMPANY EXPENDITURE

Just as the same person can be two separate legal entities, a similar situation can arise with money. The RMC will have control over two funds: the service charge, and the company's own money. It is essential to keep the funds separate, or at the very least separately accounted for.

The company's funds derive from its share capital and subscriptions or levies from members. An RMC will have very limited requirements for cash, but some will be needed.

The service charge fund is made up of contributions from lessees in accordance with the terms of their leases. The RMC is a statutory trustee for these contributions (S.42, Landlord & Tenant Act 1987), and the beneficiaries under the trust are the lessees. One of the trustee's fundamental duties is to account for all funds received and disbursed.

The leases will (hopefully) provide clearly how service charge funds may be spent. Both contractually and by statute funds can only be spent on items authorised under the leases, and further such expenditure must be reasonable.

It is a very rare lease which allows for administration costs of the company to be covered from the service charge. Many RMC company secretaries (and indeed some managing agents) have failed to appreciate the significance of this. The risks include the following:

- Breaching the Trustee Acts.
- Falling foul of the Companies Acts.
- Opening unnecessary & expensive cans of worms with lessees.
- Rendering service charges irrecoverable.
- Various obscure criminal and civil liabilities.

We suggest the safest approach is to run two completely separate banking accounts for company and service charge funds.

### PERSONAL LIABILITIES OF RMC DIRECTORS

As we have already seen, running an RMC is not a straightforward matter. Directors may be personally liable for any breaches of the Trustee Acts or the Companies Acts in relation to accounting for funds.

The directors will inevitably employ a variety of contractors to carry out the services required by the RMC. Some personal liability may attach to the directors now in relation to crimes committed by their employees or injuries suffered by them. This is a very complicated area in its own right. No doubt insurers could amplify this point and recommend appropriate cover.

The risks are so substantial in the current framework of statute and case law that all directors and officers should be advised to take out cover generally. It may well be negligent for a managing agent to fail to give such advice.

Furthermore, given the complex web of legislation and other hazards affecting RMC directors, it must be in the interests of directors and managing agents alike to encourage and facilitate training. This does not just apply to new directors. The law is changing all the time, and a long-standing RMC director could be even more at risk: after all, a little learning is a dangerous thing.

The other main area of personal risk for RMC directors arises in the event of actual or potential insolvency.

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## INSOLVENCY

In this context, the one thing which most clearly differentiates between an RMC and an investor landlord is that the RMC has no reserves or income other than the service charge fund, save only for the limited prospect of raising levies from its members. Thus, if there is a significant shortfall in the service charge fund, the RMC is very likely to be insolvent.

The shortfall can occur for a number of reasons of course:

- The service charge contributions in the leases add up to less than 100%
- Large expenditure may be irrecoverable (for example, for lack of consultation – see below)
- Expenditure is incurred which is not authorised by the leases
- Substantial arrears on the part of lessees
- There is a Court or LVT decision against the RMC
- Irrecoverable costs of attempting to enforce lessees' covenants

Very few of the above can be covered by insurance, so there is a considerable risk (in theory anyway) that an RMC could become insolvent at any time. (The same could easily happen to an RTM company incidentally.)

The consequences of insolvency upon the company can be drastic:

- There are no funds to manage, maintain or insure the property
- Management may revert to the freeholder (who may not want to do it)
- If the RMC owns the freehold, the whole property may go into the hands of a Receiver pending sale – probably to an investor
- Individual flats could become unsaleable and unmortgageable

On top of all those, if the RMC has been carrying on for some time (e.g. in excess of six months) when the directors knew or ought to have known the company was unable to pay its debts, there could be a claim against the directors personally for "wrongful trading". In such circumstances, the Receivers can seek reimbursement of the company's debts from directors' personal assets.

## CONSULTATION ON MAJOR WORKS ETC.

The fact that lessees are members of the company and may well have agreed to various proposed schemes at the company AGM does not exempt the RMC from complying fully with the statutory consultation requirements in S.20 of the Landlord & Tenant Act 1985 (as amended by the 2002 Act).

Neither can it be said that the RMC equates to a recognised tenants' association for the purposes of S.20, or that any individual lessee is estopped from exercising his rights under the Landlord & Tenant Acts by having voted in favour of proposed expenditure at the AGM.

Failure to comply with the consultation regime is likely to render substantial expenditure irrecoverable.

## THE POWERS OF AN RMC: RECOVERY AND FORFEITURE

The RMC's powers will vary considerably depending on whether it owns the freehold. In any event, they will be curtailed severely by the provisions of the 2002 Act when it is fully in force.

If the RMC owns the freehold, it will possess the power of forfeiture, subject of course to all the statutory and common law restrictions. An additional consideration for RMCs is the directors' reluctance to contemplate such a path against one of the company's members. Under the 2002 Act, forfeiture cannot be commenced (nor even a S.146 Notice served) unless the breach has been agreed by the lessee or it has been determined to exist by the LVT. This will impose major delays and additional irrecoverable costs upon the RMC.

For service charge arrears therefore, the RMC may well prefer straight debt recovery, even though it can take a good deal longer to get hold of the cash. Much will depend on the RMC's cash flow.

If the RMC does not own the freehold, forfeiture will be unavailable unless the freeholder is prepared to co-operate (in return for which the freeholder may insist upon security for its costs and the right to conduct the case in its own way).

If forfeiture is not envisaged even as an eventual possibility, there is no need to go to the LVT. Remember however that even a debt action, if defended, can be transferred to the LVT to determine an issue of reasonableness.

Whichever way the RMC elects to go, recoveries will take longer and cost more because of the provisions of the 2002 Act.

## CONCLUSION

Management of blocks of flats is becoming increasingly complex and hazardous, and this is at least as true for RMCs as anyone else. Directors should be encouraged to employ competent managing agents (preferably ARMA members of course), take out all appropriate insurance for their companies and themselves, and avail themselves of any relevant training.

## FURTHER INFORMATION

For further information and advice on lessees & Residents' Management Companies contact:

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