GN 95/2012

RICS Professional Guidance, UK

Managing mixed use developments

1st edition, guidance note

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Managing mixed use developments

RICS guidance note (England & Wales)

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Acknowledgment

Cover image © iStockphoto.com/Gunwharf Quays, Portsmouth, Hampshire (Image no. 10060456)

Published by the Royal Institution of Chartered Surveyors (RICS)

Surveyor Court

Westwood Business Park

Coventry CV4 8JE

UK

www.ricsbooks.com

Produced by the Commercial Property and Residential Professional Groups of the Royal Institution of Chartered Surveyors.

ISBN 978 1 84219 838 4

Typeset in Great Britain by Columns Design XML Ltd, Reading, Berks

Contents

Acknowledgments

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ASSOCIATION OF RESIDENTIAL
MANAGING AGENTS

RICS is grateful for the assistance
of ARMA in publishing this guidance note.

RICS guidance notes

This is a guidance note. Where recommendations are made for specific professional tasks, these are intended to represent 'best practice', i.e. recommendations which in the opinion of RICS meet a high standard of professional competence.

Although members are not required to follow the recommendations contained in the note, they should take into account the following points.

When an allegation of professional negligence is made against a surveyor, a court or tribunal may take account of the contents of any relevant guidance notes published by RICS in deciding whether or not the member had acted with reasonable competence.

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It is for each surveyor to decide on the appropriate procedure to follow in any professional task. However, where members do not comply with the practice recommended in this note, they should do so only for a good reason. In the event of a legal dispute, a court or tribunal may require them to explain why they decided not to adopt the recommended practice. Also, if members have not followed this guidance, and their actions are questioned in an RICS disciplinary case, they will be asked to explain the actions they did take and this may be taken into account by the Panel.

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It is the member's responsibility to be aware of changes in case law and legislation since the date of publication.

Document status defined

RICS produces a range of standards products. These have been defined in the table below. This document is a guidance note.

Type of document	Definition	Status
RICS practice statement	Document that provides members with mandatory requirements under Rule 4 of the Rules of Conduct for members	Mandatory
RICS code of practice	Standard approved by RICS, and endorsed by another professional body that provides users with recommendations for accepted good practice as followed by conscientious practitioners	Mandatory or recommended good practice (will be confirmed in the document itself)
RICS guidance note	Document that provides users with recommendations for accepted good practice as followed by competent and conscientious practitioners	Recommended good practice
RICS information paper	Practice based information that provides users with the latest information and/or research	Information and/or explanatory commentary

1 Introduction

This guidance note addresses the issues of managing mixed use buildings and estates, i.e. those with a mix of commercial and residential units; most specifically, long leasehold residential flats. It is applicable to properties in England and Wales and has been based around two previous RICS Papers: *Managing mixed use developments* (2009) and *Apportionment of service charges in mixed use developments* (2009), however, the contents have been expanded significantly. It is an introduction to the management of mixed use developments and is not intended to be a comprehensive handbook to all the practical issues which may arise.

There are some aspects of managing commercial, residential and mixed use developments that are consistent across all the sectors. There are, however, major statutory and regulatory differences relating to the recovery of costs as service charges. Whilst there is no statutory regulation of commercial service charges, there have been a number of Acts of Parliament regulating the recovery of costs as variable service charges from the leaseholders of residential 'dwellings'.

This guidance note focuses on the legal rights and obligations related to 'variable' residential service charges. Where residential leases contain a provision for the recovery of 'fixed' services charges, leaseholders do not benefit from the same legal protection as those paying variable service charges. The Upper Tribunal (Lands Chamber) has given clear guidance in interpreting lease terms relating to fixed or variable service charges[1].

Residential long leaseholders, paying variable service charges, have the right to be consulted before contracts are issued for major items of expenditure, to challenge the reasonableness of variable service charges at a leasehold valuation tribunal (LVT) and, in certain circumstances, collective rights to compulsorily acquire the landlord's interest or take control of the management of the development. (See Appendix 1 for a summary of legislation.)

Surveyors with no or limited experience of recovering residential service charges should ensure that they are fully aware of the relevant statutes and regulations, as failure to follow them can lead to costs being irrecoverable.

This guidance note focuses, on the different aspects of managing residential and commercial service charges within the context of mixed use property.

It largely follows the headings within the 2011 edition of the RICS Code of practice: *Service charges in commercial property* ('the Commercial Code'), which sets out best practice for commercial service charges.

It explores the similarities and differences between the Commercial Code and the RICS *Service charge residential management code* (2009) (the 'Residential Code'). The Residential Code is approved by the government, has status in law and will be used as a yardstick if residential leaseholders or landlords take cases to tribunals or the courts. The two codes are not always consistent for similar issues and this guidance note recommends best practice for managing mixed use developments where there is conflicting advice from the residential and commercial codes.

The purpose of this guide is to examine the practical difficulties imposed by the different statutory and regulatory regimes that apply to commercial and residential properties. The intention is to give practical, good practice guidance wherever possible, and especially where the requirements of the residential and commercial codes are inconsistent.

Where the guidance cannot be explicit and specific recommendations cannot be made, this guidance note aims to highlight issues in

order to bring them to the attention of the commercial surveyor and/or residential property manager and to raise awareness generally.

This guidance note also specifically considers the management of mixed use properties where the whole, or parts, of the premises are demised to an intermediate landlord via a headlease. The Court of Appeal has held[2], that a headlessee of residential premises containing several dwellings is a 'tenant of a dwelling' and hence benefits from the service charge protection of landlord and tenant legislation, as do any of their under-lessees paying variable service charges.

Prior to these cases it was assumed by many commercial landlords and their surveyors/ agents, that such headleases were purely 'commercial leases' and were not covered by residential landlord and tenant legislation. This guidance note highlights the importance for anybody managing any properties with an intermediate landlord to be aware of these obligations and their implications; for whichever party they are acting.

In recent years many complex mixed use developments have been constructed, often including shopping centres, hotels, leisure facilities, etc. which present significant property management and facilities management challenges for both commercial and residential practitioners. This guidance note considers the issues relating to recovery of costs by way of service charges; specifically, apportionment of service charges, different types of service charge schedules and consultation requirements. Many of the complex facilities management issues are beyond the scope of this guidance note.

1.1 Terminology

It is difficult to avoid using terms that are complicated or that have different meanings to different people, especially those working in different sectors. A glossary of terms and abbreviations is included at Appendix 3.

Managers should also have regard to the more extensive list of definitions within Part I of the Residential Code. To ensure consistency we have used, wherever possible, the same terms within this guidance note.

2 Core principles

Managers should be aware of the core principles laid out in the RICS Real Estate Management Standards. This guidance will specifically help in meeting the following principles:

1.	To conduct business in an honest, fair, transparent and professional manner.
2.	To carry out work with due skill, care and diligence, and ensure that staff employed have the necessary skills to carry out their tasks.
6.	To ensure that all communications are fair, clear, timely and transparent in all dealings with clients.
10.	To ensure that it is made clear to all parties for whom you are acting, the scope of your obligations to each party.
11.	Where provided as part of the service, to give a realistic assessment of the likely financial outcome of any issues and using best professional judgment.

2.1 Service provision

It is important to have regard to section 2.1.1 of the Commercial Code and Parts 3 and 7 of the Residential Code.

The property should be managed in an open and transparent way, subject to maintaining confidentiality in respect of personal information.

The levels and standards of service provided will differ according to the contractual obligations and the nature, type and complexity of each property.

Managers should ensure that services are delivered in accordance with the contractual obligations contained within the various leases and that services are beneficial and relevant to the needs of the property, its occupiers and their customers.

Services should be provided efficiently, economically, cost effectively and safely.

2.2 Value for money

Routine monitoring and regular reviews of the standards and cost effectiveness of services provided is imperative and, where possible, show that effective service standards are being delivered and value for money is being obtained.

2.3 Transparency

Appropriate management procedures should be in place, including effective communication, to provide transparency between all parties, including landlord(s), manager(s), leaseholders and occupiers, in the way services are provided and managed and how the costs of these services are recovered.

All costs and apportionments should be transparent so that all parties, owners, leaseholders, occupiers and managers, are aware of how the costs are made up. Management fees should be on a fair and reasonable basis with no hidden mark ups.

3 Lease structures

3.1 Legal documents

Both commercial and residential flats are let on leases but residential developers sell their property on long leases of 99 years or more at a low rent. Residential leases of 999 years are not uncommon. The residential developer has little or no interest in the ongoing maintenance and management (service charge). Their profit is derived from the price at which the long lease is sold and therefore they seek to maximise that sale price by giving certainty of lease terms with less consideration to the longer term income potential.

The rental income received under residential leases (ground rent) is very low in comparison to the rack rental value (market rental value of the unit if used commercially) and there is very limited scope for the landlord to amend lease terms in response to a changing commercial environment.

The structure of a residential lease is designed with a view to ensuring that the landlord can fully recover the costs of complying with all the obligations under the lease as service charges. It is usual for all the residential leases in a building to be similar, if not identical, in the main terms and to give certainty of outcome to both the landlord and the leaseholders for the full period of the term.

Commercial developers have a different relationship with their occupiers. Leases are typically granted on much shorter terms and at a commercial rent. Even if the developer sells their investment they will be conscious of the ongoing closeness of the relationship between owner and occupier and will therefore want to deliver a fair service charge, with the ability to adapt to reflect changing circumstances as they happen.

Commercial properties represent a much more active asset than residential long leases within a landlord's portfolio. The terms of any new letting will be negotiated to maximise the commercial position of the landlord and lease terms may be varied accordingly, including term, rent levels, service charge recoveries and apportionments. The lease terms of commercial units may differ significantly from one to another.

The lease terms within both sectors are paramount with regard to landlords' rights, and should contain clear provision for recovery of any costs as a service charge. Landlord and tenant legislation has given additional, wide ranging, statutory protection to residential long leaseholders, which can further limit a landlord's powers to proactively manage a mixed tenure development.

One common area of contention relates to the apportionment of service charges between sectors. This is considered in more detail in section 4.6.

The respective lease terms of the commercial and residential units need to be very carefully considered at the outset to ensure that the landlord can fully recover his costs from both sectors and respond to any changes in the nature of the scheme and/or the commercial environment.

It is recommended that separate service charge schedules be utilised wherever possible to reflect variations in 'use and benefit' of services and cost recoveries.

3.2 Headlease for residential areas

One common structure used in mixed use developments is for the residential properties to be demised to an intermediate landlord via a headlease. Alternatively, it is also common for part of a development to be demised to a head landlord on a development lease, with

residential units subsequently being developed and sold to individual purchasers by way of an underlease.

The use of a headlease structure allows the investment landlord to manage the investment in a commercial manner with limited regard to individual residential leaseholders or occupiers. There is only one contractual relationship for the investment landlord to manage, as opposed to multiple residential leaseholders.

On a large residential development, the commercial units may be demised by way of a headlease to an intermediate investment landlord. The management of a 'residential' development with intermediate commercial elements has less statutory complications than a 'commercial' development with an intermediate landlord of residential elements.

The Court of Appeal held[3] that an intermediate landlord/headlessee of residential premises containing several dwellings is a 'tenant of a dwelling' and hence benefits from the service charge protection of landlord and tenant legislation.

Where a development comprises **any** residential units demised on long leases it is, therefore, imperative that the development is managed with full regard to residential landlord and tenant legislation; especially service charges and consultation.

The headlease structure invariably leads to some aspects of dual management. For example, consider a building where several floors have been let by way of a headlease to an intermediate landlord who has developed and sold individual residential units by way of under-leases.

The freeholder (or their agent) will typically be responsible for managing the whole of the development; structural repairs, buildings insurance, lift maintenance, etc. The intermediate landlord (or their agent) may be providing additional services directly to the residential under-leaseholders, e.g. a laundry room, cleaning of communal areas within their demise, etc. The intermediate landlord will recover the costs of providing services directly as service charges but will also, typically, be responsible for a proportion of the freeholder's costs and recover those indirectly from the residential under-leaseholders in addition to the direct costs.

Both landlords may appoint their own agents/ surveyors to manage their respective obligations and employ their own on-site staff.

In this example, there is some inevitable dual management and potentially some aspects of dual service provision. Even if the intermediate landlord is purely acting as a middleman/post box and passing on freeholder costs there are some unavoidable administration costs of so doing. Leasehold Valuation Tribunals (LVTs) are likely to listen sympathetically to a residential under-leaseholder's concerns that they are paying for the same services twice.

Managers should be aware of these issues and fully prepared to justify the reasonableness of service provision and costs being recovered, both directly and indirectly. It is recommended that respective roles and services are clearly defined, specified and notified to service charge payers.

3.3 Residential Management Companies (RMCs)

It has become very common in recent years for flats to be demised by way of a tripartite lease where the landlord obligations, and the rights to recover costs as a service charge, largely sit with a third party (other than the freeholder/ head landlord). This party is often referred to as 'the manager' within the lease and is typically (but not always) a residents' management company (RMC). A similar tripartite situation occurs following completion of right to manage (RTM).

The RMC may sometimes be gifted or sold the freehold or head leasehold interest but it is much more common that these interests are retained as an investment. Where the RMC does hold the freehold or head leasehold interest, the management implications are exactly the same as for any other individual or entity holding those interests. This section of the guidance concentrates on the tripartite situation, which generates further complications.

The majority of clients for many residential managing agents are now RMCs or RTM Companies (RTMcos). The landlord and tenant structure is not easily understood by many leaseholders or members of RMCs/RTMcos and it is imperative to understand the position in order to correctly advise clients.

When managing on behalf of RMCs or RTMcos, it is important to understand that the company is a legal entity in its own right. It has landlord functions and obligations and is covered by all the statutory obligations and limitations imposed on 'landlords'. The landlord powers and obligations are limited to and imposed by the lease. It is not a leaseholders' co-operative.

3.4 Sweeper clauses

It is often difficult to predict precisely what services might be provided through the duration of a long lease and which of these should be covered by the service charge. To avoid the risk of incurring costs that might fall outside of the service charge, leases commonly contain a 'sweeper' provision entitling the landlord to charge not only for the services specifically listed, but also for other miscellaneous services that might be provided in the future.

The Commercial Code urges caution as to how sweeper clauses are used, making the point that they are not intended to provide for the recovery of costs for something that was omitted from the lease, or to cover for mistakes in drafting.

This is also the case with residential leases. The approach of the courts and tribunals has been to require clear, unambiguous lease terms to support the recovery of costs and there is a general dislike of reliance on sweeper clauses. There is potential for the Unfair Contract Terms legislation (*Unfair Terms in Consumer Contract Regulations* 1999 (SI 1999/2083) (Amended by the *Unfair Terms in Consumer Contracts (Amendments Regulations* 2001 (SI 2001/1186)) to come into play if the landlord is using sweeper clauses to recover costs for services that were never contemplated at the time the leaseholder made their purchasing decision.

Some residential leases mitigate this situation by softening the degree of control held by the landlord. Instead of leaving additional service provision entirely at the landlord's discretion they can use terms such as: *to include the cost of any services requested by a majority of leaseholders* or *requested by leaseholders*. The risk of cost recovery for extra service can be reduced by effective consultation and a good working relationship with any Recognised Tenants' Association (RTA). The landlord's risk can be removed by seeking a determination at LVT that budget costs are reasonably incurred for the additional services.

Communication of intentions and reasoning are equally important when intending to recover costs from commercial tenants by way of sweeper clauses.

Sweeper clauses cannot be used to make good a drafting defect in the lease or to impose any obligation on the tenant not envisaged when granting the lease. It is advisable, therefore, to be cautious in the recovery of costs by way of sweeper clauses, which, within residential leases, should only usually be used for the recovery of costs required by statute or in accordance with good practice.

An example may be the recovery of costs incurred in procuring risk assessments required by developing health and safety regulations. Commercial leases tend to be for much shorter terms than residential leases and are therefore capable of keeping up with statutory and good practice requirements. There is likely, therefore, to be even less justification for recovering costs by way of sweeper clauses within commercial leases.

4 Administration

4.1 Service charge costs

There are a number of core principles which are equally valid to the management of both commercial and residential properties. These are summed up within section 1 of the Commercial Code, which contains the following core principles:

- Services are procured on an appropriate value for money basis and competitive quotations are obtained or costs are benchmarked.
- Management fees reflect the actual costs of managing the services and the amount recoverable by an owner is limited to the proper and actual cost incurred in the provision or supply of services.
- Owners should not profit from the provision or supply of services.
- All costs are to be transparent so that all parties: owners, occupiers and managers, are aware of how the costs are made up.

4.2 Staffing and personnel

To ensure the services are provided efficiently and cost effectively, sufficient staff of the right type and calibre should be provided. The total costs for staff should be declared to all occupiers.

Managers should make enquiries into the legal status, employment history, relevant personal qualities and background of any prospective employee, either directly or on behalf of the clients and be sure, as far as possible, that any prospective employee is legally entitled to work in the UK, is honest and trustworthy and a suitable person for the job.

All staff should receive a contract of employment and job description that clearly defines their duties and responsibilities. An appropriate training programme should be provided based on the complexity of the tasks required, and related to the experience and qualifications of the employee. All employees should be issued with a copy of the employer's health and safety policy and be fully trained and competent before undertaking any duties with health and safety implications.

Site management teams should be required to perform according to defined performance standards. It is advisable to measure and review performance regularly against those standards. Managers should ensure that an appropriate supervision and support system is in place and that the proper practices and procedures are being followed, to the satisfaction of the client. Disciplinary, grievance and harassment procedures should be in place, details of which have been communicated to all staff

4.3 Management charges

The management charge is the reasonable price for the **total cost** of managing the provision of the services at the location, and relates only to work carried out in managing and operating the services and administering the service charge.

Property management can either be undertaken in-house or by managing agents. The use of managing agents is common within residential property management, whilst the management of properties in-house is common with commercial properties.

It is also common within commercial property management for significant management functions to be undertaken by on-site staff or outsourced to specialist facilities management contractors. LVTs have been critical of residential leaseholders being charged for 'dual management' and disallowed some costs as not being reasonably incurred. It is imperative,

therefore, that the specific duties of all parties are well defined and the costs differentiated. The need to ensure value for money is paramount.

The level of services provided and costs recovered as management charges may differ for residential and commercial occupiers. For instance, the commercial code states that the cost of asset management should be excluded from the management charges as it is related to investment interests. With residential long leases, however, where the landlord is unlikely to enjoy the benefit of the reversion for the foreseeable future, it may be appropriate (subject to lease terms) for these costs to be recovered as service charges; especially if they are informing long term maintenance plans and reserve or sinking fund contributions (see section 8).

4.3.1 Managing agents

Managers should have regard to the sections on procurement of services at 4.4.

When retained by a landlord in respect of work as a property manager, managers should ensure that they have written terms of engagement covering the basis of fee charging and duties.

The terms of engagement/management agreement should set out the activities undertaken for an annual fee and the frequency of those activities. They may also include a 'menu' of charges for duties outside the scope of the annual fee.

A list of activities that should normally be included within an annual fee and examples of activities that may form a menu of additional services are detailed within Part 2 of the Residential Code. Both the residential and commercial codes state that management fees should not be based on a percentage of costs (unless the lease dictates that this is to be the case), as this is perceived to be a disincentive to the delivery of value for money.

The length of appointment should be agreed prior to commencement and be clearly detailed within the management agreement, together with any process for renewal, review of fees and termination. Any agreement for more than a year is likely to require consultation as a qualifying long-term agreement under section 20 of the *Landlord and Tenant Act* 1985 (LTA 1985) (as amended). See section 5.6.1.

The management agreement should provide for a period of notice of termination and the means to do so if either party breaches its obligations. It should also include comprehensive details of the services to be undertaken and information to be provided to the client, or any other agent appointed, following termination.

The Commercial Code requires managers to confirm in the service charge report: the basis of their appointment; when they were appointed; and the basis of the management fee payable, which is recoverable under the service charge. This represents combined best practice and this information should be included within all service charge reports on mixed use developments.

4.3.2 In-house management

Where the owner manages the property in-house they should be able to support the basis of their fees by reference to actual costs and when benchmarked against other comparable service providers.

It is not uncommon for residential leases to contain no clauses explicitly providing for the recovery of costs of management. The Upper Tribunal have determined[4], however, that where a lease covenants the landlord to provide services, the reasonable costs of specifying, procuring and managing those services can form part of the service costs recoverable. In these instances, the landlord will need to be able to demonstrate the actual costs incurred in relation to each service cost.

No two buildings are identical in the way they need to be run to meet the requirements of all parties with an interest in the property. Management fees and the site management costs will need to be set at the appropriate level with this in mind, and the management structure in place should meet the requirements of the building.

Best practice requires transparency and a management structure where costs are clearly identified and explained within the explanatory

notes included in the budget and actual expenditure reports to occupiers.

The Residential Code recommends within Part 2, a list of activities that will usually be carried out within the annual fee.

The Commercial Code recommends that the costs of reports undertaken by specialists working for the same organisation as the manager (i.e. fire risk assessment, DDA reports, health and safety reports) should be excluded from the management fee, and for any fees for these additional services to be stated clearly and represent value for money.

This increases transparency and is also best practice for residential leasehold properties.

All fees should be subject to annual review or indexation.

4.3.3 Site management costs

Site management costs will be the full employment costs for sufficient staff to perform the required services and deliver value for money. The total cost of the staff will include wages, national insurance (NI), tax, compliance with statutory requirements, training and other appropriate benefits.

Site management costs might also include:

- the costs of providing appropriate office accommodation and administrative support where necessary
- a fee representing the HR and payroll costs associated with dealing with staff (within commercial property management this is often referred to, as an administration charge, but this term has specific legal definition within residential leasehold, as detailed in 6.11, and should be avoided); and
- separate specialist consultancy fees payable, for instance, in connection with the carrying out of health and safety risk assessments, asbestos surveys, etc. and which should be clearly identified in the service charge accounts.

One way of ensuring the costs reflect value for money is to compare them to a third party providing similar services. Where such fees are included, the basis of calculation and/or amount of the fees included should be clearly communicated to occupiers to aid transparency.

Where on-site staff oversees more than one property, their costs (and any appropriate accommodation and administrative support costs) should be adjusted accordingly so each property picks up a fair share of their cost. The service charge report should identify if this is the case and how the costs are split.

The availability of services provided by on-site staff may differ according to the nature of occupation, i.e. residential occupiers may not benefit from some of the services provided exclusively for commercial occupiers or vice versa, e.g. security staff, concierge, porters. In these circumstances, the costs should be clearly differentiated (by separate service charge schedules if possible) and only recovered from the appropriate occupants.

Lease terms are paramount and there must be clear cost recovery rights and obligations relating to the services provided. Costs must be 'reasonably incurred' to be recoverable from residential leaseholders and LVTs have the power to determine what service charges are payable, by who and to whom.

It is common within commercial property management for significant management functions to be undertaken by on-site staff or outsourced to specialist facilities management contractors. LVTs have been critical of residential leaseholders being charged for 'dual management' and disallowed some costs as not being reasonably incurred. It has been perceived that some of the functions fulfilled by the on-site staff should be covered by the management fee. It is imperative therefore that the specific duties of all on-site staff are well defined and differentiated from the management duties of the landlord's surveyor or agent. The Residential Code provides useful guidance as to the core duties (and a menu of extra duties), which should normally be covered by the management fee.

4.3.4 Who is the employer?

When employing on-site staff it is essential that all parties understand who the employer is. In

residential developments it is usual that the contract of employment is in the name of the landlord (often an RMC). This should provide a long-term solution as the employment does not change with any change of agent and there is no VAT chargeable on the payroll costs because the staff work for the landlord.

In commercial developments it is not uncommon for the contract of employment to be with either the landlord or the agent depending on the terms of, and duties identified within, the management agreement. Where the staff are employed by the agent, VAT may be payable on top of the payroll costs because the provision is a service to the landlord.

It is common however, for the agent to take on the role of staff supervision and, in this situation the courts or employment tribunals may take the view that the effective employer is the agent not the landlord. This could have implications in relation to both VAT and *Transfer of Undertakings (Protection of Employment) Regulations* 2006 (TUPE). It is recommended that all documentation, practices and procedures ensure that managers do not inadvertently become the employer.

In addition, the various suppliers of services to the property (e.g. security, cleaning etc.) will often employ individuals who spend a significant amount of their time working in or in relation to one property or portfolio. They are also likely to have the benefit of the TUPE Regulations which have the effect, in certain situations, of moving employees automatically from the old supplier to the new supplier.

This can be a complicated area of law and interpretation and it is recommended that appropriate advice is taken. Further information is available in section 7 of the RICS guidance note: *Commercial property management in England & Wales* (2001) and RICS information paper, *TUPE – Information for property managers* (2009).

4.3.5 Notional rent

The Commercial Code makes a number of recommendations regarding the recovery of a notional rent for management accommodation or other premises used in connection with the management of the property. In general, it recommends that it is not advisable to charge occupiers notional rent in situations either where the premises are incapable of beneficial occupation for any other purpose, or where provision has not been made for facilities management accommodation.

Residential leases require clear, unambiguous clauses providing for the recovery of rent of any accommodation. The benefit of such accommodation, to provide a level of service may have been reflected within the initial purchase price of the properties and recovery of additional costs should be avoided unless there is clear, unambiguous provision.

Combined best practice is therefore not to charge for notional rent unless the accommodation is capable of alternative beneficial occupation and there are clear and unambiguous cost recovery provisions within all the relevant leases.

4.4 Commission income

The Commercial Code contains at 1.6.1, the following requirements:

The principle of commission retention is now long established. In its base form the use of commission to cover administrative costs, including broker fees, should be recognised and also the owner's ability to benefit from the economies of scale generated by the pooling of risks into a common programme.

Owners and managers must always disclose any commission they are receiving.

The Residential Code contains at 2.6, the following requirements:

Insurance commissions and all other sources of income to the managing agent arising out of the management should be declared to the client and to tenants.

The final report[5] of the RICS Transparency Working Group recommended that commissions should be earned, represent remuneration for work done, or involve some added value to the service provided to the consumer. There should also be full

transparency to the client and the end user, i.e. the service charge payer.

Landlords with portfolios of property can often obtain discounts from insurers for block and repeat business. The courts[6] have considered the difference between commissions and discounts and indicated that a landlord is entitled to retain genuine commission payments, but the benefit of any discount should be passed on to the tenant so that the tenant pays the actual cost incurred.

These principles also apply to any commissions on, or percentage of, service contract costs remitted by the service contractors to the landlord, his agents or any related companies; often referred to as referral fees. Under existing practices, referral fees are permitted providing they are entirely transparent and proportionate. Where there is a lack of transparency with the customer and a lack of proportionality linking the transaction and the referral fee, the referral fee (either offered or received) would not be permitted as this would risk falling foul of the law, in particular the *UK Bribery Act* 2010. Further guidance will be issued by RICS, to help members identify what being transparent and proportionate looks like in practice.

It is best practice to declare any commission or other sources of income arising out of the provision of services, with the annual service charge accounts/statements. This should include any commission or other income accruing to any related company of the landlord or the agent. It is important to explain what services are provided for the remuneration received and be able to demonstrate those services represent good value for money.

4.5 Contract procurement

The Commercial Code requires that the owner will keep costs under review and, where appropriate (e.g. every three years), requires contractors and suppliers to submit competitive tenders or provide competing quotations. If owner and occupier are happy with the existing service standards, rather than repeat the tender process, the owner will benchmark the prices.

Owners will require major service providers to continually review methods and processes that produce further value and efficiencies.

The Residential Code also requires contracts to be routinely monitored for cost effectiveness and value for money.

Managers should have the criteria for selection of contractors in place, as detailed within section 4.4.2, and agree specifications and frequency of service delivery with the clients and occupiers prior to commencing the selection process.

4.5.1 Service standards

It is advisable to ensure that all contractors and suppliers perform according to written performance standards. It can prove valuable to regularly measure and review performance against these defined standards, as well as regularly reviewing the appropriateness of the standards used.

4.5.2 Procurement of services

Where the landlord, manager or agent has a connection with any proposed contractor, whether financial or otherwise, this should be declared to any clients, leaseholders and occupiers. Clients should be advised at the procurement stage. Declarations should be made to leaseholders within the service charge statement and within any section 20 consultation notice of estimates or notice of proposals.

Any charges for specifying, tendering and monitoring contracts should be pre-agreed with clients and proportional to the tasks involved.

All appointments (or re-appointments) should be confirmed by a written works order providing contractors with a ‘licence to work’.

The criteria for the selection of contractors should be in place prior to employing them. Pre-employment checks will include:

- identity
- financial position

- competency and experience
- membership of relevant trade organisations
- insurance: employers' liability and third party liability
- tax: HMRC construction industry scheme, VAT
- health and safety: compliance with codes and regulations and provision of safe working method statement
- compliance with *Construction (Design and Management) Regulations 2007* (CDM); and
- compliance with your equal opportunities and anti-discrimination policy.

Managers may have a list of approved contractors, pre-selected, for small value or urgent works. In those cases there should be agreed pricing mechanisms e.g. hourly rates and financial limits, which should be reviewed annually or at other appropriate intervals. Managers should have regard to the landlords' requirements to justify the reasonableness of expenditure and have some process for market testing and ensuring value for money.

Owners and/or managers are often able to achieve substantial savings and other benefits in the provision of services through bulk purchasing or through the placing of group contracts. However, the pricing of services under such contracts can differ in either providing a single contract sum, a separate cost per property or a schedule of rates for different services. Transparency in terms of the apportionment and allocation of costs to the subject property is recommended.

Procedures should include obtaining competitive prices from a minimum of two selected contractors. This may not always be appropriate for low value contracts or extremely urgent works. Selection criteria should have regard to economy, quality, value for money and health and safety compliance.

In addition, the law for residential dwellings requires some long-term agreements or contracts for services to be the subject of consultation with residential leaseholders (LTA 1985, section 20). These are contracts for more than a year and where any one leaseholder is likely to be asked to pay more than £100 in any one year. See 5.6.1 for further details

All qualifying works must also be fully consulted under section 20 of the LTA 1985 and 1987, before the appointment of a contractor. See 5.6.2 for further details of the consultation procedures

4.6 Scheme inspections

The frequency of scheme inspections and any reporting requirements should be specified in the management agreement. The frequency of inspections should be proportionate to the size and complexity of the scheme and numbers of on-site personnel.

It is recommended that the quality and cost effectiveness of all services under a manager's control are routinely monitored. Clients and customers should be advised of the monitoring procedures and details should be provided of how they can communicate any shortcomings. Any service delivery issues should be addressed without delay and clients and customers should be kept informed of any actions taken. Managers should not act outside the scope of their authority and should take the client's instruction where necessary.

4.7 Allocation and apportionment

Apportionments should be fair and reasonable. Most modern residential leases contain specific percentage apportionments, often with an option for the landlord to vary if the circumstances change. Whilst certainty of apportionments is desirable within residential schemes, the ability to be able to respond to changes by varying apportionments is preferable within mixed use schemes. The Upper Tribunal[7] considered one such variation of the residential apportionment to be reasonable and in accordance with the lease when the extent of the commercial estate contributing to the service charge reduced.

The RICS Real Estate Management Standards state at 3.1.9:

The basis and method of apportionment of service charges should be demonstrably fair and reasonable to ensure that individual occupiers bear an appropriate proportion of the total service charge expenditure, reflecting the availability, benefit and use of services.

It is very common within mixed use developments that not all the occupiers benefit from the services to the same extent. In such circumstances, the costs will be allocated to separate schedules and the costs apportioned only to those tenants that receive the benefit or use of the service. Apportioning the costs within that schedule can then itself be 'weighted' on the perceived extent of benefit and use.

There can be a difference between benefit and use. For example, an office occupier decides not to use the lift and instead utilises the stairs to reach his demise. Whilst he might choose not to use the lift, he still benefits from the availability of the lift service and should therefore contribute to the on-going maintenance costs. The principle as to the amount of the contribution will vary on a case by case basis. A discounted charge may be appropriate in some circumstances, with the costs being weighted towards each occupancy and use type.

The Commercial Code reflects these principles and contains (at 1.5.1) the following:

The basis and method of allocating and apportioning the service charge expenditure is to be transparent and clearly communicated to all. Any inducements or concessions to attract occupiers to a property are to be borne by the owner and not spread among other occupiers. The rationale for the apportionment between occupiers should be set down in writing and re- examined periodically to see whether there is a need for a new apportionment matrix or apportionment method to be applied.

Where reasonable and appropriate, costs should be allocated to separate schedules and the costs apportioned to those who benefit from those services.

In many cases, particularly buildings with a variety of different users, not all the occupiers will benefit from the services to the same extent. In such circumstances it may be necessary to divide the service charges into separate parts (schedules) to reflect the availability, benefit and use of services with each part being individually apportioned between occupiers according to the core principles. The allocation of costs to separate schedules is essential in achieving a fair and proper apportionment of costs between those occupiers that benefit from specific services. Occupiers will therefore often pay different percentage apportionments under different schedules

These principles are of particular importance with regard to mixed use developments and the apportionment between the commercial and residential units. Where the lease provides for fair and reasonable proportions there should be clear rationale as to how those provisions have been applied.

The Commercial Code also places an obligation on managers:

…to make a full apportionment matrix available to all occupiers, which clearly shows the basis and method of calculation and the total apportionment per schedule for each unit within the property/complex.

4.7.1 Combined best practice

Residential purchasers want certainty about future charges, so clear and transparent apportionments are required. Commercial landlords want greater flexibility to meet changing circumstances and regular reviews of apportionments are recommended in the Commercial Code. All parties should be sent a schedule of the way the apportionment has been made as part of their annual statement of account.

Any split between commercial and residential units should be clear, open and transparent and demonstrably fair and reasonable to ensure that individual occupiers bear an appropriate proportion of the costs that reflects the availability, benefit and use of the services. Wherever possible, it is recommended that the costs to each type of occupancy are separately identifiable and apportioned by way of separate schedules. This is particularly important where

different VAT regimes apply to each occupancy type. Additionally, there may be common estate charges split between the schedules, with the appropriate VAT regime applied to each schedule (see section 6.12).

Commercial leases typically contain greater flexibility than residential leases, with the ability to change apportionment to reflect current factors. Residential leases within a mixed use development, therefore, also need to be flexible to cope with varying apportionments.

Residential leaseholders have the option of challenging the payability of service charges at an LVT, and where a specific apportionment is not set within the lease, this could extend to the reasonableness of the apportionment methodology used. Although there is no requirement for costs to be allocated according to the most reasonable split, there needs to be a defendable rationale behind both individual apportionments and any commercial/ residential split. The LVT has no jurisdiction to determine the level of commercial service charges payable, but any determination of residential service charges may, by default, lead to the landlord having to meet any shortfall not recoverable under the commercial leases.

Where apportionments are based on floor (or other) areas managers should have regard to the current edition of the RICS *Code of Measuring Practice*.

4.7.2 Sunday trading

Leases granted in respect of retail and leisure premises, generally within shopping centre schemes, will usually stipulate hours during which a tenant is obliged to be open for trading (the keep open provisions) and other hours during which the tenant is permitted to trade (the permitted hours).

The *Sunday Trading Act* 1994 which modified the *Shops Act* 1950 came into effect on the 26 August 1994 and permits shops in England and Wales to trade seven days a week, subject to certain conditions.

The Act, for the most part, deals with the types of premises that may open and employees' rights, but section 3 provides that where a lease entered into **prior to 26 August 1994** includes a 'keep open' clause, a landlord cannot require a tenant to open on Sundays and if a tenant chooses not to open, it cannot be held in breach of the lease.

Leases granted after 26 August 1994 will not generally be covered by section 3 of the Act.

Although silent as regards service charges, the general tone of the Act is to prevent an unwilling tenant from being obliged to open on Sundays and it is reasonable to expect the courts to take the view, subject always to the terms of the lease, that if the tenant is not obliged to open on Sundays, then neither should it be obliged to contribute towards the costs incurred by the landlord in facilitating Sunday trading.

Landlords and tenants are free to agree to vary the lease to include Sunday trading hours and to include an undertaking on the part of the tenant to pay a proportion of the cost of providing the services.

Whilst in practice it is now usual for the majority of retail/leisure tenants to open during Sunday trading hours, care may be required in ensuring that the cost of Sunday trading is recovered only from those tenants on leases which require them to pay the costs of Sunday trading (whether they open or not).

4.7.3 Commercialisation income

As well as rents collected on occupational leases, some properties, particularly retail and leisure schemes, might also generate income from a number of sources such as promotional/ advertising space, vending machines and other activities within the common parts.

The Commercial Code of Practice requires that any income derived from the provision of a service or activity, the cost of which would normally fall to the service charge, should be treated as a service charge credit (e.g. income from public telephones, toilet vending machines, photocopy and fax reimbursements, etc.). Similarly, income derived from promotional activity would normally be credited to the promotional expenditure budget.

Where the owner retains income from common part areas and the space is of a permanent or

semi-permanent nature (e.g. barrows or kiosks located within malls areas), the space should be included in the service charge apportionment matrix or an appropriate equivalent credit given to reflect the benefit of the services provided.

There needs to be a clear statement of policy on how and where costs and income generated from services and activities in the common areas are allocated. Transparency is required at all times.

4.8 Direct recoveries

Service charges usually include the cost of utilities for any common parts and installations. Occupiers are usually directly responsible to the suppliers for utility costs incurred within the demised premises. Commercial leases sometimes provide for insurances and utilities supplies (to the demised premises) to be apportioned to occupiers outside of the service charge arrangement as a directly recoverable cost.

The Commercial Code requires, at 1.6, that where owners are seeking to recover the cost of insurance and utilities outside of the service charge arrangement, occupiers are entitled to expect similar transparency, accountability, etc. in these services.

Residential landlord and tenant legislation defines costs that are to be regarded as service charges and recoverable insurance and utility costs fall within that definition (s.18 LTA 85, as amended). All the requirements of demanding, accounting, keeping funds in trust, etc. apply to these costs, as to any other service charges, and LVTs have the right to make determinations as to payability and reasonableness.

4.8.1 Utilities

It is not uncommon for developers on new residential schemes to install one supply of gas, electricity and water and to leave the landlord or managing agent to sort out the charging of supplies to individual leaseholders or occupiers. The developer can make savings on the costs of metering and pipe work and/or save on meter cupboard space. However, such arrangements can be fraught with problems, as detailed in the list below.

- There are regulations on the resale of gas, water and electricity, which restrict the recovery of costs incurred and (as regards gas and electricity) prevent agents adding an administration charge onto the leaseholder's bills.
- The Water Resale Order (2001) sets maximum resale charges for water or sewage services provided to domestic customers. The maximum charges are related to actual cost plus a reasonable administration charge. Managers recovering water or sewerage charges should have regard to the Order and associated guidance published by OFWAT[8].
- Is the recharging of utility supplies part of the service charge regime in the lease or not? If it is not then on what basis can it be recharged? And on what contractual basis can the landlord or agent pursue any debts?
- If the recharging of utilities is part of the service charge regime then there may be benefits to being able to bill in advance and offer certainty in how to apportion bills. However, the cost of the utilities will be subject to the same test of payability and reasonableness as other service charge items and could be challenged at an LVT.

Separate metering or full sub-metering of utility supplies is considered essential to ensure an apportionment of cost between occupiers that reflects actual consumption and usage.

These issues can be complicated even further with mixed use schemes where there may be significant variations in the amount of utilities used by each occupier, and the costs of supply and VAT regimes may differ between residential and commercial usage.

Gas and electricity for domestic premises and communal parts of blocks of flats should be rated as domestic not commercial for VAT purposes. The domestic rate is currently five per cent and there should be no charge for the climate levy.

Water and sewerage supplies to domestic premises and non-industrial commercial premises are zero-rated[9], whereas supplies in connection with an industrial activity are standard-rated.

Managers experiencing any difficulty with a supply company are advised to ask for, and complete, a standard industrial classification (sic) code declaration form, which the supply companies should provide.

Separate metering or full sub-metering is, therefore, considered even more important for mixed use developments. If full sub-metering is not practical, it is essential that the commercial and residential usage are by separate supply or separately metered because of the implications regarding cost of supply, VAT and levels of use and benefit.

4.8.2 Insurance

The Commercial Code contains the following requirements:

Value for money

Where owners are responsible for insuring the property the insurance policy terms should be fair and reasonable and represent value for money, and be placed with reputable insurers.

Commission

The principle of commission retention is now long established. In its base form the use of commission to cover administrative costs, including broker fees, should be recognised and also the owner's ability to benefit from the economies of scale generated by the pooling of risks into a common programme.

Owners and managers must always disclose any commission they are receiving.

Service

Owners should provide full insurance details on request. Owners should also explain the process by which occupiers can make claims under the policy.

Policies should include the ability to note the interest of occupiers and include subrogation waiver and non-invalidation provisions to the benefit of the occupier, again in line with lease obligations.

4.8.2.1 Residential leaseholders

The Residential Code contains similar requirements and, in particular, the need to obtain value for money and to declare to clients and leaseholders all remuneration, commission and other income received in connection with placing or managing insurance.

The lease will set out the obligations of the parties with regard to insuring the premises. Where there is an intermediate landlord or manager under a tripartite lease, it is not uncommon for the insuring obligations to remain with the freeholder or for the freeholder to retain rights to nominate the insurers and/or brokers.

Under section 30A of, and Schedule 1 to, LTA 85, leaseholders paying service charges, directly or indirectly, towards the cost of insurance (and any RTA) can request a written summary of insurance cover and can request to inspect the policy and related documents, which may include receipts for payment of the premium. Non-compliance within 21 days of receipt of a written notice is a summary offence and it is imperative to have sufficient information to comply, or forward the request to the relevant landlord without delay.

Leaseholders can also challenge the reasonableness of insurance costs (including commissions) at an LVT.

The subject of commissions is covered in greater depth in section 4.4

5 Communication and consultation

5.1 Communication

Poor communication often leads to disputes and is probably the most commonly quoted reason for discontent with management services.

It is important to achieve good and effective communication with clients, leaseholders, occupiers, residents and any recognised tenants' associations (RTAs) for residential dwellings.

Effective communication is the key to achieving best practice – the aim being to provide transparency between manager and occupier in the way services are provided and managed and how the costs of these services are recovered. Communication needs to be timely and continuous, and works best when managers and occupiers deal with each other's reasonable enquiries and reciprocal obligations promptly and efficiently.

5.2 Budgeting and cost review

Managers should consult with leaseholders and occupiers with regard to the standard and quality of service required/desired. They should also seek feedback from occupiers on the performance management standards and service delivery and action any requirements in a timely manner.

Whilst the manager has a duty to manage the property and will not wish to avoid expenditure which might have a detrimental effect on the owner's investment, managers should ensure that the standard of service provision (and therefore the cost to occupiers) does not unnecessarily exceed the reasonable requirements and needs of the occupiers.

The Upper Tribunal (Lands Chamber)[10] have held that the financial impact of major works on lessees through service charge demands and consideration of whether major works should be phased, were capable of being material considerations when assessing whether the costs were to be reasonably incurred for the purposes of s.19(1)(a) LTA 1985. This determination highlights the necessity to undertake long term planning and provide for adequate reserve funds as described in section 8.

Key aims of landlord and tenant legislation are to ensure that residential leaseholders who are paying service charges benefit from financial transparency and demonstrable value for money. Commercial occupiers have similar concerns and it is good practice to provide similar information and to include all occupiers within any consultations. It is important to retain a distinction, however, and not use the same standard letters or consultation notices, which could give the impression of greater rights than actually exist.

5.3 Explanation of services

Residential leaseholders often have limited experience of how leases work and the obligations that they have signed up to. The production of an occupiers' handbook explaining the rights and obligations of the scheme, specific details of services, service charge recoveries, etc. is recommended.

All occupiers of mixed use developments should be aware of the services they are entitled to receive, the frequency and the estimated costs. The variety of uses may mean that one group of occupiers is contributing towards costs that they would not readily associate with occupation of their property. For example, the upkeep of communal toilets, security services, etc.

Some requirements (e.g. fire alarm testing) are likely to be more onerous and/or more frequent

for mixed use developments than for purely residential developments. Managers should ensure that costs are only recovered in accordance with the lease terms, which may differ for different categories of users. Where lease terms permit, the use of separate service charge schedules apportioning costs on the basis of use and benefit is to be encouraged. Clear notification should be given to all leaseholders and occupiers of the obligations and cost implications, together with justification as to the level of provision and recovery of costs.

5.4 Managing expectations

Residential leaseholders may have very different expectations from commercial tenants, as well as far more limited experience of how leases operate and what their obligations are. They may also have limited understanding of the role of property managers, perceiving them as acting in the collective best interests of the occupiers without fully understanding the landlord/tenant and client/agent relationships.

On mixed use developments, the commercial interests of the landlord and/or their commercial tenants and those of residential leaseholders can be in direct competition (particularly if the site was not 'sensitively' developed for mixed use).

Regular meetings of all parties, including residential leaseholders, their tenants and commercial tenants, can assist in raising awareness of the issues and understanding of the needs of each sector. On some occasions it is impossible to balance the commercial interests of the landlord with the desires of the residential leaseholders. In these instances it is imperative to ensure that lease obligations are fully complied with and that the client is fully apprised of the impact of any commercial decisions and any suitable alternatives.

One potentially difficult situation is change of use of commercial premises, possibly leading to late-night use, anti-social behaviour, loss of amenities, etc. For example, residential occupiers may perceive an on-site convenience store as beneficial but could see it quite differently if the use changed to a late-night hot-food takeaway.

Where planning constraints cannot deal with these conflicts, it is recommended that the views and needs of all occupiers are treated sensitively. Landlords should be encouraged to consult with all occupiers on any management or change of use issues and to have regard to all observations made. Ultimately, the commercial view is likely to prevail and this should be communicated to all in a sensitive and transparent manner.

Clear communication to all occupiers is a key to successful management

5.5 Consultation

In addition to the statutory consultation requirements (5.6), managers should consult with leaseholders and occupiers on management matters that are likely to have a significant effect on the level, quality or cost of services provided.

When managing on behalf of residents' management companies or right to manage companies (in particular), it is advisable to distinguish between seeking the (landlord) views of shareholders and consulting with leaseholders. Managers will frequently need to do both and should be aware of the paramount position of the lease with regard to landlord's obligations and their ability to recover costs as service charges.

Landlords and managers of commercial property are not generally obliged to 'consult' with occupiers prior to incurring costs that are ultimately to be recovered under the service charge arrangement. However, some commercial leases might set out certain procedures to be followed. In order to ensure recovery of the service charge, managers will take care to follow the procedures set down within the lease.

Landlords of residential premises are required to follow statutory consultation procedures before undertaking major expenditure or entering into long-term agreements. If the

proper procedures are not followed, the amount that can be recovered can be severely limited.

The statutory consultation requirements apply where costs above the thresholds are ultimately recoverable from residential long leaseholders even if the premises are demised to an intermediate landlord by way of a head lease. It is, therefore, imperative that **all** managers of property within a mixed use environment have a thorough understanding of the statutory consultation requirements (5.6).

5.6 Major works and service agreements

Managers should be fully aware of the consultation requirements of s. 20 LTA 85. They should ensure that their clients fully comply with the consultation requirements and recommend they take further advice where necessary. Non-compliance can have serious financial consequences for landlords and, potentially, for managing agents. It is imperative that the Regulations are fully complied with whenever required.

There are five different consultation routes and the requirements are very prescriptive and potentially complicated. Full compliance with the procedures can take up to four months before contractors can be engaged. When undertaking consultations managers may need to have regard to the specific detail contained within the *Service Charges (Consultation Requirements) (England) Regulations* 2003/1987 or the *Service Charges (Consultation Requirements) (Wales) Regulations* 20042004 No. 684 (W. 72). It is advisable to take further advice if necessary.

The Association of Residential Managing Agents (ARMA) and the Leasehold Advisory Service (LEASE) have produced joint guidance and precedent notices for each of the consultation stages within each of the five routes. These notices have been upheld and recommended by the Upper Tribunal and their view that all landlords should use these notices, where appropriate, is supported.

The Court of Appeal has held, in the cases of *Heron Maple House v Central Estates Limited* (2002) and *Oakfern Properties Ltd. v Ruddy* (2006) that an intermediate landlord/headlessee of residential premises containing several dwellings is a 'tenant of a dwelling' and hence benefits from the service charge protection of landlord and tenant legislation.

When managing on behalf of head landlords or intermediate landlords, managers should be aware of the obligations to consult or the rights to be consulted. Where the manager or their client is an intermediate landlord, they should be aware of their obligations to cascade any consultation to their own leaseholders and both parties' rights to challenge the reasonableness of service charges.

Where there is a chain of higher and lower leasehold interests, some uncertainty remains as to which level of leaseholder the consultation thresholds apply, i.e. for qualifying works, is it when the costs being recovered under the head lease exceed £250 or when the costs exceed £250 for any one individual under-lessee?

In one highly regarded County Court decision in 2009 (*Paddington Walk Management Ltd v Governors of Peabody Trust*), it was determined that the threshold applied at the lowest level of leaseholder with ultimate responsibility for making the service charge payments, i.e. for major works when the costs equate to more than £250 for, typically, any one of the residential under lessees.

There is often no direct landlord/tenant relationship between the landlord organising the works and recovering costs and the leaseholder who needs to be consulted and who is ultimately responsible for payment of the service charge. This creates significant difficulties for the intermediate landlord who has statutory obligations to consult leaseholders but no control over the works, the procurement, the timescales or the consultation process.

These situations demand good working relationships between the respective landlords/ managers. The provision of extra time additional to the statutory 30 days, and

informal discussions, can allow the consultation to be cascaded down the chain of leaseholders, who will then have sufficient opportunity to nominate a contractor and make observations.

Intermediate landlords in receipt of consultation notices giving only the statutory 30 days to nominate contractors and/or make observations, may have no alternative but to seek dispensation from an LVT, as full compliance with their obligations to their leaseholders is impossible.

If emergency works are required there will be even greater need for cooperation.

5.6.1 Qualifying long-term agreements

A qualifying long-term agreement is an agreement entered into by the landlord with a wholly independent organisation or contractor for a period of more than 12 months, where the amount payable by **any one** contributing leaseholder under the agreement, in any accounting period, exceeds £100.

Landlords must consult with every leaseholder and any RTA. Thus, in a property with unequal service charge proportions, the landlord must consult all leaseholders if any one of them would have to pay more than £100 in any one year. The figure is to be calculated on the basis of the leaseholder's total contribution resulting from the agreement, including VAT.

If consultation is not undertaken in full compliance with the procedures, the landlord may not be able to recover more than £100 per leaseholder, in any accounting period, towards the costs under the agreement.

A case in point:
In *Akzo Nobel CIF Nominees Limited v the Leaseholders of 50-56 Vicar Lane, Leeds* (2010), the LVT determined that a facilities management contract entered into in 2006 for a period of five years, was a qualifying long-term agreement that had not been subject to the consultation requirements; declined to grant dispensation from the consultation requirements and hence determined that the maximum cost recoverable under the contract from any leaseholder was £100 in any one year.

The *Service Charges (Consultation Requirements) Regulations* specify certain types of contracts that are not to be regarded as qualifying long-term agreements and hence do not require consultation under this section; they are:

- contracts of employment, e.g. caretakers
- agreements entered into before 31 October 2003, as the regulations were not retrospective
- an agreement for less than five years, entered into before there were any tenants or leaseholders, e.g. new developments
- agreements within/between holding companies/subsidiaries; and
- some local authority management agreements established under section 27 of the *Housing Act* 1985, e.g. arms length management organisations (ALMOs) and tenant management organisations (TMOs).

The five year limitation on contracts entered into before there were any residential long leaseholders is intended to allow developers to make some future provision for management and maintenance whilst ensuring that leaseholders are not exposed to the recovery of costs under very long term and potentially onerous contracts.

In the absence, to date, of any clarifying case law it is best to assume that this exception only applies until the first residential leaseholder has exchanged contracts, after which time full consultation is possible.

Valuable guidance as to what constitutes a qualifying long-term agreement was given by the High Court in the case of *Paddington Basin Developments Ltd & Ors v West End Quay Estate Management Ltd & Anr* (2010). In this case, it was determined that an estate management deed with a minimum duration of 25 years did fall within this definition.

5.6.2 Qualifying works

Qualifying works are defined for section 20 purposes as 'works on a building or any other premises'; that is, works of repair, maintenance or improvement. The inclusion of improvement in the definition of qualifying works does **not**

allow a landlord to recover costs of improvement works unless a liability for costs of improvements is included in the lease.

Landlords should consult with every leaseholder contributing to the costs and any RTA if the amount payable by **any one** contributing leaseholder is more than £250. Thus, in a property with unequal service charge proportions, the landlord must consult all contributing leaseholders if any one of them would have to pay more than £250.

If consultation is not undertaken in full compliance with the procedures, the landlord may not be able to recover costs over £250 per leaseholder.

A case in point: (this case is subject to appeal to the Supreme Court)
In *Daejan Investments Ltd v Benson & Ors* (2011), the Court of Appeal held that the legislation has no regard to the financial consequences for a landlord if the statutory consultation requirements are not complied with. In this case, the landlord had undertaken consultation before commencing works costing approximately £270,000, but there were flaws in the process and the contractor was appointed before the consultation requirements had been completed. The Court of Appeal upheld the tribunal's decision not to grant dispensation, stating: *'…in considering whether to grant dispensation, the LVT should consider whether the breach of the consultation regulations has caused significant prejudice to the leaseholders. The landlord's failure to comply with the regulations, as ruled by the LVT, caused the respondents serious prejudice. The curtailment of the consultation exercise was a serious failing. The level of costs recoverable, from each leaseholder towards these works, is therefore restricted to the statutory limit of £250'.*

5.7 Emergency works

The consultation regulations **do not** provide any exceptions from the procedures due to urgency. Even if a manager believes that works are urgently required, non-compliance with the regulations may lead to any costs in excess of £250 for each leaseholder, being irrecoverable.

Under s. 20ZA of LTA 1985, an LVT can, however, dispense with all or any of the requirements if satisfied that it is reasonable to do so. If works are urgently required that are likely to exceed the consultation threshold, managers should advise their clients that they should seek dispensation from the LVT if they wish to recover the full costs of the works as service charges.

In extremely urgent situations the client may wish to undertake works prior to obtaining dispensation from an LVT, which can be granted retrospectively. There have been a significant number of such determinations made retrospectively. One common theme from these determinations is that landlords should undertake as much of the consultation process as possible, in an attempt to ensure that leaseholders are not prejudiced and demonstrable value for money has been obtained.

The LVT will look at every individual application on its merits and managers cannot automatically assume that dispensation will be granted. Dispensation is unlikely to be forthcoming where consultation has not occurred due to incompetence, ignorance, or lack of forward planning. Before instructing any contractor to undertake works at a cost above the consultation threshold, without fulfilling all the statutory consultation requirements, managers should make their clients fully aware of all the financial risks involved and only proceed with their express instructions to do so.

5.8 Escalation of works

It is not uncommon for contracts to be specified, tendered and works commenced only to subsequently discover that more extensive works are required at greater cost. This may lead to consultation or further consultation being required. It can frequently be prudent or more cost effective to complete the required works rather than suspending the contract until the consultation requirements can be complied with. This is another situation in which an LVT can be requested to grant dispensation from the consultation, or further

consultation, requirements, in order that the works can continue in a timely and cost effective manner.

If further/full consultation is not possible, it is advisable, as a bare minimum, to keep leaseholders (service charge payers) fully advised of the extent of the works, estimated costs, etc. and to seek their observations. Scheme meetings may be a useful way of fulfilling some of these objectives.

An LVT will consider carefully the circumstances of each individual case in deciding if the consultation requirements have been fully met and, if not, whether to grant dispensation. This is a complex area of case law and tribunal determinations, with which managers should familiarise themselves and take further advice where necessary.

5.9 Other reasons for dispensation

5.9.1 Only one possible supplier

The consultation requirements (for both qualifying works and qualifying long-term agreements) require **at least** two prices to be obtained and sometimes more, depending upon connection to landlord and nominated contractors. This is not always possible; for example, with combined heat and power systems, specialised service contracts, etc. An application can be made to the LVT for dispensation in these circumstances.

If it is not possible to consult fully in accordance with the requirements of section 20, make sure that dispensation is obtained before entering into any contracts and, in any event, consult as widely as possible with all service charge payers.

5.9.2 Long-term utility contracts

Cost savings can often be achieved by entering into longer-term fixed-price contracts, typically for utilities; electricity, gas, etc. The section 20 requirements include a period of 30 days within which leaseholders can make observations on the prices obtained, but in a fast-moving market place, prices for these types of utility contracts are often only available for a short period, typically seven days, or 24 hours.

In a number of cases, the LVT have granted dispensation from the second stage requirements of section 20, in order that the landlord can contract with the best value-for-money supplier on any given date. It is possible to fully comply with the first stage of the consultation procedures – giving leaseholders details of the landlord's intentions and reasons, the opportunity to make observations and to nominate a contractor (service provider) and managers should ensure that leaseholders are not prejudiced by missing out or foreshortening this process.

It is recommended, therefore, that having undertaken the first stage of the section 20 process, and having had regard to any observations and nominations, that an application is submitted to the LVT for dispensation from the second stage requirements. It is possible (and often preferable) to submit a joint application supported by landlord and leaseholders.

Again, if it is not possible to comply with the requirements of section 20, make sure that dispensation is obtained before entering into any contracts and consult as widely as possible with all service charge payers.

5.9.3 LVTs and dispensation

The regulations are not specific or restrictive as to reasons for dispensation. They provide for the LVT to grant dispensation 'if they consider it reasonable to do so'. Managers should not, however, take an LVT's determination for granted.

In *Daejan Investments Ltd v Benson & Ors* [2011] EWCA Civ 38*,* the Court of Appeal has confirmed that prejudice to the leaseholders is a determinant factor in not granting dispensation. It has also confirmed that leaseholders have been prejudiced by the removal of an opportunity to make observations or to nominate a contractor. The leaseholders do not need to show that they would have made observations; the removal of the opportunity so to do is prejudice in its own right.

It is advisable, therefore, to assume that the LVT are unlikely to grant dispensation if the procedures are omitted, flawed, cut short, or if the contractors have been appointed prematurely.

6. Financial controls and competencies

6.1 Service charges: accounting principles

6.1.1 Commercial service charges

The commercial code states that best practice supports holding 'on-account' service charges separately from other monies. There are, however, no statutory requirements for the holding of commercial service charge monies.

6.1.2 Residential service charges

Residential landlord and tenant law requires that all variable service charge monies from residential leaseholders, and any interest accruing, are held in trust (s.42 LTA 1987). Non-compliance is a summary offence for which landlords or agents may face criminal proceedings.

The Residential Code requires that a separate bank account shall be opened for service charge monies held. Service charge funds should be held by way of statutory trusts, in either separate 'client service charge bank accounts' for each scheme managed or a global 'client service charge bank account' for all service charge monies held, but such that monies held for each scheme are separately accountable. If a manager operates one global account, it is a breach of trust to allow funds held for one scheme to be used to finance any other scheme. The accounts should include the name of the client or the property (or both) within the title of the account.

Managers should not commit expenditure unless they have the funds available to fully cover the costs. Some leases provide for the service charge account to borrow funds to meet required expenditure but managers cannot assume that to be the case without reference to the lease and, in any event, should make sure those funds have been made available prior to committing to the expenditure. Service charge funds should not be allowed to go into deficit.

Service charge funds must also be kept separate from all other funds, e.g. landlord's ground rent income.

To increase transparency, service charge accounts should include a balance sheet (in accordance with guidance in the publication *Accounting for service charges* – see 6.2) and leaseholders should be provided, on request, with a copy of the scheme bank statement.

6.1.3 Combined best practice

Despite the lack of statutory requirements relating to the holding of commercial service charges, the requirements for residential service charges represent good practice for commercial service charges. Combined best practice is to follow the residential requirements (detailed in 6.1.2) throughout a mixed use scheme.

6.2 Annual statements of account

It is usual for both commercial and residential leases to provide for an annual statement to be issued to leaseholders following the end of each service charge period, giving a summary of the costs and expenditure incurred and a statement of any balance due to either party.

Many leases will set out the procedures regarding preparation of the annual statement and will often require that the annual statement is to be 'certified' by the landlord's surveyor, managing agent and sometimes the landlord's accountant. In addition, certain leases might also require the statement to be 'audited'.

It is essential that contractual requirements in the lease are followed. Compliance with the

requirements and procedures set down in the lease may be a 'condition precedent' and recent case law has determined that where a lease sets down specific requirements and procedures, failure to comply may adversely prejudice the owner's ability to recover such sums.

Managers should, therefore, ensure that service charge statements are issued strictly in accordance with the procedures and requirements as set down under the terms of the lease.

6.2.1 Commercial service charges

The Commercial Code requires detailed statements of actual expenditure, together with a comprehensive list of accounting policies, the principles upon which the statement is prepared and explanatory text, to be issued to all occupiers within four months of the end of the financial year.

The Commercial Code recommends that the budgets and accounts are issued with a report that provides the following minimum information:

- a comprehensive level of detail to enable occupiers to compare expenditure against estimated budget
- explanations of significant individual costs and of variances from the previous year's budget/accounts
- comparison against the previous two years' actual costs, where appropriate
- information on core matters critical to that account (e.g. levels of allocation, apportionment, contracts, report on tendering, etc.)
- the achieved and/or targeted measures of improved management performance (e.g. successes in delivering improved quality services and greater value for money)
- separately identified on-site management team costs;
- details and results of the last, previous and forthcoming tendering exercise, with details of the contractors who are providing the services;
- a full apportionment matrix, which clearly shows the basis of calculation and the total apportionment per schedule for each unit within the property/complex; and
- date of issue.

6.2.2 Residential service charges

The Residential Code requires that the service charge statement should be prepared according to the provisions of the leases.

In addition, the law (s. 21 LTA 1985) gives any leaseholder or the secretary of an RTA the right to request a summary of relevant costs incurred during the last accounting year, or, where accounts are not kept on that basis, the 12 months before the tenant's request. This should be provided within one month of the request, or within six months after the end of the accounting period, whichever is later.

Residential service charge accounts will always be prepared and copies made available to all those contributing to them within six months of the end of the financial period (wherever possible), or any tighter timescales required by the lease.

Unless the lease dictates otherwise, service charge accounts will be prepared in accordance with the joint good practice guidance on accounting for service charges[11] (ICAEW – technical release 03/11). In particular, the accounts should:

- only include expenditure reasonably recoverable as a service charge under the lease
- not include any income or expenditure directly attributable to the landlord
- be prepared on a pre-payments and accrual basis
- indicate clearly all items of expenditure and income receivable during the period
- include a balance sheet showing total funds available
- be examined by an independent accountant (the examination being either an audit or an engagement to report on specified findings, depending on the requirements of the lease); and

- be separate from (and additional to) the accounts of the company where the landlord is an RMC, RTM company or similar.

Managers should ensure that they or their client satisfies the statutory obligations imposed by section 21 of the LTA in response to any requests for details of service charge expenditure, and agree with their client how full supporting information should be made available following any further request under section 22 of the LTA.

6.2.3 Combined best practice

Combined best practice where the codes differ is, therefore:

- to produce service charge accounts to all contributing leaseholders, in accordance with the joint guidance
- wherever possible these should be provided within four months of the end of the financial year, or any tighter timescale provided for within the lease
- to provide comparison against the previous year's actual costs and the current year's budget, but to provide comparisons against the previous two years' actual costs, where appropriate; and
- to provide information on any significant variations from previous years' costs and current budget.

6.3 Independent examination

The Commercial Code requires that the statement of account is reviewed by an appropriately qualified person, independent of the owner or agent.

The Residential Code requires that, unless the leases do not allow for the recovery of the costs, the service charge accounts should be examined annually by a suitably qualified independent accountant.

Both commercial and residential leases often contain specific requirements for preparation and certification or audit of the annual statement, for example, the landlord's surveyor, managing agent or an independent accountant. Failure to follow the requirements of the lease may prejudice the landlord's rights to recover costs and, for residential leases, could lead to a successful challenge against a service charge at an LVT.

Frequently, the work required by a modern auditing framework is not what was anticipated when leases were drawn up especially where the original lease dates back many years. Where this is the situation, the manager faces a dilemma where the lease requires an 'audit' but an audit in accordance with auditing standards may exceed that which was intended. ICAEW Tech 03/11[12] has attempted to resolve this issue by recommending that such audits are undertaken in accordance with International Standard on Auditing 800 (ISA 800) *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks.*

If the terms of the lease are construed as requiring an audit, or the landlord or managing agent require an audit to be carried out, the work should be conducted in accordance with ICAEW Tech 03/11. The guidance also recommends the procedures to be undertaken in order to make a factual report on service charge accounts

The auditor's (accountant's) reasonable and proper costs and fees will, subject to the terms of the lease, be charged to the service charge account.

If a residential leaseholder demands a summary of relevant costs that are paid by the tenants (leaseholders) of more than four dwellings (s. 21LTA 1985) that summary should be certified by a registered auditor (being a person who is eligible for appointment as a statutory auditor under s.1212 of the *Companies Act* 2006), who is not an officer or employee of the landlord, agent or any associated company.

The audit requirements under section 21 are, therefore, more onerous than those recommended within ICAEW Tech 03/11. Requests under section 21 LTA 1985 should be largely unnecessary if residential landlords and agents prepare service charge accounts as a matter of course in accordance with the terms of the lease and in accordance with the good practice guidance.

Certification of the service charge accounts is intended to provide occupiers with reasonable assurance that, in the opinion of the reporting accountant, the accounts produced:

- present a fair summary of the relevant costs for the accounting year in question
- comply with the requirements of section 21(5) LTA 1985; and
- are sufficiently supported by accounts, receipts and other documents produced to the accountant.

The Commercial Code requires annual statements of service charge expenditure to be certified by the manager as complying with the criteria above. In certifying the statement, the manager is required to act in a professional manner and not in a partisan spirit, supposing the only task being to recover as much money as they can for the owner.

6.3.1 Combined best practice

- Annual statements of service charge expenditure should be produced in accordance with the joint good practice guidance detailed in ICAEW Tech 03/11.
- Annual statements of service charge expenditure should be certified by the manager to confirm that they represent a true and accurate record of the expenditure incurred by the owner in supplying the services to the building, and that the expenditure the owner is seeking to recover is in accordance with the terms of the leases.
- Annual statements of service charge expenditure should be examined by an independent accountant.
- In certifying the service charge, managers have a duty of care to both owners and occupiers, to act with professional care, diligence, integrity and objectivity.
- Should the lease require an audit to be carried out, this should be undertaken in accordance with the standard recommended within ICAEW Tech 03/11.

6.4 Standard cost classifications

The Commercial Code requires industry standard cost classifications to be used in reporting budget and actual expenditure. A copy of the classifications is included at Appendix 2.

There are **no** standard cost classifications for residential property management. Adoption of the commercial standard throughout mixed use developments will, therefore, enhance the ability for residential occupiers, landlords and agents to compare costs on a scheme-by-scheme basis.

The industry standard cost classifications provide three levels of analysis, as follows:

- cost class – an example of which is management
- cost category – examples of which (within the above cost class) are management fees, site management resources; and
- cost description – examples of which are receptionist/concierge, office costs (telephones/stationery).

The Commercial Code states:

*As a **minimum** acceptable level of reporting, service charge budgets and actual expenditure reports should be prepared at **cost class and cost category** level.*

To achieve transparency, however, the Code recommends that budget and actual expenditure analyses be provided at the detailed cost description level whenever practicable, and particularly in respect of larger properties, with a summary of the total costs under each cost category. However, for smaller properties, or those with limited service charge expenditure, the minimum level of detail that would be acceptable would be to report at cost category.

The appropriate cost class and cost categories can also be used as the basis for preparing the residential service charge budgets and

accounts. It is important, however, to have regard to the wording of the lease. The recovery of costs as a service charge requires an explicit ability to do so within the lease and it may be preferable to use terminology that more clearly reflects the terms of the lease.

There may be cost classes and cost categories that apply to the commercial units but not to the residential units, or vice versa, but as much consistency as possible will aid scheme transparency. Where cost classes or categories are not consistent across tenures, it is preferable to budget and report by way of separate schedules (see section 4.7).

6.5 Budgets and service charge demands

The Commercial Code requires occupiers to be provided with an estimate of likely service charge expenditure accompanied by appropriate explanatory commentary on it, together with a breakdown of their proportion of the costs, at least one month prior to the commencement of the service charge year. It also requires industry standard cost classifications to be used at cost class and cost category level.

The Residential Code is not specific on the one-month period. Most modern residential leases do allow for advance interim payments of service charges and the Residential Code requires a budget to be prepared, and consultation on a proposed budget, with any recognised residents association. Both codes require a standard format of the budget to allow comparison between years and notification to leaseholders of significant departures from the budget.

Combined best practice for mixed use developments is, therefore, to provide the estimate of expenditure at least one month prior to the commencement of the service charge year.

When calculating a service charge budget you should have regard to Part 8 of the Residential Code. In particular to:

- use due care and diligence to make an educated estimate of expenditure required to maintain the development and services for the forthcoming period (typically a year) and beyond
- use the best information available to try and estimate costs as accurately as possible; and
- not purposefully underestimate costs or provide leaseholders with misleading estimates of future contributions required.

Service charge demands will be accompanied by a copy of the approved budget with sufficient detail to enable leaseholders to understand the nature of the charges being levied and the rationale behind the level of estimated expenditure.

It is essential that landlords/managers can justify the reasonableness of any item of expenditure and the level of the charge. Residential leaseholders can apply to an LVT if they feel that what is proposed is not payable or reasonable. In that scenario, collection may prove difficult, and cash-flow may be compromised, until an LVT has determined the reasonableness of any charges.

The purpose of an estimated budget is to ascertain and support the level of interim service charges demanded on account and to provide a robust benchmark for monitoring service costs throughout the period (typically a year). It is appropriate, within each budget heading, to make some explained allowance for contingencies; however, a global contingency sum should only be included if this is provided for within the lease.

Managers should explain to leaseholders that an estimated budget does not necessarily reflect the exact actual service charge; it is merely a forecast upon which the interim service charge is based. The final level of service charge contributions will be based on the actual expenditure incurred, which may be more or less than anticipated; especially where unforeseen matters arise during the year.

6.5.1 Ground rent demands

Most residential leases contain obligations for ground rent to be payable ‘whether demanded or not’. However, under section166 of the *Commonhold and Leasehold Reform Act* 2002

(CLRA 2002), no ground rent is payable until demanded in the prescribed manner.

Failure to demand, or to use the prescribed format of demand, means the leaseholder has the right to withhold payment. This will preclude any actions for breach of covenant, and any terms in leases regarding interest or other charges for overdue payments have no effect until the demand has been given in the prescribed format.

Note: there are specific regulations prescribing the format and content of ground rent demands in Wales (including a requirement for a Welsh version).

6.5.2 Service charge demands

Landlord and tenant legislation also imposes prescriptive requirements on residential service charge demands. It is imperative that these are fully complied with, to ensure that service charges remain due from leaseholders.

Specific requirements are contained within sections 47 and 48 of LTA 1987 and section 21B of LTA 1985.

Under section 47, every demand for service charges from a residential leaseholder must contain the landlord's name and address. If the landlord's address is not in England or Wales, the demand must contain an address for service of notices in England or Wales.

Under section 48, no service charge is payable until the landlord has given notice of an address for service of notices in England or Wales.

Under section 21B LTA 1985, every demand for service charges from a residential leaseholder must be accompanied by a prescribed summary of the rights and obligations of leaseholders. Failure to serve the summary of the rights gives leaseholders the right to withhold payment of that service charge until the correct statement is served. This will preclude any actions for breach of covenant and any terms in leases regarding interest or other charges for overdue payments have no effect until the notice has been given in the prescribed format.

Note: there are specific regulations prescribing the format and content of the summary in Wales (including a requirement for a Welsh version).

6.6 Reasonableness/rights to challenge

The Commercial Code recommends that the manager allow occupiers a reasonable period (e.g. four months from issue), in which to raise enquiries or request further information in respect of the certified accounts. Managers are expected to deal with reasonable enquiries promptly and efficiently and make all relevant paperwork available for inspection.

The Commercial Code also suggests that an appropriate management fee may be charged for providing copies of supporting documents.

The arrangements for residential property are different and are prescribed by the legislation. Once residential leaseholders have received the annual service charge statement or summary of expenditure under section 21 LTA 1985 they, and any recognised residents' associations, have a statutory right for a period of six months, under section 22 LTA 1985, to request to inspect all invoices and other supporting documents to the annual statement.

Landlords and agents have one month to respond and a further two months to arrange the inspection.

The supporting documents should be made available for inspection free of charge and facilities should be made available to take copies. A reasonable charge can be made for photocopying.

The requirement to make facilities available free of charge does not preclude a landlord from recovering the costs of making those facilities available as management costs within the service charge accounts.

Where the section 22 request relates to a summary of costs incurred by, or on behalf of, a superior landlord, section 23 requires the immediate landlord to inform the leaseholder of the superior landlord's name and address. Section 22 then applies to the superior landlord

as it applies to the immediate landlord. This situation is common within mixed use developments where the residential element has been demised by way of a headlease.

6.7 On-account payments

It is usual within modern leases for service charges to be payable in advance by way of on-account, interim payments. The lease is paramount in determining the frequency and due date of payments. The level of interim charges should be related to an estimate of expenditure for the year, supplied to each leaseholder. As soon as possible after the end of the financial year a balancing statement should be supplied, as a bare minimum, giving due credit for all interim payments. Owners are required to perform their obligations under the terms of the lease and account to occupiers for any balancing charges due/owed at the end of the service charge period.

Some leases do not require advance payments to be made, or specify a low rate of payments that do not adequately allow for recovery of the actual costs. In this situation, the landlord may have to wait over a year to recover expenditure incurred and may have to pay financing costs. In such cases the landlord may wish to consider an application to the LVT for a variation of the lease to provide for more adequate service charge payments. This is not an automatic process and you should consider the likelihood of success and the costs carefully with your clients.

Modern leases often enable owners to recover the cost of borrowing to fund major non-cyclical expenditure, as a cost to the service charge. In older leases there is a risk to the landlord of having to fund shortfalls directly until costs can ultimately be recovered from leaseholders.

6.8 Interest on service charge accounts

The Commercial Code requires all interest earned, net of tax, and late payment interest to be credited to the service charge account.

The Residential Code also requires that any interest earned shall be a credit in the account for service charges and be used to defray service charge expenditure. The requirement is based in legislation, in that residential service charge monies are subject to the statutory trust provisions of section 42 LTA 1987. The Residential Code is not specific regarding late payment interest but good practice on mixed use developments is to follow the requirements of the Commercial Code and credit to the service charge account.

Interest should clearly be shown as income within the service charge accounts and bank charges, and other operating costs as expenditure. For the sake of transparency one should not off-set against the other.

For residential units, where the law deems there to be a trust, the landlord has no tax liability on the receipt of the funds as they are not income of the landlord. There is, however, a tax liability on any interest earned from the service charge monies held, including reserve funds. The rate is currently the base rate of 20 per cent, rather than the rate attributable to trusts. If banks are willing to deduct tax at basic rate then no further liability is due; if they are not then a trust tax return is required.

6.9 Benchmarking and cost analysis

Adoption of the standard industry cost classifications enables benchmarking to facilitate better cost comparison between properties and the benchmark indices. This should reduce costs and assist in the transfer of information between managers and owners when properties are sold, or there is a change of manager (e.g. from in-house to external or between managing agents).

However, caution is needed when using benchmark information to compare operating cost for any building, and costs should be kept under review (see 6.10).

There are currently no indices available for residential properties so caution should be exercised when managing mixed use developments. The validity of the benchmarked

information may vary on any particular development, depending upon the relative size and complexity of each tenure.

6.10 Value for money

The Commercial Code states:

In providing the services, the owner/manager should endeavour to achieve value for money and effective service rather than lowest price, at all times. 'Value for money' can be simply defined as: 'paying no more for no less than is required'.

The Commercial Code requires costs to be kept under review and that contractors and suppliers should submit competitive tenders or competing quotations where appropriate (or every three years). Where formal re-tendering is not considered cost effective or practical, managers should benchmark the service standards and pricing to confirm value for money is still being achieved.

Managers are advised to ensure that major service providers can demonstrate that their services, methods and processes are continually reviewed to ensure value and efficiency.

The Residential Code is less prescriptive and recommends that the cost effectiveness of services should be routinely monitored, aiming always to maintain services and provide value for money.

Combined best practice is to follow the requirements of the Commercial Code.

6.11 Administration charges

The law for residential leasehold has defined certain charges by a landlord to a particular leaseholder that are not service charges or ground rents, to be administration charges within Schedule 11 to the CLRA 2002. In general terms, they are amounts payable by a leaseholder for, or in connection with:

- approvals or applications for approvals
- the provision of information or documents by, or on behalf of, the landlord
- failure to make a payment by the due date; and
- a breach (or alleged breach) of a covenant or condition in the lease.

You should only seek to recover administration charges that are provided for within the lease, or by statute, and only to the extent that they are reasonable.

Every demand for payment of an administration charge by a landlord should be accompanied by a prescribed summary of the rights and obligations of leaseholders regarding such charges. Failure to serve the prescribed statement means that leaseholders have the right to withhold payment of the charge until the correct statement is served with a demand.

The Commercial Code states that such costs, which are matters between the owner and an individual occupier, should not be part of the service charge. This will, in most instances, be the same in residential leases.

Landlord and tenant law adds greater protection for residential leaseholders against such administration charges in that they may challenge them at an LVT as to their payability and reasonableness.

It is common practice in commercial matters for the costs of administering site staff to be added to the costs of employment of those staff, and these should be clearly shown in the budget and on the accounts certificate. This charge or fee is often described as an 'admin fee'. Similarly, some residential managing agents have referred to their management fees as 'admin fees'. Such 'admin fees' fall within the category of 'management fees' and are not the same as administration charges.

For the sake of clarity, it is recommended that the term 'administration fee' is avoided wherever possible.

6.12 VAT

This is a difficult area and it is recommended that specialist advice is taken where appropriate. The general position is outlined below, but there can be variations in specific circumstances.

There are potentially significant differences in the way that VAT is treated under commercial leases and residential leases. These can create practical difficulties and additional management and accountancy costs within mixed use developments where costs are recoverable from both types of leaseholder/occupier.

Commercial

Supplies of land and buildings, such as freehold sales, leasing or renting, are exempt from VAT. Therefore rents received by landlords that include service charges are not generally subject to VAT. No VAT is added on to the sum demanded for rent, etc. and no input VAT is recoverable on expenditure either by the landlord or the tenant.

Following changes introduced under the *Finance Act* 1989, landlords who are registered for VAT can make a 'once-and-for-all' election to waive the exemption on commercial rents and service charges (also known as an option to tax). The effect of such an election is to make the rents and service charges liable to VAT at the standard rate. Once an option to tax is made, the landlord can then recover the VAT incurred in the provision of the services and maintenance of the building, and will charge VAT at the standard rate on both the rent and service charge.

Residential

There is no option to tax available to landlords of residential premises.

Service charges relating to the upkeep of common areas of a building of residential flats are exempt from VAT, so long as they are required to be paid under the terms of the lease. The service charge is treated as an ancillary to the main supply of exempt domestic accommodation, so VAT is not chargeable on the total sum of the service charge.

The landlord will, however, incur VAT on services procured for the benefit of the development. No input VAT is recoverable by the landlord. The gross expenditure incurred, including the VAT, is recoverable from leaseholders as service charge. Even if the leaseholder is registered for VAT, he cannot recover those costs as input VAT, as he was not the direct recipient of the supply.

Mixed use

Wherever possible, it is recommended that the costs to each type of occupancy (subject to the appropriate VAT treatment) are separately identifiable and apportioned by way of separate schedules.

This different treatment causes additional administration difficulties for landlords of mixed use developments, where both types of occupiers contribute to shared costs within the same service charge schedule, especially when the landlord has taken up the 'option to tax' on commercial rents and service charges.

Where one set of services is obtained in respect of the commercial part of the building, and another in respect of the residential building, the VAT treatment in respect of each is as set out in the previous commercial and residential paragraphs.

Where a single set of maintenance services is obtained in respect of the whole building, the landlord will need to make an apportionment of that cost between the residential element and the commercial element, and will have restricted VAT recovery based on his partial exemption method.

The standard partial exemption method provides for the landlord to recover VAT based on the proportion of the taxable supplies to total supplies (taxable plus exempt). There are many 'special' partial exemption methods that can be negotiated between the taxable party and HMRC. These are outside the scope of this guidance and specialist advice should be sought where necessary.

Utility costs can pose specific VAT issues as residential and commercial supplies are often subject to differing rates of VAT. These issues are addressed in section 4.7.1.

7 Dispute resolution

7.1 Complaint handling

It is not always straightforward to differentiate between a complaint against a manager/agent and landlord/leaseholder disputes. Managers should have a formal written complaints handling procedure in place to deal with complaints against their direct actions and/or behaviour of staff. The procedure should be made available to clients and leaseholders, include a series of steps and response times for its various stages and include provision for leaseholders to complain to the landlord.

All estate agents (via statute) and corporate members of certain professional bodies, including: RICS, ARMA, NAEA and ARLA, are required to belong to an Office of Fair Trading (OFT) approved redress scheme, e.g. ombudsman. Membership of an independent redress scheme is good practice and should be considered by all property managers. Details of membership of any scheme should be made available to the client and all customers.

There are times when managers and occupiers disagree as to which services are chargeable, what benefit the occupiers individually or collectively receive; the quality of the services and/or how much they cost. Traditionally, commercial leases have not provided contractually for any form of redress for the occupiers and therefore expensive court action has been necessary to query the service charge.

The Commercial Code recommends the use of mediation and alternative dispute resolution (ADR), even where the lease does not specify it.

The Residential Code requires that all agents have an in-house procedure for handling complaints by leaseholders. Best practice is also to consider mediation and ADR for these types of disputes, where appropriate.

Residential leases may contain a disputes procedure such as arbitration. Formal arrangements may involve extra costs and, following the introduction of the CLRA 2002, such clauses are likely to be void, with arbitration agreement now required post dispute.

It is recommended to try to resolve the dispute by informal means and best practice is to consider mediation or ADR by agreement, rather than litigation, as a means of settling particular disputes, and advise the leaseholder to seek legal advice on any such suggestion.

Unresolved disputes concerning level, quality and/or cost of services recovered as service charges for residential leases are likely to form the basis of an application to an LVT under section 27A, LTA 85. Any notification of dissatisfaction from leaseholders or occupiers should, therefore, be responded to in a timely manner, and by ensuring that services and monitoring procedures are adequate and represent value for money.

Any genuine service delivery issues should be addressed without delay and clients, leaseholders and occupiers should be kept informed of the actions that have been taken to rectify those issues and improve the service.

7.2 ADR as best practice

The Commercial Code contains comprehensive advice on ADR at section 5, including:

It will usually be of benefit to both owners and occupiers to resolve service charge disputes quickly, as going to court can be slow and expensive. Many occupiers can become dissatisfied and, believing that disputing a service charge in the courts is not cost effective, withhold payment instead. Occupiers should not arbitrarily withhold payment of sums properly demanded, although where

circumstances dictate any payment withheld should relate to the actual sums queried or in dispute and not the whole of the service charge due.

Since April 1998 the courts have encouraged parties to use ADR rather than go to trial. From April 2006, the courts have been obliged to take into account whether the parties have given proper consideration to the use of Alternative Dispute Resolution (ADR), and used it to resolve their dispute if appropriate. The attitude of the courts is that litigation should be a last resort. The courts can require parties to provide evidence that alternative means of resolving their dispute were properly considered. A party can be penalised in costs for failing to give proper consideration to the use of ADR even if it wins at trial. Therefore it is strongly recommended that in disputes about service charges ADR should be considered before taking legal action.

There are issues as to which form of ADR is most appropriate to service charges. The options are varied and include:

- *early neutral evaluation*
- *mediation (facilitative or evaluative)*
- *independent expert determination; or*
- *arbitration.*

These alternatives are explored in some detail within section 5 of the Commercial Code.

All of these options are also relevant to residential leasehold and represent best practice for mixed use developments. If ADR cannot be agreed between the parties, or mediation has not been successful, an application to an LVT (by either party) remains an option. The LVT has no jurisdiction to determine matters that have been agreed to be the subject of arbitration or have already been determined at arbitration. Such agreements to enter into arbitration are required to be reached after a particular dispute has arisen and automatic arbitration clauses within leases are null and void.

8 Anticipated future expenditure

The provision for future anticipated expenditure is one area where the obligations of commercial and residential leaseholders are likely to differ. The nature and length of commercial leases has changed substantially over recent years, with the average length now being less than five years. Many items managed under the service charge will have a life expectancy longer than the commercial lease term being granted. In contrast, residential leases are typically for terms as long as 99, 125 or even 999 years.

A well drafted residential lease will provide for the landlord to keep the building and all installations in good and substantial repair throughout the lifetime of the lease, and provide for the recovery of all the costs incurred as service charges.

The obligations within commercial leases may vary depending upon the length of term and the condition of the building at the commencement of the lease. The landlord may be responsible for some of the major costs of maintaining the building and installations, or negotiate lease terms, concessions and incentives at each lease renewal/re-letting.

8.1 Methods of financial provision

Sinking funds, reserve funds and depreciation charges are all ways of making financial provision for future repairs or replacements. It is common within residential leases for the landlord to have a right to collect service charges towards sinking funds or reserve funds, but depreciation charges are extremely rare in residential leases.

Some confusion has arisen as the description and purpose of such funds have become interchangeable. The following definitions set out industry guidance on how these terms should be used:

A **sinking fund** (also known as a replacement fund) allows the owner to build up a fund to pay for repair and replacement of major items of plant and equipment.

A **reserve fund** is a fund intended to equalise expenditure in respect of regularly recurring service items to avoid fluctuations in the amount of service charge payable each year.

A **depreciation charge** enables the owner to include an amount in the service charge to reflect the 'cost' of the annual depreciation of plant and equipment and is based on the initial cost of an installation, rather than the future cost of replacement or repair.

Managers should have regard to the particular wording of individual leases. The terms have become somewhat interchangeable and drafting may alter the meanings from the general definitions above. This is particularly the case with residential leases where the terms are not only interchangeable but the specific words 'reserve' or 'sinking fund' may often not be used at all.

Care should be taken when drafting new leases to ensure the correct terms are used throughout. This applies to both commercial and residential leases, all of which should be fully consistent with the definitions above.

Like any other service charge obligation there must be, on ordinary principles, clear terms within the lease to provide for the landlord to collect service charges towards a reserve fund or sinking fund.

There are statutory, contractual and practical differences to managing sinking funds or reserve funds within the residential and commercial sectors. These can affect the treatment of interest, tax and the ownership of

funds on the termination of a lease. Within a mixed use environment, therefore, it is usually essential to treat each of these occupancy types separately, with distinct funds for each sector. There may, however, be a requirement for a common fund where estate costs are shared across all tenures.

Residential leases commonly provide for reserve funds or sinking funds. The Residential Code supports, as best practice, the establishment of reserve funds where the lease permits. If the lease says the landlord 'must' set up a fund then this must be done. It is just as wrong not to have a fund when the lease requires one as to try to collect one when the lease does not permit it.

The intention of both sinking funds and a reserve fund is to spread the costs of 'use and occupation' as evenly as possible throughout the life of the lease so as not to penalise leaseholders who happen to be in occupation at one particular moment in time. Sinking funds and reserve funds can benefit both the landlord and leaseholders alike, by ensuring monies are available when required for major works, cyclical works or replacing expensive plant.

Section 42(3) LTA 87 requires all service charges to be held:

(a) *on trust to defray costs incurred in connection with the matters for which the relevant service charges were payable…; and*

(b) *…on trust for the persons who are the contributing tenants for the time being.*

Sinking funds and reserve fund collections are service charges held in accordance with the above requirements. Hence it is clear that such funds can only be used for the purposes for which they have been collected and that they do not belong to the landlord but are held on trust for the contributing tenants.

The residential code requires them to be in an interest bearing-account with any interest accruing to the account. They need not be in a separate account to the one used for other service charge monies, although this is preferable and, in any event, the funds should be separately accountable.

On assignment, the incoming tenant becomes the beneficiary 'for the time being' and there are no refunds due to the outgoing tenant. It is not common for residential leases to be terminated but when they are, any sums remain in trust for the benefit of the remaining contributing tenants by virtue of section 42(6) LTA 87 which provides that:

On the termination of the lease of a contributing tenant the tenant shall not be entitled to any part of any trust fund, and … any part of any such fund which is attributable to relevant service charges paid under the lease shall accordingly continue to be held on the trusts referred to in subsection (3).

Ultimately, if there are no remaining contributing tenants the funds transfer to the landlord (s. 42(6) LTA 87).

This situation is in contrast to the treatment of any commercial sinking funds or reserve funds at termination.

Commercial

The short term nature of many commercial leases can create difficulties with regard to long term maintenance as tenants only have a 'transitory' interest in the life of the structure or expensive plant. The landlord may, therefore, retain some of these obligations and negotiate rent and lease renewal terms accordingly. In multi-let buildings, however, the tenants are often responsible for buildings repair and replacement and consideration should be given to the use of sinking funds or reserve funds.

The RICS information paper: *Sinking funds, reserve funds and depreciation charges* (2009), contains detailed advice on setting up and managing sinking funds, reserve funds or levying depreciation charges. This information paper also gives detailed advice on the treatment of any remaining funds when tenancies are terminated. In essence, however, sinking funds and reserve funds are to be regarded as tenants' monies and if the fund has not been expended upon expiry of a lease then the tenant is often entitled to repayment of the monies it has contributed to the fund unless the contrary has been agreed in writing at the outset. When the fund has served its

purpose, the balance also belongs to the tenants, which could include previous tenants.

This is in contrast to the situation with residential leases where the funds will remain invested in trust until expended.

Depreciation charges, on the other hand, belong to the landlord and once the tenant has made his payment he will have no further claim to it. It is therefore essential that both parties fully understand how the landlord has calculated the charge, to what it relates and that in paying the cost of depreciation the tenant would have no responsibility for any further costs when the item to which the charge relates is eventually replaced.

Even though the monies are named 'sinking fund' or 'reserve fund' they remain part of the service charge and all payments made out of the fund should therefore be clearly communicated to tenants and included as part of the annual reconciliation of the service charge.

The Commercial Code requires that reserve or sinking funds are held in an interest-bearing account and 'in trust'.

Further detailed information and guidance is available in the aforementioned RICS information paper: *Sinking funds, reserve funds and depreciation charges*[13].

8.2 Planned preventative maintenance

It is considered good practice to maintain sinking funds or reserve funds where the leases permit. When managing properties with no, or inadequate, sinking funds or reserve funds (and the lease permits), managers should recommend future adequate provision to their clients.

The level of contributions should be assessed by reference to the age and condition of the building and likely future cost estimates. On more complicated developments, contributions should be assessed by reference to a comprehensive stock condition survey and life-cycle costing exercise, undertaken by qualified professionals. On simpler schemes, the assessment may be more general, having regard to the age and condition of the building and the expected lifespan of essential items.

The level of contributions should be reviewed annually as part of the budget process, and the underlying survey information should be reviewed at appropriate intervals, which will vary for each scheme depending upon complexity, age, condition and the relative size of funds held.

Clients should be encouraged to draw up a costed, long-term maintenance plan that reflects the stock condition information and the projected income streams. This should be made available to all leaseholders and to any potential purchasers upon resale. Where there is no provision in the lease for sinking funds or reserve funds, or the current provisions are likely to prove inadequate, clients and leaseholders should be made aware and encouraged to make their own long-term saving provisions towards the estimated expenditure.

The Upper Tribunal have held[14] that landlords and managers should take into account the financial impact on lessees when planning and undertaking major works. Large fluctuations in service charges from earlier years should be avoided by the use of sinking funds and reserve funds and the spreading of costs is a factor to be taken into account when deciding reasonableness.

Combined best practice

- All sinking funds or reserve funds to be held on trust in interest bearing accounts.
- Landlords and managers should act reasonably in estimating the level of the contributions due, which should be assessed by reference to the age and condition of the building and likely future cost estimates.
- You should provide all contributors with a clear explanation of the basis of calculating the level of contributions and the expected life and purpose of any funds.
- The level of contributions should be reviewed annually as part of the budget process, and the underlying survey information should be reviewed at appropriate intervals.

- The annual budget and reconciliation accounts will clearly state contributions to and expenditure from the sinking fund or reserve account(s) together with the account(s) opening and closing balances and the amount of interest earned and tax paid in the relevant period.
- Costed, long-term maintenance plans should be made available to all contributing leaseholders and to any potential purchasers upon resale.
- The landlord/owner should make all due payments into the sinking fund or reserve fund account for void premises.
- Managers should recognise that it may be necessary to treat each occupancy type separately and manage distinct funds for each sector where that is possible.

8.3 Initial provision, replacement and improvement

The Commercial Code contains detailed advice, at section 8, on the service charge implications of initial provision, replacement, improvement, enhancement and refurbishment.

It includes the following general principles:

The service charge would usually be limited to the recovery of the reasonable costs of maintenance, repair and replacement (usually where beyond economic repair) of the fabric, plant, equipment and materials necessary for the property's operation.

Service charge costs will not include:

- *any initial costs (including the cost of leasing of equipment) incurred in relation to the original design and construction of the fabric, plant or equipment*
- *any setting up costs that are reasonably to be considered part of the original development cost of the property*
- *improvement costs above the costs of normal maintenance, repair or replacement (but see below)*
- *future redevelopment costs.*

Service charge costs may include improvements or enhancement of the fabric, plant or equipment where such expenditure can be justified following the analysis of reasonable options and alternatives and having regard to a cost benefit analysis over the term of the occupiers' leases. Managers should provide the facts and figures to support and justify such a proposal

Whether the cost of improvement works or rectifying defects can be recovered from residential leaseholders will depend entirely upon the wording of the relevant leases. In addition, the statutory consultation provisions (detailed in section 5.5) apply to any improvement or defects works in exactly the same way as they apply to repairs, replacements or renewals.

With mixed use developments there may be conflicts between the views of the investor landlord, the long-term residential leaseholders and the short-term commercial occupiers. For example, there may be occasions when the investor landlord would like to undertake improvements, or enhancements for commercial reasons, i.e. to maximise the rental return. Landlords and managers need to be aware that if residential leaseholders are contributing towards any of the costs (either from reserve funds or current contributions) then they are required to be reasonably incurred, consulted upon if necessary, and can be challenged at LVT. There may, therefore, be occasions when an investor landlord may decide to fund improvement works to gain a wider commercial benefit.

There is considerable case law relating to what works are repairs, renewals or improvements. The Commercial Code gives some detailed advice on this subject, in section 8, but specific legal advice should be sought where necessary.

8.4 Length of the lease

One issue which impacts more upon commercial leases, due to the relatively shorter length of leases granted compared with residential, is that in certain circumstances the courts have determined that the length of the

original or unexpired terms of the tenants lease may be a factor in deciding if costs are recoverable[15].

In the case of major works, a landlord may only be entitled to recover the costs of complying with its repairing obligations over the period of the lease and the landlord cannot overlook the relatively limited interest of the paying tenant.

However, this does not mean that tenants cannot be required to pay increased service charges towards the end of the term and if it is necessary to carry out works in order to comply with the landlords covenants, the cost are likely (subject always to the terms of the lease) to be recoverable even if the lease is about to end.

9 Health and safety

The courts have clarified that the common parts of even purely residential blocks or estates are places of work and hence managers should be aware that they and their client have ongoing responsibilities under the *Health and Safety at Work Act* and related regulations. These include:

- *Reporting of Injuries, Diseases and Dangerous Occurrences Regulations* 1995
- *Management of Health and Safety at Work Regulations* 1999
- *Workplace (Health, Safety and Welfare) Regulations* 1992
- *The Control of Substances Hazardous to Health Regulations* 2002
- *Manual Handling*
- *Health and Safety (Display Screen Equipment) Regulations* 1992
- *Control of Asbestos Regulations* 2012
- *Regulatory Reform (Fire Safety) Order* 2005 – see section 8.10.1
- *The control of legionella bacteria in water systems*
- *Health and Safety (Working at Height) Regulations* 2005
- *Health and Safety (Safety Signs and Signals) Regulations* 1996
- *Lifting Operations and Lifting Equipment Regulations* 1988
- *Personal Protective Equipment at Work Regulations* 2002
- *Construction (Design & Management) Regulations* 2007

More detailed guidance is available from the Health and Safety Executive (HSE).

9.1 H&S risk assessments

The *Management of Health and Safety at Work Regulations* 1999 require employers to assess and manage health and safety risks.

Risk management involves identifying and controlling, by sensible health and safety measures, any potentially significant risk of accident or ill health to managers, staff under their supervision, contractors, leaseholders, members of the public and visitors.

Managers should ensure that periodic reviews of risk assessments are carried out by competent persons at every scheme with common parts. The frequency of formal review should form part of the risk assessment process, but this should normally be at least annually and whenever there are any significant changes to the scheme. The extent of any review should be proportional to the risks identified and the complexity of the installations at each scheme.

The HSE publish detailed guidance on managing health and safety and have the following view on managing risk:

We believe that risk management should be about practical steps to protect people from real harm and suffering – not bureaucratic back covering. If you believe some of the stories you hear, health and safety is all about stopping any activity that might possibly lead to harm. This is not our vision of sensible health and safety – we want to save lives, not stop them. Our approach is to seek a balance between the unachievable aim of absolute safety and the kind of poor management of risk that damages lives and the economy.

Ref: Principles of sensible risk management: www.hse.gov.uk/risk/principles.htm

The HSE have also produced an example risk assessment for the common parts of a block of flats, which is available online at: www.hse.gov.uk/risk/casestudies/pdf/flats.pdf

It is recommended that managers are familiar with this guidance and other advice published by the HSE.

Although a property manager is likely to be deemed to be a 'responsible person' risk assessments should be undertaken by a 'competent person'. This may be the property manager or other suitably qualified and experienced person(s). If specialist consultants are employed, they should be registered on the Occupational Safety and Health Consultants Register (OSHCR). This was launched in January 2011 and can be accessed online at: www.oshcr.org/

Copies of the risk assessment should be made available to anybody attending, or working, on site. It is also recommended that occupiers be made aware of any issues that may impact on their safety, and copies of the risk assessment should be provided on request.

It is advisable for occupiers to be involved in the risk assessment process and to be given opportunities to raise issues and inform the process. The risk assessment should be regarded as a 'live' document and kept under continual review. Any variations or newly identified risks need to be assessed and appropriate controls put in place without delay.

9.2 Regulatory Reform (Fire Safety) Order 2005

The *Regulatory Reform (Fire Safety) Order* 2005 came into force in October 2006 and replaced over 70 pieces of fire legislation. It applies to all non-domestic premises in England and Wales, including the common parts of blocks of flats and houses in multiple occupation (HMOs).

Under the Fire Safety Order, the responsible person is required to ensure that a fire safety risk assessment has been undertaken by a competent person and to implement and maintain a fire management plan. This may be included within the generic risk assessment or undertaken separately by a fire safety specialist.

Guidance is available from:

- The Local Government Association has published (draft) guidance on fire safety for purpose built blocks of flats – www.lga.gov.uk/lga/tio/18055650
- CLG Guide to fire risk assessment: offices and shops – www.communities.gov.uk/documents/fire/pdf/151543.pdf
- Local Government Regulation (formerly LACORS) – www.lacors.gov.uk/lacors/upload/19175.pdf

The recommendations should be regarded as minimum requirements for mixed use developments, which will often have greater requirements than a purpose built, purely residential development. Managers should be familiar with this guidance and wider guidance from the HSE on fire risk assessments and management plans and should ensure that assessments have been undertaken and an up-to-date fire management plan has been implemented for every scheme.

Any works required to fulfil the action plan should be planned with the client without delay. Managers should have regard to the leases to ascertain if costs are recoverable as a service charge. Where service charge monies are insufficient to meet any expenditure required, managers should consult with their client regarding longer term planning or arranging other funding options. Health and safety should not be compromised due to lack of funds, and further advice should be taken if necessary.

The fire action plan should include details of what to do in the event of a fire. All leaseholders, and other occupiers, should be made aware of the details of this action plan and, in particular, whether to evacuate or stay put within their individual properties. They may be made aware by signage and/or special information leaflets.

It is essential that escape routes, and the means provided to ensure they are used safely, are managed and maintained to ensure that they remain usable and available and corridors

and stairways should be kept clear and hazard free at all times. Items that may be a source of fuel or pose an ignition risk should not normally be located on any corridor or stairway that will be used as an escape route. You should monitor compliance and if necessary arrange for items to be removed and action taken against leaseholders breaching the terms of their lease.

Regular testing and servicing arrangements should be in place for any fire fighting and detection equipment. These requirements are likely to be more onerous and/or frequent for mixed use developments than for purely residential developments. Managers should ensure that costs are only recovered in accordance with the lease terms, which may differ for different categories of users. All leaseholders and occupiers should be notified clearly of the obligations and cost implications, together with justification as to the level of provision and recovery of costs.

9.3 Control of asbestos

The duty to manage asbestos is contained in Regulation 4 of the *Control of Asbestos Regulations* 2012. It is not always clear who has 'the duty' but it is, generally speaking, the person or persons who have responsibility for maintenance and repair or who is/are in control of the building. In the common parts of residential properties this is likely to encompass both the landlord and the managing agent (jointly and severally).

The regulation requires the 'dutyholder' to:

- take reasonable steps to find out if there are, or are likely to be, materials containing asbestos in non-domestic premises (including the common parts of blocks of flats) and if so, its amount, where it is and what condition it is in
- make and keep up to date, a record of the location and condition of the asbestos containing materials, or materials which are presumed to contain asbestos
- assess the risk of anyone being exposed to fibres from the materials identified
- prepare a plan that sets out in detail how the risks from these materials will be managed
- take the necessary steps to put the plan into action
- periodically review and monitor the plan and the arrangements to act on it so that the plan remains relevant and up to date; and
- provide information on the location and condition of the materials to anyone who is liable to work on or disturb them.

There is also a requirement on anyone to co-operate as far as is necessary to allow the dutyholder to comply with the above requirements.

Managers should, therefore, ensure that they either:

- possess a certificate from the developer confirming that there are no asbestos containing materials within the scheme; or
- have procured a survey of the property to confirm whether or not there are any asbestos-containing materials present.

If any asbestos-containing materials are present, or likely to be present, they should ensure there is an up-to-date management plan in place and details are provided to any contractor before they commence work on the scheme. The management plan should be reviewed at the frequency recommended in the plan or whenever there are any material changes.

9.4 HMO regulations

Compulsory licensing of certain HMOs is mandatory under the *Housing Act* 2004. Certain local authorities have also obtained government consent to apply additional licensing requirements and managers should be aware if they are managing property that may be affected by any of these schemes.

The definition of a HMO and further definitions of those requiring licensing is rather complicated and the purpose of this guidance is purely to raise awareness that mixed use developments may be caught by some of the

requirements; especially in older conversions, which do not meet the standard 1991 Building Regulations

'House in multiple occupation' means a building or part of a building (e.g. a flat):

1 that is occupied by more than one household, within which more than one household shares an amenity (or the building lacks an amenity) such as a bathroom, toilet or cooking facilities, for example, a flat with three students sharing;
2 that is occupied by more than one household and is a converted building that does not entirely comprise self-contained flats (whether or not there is also a sharing or lack of amenities), for example, a mixed tenure converted block, part of which is now sold leasehold and the rest are bedsits sharing a bathroom; or
3 that comprises entirely of converted self-contained flats and the standard of conversion does not meet, at a minimum, that required by the 1991 Building Regulations, and more than one third of the flats are occupied under short tenancies.

Mandatory licensing only applies to some HMOs. The threshold for mandatory licensing is any HMO, as defined in the three categories above, comprising three or more storeys, occupied by five or more persons and comprising at least two households.

Individual flats may fall within the definition of a HMO (but not require licensing) but a building or part of a building comprising only self-contained flats is unlikely to fall within the definition of a HMO unless it falls within definition 3) above, i.e. a converted building that does not meet the requirements of the 1991 Building Regulations. Further guidance on these definitions and the licensing requirements is available from Local Government Regulation (formerly LACORS).

9.5 Building managers

It is common for more upmarket residential developments to include some on-site staffing; especially concierge services or porters. It is also common for landlords or managers of commercial developments to employ on-site building managers or to outsource services to specialist facilities management contractors. Modern large scale developments typically require significant facilities management or engineering expertise.

Within commercial property management, it is common for significant management functions to be undertaken by building managers or facilities management contractors. This can also be the case within residential developments employing building managers or scheme managers. LVTs have been critical of residential leaseholders being charged for 'dual management' and disallowed some costs as not being reasonably incurred.

The duties of any on-site staff or contractors should be well defined and in accordance with the landlord's obligations and abilities to recover costs from each user group, under the leases. These should contrast and dovetail with the management duties undertaken by the landlord and/or managing agent, who should be prepared to demonstrate that all costs have been reasonably incurred and the services provided deliver value for money. The level of services provided and costs recoverable may differ for residential and commercial occupiers.

The on-site building management, health, safety and facilities management requirements are likely to be more extensive for a large modern mixed use development than for a typical residential development, therefore lease terms should be well drafted; clearly defining the rights and obligations of each user group. Fully informative sales packs can play an important role in detailing the levels of service provision and cost implications to reduce the possibility of future disputes.

Managers should be aware of the role of the LVT with regard to ensuring that costs have been 'reasonably incurred'. It is not, in itself, unreasonable for residential leaseholders to have to contribute to higher service charges required for a mixed use development, provided these obligations are clearly provided for within the leases.

9.6 Public areas/access, etc.

Mixed use developments need to encompass a variety of the rights and obligations of each user group. This can easily lead to conflict, especially when retail users, for instance, require unobstructed public access and residential occupants desire privacy and quiet enjoyment of their properties.

Minimising these difficulties is largely dependent upon the nature of the design, planning and construction phases of the development; issues which are outside the scope of this guidance note. Managers will, however, often have to juggle the requirements and expectations of the various user groups.

Car parking can be a very contentious issue and accommodating residential parking requirements, public access and commercial deliveries can be a particular problem. If possible, clearly segregated and marked up parking areas should be identified and an appropriate monitoring scheme introduced to prevent abuse and misuse.

Technical solutions may enable shared usage at different times, e.g. monitoring vehicle access to the site and allowing residential tenants to park vehicles overnight where commercial tenants only require parking during office hours. Registration number recognition software may be suitable to monitor these types of arrangements.

Leases should be structured appropriately, clearly specifying the rights and obligations of each user group. Where possible, it is preferable to have as much separation as possible between the commercial and residential areas.

10 Environmental sustainability

Environmental sustainability is becoming increasingly important for those involved in the design, planning, construction and management of the built environment. Since May 2008 all new residential properties need to be assessed and rated against the *Code for Sustainable Homes* (CSH, 2006). Pressure to achieve high-level accreditation and the push towards zero-carbon development have led to increased recycling and innovative waste management arrangements, as well as renewed popularity for district heating schemes, local power generation and combined heat and power (CHP) systems.

The Green Property Alliance, of which RICS is a part, has released a report *Establishing the Ground Rules for Property* (2010), which gives investors and tenants a set of industry-agreed measures that can be used to assess and compare energy use (and its associated greenhouse gas emissions), water use and waste generation in commercial buildings.

The report is a call for clarity, intended to encourage all parties to use a common language of measurement and reporting its importance in driving greater sustainability for commercial and non-domestic buildings.

All businesses have a legal responsibility for the impact they impose on the environment. Comprehensive guidance on these requirements is available on the environment and efficiency section of the Business Link website (www.businesslink.gov.uk). It also provides advice on the development of an environmental management system (EMS) to help review, manage and reduce the impact on the environment.

10.1 Combined heat and power

CHP is the process of capturing and utilising the heat produced by generating electricity. CHP for on-site generation will therefore involve some type of district heating scheme with electricity sold to a private network of users in, for example, a block of flats or a large mixed use development. As CHP involves high capital costs, some developers are looking at complex leasing deals to finance the initial costs.

In addition, CHP equipment requires specialist maintenance contracts and complex metering and billing systems, and such contracts and supply charges to leaseholders for these systems do not fit easily with section 20 consultation requirements. Long-term contracts with suppliers or maintenance contractors may potentially fall within the definition of qualifying long-term agreements, whilst equipment renewal or future capital investment may potentially fall within the definition of qualifying works. Satisfying section 20 consultation requirements may involve a further complication where there is only one realistic potential supplier of goods or services.

The definition of qualifying long-term agreements excludes contracts entered into for five years or less at a point when there are no leaseholders or tenants (paying variable service charges) in the building. This offers one possible opportunity for developers, but the question this poses is whether five-year contracts are likely to be sufficiently attractive to suppliers, or provide the necessary long-term security of funding required for major infrastructure investments.

There are also potential complications around the recovery of the costs for heat and power from the various parties. Wherever possible, recovery should be based on actual metered costs of consumption, but further complications can arise (which are discussed later in this section). Careful thought should be given to contractual arrangements, for example:

- via arm's length contract
- through joint venture; or
- totally outsourced.

and whether costs are recovered, for example:

- as service charges
- by direct billing; or
- under separate contract.

Residential leaseholders also have the right to challenge the reasonableness of costs recovered as service charges. There are pros and cons to each arrangement which are outside the scope of this guidance note, the purpose of which is purely to raise awareness of the issues and potential complications.

An energy service company (ESCO) may undertake all or part of the service provision for the supply of energy. An ESCO is typically a commercial business providing a broad range of comprehensive energy solutions, which can include:

- design and implementation of energy savings projects
- energy conservation
- energy infrastructure outsourcing
- power generation
- energy supply; and
- risk management.

An ESCO will generally seek a long-term agreement and, as part of the contract, may make a contribution to the capital cost of the energy network and/or give a return to the developer/landlord over the life of the contract. To manage the risk of entering a long-term agreement for supply, the ESCO will normally want to be involved at the design stage of a new development. The underlying advantage of an ESCO contract is that the provision of energy services represents the core business activities of the ESCO, thus inspiring confidence in its technical expertise.

There are a number of business models available to the landlord/developer which include a greater or lesser degree of outsourced or joint venture provision. Again, the ease (or otherwise) of compliance with section 20 consultation requirements, and the recoverability of costs, are likely to be key determinants in deciding which approach is best for any particular development.

10.2 Environmental issues

The UK government has set targets for increasing recycling and reducing the amount of waste that goes to landfill by 50 per cent by 2020. Local authorities are required to produce strategies to reduce waste and increase the recycling and composting of household waste. They are also charged for each ton of waste that goes to landfill and are therefore putting pressure on developers to find ways to increase recycling.

The CSH requires new residential developments to provide space for both non-recyclable and recyclable waste either internally to dwellings, or by a combination of internal and communal storage. In addition, extra credits are available to encourage developers to provide for either on-site or communal composting schemes.

Local authorities are aware that introducing recycling schemes into existing blocks of flats is more difficult than for streets of houses, but they do wish to co-operate with landlords and agents to find solutions that work. A number of projects have been tried, with differing levels of success, and the need to consult and communicate effectively with residents before implementing a scheme has been the key factor. Agents can encourage greater recycling for schemes that they manage, but should first discuss this with the local authority.

Both residential and commercial occupiers pay towards waste disposal services through their council tax and business rates, respectively. The design and management of systems should involve close working with the local

authority to minimise any duplication of charging and ensure value for money.

Technical solutions to waste management are constantly developing and being employed. In 2008 the Envac system was installed at Wembley City, a residential and entertainment development that has been constructed around London's Wembley Stadium. The 85-acre development includes 4,200 homes, as well as retail and entertainment facilities.

The Envac system operating at Wembley City features underground organics and recycling collection pipes, and has three above-ground, colour-coded chutes for collecting recyclables, organics and trash. The valves in the chutes open twice per day, pulling collected material into vacuum tubes and transporting at 70 km/hr to a central collection station for processing.

This system, which is used in 30 other countries, is expected to stimulate high levels of recycling whilst also reducing collection vehicle mileage by up to 90 per cent. This elimination of collection vehicles is anticipated to reduce the Wembley City development's CO2 emissions by 400 metric tons/year. However, there are significant on-going management and cost recovery implications for such large-scale solutions.

10.3 Existing buildings/Green Deal

In addition to the pressure being placed on new developments, existing properties (both residential and commercial) are being encouraged to become more environmentally sustainable.

The Commercial Code contains guidance at section 9, including:

Owners and occupiers should be aware of the environmental impact of their respective operations and this Code supports and promotes a cooperative and collaborative approach in recognising and managing the environmental impact of the occupation and management of commercial premises.

Leases are binding documents that are not easy to amend. There may be value in owners and occupiers entering into a non-legally binding 'memorandum of understanding', (MoU), which provides a roadmap for co-operation between the parties on improving the environmental performance of buildings. This allows the MoU to be updated to reflect the latest business practice as agreed.

There should be a fair and reasonable approach to:

- *the apportionment of sustainability costs between owners and occupiers, although with the emphasis on the ethos that the 'polluter should pay'*
- *the carrying out of works that improve the environmental performance of the building; and*
- *restrictions on works by either party which adversely affect the environmental performance of the building.*

In accordance with the principles set out in this Code, improved sustainability and other environmental improvement measures should be a factor taken into account when considering and assessing whether any particular service or provider offers value for money and in any cost-benefit analysis carried out to justify improvement costs above the costs of normal maintenance, repair or replacement (i.e. the installation of energy efficient plant).

This guidance and the principles are also relevant within mixed use developments however residential leases are likely to be even less flexible. Fair and reasonable apportionments across occupier classes are especially important.

At the date of publication, the government is consulting on the details of the Green Deal but it is currently uncertain how this will work within blocks of flats or mixed use developments. There are a number of issues to address, including lease terms, landlord consent, recovery of landlord costs, consultation requirements and how the scheme will apply where the landlord has one communal meter. Further information on the Green Deal can be found at www.greendealforhomes.co.uk

11 Other residential legal rights

Time is of the essence in issuing counter-notices for lease extensions, enfranchisement and right to manage. Appropriate procedures should be in place to forward any notices received to the client, in a timely manner.

11.1 Right to manage

(Part 2, chapter 1, CLRA 2002)

Leaseholders of a scheme collectively have the right to take over the management of that scheme. There is no need to prove fault and no payment of compensation has to be made to the landlord. A detailed procedure has to be followed and advice should be sought. A building can qualify for the right to manage if it is either a stand-alone block of flats or capable of vertical sub-division. Mixed use buildings may qualify if the non-residential part does not exceed 25 per cent of the total floor area.

11.2 Appointment of manager

(Sections 21-24, LTA 1987)

If one or a group of leaseholders has serious concerns about the management of a scheme, an application can be made to ask the LVT to appoint a manager to take on the landlord's management obligations. This right does not apply if the landlord is a housing association or local authority.

11.3 Right of first refusal

(Part 1, LTA 1987)

If the landlord is proposing to sell the freehold then they must offer to sell it to the leaseholders collectively before making a sale to another party; this represents an opportunity to buy at market value.

11.4 Collective enfranchisement

(Part I, LRHUDA 1993)

This is the right of a group of leaseholders to compel the sale of the freehold of a scheme, irrespective of the landlord's intentions. As long as certain qualification criteria are met, the landlord cannot refuse. Mixed use developments may qualify if the non-residential part does not exceed 25 per cent of the total floor area. The leaseholders will have to pay a price valued according to criteria as set out in the legislation and should seek the advice of a qualified valuer.

11.5 Right to extend a lease

(Part I, LRHUDA 1993)

Most leaseholders have the right to compel their landlord to grant a new lease of 90 years at a peppercorn rent, in addition to the present unexpired term. They should have owned their flats for two years and the value to be paid is fixed by reference to criteria as set out in legislation.

Appendix 1

Summary of legal rights for leaseholders of residential units

Protection of money paid for services

(Section 42, LTA 1987)

Unless the landlord is not a housing association then service charge monies must be held 'on trust'. This means that the landlord can only spend service charges for the purpose for which they were collected. Service charges should be held in trust accounts at recognised banks or building societies and should have the words 'trust' or 'client' in the account title.

Demands for service charges

(Section 21B, LTA 1985; introduced by Section 153, CLRA 2002)

All demands for service charges must be accompanied by a summary of leaseholder's rights and obligations about service charges in a prescribed form of words. If the summary is not sent, then leaseholders can withhold the payment of that demand until the summary is served.

Consultation about expenditure for services

(Section 20, LTA 1985, as amended)

A leaseholder must be consulted before a landlord carries out works above a certain value, or enters into a long-term contract for the provision of services. There is no right to be consulted about all service charge expenditure. Where a landlord proposes to carry out works of repair, maintenance, renewal or improvement that would cost any individual leaseholder more that £250, or to enter into a long-term contract (one of more than 12 months) that would cost any individual leaseholder more than £100 a year, they must consult with all the leaseholders of a scheme. The consultation process is prescribed in law and will require at least two notices, with a minimum of 30 days for leaseholders to comment. If the landlord fails to carry out the prescribed consultation process, then a leaseholder can lawfully refuse to pay any sum in excess of the consultation limits of £250 for works and £100 a year for long-term contracts.

Right to challenge service charges

(Sections 19 and 27A, LTA 1985)

A leaseholder has the right to challenge a service charge or any part of it by asking an LVT to decide if the service charge is reasonable or payable. The LVT has wide-ranging powers and can determine whether a service charge (or part of it) is payable, the amount payable, by whom and to whom. It can decide such matters whether the leaseholder has already paid the service charge or whether the costs are yet to be incurred. Leaseholders can challenge costs incurred in previous financial years.

Right to regular statements of account

(Section 21, LTA 1985)

A leaseholder has the right to demand a summary of the relevant costs of services incurred during the last accounting year. The summary must be prepared in the way prescribed and must be supplied within one month of the request. If there are more than four residential units, the summary must be certified by a qualified accountant.

Right to inspect supporting documents for service charge expenditure

(Section 22, LTA 1985)

If requested by any leaseholder, or the secretary of a recognised residents association, you must provide an opportunity for the inspection of accounts, receipts and other supporting documents to the most recent statement of account for services. You must

not charge for the inspection, and the leaseholder has a right to take copies or extracts of documents. The landlord can charge the costs of arranging an inspection as part of its normal management fee.

Right to information about insurance

(Section 30A of, and the Schedule to, LTA 1985)

A leaseholder can ask for a summary of the insurance cover held by the landlord for a scheme. The landlord has 21 days to provide it. In addition, a leaseholder has the right to inspect the actual policy document and proof of payment of the insurance premium, or the right to be sent copies of them. Again, the landlord has 21 days to comply and a charge may be made for copies.

Right to challenge administration charges

(Section 158, CLRA 2002)

Administration charges are charges payable by leaseholders under their leases that are neither service charges nor ground rent. Typical examples are charges for permission to alter or adapt a flat, to sublet, and interest or fees for late payments. Any demand for an administration charge must be accompanied by a prescribed summary of rights and obligations; if not, the leaseholder can withhold payment.

A leaseholder has the right to challenge any administration charge at the LVT and ask the LVT to decide if the charge is payable and/or reasonable. A leaseholder can challenge whether he/she has already paid the charge or not. If the administration charge is calculated by a formula in the lease, a leaseholder can ask the LVT for an order to vary the lease.

Ground rent

(Section 166, CLRA 2002)

Ground rent is not payable until demanded and the demand must be in the prescribed format. Leaseholders have no obligation to pay ground rent until this requirement is complied with.

Protection against forfeiture

(Sections 157 & 170, CLRA 2002)

Forfeiture provides a legal remedy where a landlord seeks to repossess a dwelling because there are arrears of ground rent and/or service charge. In the unlikely event a landlord takes this action, leaseholders have a number of rights. Forfeiture cannot be commenced for small debts of under £350 or unless a debt has been outstanding for more than three years. Possession cannot be taken without a determination of a breach by an LVT, court or arbitration, followed by an order from a court.

Appendix 2

Standard industry cost classifications (reproduced from the RICS code of practice: Service charges in commercial property, Appendix B)

B.1 Overriding principles

B.1.1 Transparency

- State fee basis.
- Explicitly show management fees and site resourcing costs.
- State whether figures are given inclusive or exclusive of VAT. Industry benchmarking will be undertaken exclusive of VAT.

B.1.2 Flexibility

- The cost descriptions are not intended to represent an exhaustive list, but are used for illustrative purposes only.
- Owners and managing agents are encouraged to include additional cost descriptions where this will facilitate greater transparency and clarity with regard to the expenditure incurred or proposed. However, to maintain industry standards and to facilitate benchmark comparison, it is suggested that the cost class and cost category structure is not altered.

B.1.3 Level-handedness

- Distinguish between base operational costs (management, utilities, soft services, hard services), income and exceptional expenditure, to allow benchmarking on a like-for-like basis.
- Where income is being yielded to the service charge, separately identify any associated overhead and analyse this alongside the corresponding income to derive a net income. The true benefit of any 'commercialisation' can thereby be clearly identified.

B.1.4 Additional notes

- Where reasonable and appropriate cost should be allocated to separate schedules and separate cost categories are not to be used to describe activities provided across different elements of a subject property e.g. estate, car park, etc. However, where multiple schedules are not used, in order to achieve transparency, it may be necessary to repeat certain cost descriptions to make a clear distinction between specific areas where costs have actually been incurred, e.g. estate cleaning costs and car park cleaning costs

B.2 COST CLASS

Cost category

Cost description	Notes
MANAGEMENT	
1 Management Fees	
Management fees	Owner or managing agent fees for managing and administering building services excluding rent collection, etc.
2 Accounting fees	
Service charge (S/C) accounting fees	Fees for preparation of year end service charge statement and reconciliation

S/C independent accountant's fees	Independent accountant's fees to review the year end service charge accounts
S/C audit fees	Auditor's fees to audit the service charge
3 Site management resources	
Staff costs	Direct employment or contract costs for provision of staff for management of on-site facilities
Receptionists/concierge	Direct employment or contract costs for provision of reception and concierge staff, including associated administrative and training costs
Site accommodation (rent/rates)	Rent, service charge and rates associated with site management accommodation
Office costs (telephones/stationery)	Costs of equipping and running site management office
Petty cash	Miscellaneous minor expenditure incurred in relation to site management duties
Help desk/call centre/information centre	Operational costs for providing help desk/call centre/information centre
4 Health, safety and environmental management	
Landlord risk assessment, audits and reviews	Consultancy fees and other costs associated with provision and review of owner's health and safety (H&S) management systems
UTILITIES	
5 Electricity	
Electricity	Electricity supply to common part and retained areas and central plant, excluding occupier direct consumption
Electricity procurement/consultancy	Consultancy and procurement fees for negotiating electricity supply contract and auditing of energy consumption
Fuel (standby electrical power)	Fuel oil to run any standby electrical power systems
6 Gas	
Gas	Gas supply to owner's central plant, excluding occupier direct consumption
Gas procurement/consultancy	Consultancy and procurement fees for negotiating gas supply contract and auditing of energy consumption
7 Fuel oil (heating)	
Fuel oil	Fuel oil supply to owner's central plant, excluding occupier direct consumption
Fuel oil procurement/consultancy	Consultancy and procurement fees for negotiating oil supply contract and auditing of energy consumption
8 Water	
Water and sewerage charges	Water supply to central plant, common part and retained areas excluding occupier directconsumption
Water consultancy	Consultancy fees incurred in reviewing water usage

SOFT SERVICES

9 Security

Security guarding	Direct employment or contract costs incurred in providing building security guarding
Security systems	Servicing and maintenance of building security systems (e.g. CCTV, access control, intruder alarm)

10 Cleaning and environmental

Internal cleaning	Cleaning of internal common part and retained areas
External cleaning	Cleaning of external common part and retained areas
Window cleaning	
Hygiene services/toiletries	Cleaning and servicing of common parts' toilet accommodation
Carpets/mats hire	Provision of dust and rain mats to common part areas
Waste management	Refuse collection and waste management services provided for building occupiers
Pest control	Pest control services provided to common part and retained areas
Internal floral displays	Providing and maintaining floral displays within the common part areas
External landscaping	Provision and maintenance of external landscaped areas and special features
Snow clearance/gritting	Costs incurred in snow clearance and supply of snow clearing equipment and gritting salt
Seasonal decorations	Provision and maintenance of seasonal decorations to common part areas

11 Marketing and promotions

Events	Promotional events
Marketing	Marketing and advertising in accordance with marketing strategy
Research	Research into local market conditions, customer surveys, etc.
Staff costs	Direct employment or contract costs for provision of marketing and promotional activity
Landlord's contribution to marketing	Financial contributions made by landlord towards marketing and promotions
Local authority contribution to marketing	Financial contributions made by local authority towards marketing and promotions

HARD SERVICES

12 Mechanical and electrical services (M&E)

M&E maintenance contract	Planned maintenance to the owner's M&E services, including contractor's H&S compliance
M&E repairs	Repair works to the owner's M&E services
M&E inspections and consultancy	Auditing quality of maintenance works, condition of M&E plant and H&S compliance
Life safety systems maintenance	Planned maintenance works to the owner's fire protection, emergency lighting and other specialist life safety systems, including contractor's H&S compliance

Life safety systems repairs	Repair works to the owner's fire protection, emergency lighting and other specialist life safety systems
Life safety systems inspections and consultancy	
13 Lifts and escalators	
Lift maintenance contract	Planned maintenance works to lifts in the common part and retained areas, including contractor's H&S compliance
Lift repairs	Repair works to common parts' lifts
Lift inspections and consultancy	Auditing quality of maintenance works, condition of lift plant and H&S compliance
Escalator maintenance contract	Planned maintenance works to escalators in the common part and retained areas, including contractor's H&S compliance
Escalator repairs	Repair works to common parts' escalators
Escalator inspections and consultancy	Auditing quality of maintenance works, condition of escalator plant and H&S compliance
14 Suspended access equipment	Suspended access equipment includes all forms of high-level access equipment maintenance, i.e. hatchways, eye-bolt, fall address and cradles
Suspended access maintenance contract	Planned maintenance works to the owner's suspended access equipment, including contractor's H&S compliance
Suspended access repairs	Repair works to the owner's suspended access equipment
Suspended access inspections and consultancy	Auditing quality of maintenance works, condition of suspended access equipment and H&S compliance
15 Fabric repairs and maintenance	
Internal repairs and maintenance	Repair and maintenance of internal building fabric, common part and retained areas
External repairs and maintenance	Repair and maintenance of external building fabric, structure, external common part and retained areas
Redecorations	Redecoration and decorative repairs
INCOME	Distinct activities that yield a true income to the service charge account
16 Interest	
Interest	Interest received on service charge monies held within owner's or agent's bank account
17 Income from commercialisation	Income yielded from any facilities installed and/or maintained at the occupier's expense
Car park income	
Vending machine income	
Other	
Operational expenses	
Contract charges	Overheads, expenses and operational costs incurred in providing any of the commercialisation facilities

Repairs and maintenance	
Staff costs	
INSURANCE	
18 Engineering insurance	Landlord's engineering insurances
Engineering insurance Engineering inspections	
19 All risks insurance cover	Landlord's all risk insurance costs
Building insurance Loss of rent insurance Public and property owner's liability Landlord's contents insurance	
20 Terrorism insurance	Landlord's terrorism insurance cover
Terrorism insurance	
EXCEPTIONAL EXPENDITURE	
21 Major works	
Project works	Exceptional and one-off project works, over and above routine operational costs
Refurbishments Plant replacement Major repairs	
22 Forward funding	
Sinking funds	Forward funding of specific major replacement projects (e.g. plant and equipment replacements, roof replacements)
Reserve funds	Forward funding of specific periodic works to even out fluctuations in annual service charge costs (e.g. internal/external redecorations)
Depreciation charge	Depreciation charge in lieu of sinking/ replacement fund contribution of major plant and equipment

Appendix 3

Glossary and abbreviations

Administration charges for residential units are charges payable by leaseholders under their leases which are neither service charges nor ground rent. Typical examples are charges for permission to alter or adapt a flat, to sublet, and interest or fees for late payments. They should not be confused with administration fees for commercial units.

Administration fees for commercial units occur where the manager procures services direct (i.e. not through a contractor) and is recovering the actual cost of the service (e.g. the site management team). The manager may charge an administration fee to compensate the indirect costs (e.g. payroll, HR, etc.). Administration fees are recorded to the cost category where they are incurred, as they would be were the service contracted. To avoid confusion, within mixed use developments it is recommended that the term 'administration fee' is not used.

ADR (alternative dispute resolution) is the collective description of methods of resolving disputes other than through the trial process.

ARMA is the Association of Residential Managing Agents.

DRS (dispute resolution service) is the RICS service which offers a complete range of methods for resolving disputes.

'In trust' is money kept in a separate account, held in trust to the account of its owner.

LVT (leasehold valuation tribunal) is a tribunal to which residential leaseholders may take certain disputes for a determination. The LVT is administered by the Residential Property Tribunal Service.

Leaseholder is the person with the long leasehold interest in a flat. The leaseholders are more commonly referred to by block management agents as residents or owners. In the Commercial Code the term occupier is used.

Manager in the Commercial Code is the person or team which budgets, forecasts, procures, manages and accounts for the services that comprise the service charge, whether they be an in-house team or a managing agent. In the Residential Code, the person having day-to-day control of the management of a dwelling is called the 'manager'. This person could be the landlord personally, a member of staff of a corporate landlord, a managing agent, or a group of flat owners who have formed themselves into a formal management or maintenance company (a resident management company, which could be limited by share or guarantee), or a recognised or 'informal' tenants' association. It could also be a right to manage company set up in accordance with the CLRA 2002.

Management fees are the manager's remuneration (including the manager's profit element) for managing the services comprised in the service charge.

Not for profit, not for loss is the term used to describe how a service charge works. A service charge is the means by which the costs of providing the services to a property are recovered from the users of those services. The total costs recovered will not be inflated for profit (although the individual services within the costs will contain their individual suppliers' profit element). Similarly, there should be no residual loss (assuming a fully-let property with no concessions on service costs to specific occupiers) left for the owner to pay.

Owner for commercial units is the person who receives or is entitled to receive the rent. This person is usually responsible for the

provision, management and administration of the services and the service charge.

Services is often used to describe works such as maintenance and repair of the fabric and structure, and true services such as the provision of heating, lighting, cleaning, security, etc.

Section 20 is the part of landlord and tenant legislation that governs the requirements to consult residential leaseholders

Section 42 trust is a trust created by landlord and tenant legislation for the service charge monies for residential leaseholders. Landlords must keep such service charge monies in trust. The monies do not belong to the lessees but are held in trust for the building.

Abbreviations

LTA 1985 – *Landlord and Tenant Act* 1985

LTA 1987 – *Landlord and Tenant Act* 1987

CLRA 2002 – *Commonhold and Leasehold Reform Act* 2002

LRHUDA 1993 – *Leasehold Reform, Housing and Urban Development Act* 1993

Appendix 4

Footnotes

[1]*Home Group Ltd v Lewis and others* (2007)

[2] *Heron Maple House v Central Estates Limited* (2002)1 EGLR 35 *and Oakfern Properties Ltd v Ruddy* (2006) EWCA Civ 1389

[3] *Heron Maple House v Central Estates Limited* (2002) 1 EGLR 35 *and Oakfern Properties Ltd. v Ruddy (2006)* EWCA Civ 1389

[4] *London Borough of Brent v Hamilton,* LRX/51/2005

Norwich City Council v Marshall, LRX/114/2007

[5] *Transparency in professional fees.* RICS. 2010

[6] *Williams v Southwark London Borough Council* [2000] All ER (D) 377

[7] *Rowner Estates Ltd (no respondent)* LRX/3/2006

[8] *A guide to water resale.* OFWAT (2006)

[9] See HMRC Notice 701/12 (March 2002)

[10] *Marie Garside and Michael Anson v RFYC Limited and B R Maunder Taylor* [2011] UKUT 367 (LC)

[11] *Residential Service Charge Accounts – Guidance on accounting and reporting in relation to service charge accounts for residential properties on which variable service charges are paid in accordance with a lease or tenancy agreement* Published by ICAEW, ICAS, ARMA and RICS. 2011

[12] *Residential Service Charge Accounts – Guidance on accounting and reporting in relation to service charge accounts for residential properties on which variable service charges are paid in accordance with a lease or tenancy agreement* Published by ICAEW, ICAS, ARMA and RICS. 2011

[13] *Sinking funds, reserve funds and depreciation charges.* RICS. 2009

[14] *Garside & Anson v RFYC Ltd & B R Maunder Taylor* LRX.54.2010 (2011)

[15] *Scottish Mutual Assurance Ltd v Jardine Public Relations Ltd* (1999) *and Fluor Daniel Properties Ltd v Shortlands Investments Ltd* (2001).

Appendix 5

Sources of further advice

You can find further advice regarding residential property management from:

LEASE, The Leasehold Advisory Service, is an Executive Non-Departmental Public Body (ENDPB) funded by government to provide free legal advice to leaseholders, landlords, professional advisers, managers and others on the law affecting residential leasehold in England and Wales: www.lease-advice.org

The Association of Residential Managing Agents (ARMA) is the only trade body in England and Wales focusing exclusively on matters relating to the management of residential leasehold blocks of flats: www.arma.org.uk

The Institute of Residential Property Management (IRPM) is a professional institute offering portable professional qualification in residential property management, available to anyone working in the sector: www.irpm.org.uk

The Residential Property Tribunal Service (RPTS) is the umbrella organisation that encompassed Leasehold Valuation Tribunal (LVTs), Rent Assessment Committees and Residential Property Tribunals. Details of their jurisdictions and application processes are available at: www.rpts. gov.uk

The Health and Safety Executive (HSE) is the national independent watchdog for work-related health, safety and illness: www.hse.gov.uk

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