TRIBIWNLYS EIDDO PRESWYL

RESIDENTIAL PROPERTY TRIBUNAL

LEASEHOLD VALUATION TRIBUNAL

Reference: LVT/0002/04/13

In the Matter of 3 The Manor, Talygarn, Pontyclun CF72 9WT
In the matter of 24 Western Courtyard, Talygarn, Pontyclun CF72 9WR

In the matter of an Application under Section 27A of the Landlord and Tenant Act 1985
And in the matter of an Application under Section 20C of the Landlord and Tenant Act 1985

TRIBUNAL David Evans LLB LLM
Ruth Thomas MRICS
Ceri Trotman Jones MRICS

APPLICANTS David Ian Richards
John Noel Evans

RESPONDENTS Talygarn Manor & Country Park (Management) Ltd
Cowbridge Developments Ltd
Talygarn Manor & Country Park (Dwellingholders) Ltd

DECISION

1 PRELIMINARY

1.1 On the 22nd October 2010, the Applicants, David Ian Richards (Mr Richards) and John Noel Evans (Mr Evans) made an application to this Tribunal for a determination of their liability to pay service charges for the financial years 2009/10 (which we shall refer to as "2010") and 2010/2011 ("2011"). The Application was heard on 21st, 22nd and 23rd February 2012 (the Principal Hearing) and our Decision is dated the 27th September 2012 (the Principal Decision). A large number of service charge items were considered and our determination in respect of each item was summarised in the Schedules annexed to the Principal Decision.

1.2 At the conclusion of the Principal Decision, we required the First Respondents, Talygarn Manor & Country Park (Management) Ltd (Management), to prepare accounts incorporating the various determinations and in the event of any dispute, the parties were given leave to refer the issues to us for further determination.

1.3 On the 1st April 2013, Mr Richards contacted the Tribunal requesting a further determination. He enclosed his calculation of the revised service charge. A Direction was issued on the 4th April 2013 requiring the Respondents to provide their calculations of the revised service charge together with an explanation of any differences. The matter was set down for a hearing on 14th/15th May 2013 at the Tribunal Offices in Cardiff.

2 HEARING

2.1 The Applicants appeared in person. Mr I Hixon attended as an observer for part of the hearing. Cowbridge Developments Ltd (Cowbridge) sent a letter indicating that it had ceased trading

and that did not have the records as they were now in the hands of the residents as freeholders. It did not attend.

2.2 The other Respondents were represented by Mr S Davies, Mr D Rogers, Mr M Underwood, Mr D Morton and Mr I Isaac. Mr Davies acted as spokesman on the first day and Mr Rogers did so on the second day.

2.3 Mr Davies explained the new management set up and how the directors of Management had attempted to resolve maters. They had taken advice from the Leasehold Advisory Service and had applied that advice with the result that certain credits of £305.61 and £96.65 had been issued to the lessees via the service charge.

2.4 Following an adjournment at the hearing the parties agreed that, after crediting the Service Charge Account for expenses which Management had agreed would be paid from the Sinking Fund:

(a) For 2010, Management had demanded, on account, a Service Charge of £1,400 per lessee. After applying the adjustments required in the Principal Decision, the amount of service costs for 2010 had worked out at £1,509 per lessee for a full year. This produced a deficit for the year of £109 per lessee.

(b) For 2011, Management had demanded, on account, a Service Charge of £1,750 per lessee. After applying the adjustments required in the Principal Decision, the amount of service costs for 2011 had worked out at £1,111 per lessee for a full year, resulting in a surplus for the year of £639 per lessee.

2.5 The issues which remained outstanding were:

(a) Had the deficit of £109 for 2010 been waived by Management or was it otherwise not recoverable under section 20B of the Landlord and Tenant Act 1985 (the Act)?

(b) Are the service costs disallowed or allocated to the Sinking Fund for 2011 to be deducted from the budgeted expenditure of £1,451.40 or from the amount demanded, namely £1,750? In other words, were the lessees entitled to have the full amount of the surplus credited against future service costs or only the difference between the budgeted costs and the allowed costs (£1,451.40 - £1,111 = £340.40) with the balance of £298.60 being transferred to a separate Reserve Fund?

2.6 Management accepted that when Mr Richards purchased his apartment, Cowbridge had agreed to pay, and had paid, a year's service charges. Mr Richards had purchased his apartment in September 2009 and the parties agreed that Mr Richards was not to be debited with any deficit for 2010. He would, however, only be entitled to a credit for one half of any allowed surplus for 2011.

2.7 The parties also agreed that the Applicants were not entitled to a cash refund.

3 LEASE PROVISIONS AND THE LAW

3.1 The Service Charge provisions in Applicants' leases contain the usual requirements for the lessees to pay a sum on account of the anticipated service costs and the manager to prepare a statement of the actual expenditure as soon as possible after the end of the accounting period. If the actual service costs are more than the anticipated service costs, the lessees have to pay the excess. If the actual service costs are less than the anticipated service costs, "any overpayment of Service Charge … (save such as may have been accumulated for the purpose of a reserve fund) shall be credited against the Rent or Service Charge payment in the succeeding year" (paragraph 2(c) of the Sixth Schedule).

3.2 Section 18 of the Act defines "service charge" as the amount payable for various services, "the whole or part of which varies or may vary according to the relevant costs", i.e. the costs of those services. Section 19(2) of the Act states that where service charge payments are made on account, "after the relevant costs have been incurred, any necessary adjustment shall be made by repayment, reduction or subsequent charges or otherwise".

3.3 Section 20B of the Act provides that "if any of the relevant costs taken into account in determining the amount of any service charge were incurred more than 18 months before a demand for payment of the service charge is served on the tenant, then (subject to subsection (2)), the tenant shall not be liable to pay so much of the service charge as reflects the costs so incurred" (i.e. more than 18 months before the demand). This is sometimes referred to as the 18 month rule. The proviso in subsection (2) relates to the situation where a lessee is notified within that 18 month period that the costs have been incurred and that he/she will be required to contribute to them.

4 IS THE 2010 DEFICIT PAYABLE BY MR EVANS?

Preliminary Issue

4.1 Before dealing with the argument, we had to consider whether we were able to allow the Applicants to raise it at this stage. After all, the amount of the service charge had been determined for 2010. Why had the Applicants chosen to challenge various service costs when their case was that nothing was payable anyway? The 18 month rule point had not been raised at the Principal Hearing. We were also concerned that the Respondents may have been taken by surprise by the argument in which case it would not be in the interests of justice to allow the Applicants to pursue it at this stage without at least allowing the Respondents time to prepare a counter argument.

4.2 Mr Richards said that the argument had not been raised in February 2012 because Management had told the lessees that it would not demand the deficit. The reason why the Applicants pursued the 2010 application was because Management was going to take the money out of the Sinking Fund. By challenging the 2010 service charge, he thought that it would reduce the money being taken from the Sinking Fund. He had raised the question of section 20B with Mr Isaac in an e-mail on the 16th January 2010 although that was to do with the ability of Cowbridge to recover deficits. Mr Isaac had not responded to this particular point although he had replied to the e-mail. The Applicants had raised the issue again in November 2012 when it had been suggested that the 2010 deficit should be offset against the 2011 surplus.

4.3 Mr Isaac confirmed that he was aware of the 18 month rule in a general sense although he was not aware that it was an issue in this case until November 2012. Mr Rogers indicated that he had not been aware of the point until November 2012.

4.4 We are satisfied that the Management was aware of the issue in this case in November 2012. In fact, in a document setting out the conclusions and recommendations of the Finance & Legal Portfolio Sub Committee of Talygarn Manor & Country Park (Dwellingholders) Ltd (Dwellingholders) dated the 10th January 2013, Mr Rogers, as Secretary, reported that the Applicants should not be reimbursed because, amongst other arguments, "it now falls outside the 18 month rule". In other words, the Management and Dwellingholders considered that they were entitled to use the 18 month rule for their own ends in order to defeat the Applicants' claim.

4.5 We can understand why the Applicants did not raise the issue in February 2012. Much of their concern at the time was to do with the use of the Sinking Fund (see paragraph 2 of the Principal Decision). We explained at the time that we could not examine that matter. The purpose of that hearing was to determine whether certain costs were reasonably incurred. We are now being asked to determine what is in fact payable by each of the Applicants. Section 20B and the question of whether Management waived the 2010 deficit are both relevant to this issue. We are satisfied that the management and Dwellingholders were aware that it was going to be raised as far back as November 2012 and were even prepared to raise the 18 month rule themselves in support of their own case in respect of the 2011 surplus. We therefore allowed the argument to be put.

Arguments

4.6 The Respondents conceded that the deficit had never been formally demanded. As Mr Isaac says in his reply to Mr Richards' comments of the 17th February 2013 regarding the deficits for both 2009 and 2010, "the management company decided not to invoice these amounts". We were directed to two documents by Mr Richards. In a notice circulated to the shareholders of Dwellingholders dated the 18th December 2009 following a meeting of the 17th December, 2009, relating to the proposal to purchase the freehold, Mr Isaac reports: "all invoices for service charges will not include additional charges for 2008/9 or 2009/10". Further in a report to Dwellingholders dated the 31st May 2012, Mr Isaac explained that the 2008/9 shortfall "was not the subject of a supplementary invoice. Instead the management company chose to absorb the excess expenditure by using the sinking fund". That sinking fund was in effect transferred to Cowbridge on completion of the purchase. The 2010 shortfall "was also not the subject of a supplementary invoice".
Mr Richards said that he had assumed that a line had been drawn at the end of 2010.

4.7 When asked about this issue, Mr Isaac stated that Management had decided to absorb the deficit. When it was pointed out that this might suggest that Management had agreed to waive the deficit, Mr Isaac explained that it was never Management's intention to do so. Management was not wiping the slate clean. Lessees would not be asked to pay an additional charge for the deficit. However, the deficit would be funded by transfer from the sinking fund. Mr Rogers confirmed that deficits were carried forward into reserves. He considered that Management was able to do this. Similarly any surplus for 2011 was to be carried forward onto reserves. Management's bank overdraft had been reduced to £20,000, although Mr Isaac suggested that this was in fact an unauthorised overdraft. Mr Davies stated that Management was in a much stronger financial position than previously. There was now greater transparency than there had been.

4.8 We invited the Respondents to refer us to any evidence which might indicate that Mr Evans had been notified that costs had been incurred and that he would be required to contribute to them. The only indication was a document headed "Service Charges- Summary of Costs 2009/2010". The Applicants argued that not only were they not told that they would be required to contribute to the shortfall, but they were actually told that they would <u>not</u> be required to do so.

Determination

4.9 Management invoices the Service Charge and the contribution to the Sinking Fund separately. It is not for us to interfere in the way a managing company organises services or how they are to be paid for. However, it is important to understand that a Sinking Fund is money held by the management company on trust and on account of anticipated expenditure and contributions to and payments from a Sinking Fund are governed by the same rules as apply to the ordinary service charge funds. They must be properly demanded and fully accounted for.

4.10 It is also important to understand that lessees are required to pay for the cost of the services provided. The service charge is merely the mechanism whereby this is done. The system devised in the lease is straightforward enough. A sum is paid half yearly on account. At the end of the financial year, the service costs are computed, accounts are prepared which show either a shortfall or a surplus. The shortfall is then invoiced in accordance with the lease and any surplus is carried forward as a credit against the following year's service costs.

4.11 There may be occasions when the managing company pays for things which are not services authorised under the lease or, when challenged, the costs are determined not to be reasonably incurred. The managing company has to absorb those costs and pay them out of its own non-service charge income - ground rent, management fees, other income and fees.

4.12 In this case, the costs were incurred in 2009 and up to 24th March 2010. Management must have paid for them by now. Certainly there was no suggestion that the costs were still owed by Management. The service charge summary for 2010 shows a deficit of £21,586.32 for the year or £263.97 per lessee. The Respondents confirm that this was never demanded. Without a demand, there is no obligation to pay. If there is no obligation to pay, it is difficult to argue that there is a right to set this amount, or the agreed amount of £109, against any sums due to Mr Evans. To comply with the 18 month rule, the amount would have to have been demanded before September 2011. It was not. We are also not satisfied that there was any notification to Mr Evans that he would be required to contribute to the shortfall. On the contrary, all the evidence indicates that the lessees were not going to be required to pay. The Notice to shareholders of Dwellingholders dated 18th December 2009 clearly states that "all Invoices for service charges will not include additional charges for 2008/2009 or 2009/2010". This was before the end of the 2010 financial year, but it is a clear indication that Management - which at that time was owned by Cowbridge - was not going to be recouping the shortfall which it must have realised was going to occur for 2010. There is no qualification to that statement. Mr Richards stated that he understood that "a line had been drawn" at the end of 2010. It certainly seems that way to us. The Notice is in effect reporting to shareholders on the terms agreed with Cowbridge for the purchase of the freehold. One of those terms states that Cowbridge "has written off the £43,000" it was owed. The "Notes of a meeting with Chris Nicholson (of Cowbridge) which is attached to the Notice states at paragraph 7 that Cowbridge "had used the sinking fund as cash flow for the management account…" The Sinking Fund of £86,979.10 had been transferred into the current account and used to pay service costs. The £43,000 would be written off and Cowbridge would not be charged for voids. The arrangements for 2011 onwards are referred to in paragraph 6. Lessees will be billed "as normal…without the need to impose an additional £600 service charge for 2008-2009 and 2009-2010 as would have been the case if we had carried on under the existing arrangements".

4.13 The Report of the 31st May 2012 states that the 2009 excess had been paid from the Sinking Fund and the overdraft. That is precisely what Management did when it was controlled by Cowbridge. It did the same in respect of the 2010 service costs. Dwellingholders had done a deal with Cowbridge. A line had been drawn. Matters would proceed "as normal" for 2011. There was no need to call for any additional payments for 2009 or 2010 which would have been necessary if things had carried on as before. We accept the Applicants' argument that the lessees were never intended to pay - either by way of a supplementary charge or a debit - for the 2010 deficit.

4.14 We determine that Management has waived its right to claim the deficit for 2010. Mr Evans has relied upon that and it is therefore not just or equitable that Management should now seek to set off its own liability for the surplus for 2011 against the 2010 liability which it waived. Further, as both parties agree, no demand has been made for the shortfall. It is therefore not payable. What is more, as no demand can now be made for the 2010 shortfall because the costs were incurred more than 18 months ago, Management is no longer able to submit a demand and so the amount is in effect not recoverable. A debtor cannot set off a liability against an amount that is not payable.

4.15 With regard to the 2010 Service Charge,

(a) We determine that Mr Evans' liability for the 2010 deficit is NIL
(b) As agreed, Mr Richards' liability for the 2010 deficit is NIL.

5 THE AMOUNT OF THE 2011 CREDIT

Arguments

5.1 The Respondents accepted that the Applicants were entitled to a credit of £340.40 against the Service Charge. The balance of the credit of £298.60 is not to be the subject of a credit but has been transferred into a Reserve Fund. Paragraph 2(c) of the Sixth Schedule to the lease provides for a Reserve Fund (see paragraph 3.1 above). This is a generic term and is not the same as the Sinking

Fund which has a specific definition. The Sinking Fund is paid into a separate bank account to be used for long term expenditure. The Reserve Fund was to be used for items of a short term nature. As explained in the Respondents' written submission it was to "help smooth out highs and lows in terms of underspend and any over spend." According to the Leasehold Advisory Service, cited in the submission, "it is possible that your landlord is permitted to retain them [i.e. surpluses] to set against proposed expenditure…" In response to a further enquiry, the Leasehold Advisory Service replied that the landlord "may require the excess to be put into a reserve fund." The Lease requires a surplus to be credited against rent or service charge "save such as may have been accumulated for the purpose of a reserve fund". The balance has therefore been credited to the Reserve Fund.

5.2 According to the Respondents, the Reserve Fund arrangement had been set up in March 2010 - Mr Isaac also said that the Reserve Fund was in deficit in 2008/2009. Whilst the Sinking Fund was not returnable to a lessee who sold his/her property, it was open to Management to refund any lessee's proportion of the Reserve Fund on a sale. Mr Underwood likened the Reserve Fund to a "float". If the actual expenditure was less than the amount of service charge paid on account, the excess was paid into the Reserve Fund and not credited against future service charge.

5.3 Mr Evans commented that if everyone paid, the total surpluses for 2011 and 2012 would be £49,000. Mr Richards said that the Reserve Fund had not been mentioned until this year. The Lease stated that the balance had to be credited to the Service Charge. There was already a Sinking Fund, invoiced separately, to cater for future expenditure. He could not see the purpose of a Reserve Fund. He considered that there should be a healthy Service Charge balance as payments were made in advance. Where service charges were demanded in advance, the Act was clear that the accounts had to be adjusted after the costs had been incurred. Management could not use the 18 month rule to retain surpluses. Mr Richards also enquired as to where the money was in the Reserve Fund. There ought not to be cash flow issues as there were only three non-payers. Management's financial problems arose from the deal done with Cowbridge. The service charge payers should not be paying for this.

5.4 In answer to questions from the Tribunal, Mr Isaacs and Mr Rogers explained that there was no separate Reserve Fund bank account and no separate ledger. The Reserve Fund was calculated from the surplus – i.e. the difference between the Service Charge demand of £1,750 and the actual costs incurred. The Budget for 2014 contains an entry for the Reserve Fund. There was no annual statement for the Sinking Fund. Lessees were given a periodic report. Management had three long term debtors. There were also a number of short term debtors who would pay after being chased. This had not been done diligently in the past. Some pay 6 or 12 months late whilst others pay monthly. If the Tribunal were to require the whole of the surplus to be credited against the Service Charge, it could have serious repercussions for Management.

Determination

5.5 We have no doubt that the new management team is genuinely doing its best to sort out the difficulties it inherited when it took over Management. The scale of the problem is illustrated by Management's accounts for 2011 to which reference was made during the hearing. As at the 31st March 2011, there was a deficit of £39,233. The cause cannot be money owed by the lessees as this is shown as an asset, except to the extent that any debts have been written off. To make matters worse, it appears that the Co-operative Bank has withdrawn the overdraft facility. Management is in desperate need of cash flow. It also needs to build up a substantial Sinking Fund because, as all agreed, any repairs to or redecoration of the Manor House in future years is going to be extremely expensive.

5.6 We are not unsympathetic to the problems facing the new management team. We considered Mr Davies and Mr Rogers who acted as spokesmen for Management, to be open in their approach, fully recognising the scale of those problems. However, where there is self- management, there is often a danger that the distinction between lessees and shareholders becomes blurred. This

is particularly so when there are financial issues. The solvency of a managing company is a matter for the shareholders. If the company does not have sufficient capital, as would appear to be the case here, it is for the shareholders to provide it, not the lessees. Of course, in many cases they are the same people, but not all. This makes it all the more important for the distinction to be rigidly maintained.

5.7 Lessees are required to pay their proportion of the service costs. By paying in advance, they are undoubtedly assisting with the cash flow. We do not however, accept Mr Richards' comment that this will produce a healthy balance. Expenses do not mirror income. There can be a spike in expenses before the next instalment of service charges is due. This is why it is unfortunate that the bank has withdrawn its facility. However, that is not the concern of the lessees. Management has to find its funding either by generating additional income, possibly by charging for its management services, or calling upon the shareholders to provide more capital.

5.8 The issue here is that Management demanded a payment on account of service costs of £1,750. The actual costs were £1,111. For 2011, lessees paid on account £639 more than the actual cost of services. The lease states that the overpayment shall be credited against future rent or Service Charge except "such as may have been accumulated for the purpose of a reserve fund" (our underlining). The lessees contribute separately to the Sinking Fund. This is for the purposes of future expenditure relating to the development. When the Service Charge money was demanded, it was for the payment of the current year's service costs. As the Leasehold Advisory Service reminds the Respondents, Management holds money paid by lessees "on trust to defray costs incurred in connection with the matters for which the relevant service charges were payable" (s42(3)(a) of the Landlord and Tenant Act 1987). Section 42(3)(b) continues that subject to that, the fund is to be held on trust for the contributing tenants.

5.9 We accept Mr Rogers' general principle that the phrase "reserve fund" in paragraph 2(c) of the Sixth Schedule to the Lease is generic and that in theory there can be a Reserve Fund which is not a Sinking Fund. However, the definition of Sinking Fund in the Lease is so wide that it will almost inevitably cover any money held by Management for future expenditure. That is not to say that Management cannot create a second Reserve or Sinking Fund with the one fund accumulating money to pay for major refurbishment and the second to pay for heavier than expected or even unexpected expenses. However, it must be clear to lessees that that is what is being demanded and the amount must be no more than is reasonable (see s 19 of the Act) and fully accounted for. There is, of course, no need to have a second fund as Mr Richards says. The Sinking Fund could be used for both purposes unless Management has represented to the lessees that its use is specifically restricted.

5.10 When the 2011 Service Charge was demanded there were two funds - the Service Charge Fund and the Sinking Fund. Lessees contributed to each separately. The money in the Sinking Fund had "been accumulated for the purpose of a reserve fund". Surpluses were carried forward in that fund - they were not credited against the following year's service costs as that would in effect defeat the whole purpose of the Sinking Fund. That is what the Lease recognises. Money which is paid into a reserve fund or Sinking Fund is retained there. Money which is paid for the purposes of the current year's expenditure is to be used for that purpose. If it is not - ie where there is a surplus at the end of the financial year - the surplus "shall be credited". It is not discretionary. Management is required under the Lease to do this.

5.11 We are not satisfied that the Reserve Fund was set up in March 2010, or earlier as was at one point suggested. Management's accounts refer to "Reserves", but that is shareholder funds which Mr Isaacs rightly says show a deficit. That is not a Reserve Fund for the purposes of the Lease. It is clear that Mr Richards was not aware of such a fund at that time and we accept Mr Richards' evidence in this point. In any event, it is difficult to see how a Reserve Fund can be set up without a bank account or even a ledger. There would need to be entries showing transfers from the Service Charge account into the Reserve Fund and the lessees would have been provided with information concerning it. They have not. We are satisfied on the basis of Mr Richards' evidence - which again

we accept - that the Reserve Fund is an idea of recent origin and that the practical details - the accounts and the bank - have yet to be put in place.

5.12 Certainly in 2011, the only reserve fund was the Sinking Fund. Payments were demanded specifically for that fund. General current expenditure was paid for out the Service Charge fund to which the lessees paid money on account. Lessees' contributions not so used are, according to the Lease, to be credited against future service charges (or ground rent). There was no Reserve Fund then and even if there had been, the money was paid for a specific purpose, namely current expenditure, not as a reserve. The Applicants are therefore entitled to their full credits.

5.13 With regard to the 2011 Service Charge, we determine

(a) Mr Evans is entitled to a credit of £639;

(b) Mr Richards is entitled to a credit of £320.

5.14 We appreciate from what Mr Davies and Mr Rogers said that this decision may cause Management certain difficulties. However, Parliament has set down rules which are not difficult to follow and which are designed to protect lessees from excess service charges. Whilst self-management can be a cost effective solution to the problem of high service charges, it imposes a considerable - and often thankless - burden of responsibility upon those charged with carrying out the management functions. Nonetheless, whatever steps Management now takes to deal with its financial problems, it must ensure that it maintains a clear distinction between shareholder and lessee, even though in many cases they may be one and the same. The rules for the protection of lessees must be adhered to, as well as the rules relating to corporate governance.

6 SUMMARY

6.1 Mr Evans is entitled to a credit of £639; Mr Richards is entitled to a credit of £320. Both Applicants have already received certain credits. The Applicants' credits are to be reduced by the amounts already credited. In Mr Richards' case, this will result in a debit balance which must be paid by him to Management within 14 days.

6.2 It was noted during the hearing that credits have already been given to the Applicants in respect of the adjustments arising from other decisions relating to the Amenity Land and the proportion of service charges payable.

DATED this 24th day of June 2013