

Overview

ARMA regularly receives calls from lessees about the management of their building. Very often it turns out that the lessee lives in a building owned or run by a company in which they are a shareholder.

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

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

Types of Company

Historically, RMCos will be simple companies limited by share or guarantee with the lessees being the shareholders or members. Under the Commonhold & Leasehold Reform Act 2002 ("the 2002 Act") they will have to be companies limited by guarantee if they have achieved their status by exercising the Right To Manage ("RTM") under the 2002 Act.

Guidance on setting up and running a company may be obtained from Companies House or the reader may wish to obtain a copy of 'Running A Flat Management Company' written by Nigel Cox and available from the Jordans Property List or 'How to manage your own block of flats' written by John Cumming and Richard Hickie from the College of Estate Management.

As RMCos will not be substantial trading companies the formalities required will be limited, but they will still need a Memorandum & Articles of Association (Note that from October 2009 there will be no requirement for new companies to have a Memorandum; the objects of the company will be contained in the Articles), a board of directors elected from the lessees and to comply with basic company legislation. The latter can be demanding when it comes to the presentation and timing of company returns, and the company secretary thus has a vital role. From April 2008 it is no longer a statutory requirement to have a nominated company secretary for Companies House purposes so any director or person or body nominated by the directors can carry out the secretarial duties. It is not uncommon for managing agents to serve in this capacity. If they do, the agents must make themselves thoroughly

familiar with the relevant legislation as the penalties for breaches can be severe, and company members will no doubt look for compensation from the agents.

The Role of the Managing Agent

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

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

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

Relationship to the Freehold

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

Duties to Lessees

Again, the duties to the lessees will be set out in the leases, and can take two forms: either the RMCo is a party to the leases with its covenants set out expressly; or the RMCo will be directly responsible for performing the landlord's

covenants (at least insofar as they relate to management matters).

Either way, the fact that lessees are also shareholders provides the RMCo with no excuse for failing to perform its obligations (see below). In any event, there may well be lessees who are not members of the company. Contractual duties (such as to repair, maintain, insure and account for service charge funds) are combined with statutory duties (including restricting service charges to reasonable amounts and consultation) are owed to all lessees by the RMCo as though it were an institutional landlord; the law recognises no difference.

Consequently, it is essential that RMCo's directors and those advising them are familiar and up-to-date with Landlord & Tenant legislation as well as the Companies Act.

What are the distinctions between 'shareholder' and a 'lessee'?

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

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

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

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

This all makes sense practically because the requirements of a shareholder and a lessee can be entirely different – even opposite on occasions. From a legal point of view, the fundamental issue is that a shareholder's or company member's interest is entirely personal, whereas holding a lease vests the flat in the lessee for the time being. So an RMCo board or agm should not and has no legal right to take a decision that is against the terms of the leases for the block, even if there is complete unanimity. Nor should any agent advise an RMCo to do so. Indeed to protect its position the agent should give strongly worded written advice to the directors that any such decision is incorrect and may lead to severe problems for the directors. There

are several reported LVT cases where lessees successfully overturned democratically taken decisions of RMCos because the lease is paramount. In the worst cases RMCos have had to suffer the financial consequences of irrecoverable service charges because of failing to carry out what the leases required. Even if a lessee/shareholder voted for a course of action at the RMCo meeting does not prevent he/she from changing his/her mind at a later date and asking an LVT to overturn that decision. As has been commented by LVTs, evidence of agendas and minutes of RMCo meetings are not relevant to the issues of reasonableness and payability of service charges; what is relevant are the terms of the leases and compliance with Landlord and Tenant law.

Distinctions between service charges and company expenditure

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

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

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

Service charge monies are not 'owned' by the RMCo and should not be accounted for as such. See ARMA GN72 and LAN08.

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

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

- Breaching the Trustee Acts.
- Falling foul of the Companies Acts.
- Opening unnecessary & expensive cans of worms with lessees.
- Rendering service charges irrecoverable.

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

Personal Liabilities of RMCo Directors

As we have already seen, running an RMCo is not a straightforward matter. Directors may be personally liable

for any breaches of the Trustee Acts or the Companies Act in relation to accounting for funds.

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

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

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

Insolvency

In this context, the one thing which most clearly differentiates between an RMCo and an investor landlord is that the RMCo has usually no reserves or income other than the service charge fund, save only for the limited prospect of raising levies from its members. Thus, if there

is a significant shortfall in the service charge fund, the RMCo is very likely to be insolvent.

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

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

Very few of the above can be covered by insurance, so there is a considerable risk that an RMCo could become insolvent at any time.

The consequences of insolvency upon the company can be drastic:

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

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

Where insolvency would result from substantial arrears on the part of lessees then agents should be advising the directors to take urgent action.

- What additional action can be taken to recover arrears?
- Can the directors make a personal loan to bridge the cash flow problem?
- Can certain services be temporarily withdrawn until debts are recovered?
- Can a bank loan be obtained if the directors give personal guarantees?
- Does the lease allow temporary use of funds set aside as reserves?
- Can the directors raise additional cash flow from the shareholders as shareholders rather than as lessees?

Consultation on major works etc.

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

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

Failure to comply with the consultation regime is likely to render substantial expenditure irrecoverable. Agents should advise RMCos against waiving consultation in the strongest terms.

The powers of an RMCo: Recovery and Forfeiture

The RMCo's powers vary considerably depending on whether it owns the freehold. In any event, they are curtailed severely by the provisions of the 2002 Act.

If the RMCo owns the freehold, it possesses the power of forfeiture, subject of course to all the statutory and common law restrictions. An additional consideration for RMCos is the directors' reluctance to contemplate such a path against one of the company's members. Under the 2002 Act, forfeiture cannot be commenced (nor even a S.146 Notice served) unless the breach has been agreed by the lessee or it has been determined to exist by the LVT. This will impose major delays and additional irrecoverable costs upon the RMCo. (See GN18.) For service charge arrears therefore, the RMCo may well prefer straight debt recovery, even though it can

take a good deal longer to get hold of the cash. Much will depend on the RMCo's cash flow.

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

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

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

Conclusion

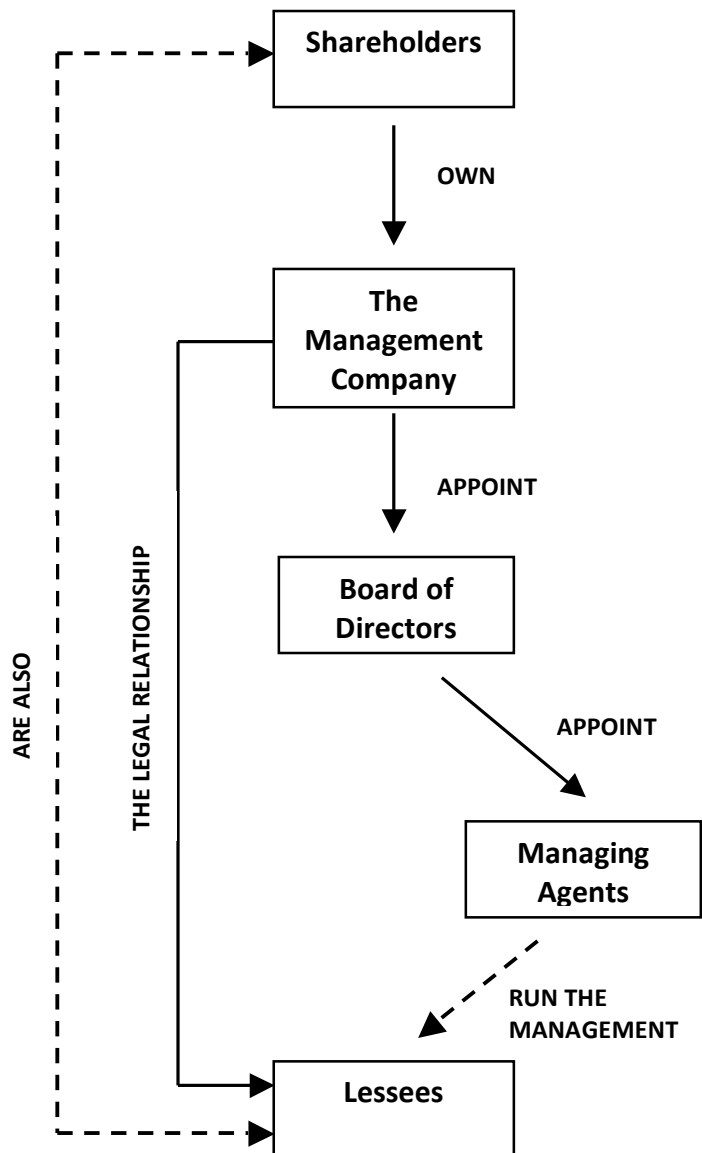
Management of blocks of flats is becoming increasingly complex and hazardous, and this is at least as true for RMCos as anyone else. Directors should be encouraged to employ competent managing agents (preferably ARMA members of course), take out all appropriate insurance for their companies and themselves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

Further Information

- GN18 Forfeiture – Members only
- GN33 RMCos and Directors' Meetings – Members only
- GN36 Annual general Meetings of RMCos – Members only
- GN72 Accounting for Lessees' Money
- LAN 08 Resident Management Company Accounts-preparing for the future
- RMC Directors DVD/CD-ROM training package available from ARMA; this can be previewed on www.arma.org.uk.

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Below is a chart showing the various relationships.



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