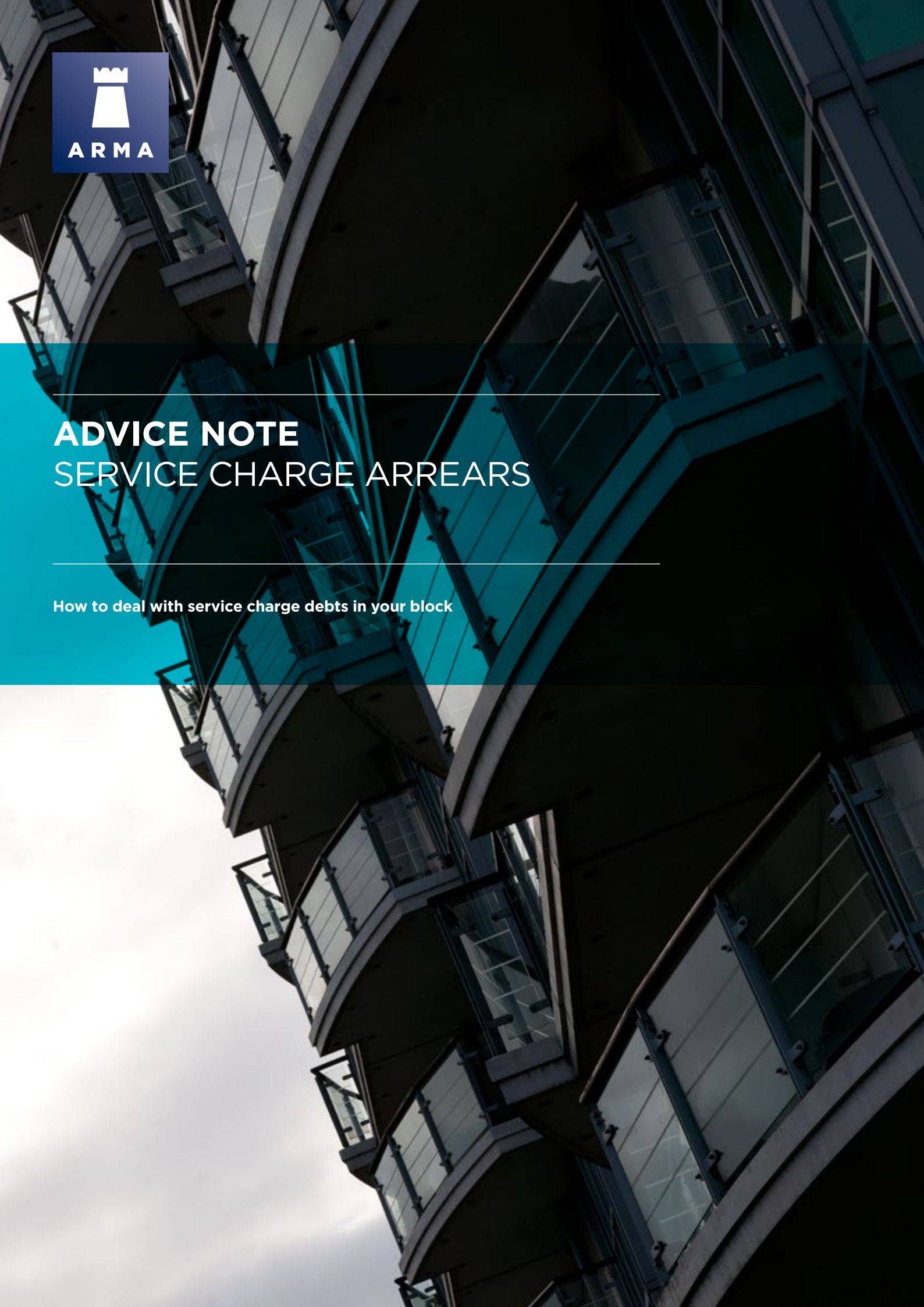

ADVICE NOTE
SERVICE CHARGE ARREARS

How to deal with service charge debts in your block

Note:
As the leading trade body for residential leasehold management, ARMA is also an important resource for leaseholders. Our Advice Notes cover a range of topics on the leasehold system to help leaseholders understand their rights and responsibilities and ultimately get the most out of living in their flat.

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SUMMARY

When leaseholders don't pay or fall behind with their service charge payments, it can cause problems for everyone else in the block. The managing agent may not have enough funds to carry out important maintenance or provide the key services that everyone expects.

In this Advice Note, we'll take a look at some of the issues and legal restrictions that leaseholders, Residents' Management Company (RMC) directors and their managing agents face when pursuing service charge debts.

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KEY POINTS

Here are some things to consider when your block is faced with a service charge shortfall:

- Taking legal action to recover service charge debts is not a step that should be taken lightly. You should always seek advice before going down this route
- Under county court rules, landlords and RMCs must take certain steps before taking legal action; if you don't the case may be thrown out
- It's important to bear in mind that the costs of taking legal action can easily outweigh the sums received; and often they're not recoverable, even if the debt is paid
- Managing agents cannot and should not start any legal action without instructions from their client; only the landlord or RMC is entitled to take action, which must be in their name
- Directors of RMCs with cash flow problems caused by arrears shouldn't assume they can continue to provide services; it's fraudulent to ask contractors to continue to provide services if you're aware that there are no funds available. Service charge monies are held in trust and should not be run in deficit
- Managing agents are not banks or lenders of last resort for the developments they manage; they shouldn't loan funds to their clients
- Most managing agents don't include the costs of chasing arrears in their management fees (so as not to penalise those who do pay promptly). Instead, with agreement from their client, they tend to recover those costs (administration fees) from the defaulting leaseholder

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TAKING LEGAL ACTION

It's not as easy as you might think to sue debtors in the courts. So before taking any legal action, you should fully consider the potential outcome and costs involved.

Under county court rules issued in April 2009, specific steps must be taken before you can take a debtor to court. These steps are set out in what's called a 'practice direction for pre-action conduct'. You can find this on the Ministry of Justice's website and you should take time to read it: www.justice.gov.uk

If you don't follow these steps, the court may suspend proceedings, penalise you in costs or in respect of interest. What matters is substance and the court will consider the proportion of steps taken against the size and importance of the matter.

Cases taken to the county court may also result in the court allowing repayments by instalments.

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COURTS AND TRIBUNALS

If a service charge dispute is taken to a county court, it's likely to be referred to the First Tier Tribunal (Property Chamber) (FTT) in England, or the Leasehold Valuation Tribunal (LVT) in Wales. If this happens, there will be a substantial delay; the matter will have to go to the Tribunal and then back to the county court. It will be a long time before any payments are received.

Tribunal hearing costs are not normally recoverable from the leaseholder, even if the Tribunal agrees that the debt is due in full.

This long legal process means that it's often better to investigate the issues fully with the leaseholder who's in arrears first, and try to seek some arrangement before starting legal action.

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FORFEITING THE LEASE OF A DEBTOR

Although forfeiture is an option, in practice it's a difficult and expensive process; not a decision to be taken lightly.

Initiating forfeiture of an offending flat owner's lease comes under Section 146 of the Law and Property Act 1925. To issue a forfeiture notice, the outstanding service charge amounts or the existence of a breach of the lease, must be determined by one of the following:

- The leaseholder
- The Tribunal
- A court (if the court has only agreed the breach and not amounts, then a Tribunal decision may also be required to confirm the reasonableness of a charge)

An application for forfeiture will only be accepted if the total amount of service charges, administrative charges or ground rent owed is more than £350, or if any of the amounts have been owed for more than three years.

A court will expect to see that a reasonable time has been given to allow the leaseholder to remedy the breach. This could be open to interpretation, which may put the landlord or RMC at risk of incurring considerable costs that they can't be recompensed for.

A determination for forfeiture is only valid after a period for appeal has passed; the landlord or RMC must then allow an additional 14 days before issuing the notice.

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WHO PAYS THE LEGAL COSTS?

The costs of chasing up debts (sending letters, solicitors' fees etc) are usually added to the debt claimed. But this may depend on the wording of the relevant lease, and such fees may be challenged in a Tribunal.

The costs of taking a case to a Tribunal are not normally recoverable from the leaseholder. But they may be recoverable through the service charge funds. Don't always assume that, however. It will depend upon the terms of the lease. The leaseholder who's in debt can also ask the Tribunal for the costs not be charged through the service charges — what's known as a Section 20C order in legal terms.

County court costs are normally awarded to the party that wins the case; so if the landlord wins, then costs will be charged to the leaseholder. But the court will limit any cost to what they think is reasonable — not the exact amount that the landlord or RMC may have spent.

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OPTIONS FOR RMCS WHOSE SERVICE CHARGES ARE RUNNING OUT

If a number of leaseholders don't pay their service charges on time, it's easy for developments to run into cash flow problems. RMCs should expect their agents to keep them informed if problems are anticipated.

Managing agents can't simply collect more service charges from other leaseholders who are willing to make up the shortfall. Leaseholders can only be expected to pay the proportion of service costs set out in their leases.

Here are some of the things you can do:

- It may be necessary to cancel some non-essential services for a time until debts are recovered. This can be difficult to explain to those who have paid and are suffering because of others, but there may not be an alternative. RMCs or managing agents should not be placing orders for repairs, or contracts for services, when they know they have no means to pay for them. If the contractor sues, it could be argued that the RMC directors are personally liable to pay

- You could ask some leaseholders to pay their next instalment of service charges before the due date

- It may be possible for the RMC directors to obtain a bank loan but that will usually require personal guarantees from the directors

Letters sent by managing agents on behalf of their client to leaseholders in arrears must by definition sound "threatening". This is not harassment, bullying or intimidation. It's often a difficult task to try and ensure there are enough communal funds for the property.

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WHAT TO EXPECT FROM YOUR MANAGING AGENT

Here are some things you should be able to expect from your managing agent when it comes to service charge collection:

- Timely billing of service charges on the due dates and in accordance with legal requirements
- A robust arrears procedure so those who don't pay are quickly chased with reminders
- Implementation of interest charges on overdue payments if the leases permit
- Regular reporting on arrears and cash flow problems to the RMC directors
- Competent advice on how best to pursue debtors
- Prompt action if the RMC issues instructions to pursue debtors

You can't expect your agent to bear the legal costs of pursuing debtors. Nor should you ask them for a loan to pay for services if there's a cash flow problem, or expect them to continue to provide services if there are no funds.

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DEBTS AND CHANGING MANAGING AGENTS

If you change your managing agent, as soon as the contract ends the outgoing agent has no legal basis to pursue any debts from leaseholders.

The RMC or landlord can instruct their new agent to pursue arrears, but you will need to hand over all relevant documents proving the debts. This is why it's important to get the outgoing agent to provide you with originals (or copies) of all demands that have not been paid; proof that summaries of rights were issued; any correspondence about the debts; and confirmation of any arrangements agreed with debtors.

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FINAL WORD

It's in everyone's best interests for service charges to be paid promptly and on time. When they're not, it can affect the supply of services that residents expect. RMC directors and landlords should take swift action to deal with debts before they spiral out of control, and carefully consider all options at their disposal.

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