

**A new lease  
of life:**  
reforming leasehold  
for the 21<sup>st</sup> century

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## ■ Executive summary

England and Wales are almost unique in maintaining the quasi-feudal system of leasehold tenure. This system, where long leases (generally between 99 and 999 years) are sold by freeholders, has emerged largely in response to the need to ensure that residents of a property with communal areas contribute equally to its maintenance. Whilst ensuring enforcement of positive covenants, however, leasehold tenure today retains significant problems, particularly concerning the balance of rights between leaseholders and freeholders.

Under a traditional arrangement, freeholders – or, more generally, managing agents appointed on their behalf - maintain a property and bill costs to leaseholders through service charges. Managing agents have no legal responsibility to leaseholders – the end customer – and therefore limited motivation to ensure work is of good value. This arrangement effectively excludes leaseholders from the management of their own homes despite the fact that they have the primary financial and emotional interest in the property.

The incentive to provide a good service is diminished further because management is exposed to little competition. Leaseholders wishing to change their managing agent or challenge a service charge must approach a Leasehold Valuation Tribunal (LVT) – an independent body that resolves disputes in the residential leasehold sector - which requires significant time, money and peer support. The owners of more than 100,000 specifically designed leasehold retirement apartments often have particular difficulty accessing this remedy. Moreover, they also face specific problems such as unjustified 'exit fees', which the OFT has spent almost two years investigating.

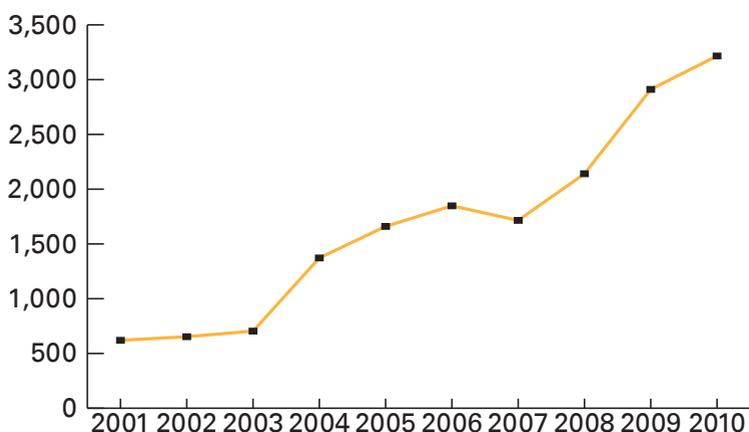
Problems created by connected companies – which occur when a freeholder also owns a management company and other service providers, creating a direct incentive to increase spending and costs – have risen sharply. Last year a leaseholder campaign led to

a freeholder repaying £1 million in unfair charges. In another case, after four tribunals a freeholder was forced to repay £500,000 to leaseholders who had suffered at the hands of a “family tree” of companies beginning with the freeholder followed by a “*trunk of [other] companies also descending in Biblical fashion*”. While there are circumstances where connected companies can work together legitimately, there is insufficient protection for leaseholders against unscrupulous freeholders.

Leasehold cannot simply be dismissed as a niche issue or an anachronistic quirk: industry figures suggest that there are up to 5 million people living in 2.5 million leasehold properties in England and Wales. These leaseholders spend in the region of £2.5 billion a year on service charges.

The Housing Minister’s priority seems to be expanding the housing supply, but this should not be pursued blindly at the expense of correcting problems in the leasehold sector, which will only increase if action is not taken. The number of cases taken to LVTs has increased by 400 per cent in the past ten years (as shown in Figure 1) and the number of leasehold properties is growing rapidly, both through the reinvigorated right-to-buy sector and through the building of new flats in line with the housing strategy. A recent report by the Greater London Authority recognised that leasehold

**Figure 1 – Service charge cases (‘New LVTs’) taken to tribunal 2001-2010**



Source: Residential Property Tribunal Service caseloads, 2001 -2010

problems have risen over the past decade, and recommended that the balance of power between freeholders and leaseholders should be redressed. Any housing strategy that has the creation of more leasehold properties at its centre must be accompanied by an improved system of leasehold tenure that is fit for purpose.

Regulation (rather than legislation) is the primary solution. This is conspicuous by its absence in English leasehold management compared to equivalent sectors in Scotland and Ireland. There are also fewer checks on managing agent power than similar professions such as estate and letting agents. The lack of regulation disproportionately hurts the most vulnerable, with 37 per cent of leaseholders not in employment.

Indeed, stakeholders from *all* sides of the leasehold sector have been calling for regulation for years. The Housing Minister, however, has stated that leasehold reform “should be driven by a more proactive approach from the sector – not by greater regulation.”

The only two arguments against regulation are the potential cost and that it may risk creating barriers to entry. However, this report illustrates how sensible regulation would create important management hurdles to protect leaseholders from incompetent or unscrupulous managing agents without harming competition. It also shows that an independent regulator could cost as little as £2 a year per managed leasehold property and that the industry would remain accessible to new management firms. The governments in Scotland and Ireland have both legislated to create regulatory systems to protect residents of properties with communal areas. The Westminster government should act to ensure that leaseholders in England and Wales are not left behind.

Park homes suffer similar issues to leasehold properties including inflated service charges and poor maintenance. Although this report does not focus on park homes, it is interesting to note that the government is currently acting to strengthen the licensing system for such properties. This, Grant Shapps has stated, is part of “sensible, practical proposals, targeted at the worst practices and minimising the burden on those who do a good job for their residents” in the park homes sector. This report shows how the same can be done for the leasehold sector.

Specifically, the report recommends:

- **The introduction of an independent regulator for leasehold management.** It would maintain a licence

to ensure that all agents meet minimum standards of competency and professionalism. The licence would also require managing agents to declare all commission received and follow a code of conduct. This would tackle problems of inflated service charges and would expose exploitative connected companies with service monopolies.

- ⚡ Light-touch regulation and licensing would ensure that **all managing agents subscribe to an ombudsman**, guaranteeing leaseholders a free and accessible arbitration. This is similar to the requirement for estate agents and would improve the quality of leasehold property management. The use of one central ombudsman which would deliver public judgement would not only offer a more consistent service for leaseholders and freeholders but would also improve understanding of the system.
- ⚡ **Reform of the LVT process to reduce power and information asymmetries** and deliver a fairer service. The rules on information disclosure should be amended to ensure that all parties have all relevant details in advance of a case. To reduce brinkmanship, freeholders objecting to a Right to Manage (RTM) / lease extension / enfranchisement application should specify grounds for doing so before a leaseholder approaches the tribunal. The 20C order, which prevents freeholders from reclaiming their LVT costs retrospectively through service charges, should be used automatically unless the freeholder can prove that they should be able to reclaim charges.
- ⚡ **The threat of forfeiture of properties for failure to pay charges should be removed** - it is disproportionate and increases power asymmetries. Rather than forfeiture, a small claims court should be used first to recover costs. As a last resort, the sale of a leasehold property should be forced, but with the remaining value of the property returning to the leaseholder.
- ⚡ **Freeholders should not be able to charge for permission for developments to leasehold properties unless they can prove that such work reduces the value of a property.** Landlords can currently demand payment in return for granting permission for home improvements (such as installing a conservatory or an ensuite bathroom) and then receive a second premium for lease extension or enfranchisement when the property's value has been increased.

- Similarly, **Estate Management Schemes** – which retain residual control over enfranchised properties – **should not have control over internal works**. Moreover, freeholders in these schemes pay estate charges, which have the same problems as service charges, but do not have the same protection. These freeholders should be protected by Section 20 legislation on major works and should be able to use the LVT to appeal against specific service charges. Finally, conveyancing protocol should be amended to ensure that EMS properties are clearly identified.

In the longer term, leaseholders should be given greater direct control. Commonhold – a system of ownership which allows individuals to own properties with common areas in perpetuity and collectively control their management – was created in 2002 but evidence from the Leasehold Knowledge Partnership shows that today only 15 developments use this form of ownership despite its significant advantages. This represents a major market failure. It is almost impossible for existing leasehold properties to convert because they require unanimous leaseholder support and developers prefer to build properties as leasehold rather than commonhold because it is familiar and allows them to sell both the leasehold and freehold.

- **Commonhold should be promoted, with priority on new properties.** The government should consider ways of creating incentives to sell new blocks of flats as commonhold. This could include legislating that all new build flats after 2020 are sold as commonhold. Once a critical mass of commonhold property owners has been created and familiarity and confidence in the system enhanced, the 100 per cent requirement for converting existing leasehold properties should be relaxed to a qualified majority of 80 per cent. This could then facilitate a serious shift to commonhold from *existing* leasehold properties.
- The Right to Manage (RTM), which allows leaseholders to assume control over management without having to pay to own the freehold, should be promoted. In order to raise awareness, **all service charges should include information about leaseholders' right to manage.** To make it easier to gain the 50 per cent qualifying support required, leaseholders should be able to ask their freeholder to forward letters to all leaseholders (many

of whom may not live in their flat) to inform them of an application. Reform of the LVT process will also assist the expansion of RTM as freeholders will need to give grounds when rejecting an RTM claim.

## ■ 1 - Introduction

Tension between landlords and tenants has been perennial throughout the history of property, and leasehold tenure is no exception. Long lease, fixed-term ownership offers lessees (leaseholders) the right to occupy their unit of property for an agreed period during which they pay service charges and a token ground rent to their lessor (freeholder).<sup>1</sup> This system is used for the ownership of around 2.5 million properties in Britain, and has evolved in response to the need to enforce positive duties upon tenants in buildings or estates with common parts.<sup>2</sup> Leasehold in this form is now almost a uniquely Anglo-Welsh system - the rest of the World has developed alternative approaches which allow individuals to own flats and houses on estates in perpetuity and which give them control over management.<sup>3</sup>

Landowners have often used the system of long leasehold to harvest repeated premiums from property over generations and in the past were able to take advantage of weak legislative protection for lessees. Leaseholders historically faced the prospect of losing their property as the lease expired and had no power to remove a bad freeholder, but considerable legislation has been passed (outlined in Chapter 2) which has improved statutory rights for lessees. However, problems persist in large part because the contemporary leasehold system is one of high legislation but low regulation.

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- 1 'Lessee' and 'lessor' mean, respectively, the person entitled to a property for the term of a lease and the person to whom it will eventually revert. The terms lessee and leaseholder are used interchangeably, as are lessor and freeholder. 'Leasehold' describes a fixed term tenancy (tenancy for years) lasting for a minimum of 21 years when first signed and most commonly for 99 or 125 years. It is distinct from the periodic tenancy used for standard rental of property.
  - 2 Positive duties include financial contributions towards common goods such as maintenance of stairways and roofing.
  - 3 America, for example, has a system of condominiums and Australia has a system of strata title ownership for flats. Hong Kong and Hawaii are rare examples of other states which still use a leasehold or similar form of ownership. This report focuses on England and Wales because Scotland has a different system of property ownership.

This report identifies the structural faults underlying leasehold tenure and provides examples of how the system's shortcomings manifest themselves. At the heart of the problems is the fact that the interests of the leaseholder – who generally holds the primary financial, practical, and emotional investment in a property – are too often excluded. This is at the root of many of the problems in the leasehold system. One survey in July 2011 showed that more than half of leaseholders with local authority freeholders do not feel that their service charges are accurate or reliable. A separate poll showed that more than 60 per cent of leaseholders felt that the value for money of their service charges was the greatest problem with their leasehold.<sup>4</sup> Thus rather than new legislation, a mechanism is needed that gives leaseholders greater access to their rights with a system to ensure that management is of an acceptable standard.

Management of leasehold properties has no independent or compulsory regulation. This allows incompetent or unscrupulous agents to continue operating and undermines the influence of those living in managed properties. Leaseholders face a high hurdle if they wish to seek redress for problems with a freeholder or managing agent because the lowest source of redress - the Leasehold Valuation Tribunal (LVT) – is a legal process often skewed against lessees which can be lengthy and expensive. The costs involved are particularly detrimental for poorer leaseholders, which is relevant because more than a third of leasehold flats are occupied by economically inactive people.<sup>5</sup> Many of the most vulnerable leaseholders live in retirement apartments, which have their own specific problems with service charges. So while there are barriers to redress for leaseholders, there are currently no hurdles to operating as a managing agent. A more appropriate balance is needed between cost recovery for the freeholder on one hand and protection, transparency and value for leaseholders on the other.

Rather than advancing a new system of ownership, we seek to improve the existing leasehold infrastructure. The government should focus on levering in the interests of all leaseholders to the management process with a compulsory ombudsman service and improving management of leasehold properties through licensing. Regulation would incur some costs for leaseholders and would create limited hurdles to entry for managing agents, but the

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4 Harlow Council Home Ownership Leasehold Survey, July 2011 and Crawley Borough Council, 2010.

5 The Survey of English Housing shows that 37 per cent of leasehold flats are occupied by economically inactive people. Department for Communities and Local Government, 'Survey of English Housing', Live Table S327, 2006.

improvement it would bring in terms of quality and value of service would *more than justify* the costs. Greater direct leaseholder empowerment should also be promoted by taking steps (outlined in Chapter 6) to encourage the process of 'Right to Manage' (RTM) and the long-term expansion of commonhold.

The Department for Housing's current priority appears to be expanding the supply of homes, which is clearly necessary. But pursuing this at the expense of leasehold reform could be costly in the long run for two main reasons.

First, problems within the leasehold system, particularly with connected companies, have become more pervasive since government last addressed leasehold tenure in 2002. Complaints about managing agents have risen sharply and the overall number of cases taken to LVTs has more than quadrupled in the past decade.<sup>6</sup> While problems with managing agents have been tackled by the Scottish and Irish governments in recent years, regulation in England and Wales remains conspicuous by its absence.<sup>7</sup>

Second, reform is also needed because the number of people living in leasehold properties – currently up to 5 million – is rising. The government is committed to 'unlocking' the housing market, and leasehold properties will be an important part of this. The reinvigorated right-to-buy scheme is already creating more leaseholders. As Britain's population becomes more urbanised and life expectancies grow, there will be more demand for leasehold flats, particularly in the retirement sector. In London alone it is expected that 320,000 new homes will be built in the next ten years, of which the "majority" sold will be leasehold flats.<sup>8</sup> Leasehold reform should therefore be a priority *alongside* increasing housing supply and will avoid creating greater problems in the future.

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6 Figures from the Residential Leasehold Property Tribunal Service.

7 The Scottish Government introduced the Property Factors (Scotland) Act 2011 which compelled managing agents to be registered and comply with a code of conduct. It also created the homeowner housing committee which offers tenants a more accessible forum at which to complain about managing agents. The Irish government has agreed to establish the National Property Services Regulatory Authority which maintains a licence for managing agents and offers an adjudication service.

8 The London Assembly, 'Highly charged: Residential leasehold service charges in London', March 2012, p. 17.

## 2 - Leasehold in context

### Leasehold today

We briefly place leasehold in contemporary context in England and Wales and will outline how it has evolved over the past hundred years. There are three forms of domestic property:

1. Freehold
2. Leasehold
3. Commonhold

Of these, freehold is by far the most common, used for 90 per cent of owner-occupied households. It offers absolute ownership of a property and the land upon which it stands. Ten per cent of owner-occupied houses are leasehold, giving tenants the right to occupy a unit of property for a fixed period until the lease expires and the rights to its use revert to the freeholder. Fewer than 160 domestic property units are held in commonhold, which offers owners perpetual ownership of their property as well as a share in the management of common parts.<sup>9</sup> This paper focuses on leasehold, which is distinct from both freehold ownership and short-term rental. Like freehold property leaseholds can be sold on the market, with buyers acquiring the rights to a unit under the terms of its lease.

Blocks of flats and housing estates sharing common areas both face the problem of enforcing positive covenants; simply offering freehold to each unit would lead to collective action problems of paying for public goods (such as maintenance of hallways or repair of roofs). The system of leasehold, with a freeholder holding powers to enforce service charges upon leaseholders evolved to address this. Flats can be owned as:

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<sup>9</sup> It is unsurprising that commonhold is the rarest; it is only relevant to flats or houses on estates and is by far the newest form of property ownership, having been created by legislation in 2002. By contrast, freehold and leasehold tenures have existed for centuries.

1. Leasehold
2. Leasehold with a Share of Freehold
3. Commonhold

Government figures state that there are almost 1.5 million leasehold properties in England, including 800,000 flats and 600,000 houses, but the Department for Communities and Local Government has noted that: “when it comes to the estimated number of leasehold properties, we believe that there are significantly more properties than are identified”.<sup>10</sup> Some industry estimates suggest that there are as many as 1.8 million leasehold *flats* alone.<sup>11</sup> Thus there are probably between 3 and 5 million people currently living in around 2.5 million leasehold properties. Of these leases, 51 per cent have more than 99 years left on their lease, but 26 per cent have fewer than 80 years left.<sup>12</sup>

### Leasehold history and legislation

Leasehold has existed as a form of property ownership for centuries, but only emerged as a significant form of flat ownership in the twentieth century. Although not technically a feudal system,<sup>13</sup> leasehold tenure does resemble it in many respects by giving residual long-term power to landowners. By the 1920s power still lay with letting and leasehold landlords, but a series of Rent Acts limited the amount of rent that letting landlords could charge tenants, as well as their ability to evict them.<sup>14</sup> Rent controls meant that freeholders could make more profit from selling than renting their flats and the need to enforce positive covenants meant that leasehold grew as a form of tenure. This growth was further fuelled by an increase of purpose-built blocks of flats from the 1950s onwards and greater conversion of houses into flats. Freehold

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- 10 Freedom of Information request, correspondence from DCLG to leaseholder, 7 February 2012.
  - 11 English Housing Survey, Household Report 2009-10. The London Assembly reports that there are around half a million leasehold flats in London alone. ARMA estimate that there are 1.8m leasehold flats in England and Wales including 300,000 right-to-buy properties, 300,000 social housing shared ownership leaseholds and 100,000 retirement flats.
  - 12 80 years is significant because a lessee renewing a lease shorter than this must pay marriage value which is the additional value gained from marrying the freehold to the leasehold extension. The sum of the two is greater than its parts, and marriage value can be worth tens of thousands of pounds. For lease duration figures see: English Housing Survey, Household Report 2009- 10.
  - 13 Damian Greenish, ‘Commonhold: The Dawning of a New Age?’, Blundell Lecture 28 June 2001.
  - 14 This included the Increase of Rent and Mortgage Interest (War Restrictions) Act 1915 and the Rent and Mortgage Interest Restrictions Act 1939.

property law was generally based on assumptions that property had clear boundaries which could be marked on a map and so was not practical for flats. Instead they were sold for a fixed period under a leasehold agreement, leaving freeholders with residual control to enforce service charges.

Initially the feudal power imbalance between landlords and tenants remained - leaseholders were not able to extend their leases and had very little power to challenge service charges. Over decades, many of the problems with the leasehold system have been highlighted by notorious freeholders and managing agents. The first of these was Peter Rachman, whose name became so synonymous with bad landlords in the 1950s and 60s that it entered the Oxford English Dictionary.<sup>15</sup> More recently Nicholas van Hoogstraten gained notoriety for his management of properties on the south coast and in the 1990s the Evening Standard's 'Nightmare Landlords Campaign' focused on the CARLA vs Harold Bebbington case.<sup>16</sup> There has recently been significant coverage of large freeholders being forced by tribunals to repay unfair service charges to their leaseholders.<sup>17</sup>

Residential leasehold law has been frequently updated in recent decades, notably more than other areas of property law.<sup>18</sup> Leasehold legislation has often been something of a political football. The 1967 Leasehold Reform Bill was introduced by Labour but opposed by the Conservative Party despite their support in principle for enfranchisement, and the 1993 Leasehold Reform Housing and Urban Development Bill was tabled by the Conservatives but opposed by Labour despite its claims to support extension of enfranchisement.

The most significant Acts relating to leasehold tenure are:

- The Leasehold Reform Act 1967
- The Landlord and Tenant Act 1985
- The Landlord and Tenant Act 1987
- The Leasehold Reform Housing and Urban Development Act 1993

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15 See, for example, Oxford English Dictionary 1996, p. 1,187: "Rachmanism: exploitation or intimidation of a tenant by an unscrupulous landlord. It is named after a London landlord, Peter Rachman (1919-62), whose practices became notorious in the early 1960s".

16 See House of Commons Housing Bill Debate, 30 April 1996. CARLA is the Campaign Against Residential Leasehold Abuse.

17 For example: 'Landlord pushes up leaseholders' fees by trading with connected firms', The Daily Telegraph, 03 December 2011.

18 Commercial Property Law, for example, has relied largely on the Landlord and Tenant Act 1954. D Greenish, 'Commonhold: The dawning of a new age?', p. 7.

- ∴ The Commonhold and Leasehold Reform Act 2002.

### The Leasehold Reform Act 1967

The 1967 Act was the first genuine attempt to address the declining nature of leasehold contracts, although it applied only to houses and not flats. The Act gave a leaseholder the automatic right to buy the freehold of their house or to extend their leasehold. Flats were omitted because they were relatively new and it was more complicated to sell freeholds whilst ensuring that positive covenants were enforced. It was not until 1972 that the first legislation focusing on leasehold flats was passed, giving leaseholders the right to know how much they faced in service charges.

### The Landlord and Tenant Act 1985

The Landlord and Tenant Act 1985 established basic ground rules for service charges for *all* leasehold properties, which had been evolving since the Housing Finance Act 1972.<sup>19</sup> Section 20 of the 1985 Act stated that significant capital works (defined as a specific jobs costing more than £250 per lessee or service contracts over one year) must follow a period of consultation with the leaseholders. The freeholder retains ultimate discretion and does not have to choose the cheapest option, but must show that their decision was reasonable. Sections 21 and 22 of the Act also gave leaseholders the right to view a broken down summary of the previous year's service charges by applying in writing to the managing agent. Some property managers complain however that the Act - especially Section 20 - is not practical for day-to-day operation, adding unnecessary costs and delays to management.

### The Landlord and Tenant Act 1987

The Landlord and Tenant Act 1987 was passed amid concerns about poor management and rising service charges in flats, which had led to the Nugee Report.<sup>20</sup> The Report's principal recommendations were put into this Act and increased statutory control on the imposition and composition of service charges, which henceforth had to be held in trust. It gave leaseholders in *flats* a right of first refusal to buy their freehold before it was offered on the open market, although this still lagged behind the right of leasehold *house* owners who

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19 The process of evolution continued with the Housing Act 1974 and the Housing Act 1980.

20 EG Nugee, 'Report of the Committee of Enquiry on the management of Privately Owned Blocks', Department of the Environment, 1986.

could buy their freehold or extend their leasehold at any time. It also gave leaseholders the option to go to court to assume management should their manager be unresponsive or incompetent. Although it gave leaseholders new rights, the Act has been criticised for being too complicated and adding too much red tape.<sup>21</sup>

### **The Leasehold Reform Housing and Urban Development Act 1993**

The 1993 Act gave flat owners the equivalent rights that the 1967 Act had offered leasehold house owners: to buy their freehold or extend their leasehold by 90 years with a Section 42 notice. This enabled collective enfranchisement - buying the freehold to flats collectively. This required the support and financial backing of at least 50 per cent of lessees and some in the sector feel that the requirements of this legislation are too complex.

### **The Commonhold and Leasehold Reform Act 2002**

The Commonhold and Leasehold Reform Act 2002 created commonhold tenure, designed to be used both in new and existing properties. Similar forms of tenure are used across the world and offer perpetual ownership of blocks of flats alongside a share of a company responsible for common area management. Commonhold has standardised documentation and requires the establishment of a commonhold community association (CA). This CA is owned by unit holders and means that they, rather than a freeholder, decide who manages the property.<sup>22</sup> The Act also introduced RTM which allows leaseholders to take control of the management of their building without having to claim that there had been any bad management. This significantly extended the management powers of the 1987 Act. Finally, it recognised that enfranchisement from 1993 had become too complicated and expensive, so sought to reduce this burden and ease the process.

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21 F Dobson and N Raynsford, 'An End to Feudalism: Labour's New Leasehold Reform Program', October 1995.

22 All unit owners are members of the Commonhold Association (CA), a limited company registered at Companies House which is responsible for the maintenance of the common areas. A CA is a company limited by guarantee with a special form of Memorandum and Articles. The name of the company must end Commonhold Association Limited. The CA must adopt a Commonhold Community Statement which sets out details of the Commonhold scheme.

## ■ **3 - The legislative framework and leaseholder rights**

As shown in Chapter 2, there is a large volume of legislation that has been passed which has provided leaseholders with a broad set of rights. The most important of these are:

- A Leasehold Valuation Tribunal (LVT) to appeal against unfair treatment or seek arbitration on other issues;
- Extension of their leasehold by 90 years beyond their current contract;
- Enfranchisement by purchasing the freehold (or share of);
- To move from share of freehold to commonhold;
- The Right To Manage (RTM), allowing leaseholders to assume control of building management;
- Consultation period for significant works under Section 20 of the 1985 Act;
- Access to details of service charge accounts under Section 21 and 22 of the 1985 Act.

### **Leasehold Valuation Tribunal**

Most disputes that leaseholders and their landlord or manager cannot resolve can be taken to an LVT - an independent non-departmental public body. Both lessees and lessors can take cases to tribunals. These are judged by a panel with three members: a solicitor, a qualified surveyor and a lay person. This is the lowest level at which a leaseholder can seek redress against their freeholder or enforce their rights when a manager is not subscribed to an ombudsman. The LVT is binding and can adjudicate on matters such as:

- Reasonable service charges, including the cost of property insurance;
- Whether a manager has met terms of a lease, such as reasonable level of service provision;

- ⋮ The cost of lease extension;
- ⋮ The eligibility for and cost of enfranchisement;
- ⋮ An RTM claim rejected by a freeholder;
- ⋮ Whether a lessee must pay a service charge.

The LVT is designed to be more accessible than a full county court. There are however still significant barriers and although not a full court, the tribunal remains a potentially intimidating legal process. It can also be expensive; an application to a tribunal can cost up to £500, leaseholders must pay their own fees, and often the freeholder's 'reasonable' legal fees if stated in their lease. The Leasehold Advisory Service is mandated to all stakeholders, so cannot offer leaseholders advice on how to build an LVT case.

Despite this, the LVT process is popular and has become oversubscribed with waiting lists often of 6 to 12 months. The fact that it is oversubscribed despite the barriers suggests that either the tribunal system is inefficient or that there is a large amount of conflict within the leasehold system. The LVT will be consumed into the new Property Chamber in 2013, although its functions for leaseholders will remain largely the same.<sup>23</sup>

## Right to extend leasehold

The right to extend a lease removes much of the risk that lessees will lose their full interest in their property and that it will revert to the freeholder. The leaseholder has the right to extend at any time, although the cost rises as the lease declines. A qualifying leaseholder must serve a Section 42 Notice to their landlord to gain a leasehold extension, including a reasonable offer to purchase the extension.<sup>24</sup> If the landlord rejects this offer, the lessee can then take the case to an LVT.<sup>25</sup> Extensions of 90 years are standard and apply on top of existing leases; a lease with 80 years remaining can

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23 The Ministry of Justice, 'Tribunal Procedure Committee Consultation on the proposed Tribunal Procedure (First-tier Tribunal) (Property Chamber) Rules 2013'.

24 A qualifying leaseholder must have a lease which was originally signed for 21 years or more and, unlike collective enfranchisement, must have owned the property for two years. Requirements have been relaxed so that a lease can be extended within two years of the death of the leaseholder. For Section 42 Notice see: [www.legislation.gov.uk/ukpga/1993/28/section/42](http://www.legislation.gov.uk/ukpga/1993/28/section/42).

25 A lessee applying to an LVT for an extension must pay £350 costs for the adjudication, in addition to covering theirs and the freeholder's reasonable expenses.

be extended to 170 years.<sup>26</sup> As long as a leaseholder is aware of the duration of their lease this should be a relatively simple process. A lease of 170 years is, in practical terms, equivalent to a freehold in terms of its market value.

The price of extending the lease depends on the market value of the flat (short lease with ground rents payable) and the value of the landlord's interest (the capitalised value of ground rent and the present value of the flat when lease has expired). Also, marriage value (the additional value of owning the extra 90 years of leasehold) is included for leases with fewer than 80 years remaining. The major issue here is extending the lease before it becomes too expensive, which requires knowledge of the lease's expiry date and access to the funds required to purchase an extension.

### Collective enfranchisement

Buying the reversionary interest of a leasehold house has been possible since the Leasehold Reform Act 1967, although it was not until the 1993 Act that flat owners in qualifying properties could do the same.<sup>27</sup> Whereas a lease extension can be obtained individually, enfranchisement of flats or houses with common parts is a collective process and requires the support of at least half of the qualifying lessees. It gives tenants the right to compel the sale of their property's freehold without having to prove any fault on the part of the freeholder. A new company with directors must be set up for joint enfranchisement, and the participating tenants must collectively purchase the full freehold.<sup>28</sup> This is not only a big undertaking in terms of effort on behalf of the tenants,<sup>29</sup> but also requires a significant financial commitment. If half of the tenants are

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- 26 There is no limit to how many times this can be done, so a leaseholder could immediately apply for another extension to create a 260 year lease. Note that flats can be extended for 90 years whereas leasehold houses can only be extended for 50 years.
- 27 A qualifying property must be an independent building containing two or more flats, two thirds of which must be occupied by qualifying tenants with an original residential lease of 21 years or more. A property is not eligible if the freeholder lives in it and there are four flats or fewer, or if more than a quarter of floor space is non-residential.
- 28 The price of the freehold includes the building's investment value to the freeholder (the capitalised value of his ground rents and the value of his reversion), half of the marriage value on properties with fewer than 80 years remaining and a peppercorn rent.
- 29 Tenants must serve an Initial Notice to their freeholders by a nominee purchaser (generally a company formed by the participants to acquire the freehold) representing the participating tenants. They must get an estimate for the value of the freehold and negotiate with the freeholder.

participating, those leaseholders proceeding with enfranchisement must buy not only their own share of the freehold but also, between them, the share of the other half of the non-participating leaseholders.

Before automatic enfranchisement rights, the Landlord and Tenant Act 1987 gave flat owners the right to first refusal on their property. It forced landlords to offer lessees the freehold to their properties before putting them on the open market. This is now less important because leaseholders have the right to enfranchise at any time, rather than solely when the freeholder wants to sell. Although enfranchisement and extension rights are now the same for flats and individual houses, the right of first refusal only applies to flats, not houses and should be extended to houses for consistency.

### Right To Manage

Leaseholders were given the right to remove an unsatisfactory manager by the 1987 Act, which initially required them to go to court, but is now overseen by the LVT.<sup>30</sup> The RTM strengthens this power and allows leaseholders to take indefinite control of management without having to prove any fault on the part of the manager. Should a freeholder reject an application, leaseholders wishing to continue their claim must either reapply or take their case to a tribunal. RTM became effective in 2003 after the 2002 Act gave qualifying leaseholders<sup>31</sup> the right to force the transfer of the landlord's management functions to an RTM company set up by them.<sup>32</sup> The RTM company can subsequently manage the property itself or appoint a managing agent. Leaseholders must continue to pay ground rent to their freeholder, but management costs of

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30 Leaseholders can recommend a managing agent to the LVT, although the appointed agent then contractually works for the tribunal.

31 RTM only applies to leasehold flats and not to leasehold houses or bungalows. A qualifying tenant is a leaseholder whose lease was originally granted for a period exceeding 21 years. The building must have two thirds of units leased to qualifying tenants, and be of a structure that can be served independently. It does not qualify if more than one quarter of its floorspace is used for commercial purposes, if there are multiple landlords or it is of four flats or fewer lived in by the freeholder. Local authority properties are not eligible.

32 An RTM application requires support of half of the leaseholders who must then serve a notice to all other tenants with the option to join the application if they wish. Following this a notice must be given to the landlord stating that they want to take RTM, giving the freeholder a month to respond. If the freeholder does not object, they can take control three months after this notice. If the freeholder challenges, they must go to an LVT or reissue the claim.

service charges and reserve fund contributions<sup>33</sup> are paid to the manager (themselves or an appointed management company). As the Labour Party stated in 1995, precisely because it allows leaseholders to access their rights, an effective RTM will “provide a proper incentive to landlords and their managing agents to deliver a high quality and cost effective service”.<sup>34</sup> For this to work lessees must be both aware of this right and subsequently able to act and take advantage of it. It can be hard to garner the support of half of the lessees in a large block of flats especially if, as one recent survey showed, more than 60 per cent of leaseholders do not even know that they have the RTM.<sup>35</sup>

## Commonhold

Commonhold, created by the Commonhold and Leasehold Reform Act 2002, is a form of tenure that allows residents of flats or housing estates to shift away from the system of long leasehold. The advantage of this, over collective enfranchisement, is that each resident owns the freehold of their ‘unit’<sup>36</sup> and a share of the commonhold association (CA) in perpetuity without any leases to extend. Another crucial distinction of the commonhold is that it has regulatory requirements that specify the rights and obligations of the unit holders under the CA. Documentation is standardised across developments unlike leasehold where rights and obligations are specified in the individual leases, which can vary significantly.<sup>37</sup>

The conveyancing process is simpler and quicker for commonhold than leasehold as it has a standardised agreement and does not face lease or title issues. However, it is not easy to shift to commonhold – the Act stipulates that the creation of a CA requires unanimous resident support and the process of moving to commonhold can only be begun once residents have completed collective enfranchisement. Because of the barriers of *shifting* from leasehold to commonhold, it is more realistic to see it as an alternative tenure type for *new* developments than as a solution for existing leaseholders.

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33 Also known as a sinking fund, it is used to offset and spread cost of large capital investments.

34 F Dobson and N Raynsford, ‘An End to Feudalism: Labour’s New Leasehold Reform Program’, October 1995.

35 Survey conducted by Wriglesworth Research on behalf of Urban Owners, December 2010.

36 A flat, and potentially a garage, for example.

37 Office for Fair Trading (OFT), ‘Property managers in Scotland – a market study: Annexe G - International comparisons’, February 2009.

## Service charges

The Landlord and Tenant Act 1985 gives lessees the right to examine their service charge receipts, although these do not have to include commission charges. It also compels freeholders to consult leaseholders before undertaking large financial commitments.<sup>38</sup> This involves serving a notice to lessees about the work and providing a notification of estimates. Lessees can submit replies, including alternative estimates, during the response period and the whole process can take around 4 months. Although the landlord does not have to act on the recommendations of the leaseholders, they do have to be able to show that their choice was reasonable and did not cost more than “an appropriate amount”.<sup>39</sup>

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38 Section 20 of the Act stated that a freeholder planning to undertake any works costing more than £250 per lessee or any contract lasting for more than a year must undertake a consultation with the leaseholders.

39 Landlord and Tenant Act 1985, Chapter 70.

## ■ 4 - Problems with the present system of leasehold

Although leaseholders have a broad set of rights – as discussed above - there are still significant problems with the system of leasehold. A clear and fundamental disadvantage of leasehold is the way that property deteriorates in value as leases decline. As David Lloyd George put it in his Limehouse Speech more than a century ago:

“You improve the building and year by year the value passes into the pockets of the landlord and at the end of sixty, seventy, eighty or ninety years the whole of it passes away to the pockets of a man who never spent a penny upon it.”<sup>40</sup>

As shown in chapters 2 and 3, decades of legislative reform have largely remedied this and leaseholders now have a right to purchase a lease extension or to buy their freehold (or share thereof). So the fundamental problem that a leaseholder’s property reverts to the freeholder has been removed. But renewing a lease remains an arduous process – especially when a freeholder rejects an application or when there are fewer than 80 years remaining on the lease.<sup>41</sup>

Given this, rather than choosing leasehold as a desirable form of property ownership, buyers usually turn to it out of necessity. It is the status quo (developers and mortgage lenders are accustomed to leasehold), and there is only a very small supply of property in commonhold or with a share of freehold. So customers who want to buy a flat in a certain area, or a specific type of property such as

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40 David Lloyd George, Limehouse Speech, 30 July 1909.

41 Both processes require valuations and, potentially, a tribunal. As long as a lease is renewed with 80 years remaining the price is reasonably low, although a lease shorter than this will be significantly more expensive to extend, and more difficult to secure a mortgage against.

retirement apartments, have little choice but to opt for leasehold. As long as leasehold remains the main form of ownership for flats, millions of people will continue to use it. This provides reason to focus on the protection of leaseholder interests and to consider the underlying structure at the root of many problems.

## Structure

Traditional leasehold contracts enforce positive covenants but effectively exclude leaseholders from the process of property management. The freeholder is responsible for the maintenance and insurance of a property as well as for collecting service charges and enforcing the terms of the lease.<sup>42</sup> This occurs despite the fact that leaseholders have greater concern for a property's long-term welfare (they have far more equity in it) and also despite the fact that leaseholders living in the property have more concern for its day-to-day management.<sup>43</sup> A standard leasehold contract compels the leaseholder to pay the freeholder an annual:

1. Ground rent;
2. Service charge – covering costs of managing common parts, and a management fee;
3. Reserve fund contribution – paid into a trust fund to cover large or irregular capital works.

In theory, the landlord's only lawful annual profit comes from ground rent and a management fee, as the service charges and sinking fund fees are designed solely to cover the costs of property management.

### RMCs

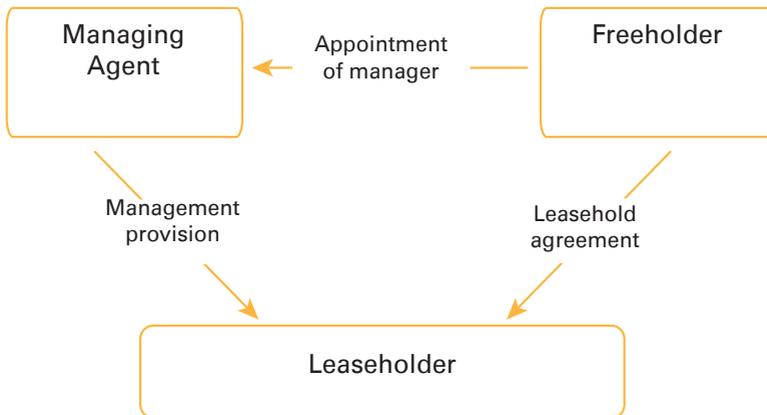
Resident Management Companies (RMCs) are used to control management where leaseholders have enfranchised or have a tripartite lease giving them control of the management. These are distinct from the traditional management structure discussed, although they raise their own questions around internal tenant democracy.

<sup>42</sup> A traditional arrangement is one simply between a freeholder and leaseholders. Alternatives with a different structure include: a headlease granted by the freeholder (landlord just collects ground rent), or a tripartite contract between landlord, lessee and a management company.

<sup>43</sup> The freehold of a property with a lease of 180 years is worth no more than a few hundred pounds, whereas a leasehold is usually worth hundreds of thousands.

Freeholders are likely to have limited incentive to manage a property themselves (other than the management fee) and usually turn to a managing agent to fulfil these duties. The agent signs a contract with the freeholder to arrange management services and to collect service charges as per the lease agreement. When a freeholder appoints a managing agent, the agent has a legal commitment to the freeholder but *no* direct legal obligation to the leaseholders unless the client is an RTM company or RMC and has appointed the agent. The managing agent's priority, therefore, is to meet the demands of its customer, the freeholder. This structural relationship is illustrated in Figure 2.

**Figure 2: Traditional arrangement of freeholder-controlled management**

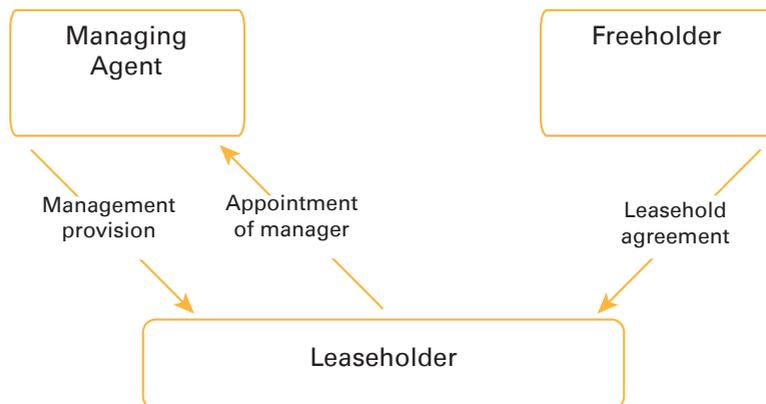


The interests of the leaseholder are excluded from the relationship that determines the management of their property. This problem is exacerbated by the fact that the freeholder does not ultimately pay the service charges, but passes them on to the leaseholders. The freeholder receives ground rent regardless of managing quality and does not benefit if management is of a high standard.

In contrast, when leaseholders are responsible for the appointment of managing agents – as is the case with RTM and commonhold – the agents work directly for the leaseholders who can easily change their manager without going to a tribunal or pressuring a freeholder. This relationship is presented in Figure 3. The leaseholders, as clients, have greater influence over the manager, who in turn is

exposed to greater competition. If the manager is working for the leaseholders there will be more direct communication between them which is important because much service charge-related conflict is a consequence of poor communication between management and leaseholders.

**Figure 3: Relationship when leaseholders are responsible for appointing managing agents**



The second figure is clearly preferable and emphasises how problematic the traditional arrangement is. Without leaseholder control, managers face less pressure to provide a good service and can more easily increase profit by reducing spending (if on a fixed management fee) or undertaking unnecessary work (if receiving commissions or a management fee as a percentage of service charges). This is easier than in a market with more direct connections between providers and those paying for services. Leaseholders can suffer from either poor value for money or low quality of service provision:

- : Poor value for money / Over-management: A manager may do more work than necessary if they can profit from additional work. This could occur if a linked company works on generous terms, if they receive a commission from the firm providing a service, or if – as occurs in some cases - the *management fee is actually a percentage of the service charge*. So lessees receive services as agreed in leasehold agreement, but pay more than they should because of unnecessary or overpriced work.

- **Poor quality / Under-management:** Given a fixed set of obligations and management fee, a manager can maximise profit by minimising the costs of adhering to the lease contract, so may reduce the frequency or quality of maintenance. Tenants must go through their freeholder to influence the managing agent but often face problems contacting their landlord, who may be out of the country, or may simply find it hard to get managing agents to complete necessary maintenance.

Problems are exacerbated in up to 20 per cent of leases where the management fee is a direct percentage of the service charge, which gives managers an explicit incentive to maximise costs.<sup>44</sup> The accountability to those paying the service charges is even weaker when lessees rent out their properties.

Firms seek to maximise profits in all sectors, but particularly in the leasehold management because of two peculiarities: the role of an agent means that there is disjoint between the freeholder and the leaseholder and, because leaseholders may have to go to a tribunal to change a managing agent, there is not a free market.

### Connected companies

The fact that managers are appointed by freeholders is particularly problematic when management for leasehold houses and flats is provided by a series of group companies connected to the freeholder.

Investor freeholder can establish a holding company owning freeholds alongside a series of connected companies which may include a management firm, insurance intermediary and other service providers. This is not uncommon; we have spoken to major management companies who confirm that the majority of their clients are freeholder companies connected to them.<sup>45</sup> This further reduces the incentive to be efficient. In fact there is clearly a direct incentive to be inefficient, because money stays within the group and costs are passed down to leaseholders. Although responsible connected companies may be able to benefit from economies of

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44 Based on authors' interviews with managing agents.

45 There is also a risk that a separate managing agent with connection to no freeholders may deal with connected companies during the provision of services. The growth of 'investor freeholders', despite legislation limiting annual income to ground rent and a management fee, may well suggest that there is potential to make profit through unofficial methods.

scale and internal efficiencies, there is not currently a sufficient system of protection for leaseholders when violations do occur - the tribunal system has too a high barrier to access and does not have the power to prevent deficient managing agents from trading.

Recent tribunals, such as Case Study 1, have exposed examples where connected companies traded on favourable terms with each other and dramatically increased service charges for leaseholders. Other hearings have revealed companies connected to the freeholder of a development signing service contracts more than a decade long, tying leaseholders into paying for the service of connected companies for years. In these cases, a tribunal can order repayment of unfair elements of service charges, but can neither compensate leaseholders further nor prevent managing agents from trading.

### Case study 1: Connected companies

In March 2011 the residents of Charter Quay in Kingston-upon-Thames took their freeholder, Charter Quay Ltd, to an LVT.<sup>46</sup> They lodged 13 separate complaints, including that management fees, insurance costs and interphone contracts were unreasonable. In total, more than £150,000 was disallowed retrospectively from service charges.

The tribunal found that the connection between the freeholder and managing agent was at the heart of the problems. It found a “family tree” of companies which included Charter Quay Ltd (the freeholder), Country Estate Management (the managing agent) and Interphone Security Ltd. The tribunal itself described a “trunk of [other] companies also descending in Biblical fashion”.

Long-term contracts were agreed with a connected company to supply interphones before leases were signed, thus circumventing Section 20 requirements. And even after leases were signed, new 14 year contracts were agreed with onerous break clauses. These contracts were seen as unreasonable by the LVT, which described it as “astonishing” that the management company’s employees were not made aware that they were dealing with connected companies nor ensured that contracts were reasonable.

The tribunal also found that, of annual insurance costing £83,000, the management company had received a

<sup>46</sup> London Leasehold Valuation Tribunal: [www.lease-advice.org/decisions/8587p-df/7001-8000/7361.pdf](http://www.lease-advice.org/decisions/8587p-df/7001-8000/7361.pdf).

commission of £26,000, which far exceeds the ten per cent considered reasonable. The management company and the freeholder were not operating at arm's length, and the LVT found "no evidence" that the price represented a market rate.

### Services charges: insurance

It is clear that the structural organisation of lease management creates problems with service charges, of which insurance is a particularly controversial area. Research by Which? magazine suggested that leaseholders pay £700 million a year in excessive fees and hidden costs.<sup>47</sup>

Blocks of flats require collective insurance for the building's structure and common parts.<sup>48</sup> This is generally stipulated in the leasehold agreement and the manager is responsible for organising insurance and recovering costs from tenants. But large commissions are not uncommon; managing agents or freeholders can receive commission from insurance brokers and bills can be presented without any sign of kickbacks.

The recent London Assembly investigation into service charges in London reported cases where leaseholders took the RTM and reduced their service charges by around 20 per cent.<sup>49</sup> Research by one managing firm found that leaseholders could save on average as much as 42 per cent on their insurance costs by taking the RTM.<sup>50</sup> Case Study 1 – in which commission of almost 50 per cent was charged - shows how significant a problem this can be. LVTs have ruled against large commissions, although they generally see 10-15 per cent as a reasonable level. As well as insurance, there is opportunity to receive commission for other works, to varying degrees, especially if such work is conducted by a corollary of the managing agent or freeholder.

The Royal Institute of Chartered Surveyors (RICS) and the Association of Residential Managing Agents both state that "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".<sup>51</sup> The emphasis here is that

47 Which?, 'Break free of flat fees', November 2011.

48 Leaseholders are generally responsible for insuring everything within their flat.

49 Greater London Authority, 'Highly charged: Residential leasehold service charges in London', March 2012, p 45.

50 [www.urbanowners.co.uk/agent-scandals.php](http://www.urbanowners.co.uk/agent-scandals.php).

51 The RICS Code of Practice and Insurance Commissions, paragraph 2.6.

commission *should* be declared when requested by primary clients, who could be freeholders, RTM companies or RMCs. But managing agents are not compelled to do so and when the primary client is the freeholder they have no obligation to disclose commission to the leaseholders (consumer clients). Indeed, this was recognised by RICS as a problem in a recent review which stated that:

“there should be greater emphasis placed on making sure clients, especially consumer clients, are made aware of the relevant remuneration, commission and any other payments paid through purchasing insurance.”<sup>52</sup>

Alarming, the wording of the RICS code of conduct only relates to profit on commission made by the managing agent – if an agent is connected to either a freeholder or an insurance broker they can direct commission to them without needing to declare anything.

Case Study 2 shows that even if companies are not connected, there is a lack of incentive for the manager to get a good price for the leaseholders who ultimately pay for insurance. As much as anything else, suspicion of commissions in service charges reduces *trust* and increases conflict between leaseholders and property managers.

### Case Study 2: Insurance

In February 2012, the London Rent Assessment Panel heard a case made by a resident of Mill Hill against his freeholder, represented by the managing agent Symon Smith & Partners. Insurance costs increased from £6,700 in 2009 to £7,700 and £8,200 in 2010 and 2011 respectively, despite the fact that no claims had been made since 2006.

The leaseholder conducted his own market exercise, in which he sought quotes to insure the property with its recent claims history under his name. These were consistently close to an average price of £2,350.

The LVT recognised that a landlord is not required to seek the lowest insurance premium, but must act reasonably. The insurance broker had only obtained one quote each year which was from the same insurance company. The tribunal ruled that:

52 RICS, Transparency in professional fees: [www.rics.org/site/download\\_feed.aspx?fileID=5978&fileExtension=PDF](http://www.rics.org/site/download_feed.aspx?fileID=5978&fileExtension=PDF).

“the service charge payers have a right to expect that the brokers, St Giles, or the agents, Symon Smith, would have attempted to query what was happening in order to ensure that the exercise was valid and they were getting value for money”.<sup>53</sup>

The tribunal found that insurance charges in 2010 and 2011 should not have exceeded £2,500. In effect, the leaseholder was paying more than 300 per cent of a reasonable price. This case is not atypical. It highlights the problems of a system where insurance is purchased by one party but paid for by another, leaving the purchaser with less incentive to be efficient.

### Access to rights: Leasehold Valuation Tribunals

Leaseholders currently face a high barrier if they wish to raise complaints against a freeholder or managing agent. Service charges are by far the most common area of contention, including issues over a lack of maintenance (see ‘Under-management’ above), seemingly unnecessary work (‘Over-management’) and high insurance costs (‘Insurance’). LEASE reported that annual complaints rose by 46 per cent between September 2009 and September 2011 to 7,600 complaints, most of which were about service charges.<sup>54</sup>

Although lessees have a comprehensive set of rights, there is currently a lack of infrastructure to help them use these rights. The lowest form of redress for leaseholders with a grievance against their property manager is the LVT which has significant costs and imbalances. Many managers use an ombudsman service which offers leaseholders a free forum for appeal on service issues. But without a licensing system that compels subscription to an ombudsman, LVTs remain the lowest point of redress available to all leaseholders.

A tension exists between maintaining a high quality, reliable arbitration service and avoiding an unreasonably high barrier for leaseholders. The tribunal system was designed to be more accessible to leaseholders or freeholders than a standard court, but has experienced something of a legal arms race. Some stakeholders

53 London Leasehold Valuation Tribunal: [www.lease-advice.org/decisions/8587p df/7001-8000/7622.pdf](http://www.lease-advice.org/decisions/8587p df/7001-8000/7622.pdf).

54 B Milligan, ‘Service charge complaints ‘up 46%’ among leaseholders’, BBC News, 24 September 2011.

complain that tribunals can be just as intimidating for leaseholders because of their resemblance to formal court situations, with expensive lawyers representing the freeholder. Meanwhile, other stakeholders complain that the tribunal system is not professional enough (because those sitting on a case may only do so once a month) and the tribunal's decisions can be inconsistent at best or ill-informed at worst. Of these opposing views, the former is more commonly held by leaseholders and the latter by management companies which reflects the information and power asymmetries that exist within the system. Large managing firms take solicitors or barristers because they are afraid of inconsistency between different panels and are aware that leaseholders may bring their own legal support. Leaseholders face a disadvantage if they self-represent, which particularly hurts poorer leaseholders and puts pressure on them to take legal support which increases costs and thus barriers to appeal.<sup>55</sup>

Barriers to tribunals include both time and cost. It can take months to assemble leaseholder support and to subsequently organise the claim itself. LVTs have a backlog because of the high number of grievances raised - as a direct result of the poor structure of the system and lack of a regulatory body. The whole process of organising a claim, negotiating with the freeholder and going through the tribunal process itself can take more than 12 months.<sup>56</sup> An application to the LVT costs up to £500, but leaseholders must also pay the associated costs of making a case. Costs create an especially high barrier for those on low incomes and this is a genuine problem because 37 per cent of leaseholders in flats are not in employment. The time and cost involved is particularly problematic for retirees (as outlined below in the 'Retirement Apartments' section).

On top of these costs is the potential for freeholders to reclaim their reasonable LVT legal costs through service charges - *regardless of the outcome of the tribunal* - when stated in the leasehold agreement.<sup>57</sup> This is a significant deterrent for leaseholders and

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55 Civil Justice Council, 'Access to Justice for Litigants in Person (or self-represented litigants): A Report and Series of Recommendations to the Lord Chancellor and to the Lord Chief Justice', November 2011.

56 Tribunals have a target to deliver, in 75 per cent of cases, a verdict within six months of a claim being lodged.

57 Leasehold agreements often have clauses such as "and the landlord may recover any legal costs in connection with arrears" through the service charge fund. They can reclaim costs from a tribunal through service charges win or lose unless a 20C order is served by the LVT. This provision is generally only used if a leaseholder loses very heavily.

enables freeholders to indulge in brinkmanship by opposing a leaseholder's claim without genuine grounds in the hope that costs will act as a deterrent to them advancing a claim. If leaseholders proceed, a freeholder may withdraw their opposition at any time without having to pay any costs to the leaseholder or tribunal. The only cases in which freeholders cannot reclaim their funds is if the tribunal uses a 20C order to disallow claiming all or part of their costs in service charge.

This represents a considerable imbalance, as leaseholders can only in rare circumstances receive any costs from a freeholder - up to £500 – if a tribunal rules that they have been deliberately vexatious. The maximum award may just cover administration cost of the LVT, so may not even begin to cover leaseholders' own legal costs. This is in stark contrast to leaseholders having to pay their freeholders' full reasonable costs.

Another imbalance in the system is the weak set of disclosure rules which mean that residents can have hundreds of pages of relevant documents given to them just hours before a hearing. This should be corrected as it creates an asymmetry of information and facilitates brinkmanship. Although balance is vital to a professional and consistent service, brinkmanship or withholding information before a tribunal is not part of this.

As well as barriers to reaching a tribunal, its approach can also hinder leaseholders. The tribunal refers back to the lease agreement, which may itself be unfair and it is more concerned whether the manager has complied with the terms of the lease and provided a reasonable standard of service than with value for money.<sup>58</sup> This is because the 1985 Acts stated that service charges must be "reasonably incurred" and can be charged, "only if the services or works are of a reasonable standard, and the amount payable shall be limited accordingly."<sup>59</sup>

## Retirement apartments

Almost 30 per cent of leaseholders are retired, many of whom inhabit the 100,000 purpose-built leasehold retirement apartments in England and Wales. People in their old age face particularly high barriers to redress because they are less likely to be able to invest the time, effort, money and energy required to successfully take

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58 An example of an unfair leasehold agreement is one that allows the freeholder to charge any LVT fees to leaseholders through service charges.

59 Landlord and Tenant Act 1985, Chapter 70.

a grievance to tribunal. Retirement apartments are often in small buildings, which makes it hard to gain a sufficient critical mass of support to make a case - this problem is exacerbated when an influential resident dies or moves out. In these ways the barriers to redress are particularly high for the most vulnerable leaseholders.

Leaseholders in retirement blocks face at least two other specific problems which they may seek redress against. First, many blocks of retirement apartments have a resident on-site manager and it is common for the freeholder to charge rent for this property to the leaseholders through their service charges. This adds significant costs to elderly leaseholders. Second, it is common for retirement flat lease agreements to include a clause requiring leaseholders to pay an 'exit' or 'transfer' fee when they wish to sell their homes. In some cases managing agents are connected to the freeholders and defend the charges by saying that they are simply following the lease and passing the fees onto the freeholder. There have not been clear justifications for the fees which are usually one or two per cent, but in some cases are as much as five per cent. There is doubt about whether these charges are legal, to the extent that the OFT is still working on an investigation - which began in 2009 - into the issue.<sup>60</sup>

So elderly people, many of the most vulnerable leaseholders, not only have additional problems but also greater difficulty in accessing arbitration. These problems emphasise the need to ensure not just that leaseholders are offered fair lease agreements and receive a good quality of management, but also that they have easier access to redress than the current tribunal system.

### Case Study 3: Retirement apartments

A retired leaseholder in Meadowbrook Court, Shropshire, challenged the reasonableness of the management fee element of his service charges at an LVT, focusing on charges made over a period of three years.<sup>61</sup> A management fee of 22.5 per cent was levied on all expenditure in each service charge. The applicant argued that not only was this more than ten percentage points more than other similar properties, but also that this went against the Association of Retirement Housing Managers' (ARHM) Code of Practice, which suggested charging an annual unit fee.

60 OFT, 'OFT investigates retirement home exit fees', Press Release, 3 September 2009.

61 Midland Leasehold Valuation Tribunal, Case 1736. [www.lease-advice.org/decisions/8587pdf/1001-2000/1736.pdf](http://www.lease-advice.org/decisions/8587pdf/1001-2000/1736.pdf).

The tribunal found the fees to be “inappropriate” and determined what it felt were reasonable management fees in the circumstances. The difference between the actual charges levied and those deemed reasonable are listed below.

*Table 1: Discrepancy between actual and tribunal charges*

<i>Year</i>	<i>Initial service charge</i>	<i>Tribunal approved 'reasonable' charge</i>	<i>Overcharging of actual charge</i>
<i>2004</i>	<i>£548</i>	<i>£330</i>	<i>40%</i>
<i>2005</i>	<i>£630</i>	<i>£340</i>	<i>46%</i>
<i>2006</i>	<i>£633</i>	<i>£350</i>	<i>45%</i>

#### Case Study 4: Retirement apartments<sup>62</sup>

Having finished his working life, Frank Gadd purchased a two bedroom retirement property in Hampshire. He used a solicitor to oversee the purchase of the maisonette which was one of four within the development. Soon however, his life became “grim”, as annual service charges reached £4,400. Although he wanted to challenge the costs at an LVT, the other three leaseholders did not want to go through the stress and costs of pursuing the case to a tribunal.

Instead, to cut their losses, the leaseholders decided to buy the freehold to their property. Mr Gadd hired a solicitor who stated that his agreement was heavily slanted in favour of the freeholder, who also happened to be connected to the property’s managing agent. Mr Gadd had been unaware of both of these facts after the initial conveyancing process.

Eventually the four leaseholders made an offer to buy the freehold, which the freeholder rejected, demanding a far higher price. Exasperated and keen to avoid additional costs of going to an LVT, the leaseholders relented and agreed to pay the price requested.

Having enfranchised, Mr Gadd’s service charges have now dropped from £4,400 to just £200 a year. Mr Gadd’s experience illustrates that there is a lack of transparency when managing agents are linked to freeholders, and that the LVT is too high a hurdle for those in the most vulnerable positions.

62 Case study from Patrick Collinson, ‘Peverel property management faces tenant rebellion over service’, The Guardian, 12 February 2011, and reproduced and developed following authors’ interview with Mr Gadd.

## Lack of regulatory regime

Regulation can be introduced for a variety of reasons, such as to address market failures, prevent power or information asymmetries and to promote professional conduct. All of these apply to leasehold.

First, leasehold management is not a free market because management is appointed by a generally indifferent freeholder which creates a disjoint in the relationship between the provider of the service and those paying for it. To expose managers to market competition, lessees must go to a tribunal or use the RTM process (which itself requires an LVT if a freeholder rejects a claim). This is unlikely if they are unable, or do not know how, to enforce their rights. The significant obstacles to leaseholders changing managing agents mean that the industry, like other sectors without effective competition, such as water supply, requires some form of regulation to ensure that firms offer a high quality service at a fair price.<sup>63</sup>

Second, there can be significant power asymmetries between leaseholders and large investor freeholders, particularly around the tribunal process. As discussed in the LVT section, tribunals can be particularly intimidating for the most vulnerable leaseholders who may lack resources to make a strong case and may be intimidated by a court setting. Notwithstanding this, leaseholders can have large quantities of information given to them only at the last minute before a tribunal. Instead, an ombudsman service is free for leaseholders and takes cases in writing, making it a more accessible forum for redress.

Third, high standards of competence are necessary not only because of the importance and complexity of housing, but also because of the money involved. Management of large blocks of flats or a housing estate has become a complex business, particularly with contemporary health and safety regulations - to run a block effectively, managers must have skill in areas as diverse as law, accountancy, surveying, building and engineering. The central importance of housing to people's lives means that those managing it should have professional standards and that incompetent managers cannot continue to operate. A licensing

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63 The OFT has reported that for leasehold management in Scotland, it found a "very low level of switching in this market...In part this is due the difficulties of coordinating the individual owners in a tenement block or property development to facilitate a switch, but it is also due to the problems these consumers have in understanding the processes involved in switching to another property manager." OFT, 'Property managers in Scotland: A market study', February 2009.

scheme would ensure that these standards are met by all managing agents, and would raise standards by introducing qualifications and an ombudsman service.

The huge sums of money held and spent by managers in England and Wales - which could be between £1.275 billion and £2.5 billion<sup>64</sup> - mean that an appropriate level of accounting competency is essential. But leasehold managers are subject to less regulation than other similar professionals such as letting agents or estate agents, despite the fact that these have less responsibility but considerably more accounting regulation.<sup>65</sup> For example, all estate agents must sign up to an ombudsman service and the Office for Fair Trading (OFT) has a duty to ensure that they comply with the Estate Agents Act. It also has the ability to ban agents from operating if they fail to do so.

Beyond estate agent regulation, the previous government sought to establish a licensing scheme for letting agents with the Association of Residential Letting Agents (ARLA) but the plans were blocked by the current government.<sup>66</sup> The state also funds the National Approved Letting Scheme (NALS), an accreditation service for private rented lettings and management agents. In this context, the leasehold management sector appears peculiarly overlooked in terms of consumer support.

The nature of leasehold management means that many years' worth of savings in reserve accounts can be removed without leaseholders realising, whereas the monthly nature of letting agents' work means that unscrupulous agents will be quickly detected. So it is surprising that leasehold management is less regulated than almost all other professions in which money is held and the failure of sections 152 and 156 of the 2002 Act – which dealt with service charge accounts and holding money in separate accounts

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64 The London Assembly estimates that in London alone more than £500 million is spent a year on service charges, based on an average of £850 per lease in the public sector and £1,800 to £2,000 for the private sector. ARMA written submission to 'Highly charged: Residential leasehold service charges in London', March 2012.

65 A letting agent simply holds rent, pays bills, and then passes the remainder of the money to the property owner. A leaseholder managing agent must commission work and spend large amounts of money on behalf of leaseholders. Letting agents have a statutory scheme of deposit protection for renters, and estate agents have to abide by standards in the Estate Agents Act. Moreover, the shorter nature of letting contracts mean that it is easier for letting customers to find a new agent if they are unsatisfied.

66 See BBC News, 'Letting agents set for regulation', 5 May 2009, and BBC News, Letting agents 'let off the hook' by government, 12 June 2010.

respectively – to pass into law have made this more acute. Even the British Property Federation, which represents freeholders, has recognised that greater regulation of accounts is necessary. The government should pursue this as a matter of priority.<sup>67</sup>

### Self-regulation

Because of the current total lack of statutory regulation, other bodies in the sector have sought to fill the regulatory void in a piecemeal fashion. Voluntary self-regulation has been employed primarily through trade bodies RICS and ARMA which, alongside the Leasehold Knowledge Partnership, is the only specialised accreditation body for leasehold managing agents. Other bodies such as the Chartered Institution of Housing have also felt pressure to play an increasingly active role. Although ARMA describes itself as a trade association rather than a professional body, its regulatory functions have helped to raise standards of its members in a variety of ways. It has compelled members to subscribe to ombudsman services, for example, as well as creating a dispute resolution service, albeit one run by its managing agent members. It has also led to the publication of guidance notes to help managing agents and leaseholders, and RICS has produced a government-approved code of conduct for service charges.<sup>68</sup>

### Problems with self-regulation

The Housing Minister, Grant Shapps, has stated that the interests of leaseholders, freeholders and managing agents are balanced, and reform of the sector “should be driven by a more proactive approach from the sector – not by greater regulation.”<sup>69</sup> This stance is problematic, even ignoring doubts about whether leasehold management is a sector best regulated by managing agents themselves. More pressingly, voluntary regulation allows the worst companies to operate outside *any* regulatory regime. Because of the difficulties that leaseholders wishing to change managers can face going through the tribunal process, it is very important that *all* managing agents meet an acceptable standard of service.

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67 Letter from BPF Director of Policy, ‘S152 and S156 of the Commonhold and Leasehold Reform Act 2002’, 9 February 2010.

68 See RICS code of practice: [www.rics.org/site/scripts/download\\_info.aspx?fileID=3606&categoryID=455](http://www.rics.org/site/scripts/download_info.aspx?fileID=3606&categoryID=455).

69 Letter from Grant Shapps to the Prime Minister: [www.cqra.org/index.php/ltv/11/214-letter-to-grant-shapps-housing-minister](http://www.cqra.org/index.php/ltv/11/214-letter-to-grant-shapps-housing-minister).

Self-regulation has raised standards to some extent, but leaving managing agents to manage themselves unquestionably has significant flaws and does not look as if it will adequately balance the interests of leaseholders, freeholders and managing agents. ARMA cannot reasonably be expected to offer a full regulatory service because it was established as a trade association rather than a professional body – its priority remains representation of managing agents. Rather than seeing itself as an ideal industry regulator, the association has sought to fill some of the gaps created by successive governments' inaction. There are clear conflicts of interests when a trade association seeks to perform regulatory functions for its own members. ARMA recognises the need for independent regulation and in a recent review stated that their industry required:

“an acknowledgement of interests which go beyond the direct client. We have recommended that ARMA separate regulation and representation with the regulatory role involving independent consumer representatives.”<sup>70</sup>

If ARMA is going to have a separate, independent regulatory function, it seems preferable to have a new, fully independent regulator rather than one funded by the existing association for managing agents. The fact that ARMA recognises the need for separate regulation should send a clear message to the government.

Indeed, full regulation is supported not just by ARMA but also seemingly unanimously by other groups across the sector including leaseholders, freeholders and lawyers.<sup>71</sup> ARMA supports government regulation, and its own regulatory function has arisen largely because independent regulation has not been implemented by government.<sup>72</sup> Regulation needs an impartial balance and cannot work if it is weighted to either managing practitioners or consumers. As a task force on the regulation of letting and managing agents noted, “A single independent regulator would be the ideal approach

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70 Baroness Hayter conducted an independent review for ARMA: [www.arma.org.uk/doc/public/ARMA-Conference-2011PR.pdf](http://www.arma.org.uk/doc/public/ARMA-Conference-2011PR.pdf).

71 Based on authors' interviews, and FOI minutes from task and finish meeting with CLG for leasehold managing agents in the private sector.

72 An example of this is collaboration between ARMA, The Institute of Chartered Accountants in England & Wales and the Royal Institution of Chartered Surveyors (RICS) in defining Best practice for accounting for service charges. This is something that filled a perceived gap after the government opted not to introduce new accounting regulations under the Commonhold and Leasehold Reform Act 2002.

and would give tenants most confidence in the system".<sup>73</sup>

Even if ARMA were to operate as a fully independent regulatory body, the fundamental problem would persist that individual management agencies could continue to operate despite having been expelled from, or never being members of, a regulatory body. ARMA estimates that around 80 per cent of units managed by professional agents are subject to self-regulation. This suggests that a significant proportion of managed flats are maintained by companies subject to no standards. This means that one fifth of leaseholders with professional agents – up to 100,000 properties – have their management entirely unregulated. Thus regulation must be compulsory: if it is not, it will fail to protect leaseholders from the most unscrupulous agents.

Case Studies 5 and 6 show how both the Irish and Scottish governments have sought to introduce independent regulation in the past two years. In this context, protection for leaseholders in England and Wales is lagging behind.

#### Case study 5: Ireland

Ireland is currently in the process of introducing a National Property Services Regulatory Authority, overseeing estate, letting and managing agents. It was ordered by the Property Services (Regulation) Act 2011 and the Authority was established on a statutory basis in April this year. It will begin licensing in July, and will:

- Operate a comprehensive licensing system covering all providers of property services;
- Set and enforce standards for the grant of licences and provision of services;
- Establish a system of investigation and adjudication of complaints;
- Promote increased consumer protection and public awareness;
- Establish a Compensation Fund to compensate parties who lose money as a consequence of the dishonesty of a licensee.<sup>74</sup>

73 Private Rented Sector Task Force – Regulation of Letting and Management Agents, Note of Meeting – Wednesday 31 March.

74 The Property Service Regulatory Authority, [www.npsra.ie/website/npsra/npsraweb.nsf/page/aboutus-whatnpsra](http://www.npsra.ie/website/npsra/npsraweb.nsf/page/aboutus-whatnpsra).

### Case study 6: Scottish managing agents

*The Property Factors (Scotland) Act 2011 radically changed the relationship between managing agents (factors) and residents.<sup>75</sup> It introduced:*

- Compulsory registration for all managing agents (factors);
- A code of conduct, to be followed as a condition of registration;
- A more accessible dispute resolution service.

The Act states that “any person who is, or intends to become, a property factor” (managing agent) must be registered, and once they are registered are liable to a fine or removal from the register for poor service. It pledges to create a code of conduct “setting out minimum standards of practice” for all managing agents. It also creates a homeowner housing panel and committee which can determine whether a managing agent has failed to either carry out their duties or to comply with the code of conduct. The committee has the power to order both a compensatory award and a refund. In this way, the act is able to both ensure a minimum standard for managing agents and also offer more accessible redress to residents.

### Right To Manage

RTM is a useful tool allowing leaseholders to assume control of management without having to purchase anything from the freeholders. But hundreds of thousands of units are ineligible, while those that are eligible can face difficulties in applying. Because RTM is only available to flats, 600,000 leasehold houses are not eligible for RTM. Neither are leaseholders with local housing authority freeholders, nor those in properties with more than 25 per cent commercial floorspace, which is a common feature of many modern developments. This requirement also means that flats above shops are not eligible for RTM. Other social considerations mean that planning permission in property developments generally require any new builds with more than ten units to offer 30 per cent of their units as social housing or mixed tenure. This is problematic because mixed ownership units do not qualify for RTM.

<sup>75</sup> See the Property Factors (Scotland) Act 2011.

## Local authority leaseholders

Leasehold properties with local authorities are not eligible for RTM, and their properties are managed by Arms Length Management Organisations (ALMOs). These have been regarded to some extent as part of the government, so are not subject to the same scrutiny as private managing agents. In particular, much of the protection afforded to lessees in the 2002 Act excluded local authority leaseholders.

There are also too many obstacles for those lessees who are eligible for RTM. Gaining the support of 50 per cent of lessees is a necessary requirement, but is one that is becoming increasingly complicated to comply with. Groups seeking RTM in properties with buy-to-let owners can have significant problems merely getting in contact with head lessees to discuss RTM, let alone reaching an agreement. In many ways the biggest problem is lack of awareness: one survey showed that more than 60 per cent of lessees are unaware of their right to manage.<sup>76</sup> It can be relatively straightforward to get 50 per cent support in a block of ten flats, but quite the opposite in a block of 100.

As already discussed, the organisation of the tribunal system allows freeholders to object to an RTM application without having to reveal their grounds before the tribunal itself. Although qualifying tenants have the automatic right to manage their own properties, freeholders can reject an application on a technicality or incorrectly completed application form. This can be used by freeholders employing brinkmanship by disputing a claim, hoping that the prospect of going to a tribunal will deter leaseholders. This disproportionately hinders poorer and less informed leaseholders.

The fact that there are leaseholders who are not eligible for the RTM, and others who face significant barriers to accessing it, only emphasises the importance of having a more effective mechanism to enforce minimum standards of management through a regulatory body.

## Commonhold

Commonhold gives the unit-owners control over their property's management through a Commonhold Association (CA). But there is a general consensus that, in terms of uptake, it has been a failure - research by the Leasehold Knowledge Partnership shows that there

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<sup>76</sup> Survey by Wriglesworth Research for Urban Owners.

are only 15 commonhold developments in the UK, and the Land Registry confirms that there are only 152 commonhold unit titles (flats) within these developments.<sup>77</sup> This could be because there is little interest in it - lessees are happy with the current system and other options such as collective enfranchisement and RTM. But it seems more likely to be because there are large barriers to switch to commonhold, and those involved in the development of new properties prefer the status quo of leasehold.

It is virtually impossible to convert from existing leasehold to commonhold because the creation of a CA requires the unanimous support of all lessees.<sup>78</sup> This is a strict requirement compared to the half needed to gain the RTM or to buy a share of the freehold. It is also difficult to acquire a mortgage because lenders do not have significant experience of commonhold as a form of property ownership and fear that a commonhold association can lack mortgage security if wound up (although this in principle is the same if a freeholder goes bankrupt). Leaseholders hoping to convert to commonhold must get permission to do so from their mortgage providers for the commonhold association to become effective. For these reasons, commonhold is best seen as a solution for new developments rather than for existing leaseholders.

Commonhold has not been used for new developments of flats, largely because the benefits of commonhold are clearer for buyers than for sellers. Commonhold is more risky for developers and investors who are familiar with leasehold. Leasehold can be more profitable because developers can sell leaseholds and subsequently the freehold as well. Instead, the benefits of commonhold are enjoyed primarily by the buyers of properties, who gain responsibility for appointing managing agents and own their property in perpetuity. If commonhold caught on, developers could also benefit as they would see fewer risks and greater consumer demand could make it more profitable. So despite the obvious shortcomings of the leasehold system, and the clear benefits of commonhold, there has been little use of commonhold because the obstacles to shifting to commonhold are significant both for new developments and existing properties.

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77 The Leasehold Knowledge Partnership, 'The 15 commonholds', [www.leaseholdknowledge.com/i-want-to-break-free/the-15-commonholds](http://www.leaseholdknowledge.com/i-want-to-break-free/the-15-commonholds). The Land Registry, Disclosures - Commonhold Registration, [www1.landregistry.gov.uk/right-to-information/disclosure-log/organisation](http://www1.landregistry.gov.uk/right-to-information/disclosure-log/organisation)

78 Barry Gardiner MP described this 100 per cent qualification as the "the death knell of commonhold" in the House of Commons, 8 January 2002.

## Freeholder control over leasehold property development

A significant issue arises when freeholders charge leaseholders for consent to amend their properties. This occurs because most lease agreements contain a clause requiring consent, designed to protect the freeholder from losing value and to allow them to prevent work which would harm other properties. It is often used today however to claim unwarranted premiums from leaseholders who are seeking to improve their homes.

Freeholder control is especially problematic with leasehold houses, where external amendments such as conservatories and garages are more common than with flats. In particular, houses sold on 999 leases have a greater likelihood that problems will arise because leaseholders often consider themselves to effectively be freeholders and may not revert to their lease agreement or realise that consent is required before commissioning work.

In many cases freeholders demand significant administrative charges for considering an application and granting permission, which can leave leaseholders with little option other than paying up or cancelling planned development. In other circumstances, where leaseholders have not gained permission prior to commencing work, freeholders can demand a fee in retrospect. If an amendment has already been completed, freeholders can threaten forfeiture if the requested payment is not made. This means that, in most cases, leaseholders will pay the fee demanded even when it is unjustifiably high.

Leaseholders also face problems when they wish to amend the interior of their properties where leasehold agreements require freeholder consent. For example, a lessee wanting to install a shower can have to apply to their freeholder, who, in turn, can simply grant permission, demand a fee for doing so or impose unnecessary sanctions.<sup>79</sup>

The rationale behind control over interior development could again be that it protects freeholders from changes which will reduce the value of their asset and they must retain control to prevent development where it will harm a building's structure. But this power is open to abuse by freeholders demanding premiums for

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79 This is despite the fact that leases generally give repairing obligations to the freeholder for the external parts of the building, services and installations, but leave matters within a unit's interior walls to the leaseholder.

beneficial developments. If a leaseholder is going to increase the value of a property, the freeholder will benefit when the lease is extended or enfranchised. This is a more than sufficient benefit considering that the freeholder has not spent anything. It is unacceptable that a freeholder should receive a significant double benefit by also charging for consent for beneficial work, particularly where individuals have leases longer than 80 years and hold the vast majority of the financial interest in the property.

Freeholder 'grazers' – who seek relatively minor opportunistic profits from a large number of properties - have emerged, aiming to benefit from charges for development consent. This phenomenon has been particularly prevalent in northern England, where large swathes of freeholds have been bought at auction for relatively low prices.<sup>80</sup> Some may argue that ground rent alone delivers sufficient return on the freehold investment but, in reality, most rents are too low to deliver competitive rewards. This, combined with the way that many 'grazer' freeholders use connected management companies and put significant emphasis on charges for development consent, suggests that this is a direct aspect of their business model.

### **Estate Management Schemes: control over freehold property development**

There are also cases where an erstwhile freeholder can retain control over properties, even after former leaseholders have enfranchised. This occurs in the presence of Estate Management Schemes, which were created by legislation in 1967 (and extended in 1993) to bolster usual planning laws to ensure that the character of specified areas may be protected. Powers of EMSs can include:<sup>81</sup>

- ⌚ Regulation of redevelopment, use or appearance of properties;
- ⌚ Ability to conduct works of maintenance, repair, renewal or replacement on properties within the scheme;
- ⌚ Empowerment to charge residents for these associated costs;
- ⌚ Authorisation to inspect properties.

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80 Barry Gardner MP: "ground rent grazers that have bought up literally hundreds of thousands of freehold interests, usually at auction in the north-west of England". See [www.publications.parliament.uk/pa/cm199798/cmhansrd/vo980610/debtext/80610-04.htm](http://www.publications.parliament.uk/pa/cm199798/cmhansrd/vo980610/debtext/80610-04.htm).

81 Leasehold Reform, Housing and Urban Development Act 1993, Chapter 5.

Schemes “may provide for all or any” of the above powers.<sup>82</sup> As a result of these powers, two problems raised in this chapter can occur even where individuals own the *freehold* – alterations to properties and service charges. It is no longer possible to create new schemes, which may explain why the problems confronting existing ones have not been addressed.

First, some schemes simply regulate the external appearance of properties but others seek tighter control of properties’ *interiors*. This can mean that many freeholders wishing to alter the inside of their property must pay a premium to do so and the directors of the scheme have the power to block a proposed development altogether. There can be legitimate reasons for preserving the character of an area, through controls on external development or the use of a building. But it is hard to understand why a scheme should have control over the interior of a property.

Second, schemes can charge property owners ‘estate charges’ for general work maintaining the area, such as railings, gardening or drains, which are similar to service charges for leaseholders. Freeholders can ask an LVT to amend a scheme if they are unhappy with service charges set through variable estate charges or calculated with a formula. But they cannot appeal against a specific unreasonable service charge at a tribunal, and are not protected by the Section 20 regulations for consultation on significant works or long contracts. This means that there is more potential for profiteering through estate charges.

## Forfeiture

Lessees can currently lose all rights to their leasehold if they breach their contract, meaning that the full value of their flat may be lost for comparatively minor sums, such as failure to pay ground rent. Thus a leaseholder could lose the full value of their property for failure to pay their freeholder a sum which could be worth just 0.1 per cent of its value. The OFT has stated, understandably, that this system is “disproportionate”.<sup>83</sup>

Forfeiture occurs only rarely, with its main power residing in the *potential* that it could be used; its existence facilitates freeholder

82 Leasehold Reform, Housing and Urban Development Act 1993, Chapter 5.

83 Under leasehold tenure, the leaseholder may have the flat repossessed by the freeholder without compensation for non-payment of service charges. The lack of monetary compensation is felt by many to be disproportionate. Office for Fair Trading (OFT), ‘Property managers in Scotland – a market study: Annexe G - International comparisons’, February 2009.

brinkmanship and exacerbates power asymmetries between lessors and lessees. For example, some managing agents write directly to mortgage providers as well as leaseholders to demand payment of unpaid charges with large administration fees. Risk averse mortgage lenders are likely to simply pay the charge, even when it is unreasonable, and pass the cost onto the leaseholder. Forfeiture can also be used to exacerbate other weaknesses of leasehold tenure. As discussed in 'Freeholder Control' above, for example, the owner of a house with a 999 year lease could choose to pay an exorbitant fee for retrospective consent for development from their freeholder in order to avoid the risk of forfeiture.

Clearly, it is essential that the freeholder has powers to enforce the lease agreement and recover costs. But at the very least, the lessee should get the majority of the value of their property back minus their debt, a fine and the freeholder's costs, rather than losing the full value.<sup>84</sup> A small claims court could be used to recover the costs and if this was unsuccessful then as a last resort the sale of a leasehold property could be forced. The key element that any reform in this area must contain is that, as opposed to current arrangements, the leaseholder should receive the remaining value of their property after outstanding debts and costs have been paid.

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84 A £350,000 leasehold property in Camden faced outstanding bills of £1,266.38, which was forfeited meaning that the owner made a loss of £348,733.62 . See [www.publications.parliament.uk/pa/cm200102/cmhansrd/vo020108/debtext/20108-22.htm](http://www.publications.parliament.uk/pa/cm200102/cmhansrd/vo020108/debtext/20108-22.htm).

## ■ 5 - Access to rights - immediate solutions

We seek to offer solutions to the problems within the leasehold system while maintaining a fair and practical balance between the interests of leaseholders, freeholders and property managers. What is needed most is not more legislation, but robust infrastructure giving leaseholders greater access to their rights. The government should lever the interests of leaseholders into the process of management through a licensing system with a compulsory ombudsman, which would raise the standards through the supply side. An independent regulator would be slightly more expensive than self-regulation, but would breed greater confidence and would be more effective with more powers to impose sanctions.<sup>85</sup> In the longer term, management can also be improved from the demand side: transition to more direct tenant control, through RTM and commonhold, should be encouraged. Both of these give direct power to groups of property owners, and allow them to choose how their homes are managed.

### Regulation

A licensing system with a compulsory ombudsman service would protect leaseholders' rights and ensure reasonable treatment, which has been recognised by parties from all sides of the sector.<sup>86</sup> It should cover all managing agents, including ALMOs and landlords who manage properties on behalf of other landlords. Regulation should be light-touch, mainly relying on referrals from the ombudsman and LVTs. It would be cost effective for the government and for leaseholders, and would create a consumer

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85 Department for Communities and Local Government, 'The private rented sector: professionalism and quality – consultation Summary of responses and next steps'.

86 This could use a model similar to the Financial Services Authority as regulator with the Financial Ombudsman as a dispute resolution service. Lease retains an impartial stance.

champion for leaseholders to balance against managers' associations. The regulatory regime could be similar to the models used by the Scottish and Irish governments, and should include:

- Maintenance of a licence to operate with a monitoring regime and disciplinary process;
- Qualifications with training and exams;
- A compulsory ombudsman service.

Regulation should ensure both that managing companies have correct procedures in place and that their staff have sufficient knowledge and skills.

### **Maintain licence to operate with the threat of expulsion**

All managing agents would require a licence to operate. The regulator should maintain a register of companies and communicate with managing agents the standards that they must maintain through a code of conduct. It would be simple to introduce such a code – self-regulating agents already abide by a RICS management code of practice which is approved by the government.<sup>87</sup> This, or a similar document, would simply have to be rolled out and adopted across the industry. The most important elements should be that managing agents:

- Subscribe to the ombudsman service;
- Attain necessary qualifications;
- Operate an internal complaints procedure;
- Publicise the leaseholders' handbook of rights;
- Operate at arm's length with any connected companies, and declare such relationships;
- Declare all commission received.

The regulator should maintain a complaints and disciplinary process, including the ability to issue fines and formal warnings. The regulator's ultimate sanction would be the removal of the licence to operate. This would be an important new power that does not currently exist and should be seen as an option of last resort - but a real one - to be used when an agent has consistently failed to manage in accordance with the licence.

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87 Members of ARMA and RICS must abide by a government-approved code of practice (produced by RICS) for property management.

All managing agents would need to have their own internal complaints process and leaseholders could use an ombudsman or a tribunal when this failed to offer resolution. The ombudsman or tribunal would be able to lodge a complaint to the regulator where necessary, who in turn could launch a formal investigation if a significant number of specific complaints were received.

### **Professionalism: qualifications and transparency**

Beyond its code of conduct, the regulator should promote professional competence with a set of standards and qualification. As such, all management companies should be licenced and their employees should be registered. Qualifications should be tailored to the job of a managing agent and can avoid creating high barriers. Rather than needing to be a fully qualified chartered surveyor, a managing agent could take a set of courses authorised by the regulator covering accounting, surveying and leasehold law. These training courses could be operated by existing external providers which already offer relevant training and would involve examinations.<sup>88</sup> They would be affordable and relevant to the responsibilities of a managing agent.

#### **Case Study 7: New South Wales, Australia**

In New South Wales, the Property, Stock and Business Agents Act 2002 requires all professional managing agents to be licenced. Licences are used “to reinforce professionalism and ethical conduct in the property agency industry or to protect consumers”. New firms wishing to enter the market can apply for a certificate of registration. Where licencees break the licence’s code of conduct they can receive penalty points on their licence and have specific conditions attached to it.

There is a distinction between a head manager with a ‘strata managing agent’s licence’, and employees of the managing agent. The head manager requires a Certificate IV in Property Services, which includes units of competency for safety, financial accounting, handling conflicts and procurement

88 As stated by LEASE, “The proposed requirements for common competency standard, based on an approved course of study and continuing professional development, should form the basics of any UK proposal for regulation; much work is already in progress by the Institute of Residential Property Management/Chartered Institute of Housing to provide a suitable professional qualification which could be incorporated in only statutory proposals.” [www.lease-advice.org/publications/documents/document.asp?item=43](http://www.lease-advice.org/publications/documents/document.asp?item=43).

of contracts. By contrast, employees of the head manager require Certificate III in Property Services, which has fewer units, involving working in property management and how to deal with clients.<sup>89</sup>

Transparency of accounting, commissions and connection to companies should be at the heart of the licence. The disclosure of commission should be enforced by the regulator rather than a hard cap. Some large freeholders can receive hefty commissions but still offer their customers cheaper insurance by taking advantage of economies of scale. Ultimately, the price that the leaseholder pays compared to the open market is more important than the commission received by the manager. So a regulator should compel managing agents to declare commission - both to their primary client and, when they are not the primary client, the leaseholders. This would increase trust, expose unscrupulous managers and reduce conflict over commission and fees. Disclosure of commission should not concern managers with nothing to hide. Because of the complexities of the relationships between insurance companies, brokers and managing agents, the government should also consider working with the FSA to ensure that new regulations are followed.

Other regulatory regimes, such as those in New Zealand and Australia insist that managers must disclose all commissions and discounts received. Restrictions are particularly tight in New Zealand, requiring declaration of all legal and financial relationships between the manager and the freeholder.<sup>90</sup> A similar requirement could be effective in England and Wales. Alongside a licensing system ensuring that connected companies trade on an arm's length basis which has the ability to prevent unscrupulous connected managing agents from trading, greater transparency would reduce the present problems created by connected companies. In cases where licences were revoked, leaseholders should have an input into the appointment of their replacement.

## Ombudsman

An ombudsman service would create a more accessible form

<sup>89</sup> See the Property, Stock and Business Agents Act 2002 No 66. The New South Wales Fair Trading office has more information about licensing of managing agents. For the different qualifications required see [nsw.stratacommunity.org.au/page/members/member-news/qualifications-for-registration-as-a-strata-managing-agent/](http://nsw.stratacommunity.org.au/page/members/member-news/qualifications-for-registration-as-a-strata-managing-agent/).

<sup>90</sup> LEASE advice: 'Improving the standard of residential property management: Implications of Australian / New Zealand legislation and practices', Advice guide.

of redress for leaseholders with independent adjudication on leaseholder complaints. This would give leaseholders better access to their rights because it would be free to use and would not incur large legal costs. It would have a similar effect to the homeowner housing panel legislated for by the Scottish Parliament, as shown in Case Study 6.

The ombudsman would deal generally with customer services issues, such as management failing to respond to an infrastructure problem quickly enough, complete a job properly, or take care when sending service charges.<sup>91</sup> It should also deal with small and medium service charge cases.<sup>92</sup> The ombudsman could refer cases to an LVT, and major service charge claims should be dealt with by the tribunal. Complaints against the freeholder and quantitative financial issues, such as lease extension or enfranchisement, should go directly to a tribunal. The LVT would continue to be used to deal with issues of covenant enforcement such as non-payment of bills, but the ombudsman would reduce its workload overall.

The ombudsman would ask both sides to undertake a dialogue of mediation before hearing a case and if this failed to solve a dispute both sides would be asked to present their cases in writing. This would be less intimidating than appearing at a tribunal to give oral evidence, so would reduce power asymmetries. Although it is free to use, the mediation procedure and application process should be sufficient to deter disingenuous or spurious claims.

There are currently three major ombudsman services for leasehold property, which were all established for different purposes. Their terms of reference are now similar and they hold regular meetings to strive for consistency, but this is not an optimal arrangement.<sup>93</sup> It would be simpler and more consistent for all stakeholders if one sector-wide ombudsman was used for leasehold management. This would ensure the most consistent service possible and prevent the risk of a 'race to the bottom' where ombudsman may offer favourable treatment to managing agents to gain their custom.

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91 Ombudsman Services: Property. Full list of their cases [www.ombudsman-services.org/investigated-cases-property.html](http://www.ombudsman-services.org/investigated-cases-property.html).

92 Currently the Ombudsman Service: Property can make awards up to £25,000 – it seems reasonable that service charge cases up to this level could be taken to the ombudsman. [www.ombudsman-services.org/awards-property.html](http://www.ombudsman-services.org/awards-property.html).

93 The three ombudsman services are: The property ombudsman (See [www.tpos.co.uk](http://www.tpos.co.uk)) which was originally designed for estate agents; Ombudsman Services: Property ([www.ombudsman-services.org/property.html](http://www.ombudsman-services.org/property.html)) which was originally for chartered surveyors; and the Housing Ombudsman ([www.housing-ombudsman.org.uk](http://www.housing-ombudsman.org.uk)) which was originally and predominantly for social housing.

A central ombudsman service should deliver public judgements to offer other leaseholders and freeholders greater information.

Enforcing a compulsory ombudsman service would be straightforward as part of a licence and has a precedent in the estate agent sector, where all agents are compelled to subscribe to an ombudsman.<sup>94</sup> Managers of leasehold properties with local authority freeholders must also subscribe to an ombudsman, and there is no clear reason why the private sector should not meet similar standards. ARMA also already insists that its members sign up to an ombudsman service and some other unaffiliated agents also choose to do so. Thus enforcing a sector-wide ombudsman is eminently feasible and would only force unregulated private sector leaseholders into any changes.

Ombudsman costs would be funded by managing agents' annual licence fees and a fee (paid by the manager) for each case heard by the ombudsman. The Property Ombudsman provides a rough idea of how much fees may be, charging £258 to each managing agent for an annual subscription. The fact that managing agents would fund the ombudsman scheme would mean that leaseholders know before a case that they will face no costs. This would have lower barriers than LVTs and avoid problems of brinkmanship. Managers would also be motivated to provide a better service in order to avoid costs associated with going to an ombudsman.

### Pre-ombudsman

It is important that, as power is rebalanced to give leaseholders more influence, there is greater support through a mediation and reconciliation service both between leaseholders and between leaseholders and managers.<sup>95</sup> For disputes between managers and leaseholders, all parties must attempt a period of mediation before being accepted by the ombudsman or LVT. This should have similar goals to the Advisory, Conciliation and Arbitration Service (ACAS), which seeks to avoid cases going to employment tribunals.<sup>96</sup> Either

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94 As the Department for Business, Innovation and Skills states: "Regulations requiring estate agents engaged in residential estate agency work to join an approved redress scheme dealing with complaints about the buying and selling of residential property, came into force on 1 October 2008. Consumers who experience problems with estate agents now have access to free and independent redress." See also the Consumers, Estate Agents and Redress Act 2007.

95 Intra-resident mediation is important for scenarios where individuals are renting a leasehold property or where there is discord between directors of RTM companies or RMCs.

96 See [www.acas.org.uk](http://www.acas.org.uk).

internal procedures or a conciliation service for leaseholders and managers would seek to do the same to avoid an LVT.

Resolution of intra-leaseholder disputes is also important. Often complaints made against managers result from decisions made by the residents' board, but enacted by the managing agents. If more leaseholders take control of management they will need a mediation service which they should use if they cannot resolve an issue amongst themselves. If this process fails, the leaseholders could then have access to an ombudsman which could take their competing claims in writing and offer a verdict. This should follow the Australian model, based on the Strata Schemes Management Act 1996, which introduced a process which removed, for the most part, the involvement of the courts in disputes between tenants. Disputes with a property manager still revert to the management contract, and would be dealt with by the ombudsman or LVT as discussed above.<sup>97</sup>

## Other Issues of Regulation

### *Consumer awareness*

The regulator should address what is possibly the greatest practical shortcoming of the current 'high legislation-low regulation' system: leaseholders' lack of awareness of their rights. LEASE already serves a valuable role in providing *impartial* information to leaseholders and freeholders. A regulator should act as a leaseholder champion and by improving leaseholders' access to their rights, it would give them more incentive to understand their rights. It could also work with LEASE to take advantage of the fact that managing agents would be licenced, by stating that service charge bills must include an information sheet with a broader range of rights than is currently required. For example, it could also give details of LEASE, the regulator and the ombudsman's websites and a set of relevant rights such as RTM and lease extension. The regulator should also produce an official handbook of rights, a link to which should be publicised on all service charges.

There is a problem that leaseholders may not understand the full cost of service charges when buying a property. Statutory requirements exist in the public sector that individuals considering the right-to-

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97 New South Wales Fair Trading, 'Strata and community disputes', [www.fairtrading.nsw.gov.au/Tenants\\_and\\_home\\_owners/Strata\\_schemes/Resolving\\_issues\\_strata\\_schemes/Strata\\_and\\_community\\_disputes.html](http://www.fairtrading.nsw.gov.au/Tenants_and_home_owners/Strata_schemes/Resolving_issues_strata_schemes/Strata_and_community_disputes.html).

buy must be given details of all associated costs such as stamp duty, service charges and boiler repairs. A similar publication should be produced for the private sector to inform potential leaseholders of the costs involved, with emphasis on service charges. The Law Society should also review its conveyancing protocol to ensure that potential purchasers get more information about a property. This should include whether it is part of an EMS and should include details of previous years' service charges and estimates for the coming years. A similar recommendation was made by the London Assembly, which also suggested that conveyancing should ascertain whether there were any planned major works.<sup>98</sup>

### Implementation

The liberal model of regulation that we propose would initially seek to help licenced managing agents meet the required standards and implement sanctions only once this was deemed to have failed. Light-touch regulation will enable the regulator to monitor large volumes of information and deal with pressing problems, without creating an excessive caseload for the regulator or financial burdens for managing agents and their customers. It is not possible to provide an exact figure for how much a regulatory framework would cost annually, although we can get an estimate based on the annual expenditure of existing organisations:<sup>99</sup>

- ARMA: Acts as a trade body primarily, but also as a regulator to its members: £661,000
- LEASE: Impartial advice service for both leaseholders and freeholders: £1,399,000
- The Property Ombudsman: Ombudsman service for sales, lettings and charges: £2,140,000

The combined cost of these three services is £4.2 million, but a light-touch regulatory regime would cost considerably less for three reasons.

First, it would perform a similar regulatory function to that currently done by ARMA (but covering *all* managing agents), but would not have the same trade body responsibilities which constitute the majority of ARMA's costs. This suggests that the full regulatory

98 Greater London Authority, 'Highly charged: Residential leasehold service charges in London', March 2012, p.17.

99 ARMA: Annual Report 2010/2011, The Leasehold Advisory Service (LEASE) Annual Report & Accounts 2010–2011, The Property Ombudsman: Annual Report 2011.

package could cost less than £1 million. With an independent regulator, ARMA has stated that it would no longer act as a regulator, and would reduce its membership fees correspondingly.

Second, the regulator would not incur LEASE's responsibilities, but would provide a lighter advice service (such as maintaining an official handbook of rights) aimed specifically at leaseholders. This would cost less than £100,000, well below LEASE's £1.4 million annual expenditure.

Third, the ombudsman is the most expensive service of the three, but many managing agents already subscribed would not face any additional costs. As already stated, these costs would only fall on firms currently not using an ombudsman service, and would cost around £250 per firm plus a fee per case.

So a realistic assessment could see a regulatory regime's costs as follows:

- Regulatory function, similar to ARMA: £300,000
- Ombudsman (on top of existing services): £600,000
- Publicity and Information provision: £100,000
- Total: £1 million

Thus it seems likely that independent regulation would cost around £1 million on top of current processes. If, at a conservative estimate, there are 500,000 lease units managed by professional agents, this would represent a cost to each leaseholder of no more than £2 a year. This clearly represents good value for money and is extremely cost efficient for leaseholders considering the improvement in the quality and value of their service provision.

Leaseholders, who will benefit from regulatory reform, should cover the costs. This would be best done by charging a licensing fee for all managing agents, and a rising scale could be applied to each company depending on their size.<sup>100</sup> This licence fee may be passed onto lessees in their services charges as additional overheads in management fees – as stated around £2. A precedent here can be found in the 2002 Act which the government stated would increase costs of management - and therefore service charges for leaseholders – but was justifiable because it felt lessees would be happy to pay for the improvement of service that legislation would bring. Furthermore, the government has decided to introduce

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<sup>100</sup> Currently ARMA's fees are £750 for agents with fewer than 500 units, rising to a maximum of £5,000 for the largest firms.

license fees in other similar sectors such as park homes, tackling “the worst practices and minimising the burden on those who do a good job for their residents”.<sup>101</sup>

### *Avoiding barriers to entry*

Resident groups and trade bodies have for years been calling unanimously for the introduction of statutory regulation.<sup>102</sup> The only discernible case made against this is that regulation would add costs to the management process and would reduce competition in the management sector. We have shown above that costs are small. Clearly regulation would create some obstacles, but one of the problems it is tackling is precisely that there are currently *no* barriers or guaranteed standards for managing agents. As the previous government noted, whilst avoiding anti-competitive barriers, it is important that there are ‘hurdles to entry’ ensuring that managing agents have a sufficient level of knowledge and expertise.<sup>103</sup> We face a choice between a good sector with reasonable hurdles and an unregulated sector without any. Regulation and qualifications can be introduced without creating uncompetitive barriers to entry into the management industry and without adding unnecessary costs to management.

It is vital that regulation does not create an unfair barrier for prospective managing agent companies. The Housing Minister has stated that he wants to rely on more proactive self-regulation which assumes that good new firms will volunteer to be regulated and pay the associated costs. This means that regulation would *only* impose a real barrier for new firms that were not planning to be self-regulated. It is true that new firms entering the market would have to pay for management training, but this is clearly a valuable and worthwhile process. Rather than applying for a full licence, new managing agents should apply for a certificate of registration

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101 Department for Communities and Local Government, ‘A better deal for mobile home owners: Consultation’, p 5.

102 Based on authors’ interviews with relevant stakeholders, as well as other background research. For example, a freedom of information request document, entitled ‘Key notes from task and finish group meeting 10th August 2009 - regulation of leasehold managing agents in the private sector’, shows that consensus was reached by members (including Lease, ARMA, ARHM, RICS and ARLA) that “There needs to be regulation and redress”.

103 Department for Communities and Local Government, ‘The private rented sector: professionalism and quality – consultation Summary of responses and next steps’.

for a probationary period.<sup>104</sup> If it employed experienced staff with existing qualifications, it would not have to pay to retrain them.

The costs associated with being regulated would include a licence or registration fee (including ombudsman subscription), training courses and costs of in-house complaints and mediation procedures. We have shown that a regulatory regime would not be unduly expensive and it is likely that a licence would cost less than overall membership of existing self-regulating bodies.<sup>105</sup> Members of ARMA and RICS already face the internal costs of *complying* with their regulatory systems, so would not face significant additional costs following the introduction of a regulator. Similarly, unaffiliated managing agents which already have these important procedures in place will not have significant extra costs of complying. Rather, additional costs would be incurred by new or existing managing agents who do not meet acceptable standards.

So although independent regulation will create costs, these will only fall on new and existing firms which do not subscribe to self-regulation or the in-house support procedures which are vital to provide a good quality of service. There is no reason why independent regulation should cost more per licensee than voluntary self-regulation, and it will do considerably more to root out incompetent managing agents.

### Leasehold Valuation Tribunal reform

Although the tribunal system can have significant barriers to access, it performs an essential adjudication function below (and more accessible than) a full court. Rather than wholesale reform, we propose three changes that would make the process fairer and more effective.

First, the rules over cost awards are skewed unnecessarily in freeholders' favour. Whilst freeholders can, in some circumstances, reclaim their full 'reasonable' costs from a case, the most that a tribunal can award leaseholders in compensation is £500. It is important that the tribunal does not expand its remit to become a significant awarder of costs, but it would be fairer for the tribunal

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104 This model is used in New South Wales, where firms entering the managing agent industry apply initially for a certificate of registration. See the *Property, Stock and Business Agents Act 2002*.

105 A regulator should not cost more than ARMA, for example, which has major costs beyond regulation and lessee information provision, which are not its primary functions.

to assume that 20C notices were served, leaving the onus on the freeholder to prove that they should be able to recoup legal costs through service charges. This is a more balanced approach and would also reduce problems associated with freeholder brinkmanship. The tribunal could also, in particularly one-sided cases, offer a supporting testimony to leaseholders wishing to take a case to the county courts to seek to recover costs.

Second, rules of disclosure should be corrected to ensure that everybody has all relevant information about the claims of both parties in advance of a trial. Alongside this, any freeholder objecting to a claim for RTM or enfranchisement should have to formally state their reasons up front. This would prevent unscrupulous freeholders from abusing their power without harming those freeholders acting fairly.

Third, as we have recommended with the ombudsman, a condition of presenting a case to a LVT should be that both parties have been through a process of mediation. This could be a swift process which would benefit both freeholders and leaseholders where it worked – not only by increasing the speed of reaching an agreement, but also by reducing costs for both parties. A meeting of the Residential Property Service showed that mediation before LVTs has a success rate of over 70 per cent.<sup>106</sup> So although mediation would add a cost for freeholders, overall it should save money by avoiding costly LVT cases. It would also reduce the burden on tribunals, which would make it a more efficient service for leaseholders and freeholders alike.

### Leaseholder property amendment

Most leasehold agreements contain strict conditions about how lessees can alter their properties and in what cases they require freeholder consent to do so. These conditions can be used by freeholders to gain unwarranted profit by demanding significant payments for considering an application and granting permission. The majority of development will *enhance*, rather than reduce, the value of a property and there is no reason why leaseholders improving their homes should have to pay a *triple* premium for doing so: to gain permission from the freeholder for development, for the development itself and additional cost when extending or enfranchising. Similarly, the freeholder will benefit from any

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<sup>106</sup> The London Assembly, 'Highly charged: Residential leasehold service charges in London', March 2012, p. 42.

improvements when a lease is extended or bought, so there is no justifiable reason why they should be able to benefit financially further from giving consent for work.

Leaseholders with more than 80 years on their lease – i.e. the vast majority of the interest in the property - should not have to pay the freeholder to enhance their property. They should still obtain freeholder permission for external or structural works and the freeholder should be able to request that the freeholders obtain professional advice in certain cases, but leaseholders should not have to pay for permission unless the freeholder could demonstrate that such changes would in some way harm the value of the property (or neighbouring ones). Unless there was proof that a proposal would reduce the value of the property, a freeholder would simply have to comply gain planning permission and comply with existing legislation such as the Party Wall Act 1995.

For leases with fewer than 80 years remaining, leaseholders should still be able to alter their property without paying for permission on the condition that the leaseholder can prove that proposed development would not reduce the value of any properties. The LVT would be an appropriate arena for leaseholders and freeholders to make their cases of whether a proposed development would reduce the value of a property if they could not reach agreement. This would mean that the practice of charging fees for consent would be removed except in cases where proposed work reduced a property's value, in which case the freeholder should receive compensation.

### **Estate Management Schemes**

There may be valid reasons to maintain the character of certain areas by controlling their appearance and property use, but there is no justification for an EMS having control over what *freeholders* do inside their properties. Similarly, it is hard to justify why enfranchised former leaseholders paying service charges to such schemes should have fewer rights than leaseholders paying similar charges outside the schemes. Both of these inconsistencies should be addressed.

First, an EMS should not be able to control alterations to the interior of properties. As long as use of the property remains the same and the external appearance remains consistent with the surrounding area, there is no reason to limit alterations within the building. Removing EMS control over the interior would mean that freeholders in schemes would simply have to comply

with usual planning conditions. It is important to stress that some schemes already control external development without interfering with internal amendments. But other schemes continue to exert excessive control.

Second, as raised in 'Consumer Awareness' above, the standard conveyancing process should ensure that potential buyers are aware of the fact that a property is part of an EMS, and the implications of this. The Law Society should ensure that all conveyancing processes clarify whether there are restrictions on development under a scheme and, if so, what they are.

Third, management of schemes with estate charges should be subject to Section 20 of the 1985 Act. And freeholders should have access to the tribunal service to appeal more generally against *specific* service charges (rather than their current ability just to appeal against how the estate charges are calculated). This will ensure that those leaseholders and freeholders in EMSs have equal protection to those paying service charges in standard leasehold properties.

### Exit charges

There have not been satisfactory justifications for the fees. They target vulnerable people purchasing retirement flats, and there is doubt about whether such charges are legal. The fact that the ongoing OFT investigation, which began in 2009, has taken so long suggests that the issue is a complex one. But unless it finds a satisfactory justification, exit fees should be banned.

### Forfeiture

The threat of forfeiture can be used as an intimidation tool which contributes to power asymmetries, and the OFT has stated that existing forfeiture legislation is disproportionate. The government should consider less crude methods of ensuring that freeholders have the power to reclaim outstanding debts without leaseholders losing the full value of their properties.

We propose that a small claims court should, in the first instance, be used to recover costs. This would reduce the ability of freeholders to intimidate leaseholders as may happen when demanding payment for retrospective consent for development. The sale of a leasehold property should be forced only as a last resort. But when this is done, the full value of the lease remaining (after payment

of debt and associated recovery costs) should be returned to the leaseholder rather than the freeholder.

## ■ 6 - Leaseholder empowerment: longer term solutions

An underlying problem of the leasehold system is that leaseholders pay for services but do not have control over who commissions them. The immediate solutions in Chapter 5 ensure that leaseholders are given a greater voice in the management process, but the government should also seek to promote *direct* leasehold empowerment. Giving leaseholders control of management places them at the heart of the process, which is preferable to simply leveraging their interests into it. This can be done by taking the RTM, by enfranchising, or by using commonhold. We discuss how the government can promote RTM and commonhold.<sup>107</sup>

### Right to Manage

RTM ensures that managing agents are legally accountable to leaseholders, by giving direct control to leaseholders to select their managers.<sup>108</sup> Some leaseholder-appointed agents may still perform badly, but leaseholders are able to appoint a new manager without going to a tribunal. In this way it directly exposes managing agents to competition.

Collective enfranchisement offers similar benefits, but RTM has distinct advantages. First, leaseholders do not have to make any payments to the freeholder in order to take control – they are not buying anything, so only pay the administrative costs of the RTM application. Second, an RTM application generally faces less freeholder opposition than lease enfranchisement or extension

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107 We do not discuss enfranchisement in detail because the system is already in place and there is little that can be done about the main barrier of raising the funds to purchase the freehold. By contrast, RTM offers similar benefits to enfranchisement without the costs.

108 Leaseholders also have the right to ask a tribunal to appoint a new manager if they can show that their manager is deficient, but a new manager only has a legal relationship with the tribunal, not with the leaseholders.

because it does not affect the freeholder's potential premium income. Third, it does not require valuations, so is a simpler and cheaper process for leaseholders and tribunals alike.

RTM will work better if leaseholders fully understand it before applying, the application process is made easier and available to more leaseholders and there are mechanisms in place for leaseholder governance once the RTM is granted.

Expanding awareness of responsibility and rights is crucial. The summary of rights and obligations – a statutory instrument ensuring that rights are included with service charges – should be extended to ensure that leaseholders are aware of RTM. Similar information about RTM and enfranchisement should be included in annual accounts.

The two main practical barriers for taking the RTM are fear of the unknown and difficulties in gathering a sufficient number of qualifying tenants. It is particularly complicated to get enough qualifying tenants when individuals rent their properties because the people actually living in a property will not be eligible to support an RTM application. To make it easier for developments with absent buy-to-let owners, leaseholders should be able to request that freeholders forward a statement of an RTM application to all leaseholders in return for a fixed administration fee.

Another barrier is that leaseholders must go to a tribunal if the lessor disputes their RTM claim which can be based on a technicality or an incorrectly completed form. This can allow unscrupulous freeholders to oppose an application in the hope that the costs of going to an LVT will deter leaseholders from pursuing their application. As stated in the LVT section of Chapter 5, any freeholder objecting to an RTM application should give their grounds of objection within a specified period of time. This would make leaseholders aware of whether they could amend their application and reapply and would reduce the power asymmetries which facilitate brinkmanship. Shifting the onus onto the freeholder to show that a 20C order should be served would also help to reduce brinkmanship.

In specific cases where developments are not eligible for the RTM – such as flats above shops – it could be possible to allow leaseholders to go to an LVT to make a case for special permission to assume control of management.

Government should also consider whether lighter controls on section 20 consultation could be applied to self-managed blocks.

The burdens of some controls can deter residents from becoming directors of a residents' associations and more appropriate regulations would recognise the removal of many leaseholder-freeholder tensions when leaseholders assume control.

## Commonhold

Commonhold is a preferable system of property ownership to leasehold. It removes the need to extend leases and affords flat owners collective control over management of their property. It is used in similar forms across the rest of the world, from North America to Australia. Yet it has failed to catch on in England and Wales.

The biggest barrier to the spread of commonhold is a lack of understanding and experience – this applies to buyers, mortgage providers, developers and investors. One of the challenges is that developers favour leasehold, which allows them to sell both the leasehold and the freehold and many perspective buyers are not aware that commonhold exists. In essence, there is little supply and little demand. In large part, the lack of supply is due to lack of consumer awareness. It is ten years since the original legislation was passed, so now would be a good time to review the policy which could precede efforts to breathe new life into commonhold.

There are two sectors that must be addressed if commonhold is to be a success. The first is the 1.5 – 2.5 million existing leasehold units. The second is the potential commonhold units that will be created in the future, including existing buildings which will be converted into flats and importantly, new housing developments. The government should place particular emphasis on new developments because, due to the complexities of converting existing properties, this is a more realistic way to develop a critical mass of commonhold units.<sup>109</sup>

New developments are not being sold as commonhold currently because the vast majority of benefits go to the buyers, rather than developers who see little gain from switching. To encourage developers to go down the commonhold route, the incentives must be altered.<sup>110</sup> This could include legislating that all new

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109 These policies to promote commonhold should be introduced alongside a review of how commonhold has functioned in cases where it has been adopted.

110 This is particularly necessary because current property demand and lack of alternative forms of flat ownership mean that developers can sell leasehold flats and do not need to explore commonhold.

build properties constructed from 2020 must only be sold as commonhold, which could be incorporated into the government's housing strategy.

A shift towards commonhold in newly built units should make it easier for existing leaseholders to use commonhold, as mortgage lenders and others become more familiar with the system. The government should add further momentum by lowering the 100 per cent threshold required to shift to commonhold; a qualified majority could be used, as in the 1987 Act for deeds of variation. Commonhold could be approved if 80 per cent of leaseholders formally supported it and no more than ten per cent oppose. Those who do not actively support it could retain their leasehold but own it from the commonhold association which would own the building, but then lease individual units to the non-participating members. Any non-participating members could be able to join the CA at a later date.

More widespread use of RMCs and RTM companies would also help a transition to commonhold. As lessees become more used to working together, having a commonhold association would seem less alien. This is very much a long-term strategy, but the benefits of a successful transition to commonhold are clear.

## ■ 7 - Conclusion

The evidence in this paper supports the overwhelming view of those working in the leasehold sector that regulation of managing agents is urgently needed. By introducing an independent regulator, the government could lever the interests of leaseholders into the management process and ensure that they all have greater access to redress. In the longer term, direct leasehold empowerment should be promoted through commonhold and RTM.

The case studies included in this report show just how serious the shortcomings of the current leasehold system can be. In many ways, these are just the tip of the iceberg because the most vulnerable leaseholders often cannot even get a case to a tribunal. Moreover, in many of the most serious cases, freeholders settle outside the LVT in an effort to avoid negative publicity.

It is essential that the government addresses this problem. Cases taken to LVTs have increased by 400 per cent in the past decade, and problems with connected companies have become increasingly rife. Moreover, the number of leasehold properties will increase significantly in the coming years, precisely because of other government policies – both the right-to-buy and the housing strategy to increase the supply of homes. The government must therefore seek to integrate policy so that reform of the leasehold system and promotion of commonhold and RTM are pursued alongside the development of new houses.