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LON/00AN/LSC/2007/0418

THE RESIDENTIAL PROPERTY TRIBUNAL SERVICE

DECISION OF THE LONDON LEASEHOLD VALUATION TRIBUNAL ON AN APPLICATION UNDER SECTION 27A OF THE LANDLORD AND TENANT ACT 1985

Property; **64 Colet Gardens, St Paul's Court, LondonW14 9DN**

Applicants: Feargal and Olive Brennan

Respondent: St Paul's Court Limited

Date heard: 6 March 2008

Appearances: Mr and Mrs Brennan, the applicants

Mr Christopher Heather, counsel, instructed by Forsters LLP, solicitors,
for the respondent
Mr John Culhane, chairman of the respondent company

Members of the leasehold valuation tribunal:

Lady Wilson
Mr T W Sennett MA FCIEH
Mr D J Wills ACIB

Date of the tribunal's decision: 26 March 2008

Summary of decision

A loss made on the disposal of investments of accumulated service charges is not recoverable as a service charge and the applicant leaseholders are not estopped by their conduct from asserting otherwise, nor are they to be taken as having agreed or admitted that the loss is payable as a service charge. The tribunal has no jurisdiction to determine that the loss should be set off against profits made by the landlord and set against costs in previous years.

Introduction

1. This is an application by Mr and Mrs Brennan ("the tenants") under section 27A of the Landlord and Tenant Act 1985 ("the Act"). The tenants hold a long lease of 64 Colet Gardens, a flat on the St Paul's Court Estate. The freehold is owned by St Paul's Court Limited ("the landlord") which is the respondent to the application. The Estate, which comprises 267 dwellings grouped in six blocks, together with a management suite and a building let to the local authority for use as a nursery school, was once owned by the local authority and the landlord, formerly a management company, acquired the freehold in 1991. Each leaseholder has one share in the landlord. The leaseholders of five of the six blocks in the Estate each elect one director, and those in the largest block elect three directors.

2. By their application the tenants seek a determination of their liability to pay a charge of £352.85 included within the service charge certificate and demanded for the year ended 24 December 2003 under the head "depreciation and loss on investments", it having been the practice of the landlord, as management company and then as freeholder, to invest some of the money collected from the leaseholders as service charges in shares, including equities. The disputed charge is the proportion of the loss made on the sale of the portfolio of these investments payable by the tenants in accordance with their lease. It is the tenants' case that this loss is not a service charge and that it should not have been treated as such in the service charge accounts. The landlord's case is that it is a service charge but that, even if it is not, the tenants are

estopped by their conduct from saying otherwise; or, alternatively, that the tenants have agreed or admitted that it is payable as a service charge; or, alternatively, that the landlord should be permitted to set off, against any liability it may have to the tenants to reimburse service charges, profits on investments credited in previous years against the costs forming the subject of the service charges.

The lease

3. The leases are understood to be in common form save for the service charge percentages payable. The tenants' lease (from page 158 of the bundle – all page references in this decision are to documents in the agreed bundle), and, we understand, the leases of all the dwellings on the Estate, date from 1982 or thereabouts and thus pre-date the Landlord and Tenant Act 1987 ("the 1987 Act"). By clause 3(1) the tenants covenant to pay an annual service charge, called "the aggregate service charge", of an amount determined in accordance with clause 4. Clause 4 provides that the aggregate service charge comprises specified proportions of the "main block expenditure", the "heating expenditure", the "estate expenditure" and the "additional expenditure" described in parts 1, 2, 3 and 4 respectively of the sixth schedule. Among the estate expenditure is, at paragraph 9 of part 3 of the sixth schedule:

> *Any other expenditure (not being expenditure of a kind similar mutatis mutandis to that described herein as Main Block External Expenditure) incurred by the Lessor in respect of or incidental to the performance and exercise by the Lessor of the obligations and powers imposed or conferred under the provisions of this Lease or any other lease of any part of the Estate to which the Lessor shall be a party ...*
>
> *PROVIDED that there shall be deducted from the cost of Estate Expenditure (i) all sums payable by the underlessee of the Nursery School under the provisions of the said underlease to the Council thereof in respect of Estate Expenditure... and (ii) such sums as may be paid by the Council or other the* [sic] *Superior Lessor for the time being under the Superior lease and (iii)*

such other sums as the Accountant shall reasonably direct in respect of receipts from any underletting of the Management Properties or the Management Company Maisonette by the Management Company.

4. Clause 4(11)(C) provides:

> *If and in so far as any moneys received by the Lessor from the Lessee during any financial year by way of Aggregate Service Charge are not actually expended by the Lessor during that financial year on any of the heads of expenditure particulars whereof are set out in the ... Sixth Schedule nor otherwise dealt with so as to be an allowable expense in calculating the Lessor's income for tax purposes for that financial year the Lessor shall hold those moneys upon trust to expend them in subsequent financial years on such heads of expenditure and subject to thereto upon trust for the Lessee absolutely.*

The memorandum and articles of association of the landlord

5. The landlord was incorporated in 1980. Clause 3(i) of its memorandum of association (from page 137) includes as an object of the company:

> *To subscribe or underwrite purchase or otherwise acquire and to hold dispose of and deal with the shares stocks securities and evidences of indebtedness or the right to participate in profits and other similar documents issued by any government authority corporation or body of persons and any options or rights in respect thereof.*

The statutory framework

6. By section 27A(1) of the Act an application may be made to the tribunal to determine whether a service charge is payable and, if it is, the amount which is payable. A "service charge" is defined by section 18(1) of the Act as *"an amount*

payable by the tenant of a dwelling as part of or in addition to the rent (a) which is payable, directly or indirectly, for services, repairs, maintenance, improvements or insurance or the landlord's costs of management, and, (b) the whole or part of which varies or may vary according to the relevant costs". Relevant costs are defined by section 18(2) and (3). By section 19(1), *"Relevant costs shall be taken into account in determining the amount of a service charge payable for a period (a) only to the extent that they are reasonably incurred, and (b) where they are incurred on the provision of services or the carrying out of works, only if the services or works are of a reasonable standard, and the amount payable shall be limited accordingly"*. Section 27A(4)(a), no application may be made in respect of matter which has been agreed or admitted by the tenant.

7. Section 42 of the Landlord and Tenant Act 1987 ("the 1987 Act") requires service charge contributions to be held in trust. By section 42(9), as amended:

> *Subject to subsection (8), the provisions of this section shall prevail over the terms of any express or implied trust created by a lease so far as inconsistent with those provisions, other than an express trust so created, in the case of a lease of any of the contributing tenants, before the commencement of this section ...*

8. The manner in which trust funds, including accumulated service charges, might be held by was until February 2001 governed principally by the Trustee Investments Act 1961 and, in respect of service charges, by the Service Charge Contributions (Authorised Investments) Order 1988 (SI 1988 No 1284), both of which severely restricted the power of trustees, including landlords, to invest trust funds. On 1 February 2001 the Trustee Act 2000 came into force and this greatly extended the investment powers of trustees.

The hearing

9. At the hearing on 6 March 2008 the tenants appeared in person and gave evidence and the landlord was represented by Mr Christopher Heather, counsel, instructed by

Forsters LLP, solicitors. The hearing was mainly occupied by legal submissions, the factual background being largely agreed, but Mr Brennan gave evidence for the applicants and Mr John Culhane, the chairman of the landlord, briefly gave evidence for the landlord.

The factual background to the issues

10. The essential facts were not in dispute and are as follows.

11. The landlord has at all material times been managed by the directors, who are leaseholders. In 1987 (see chronology "JC1" from page 103) the board of directors decided to invest £100,000, which was part of the reserves of service charges collected from the leaseholders, in a portfolio of shares managed by National Westminster Bank. The portfolio was spread across a range of gilt edged and fixed interest securities and equities to minimise the risk of loss. The charges made by National Westminster were included within the service charges as "investment service charges". From 1999 to 2001 inclusive the portfolio made a profit which was offset against the costs of providing services and thus went to reduce the leaseholders' service charge liability. In 2002 and 2003 the portfolio made a loss, and questions were asked by leaseholders as to the legality and wisdom of investing in equities money collected from leaseholders, as a result of which the landlord obtained the opinion of counsel and of an experienced professional residential managing agent. Counsel's opinion, dated 31 March 2004, (from page 37) was, on the relevant issue, to the effect that unexpended moneys received in response to requests for service charges must be held on account for individual leaseholders in respect of heads of expenditure under the lease in strict compliance with the terms of the lease, and that any other method of proceeding would be a breach of trust. Consequent upon the advice the landlord had received the entire portfolio was sold on 23 June 2004 at a loss, excluding management fees and other expenses, of £55,227. The portion of the loss which was referable to the year ended 24 December 2003 was taken into account when the service charge certificate for that year (page 212) was prepared by the landlord's then accountants and included as a service charge in the service charge accounts for the year. The tenants' share of this sum, according to their lease, was the

£352.85 which is the subject of this dispute. In the accounts for the year ended 24 December 2004 the portion of the loss on the sale of the investments referable to that year was not charged as a service charge but was treated as a loss by the company (see the landlord's income and expenditure account at page 367). Since the investments were sold it appears that all reserves have been held in a single interest-bearing account on trust to be applied in accordance with paragraph 9 of part 3 of the sixth schedule to the lease.

12. Mr Brennan was a director of the landlord from 17 July 1996 and deputy chairman of the board from 12 August 1998. He resigned as a director in or about March 1999 and re-joined the board on 8 March 2000. From December 2000 until April 2002 he was its chairman (see chronology at pages 105 to 109). In April 2002 he resigned but re-joined from May 2005 until April 2007. He agreed that he was throughout aware that funds collected as service charges were invested in equities and he agreed that all the directors acted honestly and in good faith throughout.

The issues

1. Was the loss on investments a service charge?

13. It is clear, and was not disputed, that we have jurisdiction to determine, as a threshold step to the exercise of our jurisdiction under section 27A, whether a charge made by the landlord is a service charge.

14. Mr Heather submitted that the loss on investments was estate expenditure which fell within the definition in paragraph 9 of part 3 of the sixth schedule in that it was *incurred by the Lessor in respect of or incidental to the performance and exercise by the Lessor of the obligations and powers imposed or conferred under the provisions of this Lease*, the relevant obligation or power being that in clause 4(11)(C) to hold service charges not actually expended *upon [the] heads of expenditure [set out in the sixth schedule] and subject to thereto upon trust for the Lessee absolutely.* He said that this clause contains an express trust which confers the statutory powers of a trustee, and that the trust should be considered in the light of the memorandum of

association, in existence when the lease was granted, which contains an express power to invest in equities.

15. Mr Brennan said that this is a detailed lease and that if losses on investments of funds held as a reserve were intended to be recoverable as a service charge one would expect that to be expressed in the lease. He said that until this application was made the directors and the landlord's solicitors had accepted that the loss was not properly chargeable to the service charge and he referred to a memorandum dated 3 April 2005 which Mr Culhane, then a director and now chairman, had written to the board headed "Costs wrongly charged to Lessees" (from page 61). This included "Forsters have confirmed that the legal position is quite clear – these amounts ought never to have been charged to Lessees and it is the duty of the company to make them good" and urged the auditor to reissue the 2003 accounts so as to treat the losses as a company liability and not a service charge and to prepare the 2004 accounts on that basis. As we have said, the 2004 accounts were indeed prepared on that basis but the 2003 accounts were not reissued. He said that the incorrect treatment of the loss as a service charge could have practical consequences and was not just a theoretical argument because, if the company was wound up, its assets would have to be distributed in accordance with clause 5 of the memorandum of association whereas leaseholders' funds would be subject to the trusts of the lease. As a shareholder, he said, he owned the same part of the company as every other leaseholder, whereas his liability as a shareholder was to pay the proportion of service charge expenditure for which his lease provided, which differed from that of many other leaseholders.

16. On balance we agree with Mr Brennan. We bear in mind that the landlord is given, by its memorandum of association, the power to invest. We accept that, by virtue of the Trustee Act 2000, the landlord, as trustee of the service charges it collected, had, at least from 1 February 2001, wide investment powers provided it exercised them in accordance with the 2000 Act, as it appears to have done throughout. There is thus no reason to suppose that the directors were in breach of their fiduciary duty to the shareholders, although this is not an aspect with which we have jurisdiction to deal. That is not, however, to say that the losses were recoverable as service charges within the meaning of the lease. The lease itself gives no express power to invest, and it appears that at the relevant time the landlord was not in fact

applying the reserve fund strictly in accordance with the express trusts contained in clause 4(11)(C). Certainly loss on investments was not one of the heads of expenditure on which the landlord was entitled to expend accumulated service charges. For a charge to amount to a service charge within the meaning of section 18(1) of the Act it must clearly and beyond doubt fall with the charges recoverable as such under the lease, and in our view it goes too far to say, on the facts of this case, that the losses on investments were *incidental to the performance* of the landlord's obligations when the reserve funds were not at the time being applied strictly in accordance with the trusts of the lease. We have no reason to doubt, from the evidence we were given, that the losses were not properly payable by the landlord *qua* company, but that is not a matter within our jurisdiction.

2. If the loss is not a service charge, are the tenants estopped from asserting otherwise?

17. Mr Heather submitted that the tenants were estopped by their conduct from asserting that the loss was not recoverable as a service charge. He said that Mr Brennan as a director and chairman of the board had actively participated in the investment of accumulated service charges, and, indeed, had signed off the 2004 accounts in October 2005 and that he had thus clearly endorsed the practice, which had continued for many years, of expressly crediting against the costs on which the service charges were based the profits from these investments. There was in these circumstances, he submitted, an estoppel by convention between the parties that profits on investments should be treated as service charge income and that, accordingly, any losses should be treated as recoverable as a service charge. As the tenants and other leaseholders had had the benefit of this income off-set against their service charges over many years, it would, he submitted, be inequitable now to permit them to assert that the loss in question was recoverable as a service charge.

18. Mr Brennan, while he accepted that he was aware of, and had actively participated as a director of the landlord in, the practice of investing shareholders' funds on the stock market, said that he had never at any time agreed by words or conduct that any losses on investments should be passed on to the leaseholders as a

service charge. He said that crediting profits from investment against costs did not amount to acceptance that, if losses were made, they could be recovered from leaseholders as service charges rather than treated as losses of the company *qua* company. He said that he was not a director at the time when such losses were demanded as a service charge for the year to 24 December 2003, the only year in which losses were so demanded.

19. We are on balance not satisfied, the onus in this respect being on the landlord, that the tenants are estopped by convention from denying that losses on investment are not recoverable as service charges. It is clear that Mr Brennan, in the circumstances acting, as we are satisfied, on behalf of himself and his wife, concurred and participated in the practice of investing shareholders' funds on the stock exchange, and, if his challenge had been to the propriety or lawfulness of that practice, he would in our view be estopped by convention arising from his express or implied consent to it. The most cogent evidence to support an estoppel is in our view the past practice, to which the tenants did not object, of charging the cost of administering the investment portfolio as "investment service charges". But we are not persuaded that this, or any other evidence, is sufficient to amount to an agreement by the tenants, expressly or by implication, that any losses on investments could be recovered from any leaseholder as a service charge. There is, as Mr Brennan says, a distinction between leaseholders' funds, which must be dealt with in accordance with the lease, and shareholders' funds, which are a matter for the company and subject to the memorandum and articles of association and to company law. The distinction is a fine one where, as here, each leaseholder is also a shareholder, but it exists, and there are circumstances, such as the one he raises of the company being wound up, when it might be of significant practical importance. We do not accept the suggestion that by agreeing to the practice of applying profits from investment in previous years to the costs upon which the service charge demands were made, thereby benefiting the leaseholders and, in particular, the tenants, any losses on investments were somehow converted to service charges. It is for the company to decide how to apply its income, provided it acts lawfully and according to its articles of association, and we do not accept the suggestion that, by accepting the benefit of past profits, the tenants have expressly or by implication accepted that losses should be regarded as the subject of a service charge.

3. Have the tenants agreed or admitted that the loss is recoverable as a service charge?

20. For similar reasons we are not satisfied that the tenants have admitted or agreed that the loss was recoverable from them as a service charge.

4. Is the amount recoverable by the tenants as not payable as a service charge subject to a set-off against profits on investments in previous years?

21. This is not an action for restitution, or a determination that a sum demanded of the tenants is not a service charge. No question of set-off therefore arises.

Costs

22. The tenants have asked for an order under section 20C of the Act to prevent the landlord from recovering its costs incurred in connection with these proceedings on any service charge, and for an order under regulation 9 of the Leasehold Valuation Tribunals (Fees) (England) Regulations 2003 ("the Fees Regulations") reimbursing the fees they have paid in connection with this application. The landlord opposes both requests.

23. The tenants have been successful in their application, but in this jurisdiction costs do not always follow the event – both under section 20C and under the Fees Regulations all the circumstances, and not just the result, are relevant to the exercise of our jurisdiction.

24. The tenants accept that the lease permits the landlord to treat its reasonable costs in relation to proceedings before the tribunal as recoverable as a service charge, and we agree. They say, however, that the landlord should have resolved what, until recently, it has acknowledged to be an incorrect treatment of the losses in the accounts

by suing the accountants who prepared the accounts or the directors who allowed them to be made. They also say that the landlord, rather than they, should have initiated the proceedings before the tribunal by applying to it under section 27A of the Act. However, it is clear from the documents that the landlord has carefully considered suing the accountants and directors and has, rightly in our view, rejected those options as expensive and likely to fail. Mr Heather also points out that the tenants initiated this application without any warning or attempt to resolve the issue by negotiation or some other form of dispute resolution.

25. We accept that the tenants should have at least tried to achieve a negotiated solution before resorting to an application to the tribunal, but in our view the most relevant consideration, both under section 20C and under the Fees Regulations, is why it was that the application required a hearing to resolve it. The chairman of the landlord's board of directors appears to have acknowledged at an early stage that the accounts for 2003 incorrectly presented the loss on investments as recoverable as a service charge (page 61). It seems clear to us that with reasonable good will and common sense on both sides the incorrect treatment of the loss in the accounts was capable of being rectified without significant expense, possibly by a special resolution of the company followed by an adjustment of the accounts to reflect the loss as a loss to the company, to be paid by the shareholders in return for a credit against their service charge liability as leaseholders, thus reflecting what was, until recently, apparently accepted to be the correct legal position. The pre-trial directions included an unusually strong direction recommending mediation, and the correspondence shows that both sides professed themselves keen to resolve the issue in that way. Why mediation or negotiation did not take place appears to us to be the fault of both sides. The correspondence became rather acrimonious (see pages 397 – 407) and the wisdom of mediation or negotiation appears to have been forgotten by both sides. The consequence has been a relatively expensive hearing which will have in the end to be paid for by the leaseholders or by the shareholders, who are one and the same.

26. It could be said with some force that in these circumstances there is little point in an order under 20C preventing the costs associated with the proceedings from being placed on the service charges, but we have decided on balance that the better course in the circumstances is to order under section 20 that the landlord may treat one half of

its reasonable costs in connection with the proceedings as recoverable as a service charge. The balance must be paid by the company *qua* company. This is not, of course, a determination that the costs, which have not yet been quantified, were reasonable in amount (although the leaseholders, including the tenants, should think carefully about challenging their reasonableness, other than as between solicitor and client, when they are quantified, since the costs will have to come from them in one way or another).

27. Given the tenants' failure to give notice, before they made the application, to the landlord of their intention to do so, but their success in the proceedings, we have decided on balance that the landlord should reimburse to them one half of the application and hearing fees which they have paid, namely £100 out of the £200 they have paid.

CHAIRMAN.....

DATE: ....26 March 2008....