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Understanding Leasehold Ownership



Understanding Leasehold Property Ownership

This guide has been produced by Flat Management Limited to assist leaseholders to understand the basic legal and practical issues of Leasehold ownership – an area that conveyancing solicitors often do not adequately explain to new owners. Reference is made to “Flats”, but the same points may also apply to other types of leasehold property.

Freehold and Leasehold

Freehold title of a property is where there is outright ownership of the land and the buildings thereon. Unlike some other countries, English property law is old and out of date and prevents direct freehold ownership of individual flats. So, each flat is owned as a leasehold (usually 99 to 999 years from the original lease commencement date) – which effectively equates to a long-term rented property with ownership reverting to the freehold owner at the end of the lease term.

There may be an independent party that owns the freehold and then nominal annual ground rent is payable by each leaseholder to the freeholder. These days it is becoming more common for leaseholders of a block of flats to “acquire the freehold” and this is achieved by forming a limited company to buy and then hold the freehold interest – in which case each participating leaseholder would receive a share in the limited company and hence have a proportionate interest in the freehold by that indirect share in their Freehold company (although the company itself is technically the freeholder).

Independent Freehold Ownership

Where there is an independent ownership of the freehold by a party unrelated to the leaseholders, then effectively the leaseholders are at the mercy of that party who controls long-term and day to day running of the building. There is legislation in place to ensure leaseholder rights, but in practice leaseholders have little real control over communal costs and decisions in such circumstances.

Right to Manage

There are regulations that enable a sufficient proportion of leaseholders to acquire either freehold ownership or “right to manage” control by legal process and where leases are short to enforce extensions to the duration of their leases, but at varying and expensive costs.

Where legal right to manage has been obtained, the freehold ownership will still be with the independent freeholder and annual ground rent will apply. However, through a special limited company of which the leaseholders will be sole members, the leaseholders will control the management of the block and most importantly its finances.

Head Lease

In some situations, there can be an independently owned freehold with a head-lease interposed between the freehold title and the leaseholders. Where this head lease is held by a limited company controlled by the leaseholders, then the leaseholders will have control of the management and finances of the block.

In House Freehold ownership

The most beneficial situation is where freehold ownership rests in a limited company owned by the leaseholders (usually with each leaseholder holding an equal number of shares (e.g. 12 leaseholders holding 1 share of a total of 12 issued).

The limited company's internal regulations are contained in what is called its memorandum and articles of association. The limited company is controlled by its Directors, who would usually be appointed at general meetings of the company from the leaseholders. All members of the company are entitled to attend general meetings and vote, but outside of such meetings Directors make all decisions. Clearly management works better when the Directors make decisions in liaison with leaseholders, but the Directors have full decision control and shoulder legal risk and responsibility.

Managing agent

Management of blocks is demanding both in terms of time and compliance with legal regulations. Consequently, full and up-to-date knowledge is essential and realistically makes it unlikely that leaseholders can correctly self-manage a block. Hence managing a block is normally contracted to a professional agent. Although the agent contracts to manage the block, ultimately the Directors should be making major decisions, subject to technical compliance advice from the agent.

Budgeting and service charges (sometimes called maintenance demands)

All leaseholders must contribute towards the running costs of the communal areas and other costs specified in the lease.

The freeholder will produce a budget for each service charge reporting period (usually annually). This budget will estimate the funds to be collected in that period to cover all block recurring running costs. Service charge invoices are raised in advance on leaseholders based on each budget. The apportionment between leaseholders is determined by the leases.

The budget would normally be set to ensure that sufficient funds are collected to ensure all recurring costs are covered. After the end of the reporting period, accounts will be drawn up detailing the actual costs incurred. Any surplus arising between amounts collected and actual costs will in practice be carried forward as a general reserve for future use. Any deficit could be set against past accumulated surpluses brought forward or may need to be collected as an additional service charge.

Special levy

A special levy is essentially a one-off service charge invoice raised to cover a shortfall in funds. For example, for a costly unexpected roof leak, that is not covered by the annual budget or by a sinking fund reserve.

Sinking Fund and major expenditure

A sinking fund is an advance collection of money, often over several years, which is held by the freeholder to fund specific forthcoming projects (such as a new roof). Many leases require a sinking fund to be maintained and this is universally recommended.

The advantages are:

- (a) individual leaseholders may not have to find a large sum of money at short notice;
- (b) projects are less likely to be held up where one or more leaseholders struggle to make their contribution or indeed where slow legal action for collection is required; [Bear in mind that it would be extremely risky to contract for a project without being in a position to pay the contractor's bill];

Some leaseholders will argue that they prefer to have their potential contribution in their own savings and pay as needed rather than have a sinking fund. However, this invariably results in issues.

Lease and House regulations

Leases vary but follow the same pattern. Sections define: the part of the block "demised" to the leaseholder (i.e. to become the private area of the leaseholder); the rights and obligations that the leaseholder has; the responsibilities of the freeholder; site and detailed room plans.

The responsibilities of the leaseholder under the lease are critical and should be carefully understood. They are designed to protect the building and site itself as well as other leaseholders. In addition, house regulations are also often made by the freeholder.

Demised areas

The areas forming the exclusive part of the flat will be specified in detail in the lease. They usually include the flat's inner half of all walls and the surfaces of the floors and ceiling. In addition, service media (e.g. pipes, drains and wiring) will usually be defined as leaseholder's responsibility from the point where they serve only that flat. The individual front door and windows of each flat are usually demised to the leaseholder, but frequently exclusive responsibility for redecorating exteriors of doors and frames is communal.

Communal areas

Any area not demised under the various leases is classed as communal area. Rights to transit across communal areas will be built into the lease, but most communal areas will have restrictions on use. Communal corridors and gardens in particular are likely to have restrictions (e.g. No ball games on the grass or No personal items in communal halls).

Permissions

It is important to bear in mind that a leaseholder is in many respects just a renter. This means that they cannot undertake restructuring of their flat or interfere with communal areas. Any internal alterations to the layout (e.g. moving walls) can not legally be started without specific written permission of the freeholder. Otherwise, re-sale might be an issue and the freeholder may be able to enforce reinstatement to the original design.

Sub-letting

Several leases completely prohibit sub-letting and of those that do allow it most will have some restrictions. Restrictions can include: only sub-letting of the demised property as a whole; only subletting to family units; minimum periods of letting contracts; etc. All leases will be different.

Note that the freeholder through their managing agent should be notified of the letting in advance (although this rarely happens). The leaseholder is entirely legally responsible for ensuring that their tenant observes the lease and house regulations, as there is no direct contract between the freeholder and the sub-let tenant to enforce anything. Many letting agents have their own standard contracts and do not seem to worry about informing the tenants of the lease rules for that property. However, to complete the legal links, letting contracts should incorporate adherence to the leaseholders lease and house rules, which should be fully detailed to the tenant.

Funds in trust

Service charge and sinking fund monies held by the freeholder (or their agent) do not constitute their own funds as the monies are effectively held in trust and can only be used for relevant purposes. Sinking fund reserves should be held in a separate bank account from general service charge money.

Costs and finances

The budget will show a summary of the various communal costs that the service charges cover. These will vary between blocks, but significant elements will include insurances, gardening, managing agents' fees, and general repairs. The lease will clarify which costs are a communal responsibility and which are personal to each leaseholder (e.g. window cleaning can be either from lease to lease).

Significant one-off communal repairs can be slower to undertake on blocks compared to an individual dealing with their personal house. There will usually be at least two quotes to arrange and be discussed by Directors /Leaseholders. There may be difficulties accessing individual flats where necessary for inspection of an issue. In most cases consideration will be given to value for money rather than speed – all reliable, reasonably priced and favoured contractors will have busy work schedules.

Arrears

Service charge payments should not be the last bill that a leaseholder pays. Where a leaseholder is late paying their service charge invoices they are effectively borrowing from their neighbours and if reserves are low put maintenance of the block at risk. Late payments can be referred to solicitors for legal process collection.

Lifts

Most purpose-built blocks of flats have a lift. Cost responsibilities will be determined in the lease, but vary between equal shares for all flats or just to upper floor flats. Maintenance costs are unpredictable but vary with the age of the lift and proper usage. Major refurbishment of a lift is a significant cost to watch out for. In small blocks leaseholders can often feel that the lift costs are not justified where infrequently used for one or two flights of stairs, but lifts must be maintained and cannot be mothballed.

Insurances

There are three main types of communal insurance cost; building, terrorism and officers.

Buildings insurance is vital and can cover building damage, liability for accidents on site, internal damage inside any flat in some limited circumstance and so on. It is vital to ensure that the valuation of the building is adequate under the policy or the insurer may raise issues with the claim. A building reinstatement valuation should be undertaken on a regular basis by a specialist. The cost of building insurance can vary with the level of the excess clause and the claims history. Insurance claims can be made by any leaseholder, but should be promptly dealt with through the managing agent and the broker. It is strongly recommended that each leaseholder also has their own personal insurance cover for contents and liabilities within their flat.

Terrorism insurance used to be part of the building insurance, but is these days a separate add on policy. The risk may be considered low, but cover is important.

Officers' insurance covers personal responsibility of the block's directors and company secretary whilst acting as officers and the cost is determined by the level of financial cover. Claims are rare, but if made the insurance company would presumably want to ensure that officers did not act recklessly.

Major works (Section 20 procedures)

Major expenditures (greater than £250 per flat) require a special statutory process. This process is precise and complex and incorrect application can invalidate the process. The effect of invalidating the process is that any leaseholder can refuse to pay more than a £250 contribution (whether direct or out of reserves).

The process involves three specific notices to leaseholders, which cover notification of the proposed works, the option for leaseholders to suggest contractors, details of at least two quotes for the works being considered and the final decision made. There are minimum time periods between stages and if payment of funds being levied at the end of the notices is delayed, then the whole process is extremely slow.

Health and Safety

Health and safety compliance is of paramount importance in blocks and their grounds. Areas covered by inspections and maintenance include fire risk assessment, fire safety electrical systems, asbestos, lift and mechanical systems and communal electrical wiring.

It is fast becoming a minefield of regulatory control both by direct legislation and by implied responsibilities with escalating compliance costs. Much of the compliance requirements are being driven by customary practice and industry expectations, which are constantly changing. This gives rise to high levels of disparity between interpretations. The risks of negligence include the safety of individuals, personal risks of management and possible insurance claim rejection. Safety expectations are constantly evolving; what was fine at one point can be insufficient later (e.g. smoke seals, glass, hinges and even closing systems of individual flat front doors are under current review).

Issues that frequently arise in communal living

Living in a shared building requires consideration of neighbours. Whether blocks are purpose built or converted buildings similar issues arise:

Noise: Noise easily carries around the building, especially at night when the outside is quiet. Open windows are in close proximity to other flats. Leases will usually restrict noise levels outside of certain hours, but common sense does need to be applied.

Parking: There are never enough parking spaces at any block. Parking is dictated by the lease and/or house rules, but issues tend to arise where communal or guest parking spaces are abused.

Pets: The lease will usually cover any restrictions for pets or specify the circumstances where permission can be granted for pets. Obviously noisy or messy pets can be an issue for others.

DISCLAIMER

Flat Management Limited hopes this publication will assist with the basic understanding of leasehold property ownership. The information has been simplified to achieve the objective of clearer presentation. Most points are far more complex and specialist than specified, so it is important to realise that no action should be taken based on the above without first obtaining good detailed professional advice.