RESIDENTIAL LEASES:
LIFE AFTER *DAEJAN*

Section 20 and the Regulations

As we know, Parliament decided that in relation to certain works, landlords ought to involve tenants in the decision-making process. In relation to qualifying works and qualifying long term agreements, landlords must engage in a rather lengthy and cumbersome consultation process containing any number of pitfalls. The relevant provisions are to be found in section 20 of the Landlord and Tenant Act 1985 and in the Service Charges (Consultation (England) Regulations 2003. How those rules operate as been dramatically altered by Daejan Investments Limited v Benson. [2013] 1 W.L.R. 2330, the first time the Supreme Court has considered the question of residential service charges.

We will focus on the question of works, rather than on agreements, though the latter have their own important problems.[1] Works are covered if they are over the "appropriate amount", which is prescribed as an amount resulting in contributions of over £250 by a tenant (section 20(3)). Works must be "works to a building", though no better definition exists. In Paddington Walk Management Ltd v Peabody Trust [2010] L & T.R. 6. Whether a programme of works can be "salami-sliced" so that each slice falls below that threshold, and (as a related point) whether a landlord can add further costs items on when additional work is identified during a scheme of works (e.g. discovery of asbestos in the course of roof works) is a matter we will need to revisit once we have the Court of Appeal's answer, as the position is in a state of flux following the case of Phillips v Francis [2012] EWHC 3650 (Ch), presently under appeal to the Court of Appeal (late permission having been granted).[2]

[1] A full discussion can be found at Rosenthal & others, Residential and Commercial Service Charges, paragraphs 30-28 and following, which is available at all good book sellers.
[2] For a discussion see *ibid*, Chapter 30.

We are concerned here with the most common consultation requirements, which are found in Part 2 of Schedule 4 to the Regulations). The Supreme Court in Benson set out the stages for compliance as follows:

> "***Stage 1: Notice of intention to do the works***
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> *Notice must be given to each tenant and any tenants' association, describing the works, or saying where and when a description may be inspected, stating the reasons for the works, specifying where and when observations and nominations for possible contractors should be sent, allowing at least 30 days. The landlord must have regard to those observations.*
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> ***Stage 2: Estimates***
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> *The landlord must seek estimates for the works, including from any nominee identified by any tenants or the association.*
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> ***Stage 3: Notices about Estimates***
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> *The landlord must issue a statement to tenants and the association, with two or more estimates, a summary of the observations, and its responses. Any nominee's estimate must be included. The statement must say where and when estimates may be inspected, and where and by when observations can be sent, allowing at least 30 days. The landlord must have regard to such observations.*
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> ***Stage 4: Notification of reasons***
>
> *Unless the chosen contractor is a nominee or submitted the lowest estimate, the landlord must, within 21 days of contracting, give a statement to each tenant and the association of its reasons, or specifying where and when such a statement may be inspected*."

The problem is that a slip-up in the procedure could mean that the landlord is limited to the appropriate amount of £250 per tenant, which can mean a rather large shortfall in recovery. It can be extremely difficult where the manager or the landlord is a tenant-owned, tenant-funded company which might thereby be driven into liquidation. The one

possible solution to that problem is to call upon the tenant-shareholders to inject some capital: see Morshead Mansions v DiMarco [2009] 1 BCLC 559.[3]

A non-tenant owned landlord does not have that option, and must ask for dispensation under section 20ZA of the 1985 Act. The First Tier Tribunal (as the LVT now is) can dispense if it is satisfied that it is reasonable to do so. Pre-Benson, that was a difficult task, as the attitude of the Courts and Tribunals was largely to take the view that the Regulations were a good in themselves, aimed at promoting tenant engagement, and that it was no answer that a landlord could show that the tenants would not have asked for anything different.[4] The fact that the tenants had an improved block, and presumably more valuable leases as a result, cut no ice.

Daejan

Facts

Daejan was the landlord of a block containing seven flats and some shops. Five of the flats were liable for service charges. The landlord, wishing to carry out major works, served a notice under "stage 1" of the Regulations in July 2005. The works were in the amount of about £400,000. Tenders were received, but only one tender was given to the tenants. It then served a notice under "stage 2" in June 2006, to which the tenants objected as they wished to see all of the tenders. A second notice was served under stage 2 in July of that year, but the tenders had still not been provided. By the time that they were provided, the landlord said a contract had been placed and there was therefore a breach of the Regulations, and a need for dispensation arose. Without dispensation, the landlord was capped at 5 x £250/£400,000, that is, a 0.004% recovery.

Decisions Below

The landlord lost at all instances before the Supreme Court. The landlord's argument, that the financial outcome for the landlord was a relevant factor under section 20ZA, was rejected at all instances up to and including the Court of Appeal, who emphasised the

[3] Because that is not a payment by a tenant under a lease, it is not caught by the 1985 Act.
[4] Camden London Borough Council v The Leaseholders of 37 Flats at 30-40 Grafton Way LRX/185/2006

importance of compliance with the procedure within the Regulations. As regards the issue of prejudice, Gross LJ expressly agreed with the observations made in the *Grafton Way* case, quoted above. His Lordship stressed that significant prejudice to the tenants is a consideration of the first importance in exercising the dispensatory discretion under section 20ZA(1). Importantly, however, the Court of Appeal held that the gravity of the failure to comply was of significance. Gross LJ said that that loss of opportunity for the tenants to make further representations and have them considered in itself amounted to significant prejudice. The financial downside for the landlord was not a relevant factor. Nor was the identity of the landlord a relevant factor.

The Supreme Court

A bare majority in the Supreme Court upheld the landlord's appeal. In so doing, the underlying philosophy of the critical parts of the 1985 Act and the Regulations was re-cast in a potentially significant way. The starting point for the majority (led by Lord Neuberger, with Lord Clarke and Lord Sumption) was the purpose of the Regulations. In the earlier case of Paddington Basin Lewison J had identified two distinct statutory purposes lying behind the regulation of service charges:

> *"First, they are protected by section 19 from having to pay excessive and unreasonable service charges or charges for work and services that are not carried out to a reasonable standard. Second, even if service charges are reasonable in amount, reasonably incurred and are for work and services that are provided to a reasonable standard, they will not be recoverable above the statutory maximum if they relate to qualifying works or a qualifying long term agreement and the consultation process has not been complied with or dispensed with. It follows that the consultation provisions are imposed for an additional reason; namely, to ensure a degree of transparency and accountability when a landlord decides to undertake qualifying works or enter into a qualifying long term agreement."*

The Regulations sought to implement these policies. The scheme of the 1985 Act was to ensure that tenants were not required (i) to pay for unnecessary services or poor services, and (ii) to pay the correct price for appropriate services. The consultation requirements

were not an end in themselves, and were not there to punish landlords. In this regard, the philosophy adopted by the Supreme Court is closer to that adopted in the Court of Appeal in the commercial service charge context: procedural requirements are there to allow landlords to navigate towards a sensible commercial goal. They are not to be treated as an assault course which the landlord must traverse at his own peril.

The approach to dispensing under section 20ZA(1)

After a warning that each case is going to turn on its own nuanced facts, Lord Neuberger gave the following guidance:

(1) Sections 19 to 20ZA are directed towards ensuring that tenants of flats are not required (i) to pay for unnecessary services or services which are provided to a defective standard, and (ii) to pay more than they should for services which are necessary and are provided to an acceptable standard. The former purpose is encapsulated in section 19(1)(b) and the latter in section 19(1)(a). The following two sections, namely sections 20 and 20ZA are intended to reinforce, and to give practical effect to, those two purposes. This view is confirmed by the titles to those two sections, which echo the title of section 19.

(2) The obligation to consult the tenants in advance about proposed works goes to the issue of the appropriateness of those works, and the obligations to obtain more than one estimate and to consult about them go to both the quality and the cost of the proposed works.

(3) Given that the purpose of the Regulations is to ensure that the tenants are protected from (i) paying for inappropriate works or (ii) paying more than would be appropriate, the issue on which the LVT should focus when entertaining an application by a landlord under section 20ZA(1) must be the extent, if any, to which the tenants were prejudiced in either respect by the failure of the landlord to comply with the Regulations.

(4) Thus, in a case where it was common ground that the extent, quality and cost of the works were in no way affected by the landlord's failure to comply with the

Regulation, it is hard to see why the dispensation should not be granted (at least in the absence of some very good reason).

(5) Dispensation should not be refused solely because the landlord seriously breached, or departed from, the Regulations. That view could only be justified on the grounds that adherence to the Regulations was an end in itself, or that the dispensing jurisdiction was a punitive or exemplary exercise.

(6) The Regulations are a means to an end, not an end in themselves, and the end to which they are directed is the protection of tenants in relation to service charges, to the extent identified above. After all, the Regulations leave untouched the fact that it is the landlord who decides what works need to be done, when they are to be done, who they are to be done by, and what amount is to be paid for them.

To that extent, gravity of breach of the Regulations was not to be treated as a helpful test, albeit that it must be accepted that a serious failing is more likely to cause tenants substantial prejudice, which is the real concern of the Regulations. By the same token, however, the seriousness of the loss caused to the landlord was not a relevant factor, and nor was the identity of the landlord. From hereon in, procedural non-compliance is not enough to preclude a landlord from obtaining dispensation. The tenants must be able to demonstrate that there has been prejudice caused.[5]

To Dispense or Not to Dispense, or is there a "Third Way"?

Lord Neuberger clarified that, on an application for dispensation, the First Tier Tribunal is not faced with a simple binary choice:

> *53. The respondents contend that, on an application under section 20ZA(1), the LVT has to choose between two simple alternatives: it must either dispense with the Requirements unconditionally or refuse to dispense with the Requirements. If this argument is correct, then as the Upper Tribunal held, and the Court of Appeal thought probable, it would not have been possible for the LVT in this case to grant Daejan's section 20ZA(1) application on the terms offered by Daejan, namely to reduce*

[5] That prejudice is the touchstone is emphasised in BDW Trading Ltd & Anor v South Anglia Housing Ltd [2013] EWHC B10 (Ch) at paragraph [14]. See too the helpful summary in OM Property Management [2014] UKUT 9 (LC), paragraph 14.

the aggregate of the sum payable by the respondents in respect of the Works by £50,000.

54. *In my view, the LVT is not so constrained when exercising its jurisdiction under section 20ZA(1): it has power to grant a dispensation on such terms as it thinks fit – provided, of course, that any such terms are appropriate in their nature and their effect.*

55. *In the absence of clear words precluding the LVT imposing terms, I consider that one would expect it to have power to impose appropriate terms as a condition of exercising its power of dispensation. The circumstances in which an application could be made are, as already mentioned, potentially almost infinitely various, and, given the purpose of sections 20 and 20ZA, it seems unlikely that the LVT's powers could have been intended to be as limited as the respondents suggest.*

56. *More detailed consideration of the circumstances in which the jurisdiction can be invoked confirms this conclusion. It is clear that a landlord may ask for a dispensation in advance. The most obvious cases would be where it was necessary to carry out some works very urgently, or where it only became apparent that it was necessary to carry out some works while contractors were already on site carrying out other work. In such cases, it would be odd if, for instance, the LVT could not dispense with the Requirements on terms which required the landlord, for instance, (i) to convene a meeting of the tenants at short notice to explain and discuss the necessary works, or (ii) to comply with stage 1 and/or stage 3, but with (for example) 5 days instead of 30 days for the tenants to reply.*

57. *Further, consider a case where a landlord carried out works costing, say, £1m, and failed to comply with the Requirements to a small extent (eg in accidentally not having regard to an observation), and the tenants establish that the works might well have cost, at the most, £25,000 more as a result of the failure. It would seem grossly disproportionate to refuse the landlord a dispensation, but, equally, it would seem rather unfair on the tenants to grant a dispensation without reducing the recoverable sum by £25,000. In some cases, such a reduction could be achieved by the tenants invoking section 19(1)(b), but there is no necessary equivalence between a reduction which might have been achieved if the Requirements had been strictly adhered to and a deduction which would be granted under section 19(1)(b) – see the next section of this judgment.*

58. *Accordingly, where it is appropriate to do so, it seems clear to me that the LVT can impose conditions on the grant of a dispensation under section 20(1)(b). In effect, the LVT would be concluding that, applying*

the approach laid down in section 20ZA(1), it would be "reasonable" to grant a dispensation, but only if the landlord accepts certain conditions. In the example just given, the condition would be that the landlord agrees to reduce the recoverable cost of the works from £1m to £975,000.

59. *I also consider that the LVT would have power to impose a condition as to costs – eg that the landlord pays the tenants' reasonable costs incurred in connection with the landlord's application under section 20ZA(1).*

60. *It is true that the powers of the LVT to make an actual order for costs are very limited. The effect of para 10 of Schedule 12 to the 2002 Act is that the LVT can only award costs (in a limited amount) (i) where an application is dismissed on the ground that it is frivolous, vexatious or an abuse of process, or (ii) where the applicant has "acted frivolously, vexatiously, abusively, disruptively or otherwise unreasonably in connection with the proceedings".*

61. *However, in my view, that does not preclude the LVT from imposing, as a condition for dispensing with all or any of the Requirements under section 20(1)(b), a term that the landlord pays the costs incurred by the tenants in resisting the landlord's application for such dispensation. The condition would be a term on which the LVT granted the statutory indulgence of a dispensation to the landlord, not a free-standing order for costs, which is what para 10 of Schedule 12 to the 2002 Act is concerned with. To put it another way, the LVT would require the landlord to pay the tenants' costs on the ground that it would not consider it "reasonable" to dispense with the Requirements unless such a term was imposed.*

62. *The case-law relating to the approach of courts to the grant to tenants of relief from forfeiture of their leases is instructive in this connection. Where a landlord forfeits a lease, a tenant is entitled to seek relief from forfeiture. When the court grants relief from forfeiture, it will often do so on terms that the tenant pays the costs of the landlord in connection with the tenant's application for relief, at least in so far as the landlord has acted reasonably – see eg Egerton v Jones [1939] 2 KB 702, 705-706, 709. However, if and in so far as the landlord opposes the tenant's application for relief unreasonably, it will not recover its costs, and may even find itself paying the tenant's costs, as in Howard v Fanshawe [1895] 2 Ch 581, 592.*

63. *As Mr Dowding QC, for Daejan, pointed out, in Factors (Sundries) Ltd v Miller [1952] 2 All ER 630, the tenant was legally aided and the court was precluded by statute from making an order for costs against him,*

> *but the Court of Appeal held that there was nonetheless jurisdiction to require him to pay the landlord's costs as a condition of being granted relief from forfeiture. As Somervell LJ explained it at 633D-F, the liability under such a condition was "not an order to pay costs in the ordinary sense", but "a payment of a sum equal to the costs as a condition of relief".*
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> 64. *Like a party seeking a dispensation under section 20(1)(b), a party seeking relief from forfeiture is claiming what can be characterised as an indulgence from a tribunal at the expense of another party. Accordingly, in so far as the other party reasonably incurs costs in considering the claim, and arguing whether it should be granted, and, if so, on what terms, it seems appropriate that the first party should pay those costs as a term of being accorded the indulgence.*

By this approach, the First Tier Tribunal therefore has a wider jurisdiction than had previously been appreciated, namely, when dispensing, to do so on a range of possible terms to achieve justice between the parties.

Burden of Proof/Prejudice

Finally, Lord Neuberger had the following to say on the issue of burden of proof:[6]

> 67. *[i]t is true that, while the legal burden of proof would be, and would remain throughout, on the landlord, the factual burden of identifying some relevant prejudice that they would or might have suffered would be on the tenants. However, given that the landlord will have failed to comply with the Requirements, the landlord can scarcely complain if the LVT views the tenants' arguments sympathetically, for instance by resolving in their favour any doubts as to whether the works would have cost less (or, for instance, that some of the works would not have been carried out or would have been carried out in a different way), if the tenants had been given a proper opportunity to make their points. As Lord Sumption said during the argument, if the tenants show that, because of the landlord's non-compliance with the Requirements, they were unable to make a reasonable point which, if adopted, would have been likely to have reduced the costs of the works or to have resulted in some other advantage, the LVT would be likely to proceed on the assumption that the point would have been accepted by the landlord. Further, the more egregious the landlord's failure, the more readily an LVT would be likely to accept that the tenants had suffered prejudice.*

[6] OM Properties Limited [2014] UKUT 9 (LC) highlights the importance of providing relevant evidence on the part of the tenants.

68. *The LVT should be sympathetic to the tenants not merely because the landlord is in default of its statutory duty to the tenants, and the LVT is deciding whether to grant the landlord a dispensation. Such an approach is also justified because the LVT is having to undertake the exercise of reconstructing what would have happened, and it is because of the landlord's failure to comply with its duty to the tenants that it is having to do so. For the same reasons, the LVT should not be too ready to deprive the tenants of the costs of investigating relevant prejudice, or seeking to establish that they would suffer such prejudice. This does not mean that LVT should uncritically accept any suggested prejudice, however far-fetched, or that the tenants and their advisers should have carte blanche as to recovering their costs of investigating, or seeking to establish, prejudice. But, once the tenants have shown a credible case for prejudice, the LVT should look to the landlord to rebut it. And, save where the expenditure is self-evidently unreasonable, it would be for the landlord to show that any costs incurred by the tenants were unreasonably incurred before it could avoid being required to repay as a term of dispensing with the Requirements.*

69. *Apart from the fact that the LVT should be sympathetic to any points they may raise, it is worth remembering that the tenants' complaint will normally be, as in this case, that they were not given the requisite opportunity to make representations about proposed works to the landlord. Accordingly, it does not appear onerous to suggest that the tenants have an obligation to identify what they would have said, given that their complaint is that they have been deprived of the opportunity to say it. Indeed, in most cases, they will be better off, as, knowing how the works have progressed, they will have the added benefit of wisdom of hindsight to assist them before the LVT, and they are likely to have their costs of consulting a surveyor and/or solicitor paid by the landlord.*

Lord Neuberger's Summary

Lord Neuberger summarised the position as follows:

70. *Before turning to the disposition of this appeal, it is worth considering the effect of the conclusions I have reached so far.*

71. *If a landlord fails to comply with the Requirements in connection with qualifying works, then it must get a dispensation under section 20(1)(b) if it is to recover service charges in respect of those works in a sum greater than the statutory minimum. Insofar as the tenants will suffer relevant prejudice as a result of the landlord's failure, the LVT should, at least in the absence of some good reason to the contrary, effectively require the landlord to reduce the amount claimed as service charges to compensate the tenants fully for that prejudice. That outcome seems fair*

on the face of it, as the tenants will be in the same position as if the Requirements have been satisfied, and they will not be getting something of a windfall.

72. *On the approach adopted by the courts below, as the Upper Tribunal said at the very end of its judgment, requiring the landlord to limit the recoverable service charge to the statutory minimum in a case such as this "may be thought to be disproportionately damaging to the landlord, and disproportionately advantageous to the lessees". That criticism could not, it seems to me, be fairly made of the conclusion I have reached.*

73. *However, drilling a little deeper, if matters rested there, the simple conclusion described in para 71 could be too favourable to the landlord. It might fairly be said that it would enable a landlord to buy its way out of having failed to comply with the Requirements. However, that concern is, I believe, answered by the significant disadvantages which a landlord would face if it fails to comply with the Requirements. I have in mind that the landlord would have (i) to pay its own costs of making and pursuing an application to the LVT for a section 20(1)(b) dispensation, (ii) to pay the tenants' reasonable costs in connection of investigating and challenging that application, (iii) to accord the tenants a reduction to compensate fully for any relevant prejudice, knowing that the LVT will adopt a sympathetic (albeit not unrealistically sympathetic) attitude to the tenants on that issue.*

74. *All in all, it appears to me that the conclusions which I have reached, taken together, will result in (i) the power to dispense with the Requirements being exercised in a proportionate way consistent with their purpose, and (ii) a fair balance between (a) ensuring that tenants do not receive a windfall because the power is exercised too sparingly and (b) ensuring that landlords are not cavalier, or worse, about adhering to the Requirements because the power is exercised too loosely.*

After Benson[7]

Jastrzembski v Westminster City Council the issue was whether dispensation should be granted where the tenant had not been served with a notice of intention to carry out works at all (i.e. stage one). On the face of it that is a serious failure to comply (although there

[7] I would also recommend reading Phillip Sissons' forthcoming "*Is Talk Cheap? After Daejan …*", which is due to appear in the next issue of the Conveyancer and Property Lawyer and discusses the issue of a landlord "buying out" his breach.

were mitigating circumstances) and under the Court of Appeal's preferred approach in Benson might well have lead to a refusal to grant dispensation. The Tribunal concluded:

> *the respondents did consult with the appellant and he did have the opportunity to make observations on the proposed works and nominate a contractor – the very matters that the initial notice is designed to deal with. In the circumstances, we cannot find that the appellant suffered relevant prejudice as is set out in Daejan as he was not under a disadvantage that he would not have suffered had the consultation requirements been fully complied with. The appellant was, in our judgment, in the same position he would have been in had the consultation requirements been fully complied with.*

Voyvoda v Grosvenor West End Properties & Anor [2013] UKUT 334 (LC) was a case in a completely different context. It was a case in which the Upper Tribunal had to consider the so-called Zuckerman addition to the Sportelli deferment rate in enfranchisement cases. As will be known, in Sportelli, the Lands Tribunal (as it was) had decided to fix generic deferment rates for enfranchisements. In Zuckerman, the deferment rate was increased by 0.25% to reflect the risk that there might in due course be a catastrophic non-compliance with the Regulations, which risk would mean that an investor in reversions to blocks of flats would reduce their bid in response. Voyvoda decided that, after Benson, that addition was no longer appropriate. The view was taken that the effect of Benson was to cancel that risk out.

A case in the Upper Tribunal where dispensation was in fact ordered was OM Property Management Limited [2014] UKUT 9 (LC), where the tenants did not play a part on appeal. The LVT had declined to dispense, referring to a number of irrelevant (in light of Benson) prejudice matters, and the tenants had not provided any material from which prejudice could be deduced. It followed that this was a case in which dispensation could be awarded, but appropriate costs orders were made (and the order at [49] is instructive as to how the First Tier Tribunal is likely to proceed in future.