

Property Litigation Quarterly Bulletin

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COMMERCIAL SERVICE CHARGES- Avoiding Disputes



Although less common in number than claims for recovery of rent, because of their extra complexity, service charge disputes tend to be much more involved. In addition, as the amounts owed are almost always in dispute, options for recovery are generally limited to court proceedings. Accordingly, as well as being extremely expensive for both parties, the potential for damage to long term landlord and tenant relations when service charges are in dispute is immense.

The majority of guidance on the topic of disputes concentrates on tactics for the tenant and recovery for the landlord. However, it is far more efficient for both parties to avoid disputes in the first place. To achieve this, good planning is essential.

Unlike residential service charges, which are beyond the scope of this article, commercial service charges are mercifully free from regulation by Parliament and are entirely contractual in nature, i.e. governed by the lease itself. This article covers some of the most common areas of discord.

When should you consider disputes?

1 At Drafting stage - "Contra landlordum"

Both landlords and tenants have a golden opportunity to shape their future relationship right at the drafting stage. Indeed, when considering potential major expenditure, future recovery should not be ignored even when negotiating heads of terms.

There is a basic contractual doctrine that any term is to be construed contra proferentum i.e. against the party putting forward the instrument. When dealing with service charge clauses, however, the Courts' view seems to be to construe clauses

against the landlord regardless of whether the clause, or indeed the lease, is his document.

Service charge clauses are accordingly construed strictly by the Court. It is well settled that, in order for a landlord to recover a particular head of expenditure, he must satisfy the Court that it sits squarely within one of the heads recoverable under the service charge clause.

The message is clear – if the landlord knows there are specific heads of expenditure which he will be seeking to recharge, the lease must refer to them. 'Sweep up' clauses can be less than effective.

2 Prior to major expenditure – repairs or improvements?

All leases and all situations are different and it is not possible to give generic advice on what is a repair, and therefore recoverable through a 'standard' service charge clause. However, by following one or two guidelines, landlords can minimise the likelihood of a dispute and, should one occur, maximise their chances of recovery.

2.1 The adoption of current building practice to replace outmoded systems does not prevent work from being repair. Provided there is some disrepair to begin with, the landlord is within his rights to repair and update simultaneously. Were this not the case, landlords everywhere would still be using thatch.

2.2 Although the tenant is paying for the works, they remain the landlord's works and he has, within reason, freedom to choose between alternative methods. He must, however, consider the circumstances, not least, the limited length of the tenant's interest – whilst the landlord may consider it ideal to replace the entirety of the roof covering with Welsh slate, the tenant on a three year lease can legitimately object to paying for it.

2.3 As a rule of thumb, if the works are likely to increase the value of the reversion significantly, they are improvements.

2.4 Consulting the tenant prior to carrying out the works can reduce the likelihood of disputes later. Also, if a dispute does arise the landlord can point to his open consultation as evidence of his reasonableness. This, and the fact that consultation is encouraged by the Guide for Good Practice for Service Charges in Commercial Property, will count very much in the landlord's favour if costs

in any litigation are borne in mind.

2.5 Fact and degree will always cloud the issue but the overreaching provision remains as held in *Ravenseft v Davstone* – works are not repairs where they give back to the landlord something entirely different than he had before.

2.6 The burden of proof lies with the landlord to prove the works were repair rather than with the tenant to prove they were not.

3 Follow the mechanism!

The most common mechanism for recovery of service charges is for the landlord to notify of the estimate for the year ahead and demand quarterly payments on account subject to a balancing charge once the accounts are in.

It is not a difficult concept so why do so many landlords depart from it, particularly when faced with significant, one off expenditure? If this is envisaged throughout the life of the lease then steps should be taken to incorporate it, usually by means of a sinking fund to amortise the cost of major works.

If a mechanism such as that above exists, a tenant faced with a one off bill for a lift replacement will, if well advised, merely refuse to pay and there will be little that can be done if the demand is not in accordance with the lease mechanism. Ultimately, it may be that the landlord has no option but to collect the cost of the major works as a balancing charge at the year end which does no favours to the landlord's cash flow.

4 Time limits: of the essence?

The rule that time limits are, as a rule, considered not to be of the essence applies as much to service charge clauses as it does to rent reviews.

It is quite within a tenant's rights,

however, to make time of the essence by serving notice on a landlord to carry out an act within a specified time or lose the right to do so. A landlord obliged to supply year end accounts by a certain date can accordingly, lose the right to collect any balancing payment determined by those accounts if he cannot or does not abide by the time limit once notified by the tenant to do so.

Summary

Recovery proceedings in service charge disputes are expensive and damaging to landlord and tenant relationships.

Landlords also need to beware the 'renegade tenant' in a multi let building. Him winning his case may give others the ability to recover payments made under the same circumstances on the basis that these were made under a mistake of law and/or fact.

Avoidance of disputes by advance awareness of their likely triggers is far more efficient for both landlords and tenants, as well as far more conducive to good relations between the two, than damage limitation once the dispute occurs.

Hopefully the above provides some pointers to help achieve that.

CASE LAW UPDATE



Two weeks too slow?

Landlords in receipt of a written application for licence to assign or sub-let are under a statutory duty to respond within a reasonable time. Alarm bells sounded recently when, in **NCR Ltd v Riverland**, the trial judge stated that: "In my judgment, a period of two weeks from the [date a complete application was delivered] was quite sufficient time for Riverland [the landlord] to make a decision."

The alarm bells have been quietened, to a degree, because the Court of Appeal has now overturned the judge's ruling. The two week period referred to by the trial judge was too short. The Court of Appeal felt that, following receipt of a full, formal application for consent, the landlord was entitled to "adequate time...to consider the serious financial and legal implications of a refusal with its advisers, and if necessary to report to the relevant Board." In the absence of special exceptional circumstances, a period of less than three weeks "particularly in the holiday period" (July/August) could not be categorised as inherently unreasonable.

Practical point: What is a reasonable length of time will depend upon the circumstances of the case, but whether it is two weeks or three weeks, the sands of time will quite quickly run out for a landlord whose response is not well organised.

Ask questions first, or pay for it later

In **Bon Appetito Ltd v Michael Poon** the landlord forfeited a lease for a breach of the covenant against subletting without consent. Without consulting the landlord, the tenant had entered into a management agreement to enable a third party to operate a restaurant.

In court, the tenant argued that the management agreement did not amount to a sub-letting, and that any breach had in any event been remedied prior to the forfeiture. The court had little sympathy. It held that the agreement did create a tenancy as it granted to the third party the sole and exclusive right to operate the business from the premises. As no permission had been obtained, there was a breach of a covenant of a kind that was not capable of remedy – it was therefore irrelevant that the tenant had terminated the agreement prior to the forfeiture. Relief from the forfeiture was refused because the tenant had had a clear intention to sublet in circumstances where, most likely, the landlord would have been entitled to refuse to consent (in view of the fact that sub-tenant had no track record). Relief was also denied to the sub-tenant since, otherwise, it would result in compelling the landlord to accept as tenant a person who had deliberately been party to a breach of covenant and was of dubious financial standing.

Practical point: Consider carefully the consequences of premature action where landlord's consent may be required.

Lease termination – testing the landlord's intention

Under the Landlord and Tenant Act 1954 (part II), where a landlord seeks to repossess at the end of a lease, what evidence of an intention to redevelop is necessary, and is the landlord's motive relevant?

In **BP International Ltd v Newcastle International Airport Ltd** land was used for the storage and supply of aircraft fuel. The landlord claimed that it needed to obtain possession to carry out works of redevelopment as part of an expansion of the airport. The tenants argued that the landlord's redevelopment plans were not genuine and that its real motivation in opposing the grant of new leases was to remove competition from the airport. They argued that there was no evidence of any real need to use their land as part of the proposed expansion, and that its use was inconsistent with the airport's stated expansion master plans. Further, it was argued that the landlord's plans were not sufficiently far advanced, so that the landlord lacked the necessary degree of intention to commence development on the termination of the lease. However, the court preferred the evidence of the landlord. The fact that the landlord had passed board resolutions in relation to its plans was good evidence of a genuine intention.

Practical point: Where a landlord opposes lease renewal upon redevelopment grounds, the motive of the landlord is irrelevant. Provided the landlord is able to show that it possesses a genuine intention to redevelop, it does not matter that a by-product of the landlord's proposals is the relocation of a competitor. A landlord is entitled to redevelop its premises whatever its motives for doing so.

Court applications to modify restrictive covenants

What can be done to challenge the effectiveness of covenants which appear to prevent use and/or development of land? One possibility is to apply to the Lands Tribunal to modify or extinguish a covenant which is restrictive of the use of land.

Re Bramley shows the need for an applicant to the Tribunal to set out clear objectives from the start. This case involved an application to discharge restrictive covenants which prevented use for any purpose other than as a private dwellinghouse. The applicant had obtained planning permission for change of use to a day nursery. The application for discharge was made on the basis that, by reason of changes in the character of the property or the neighbourhood, the restriction ought to be deemed obsolete.

At the hearing, the applicant requested leave to amend her application so as to seek modification of the covenants (as an alternative to outright discharge). She also sought permission to rely upon additional grounds (i.e. that the restriction impeded a reasonable use of the land). The Tribunal refused leave to amend so late in the process, and further held that ground originally relied upon had not been established.

Practical point: It is notoriously difficult to persuade the Lands Tribunal to sanction the complete discharge of a restrictive covenant. It is equally difficult to persuade it either to discharge or modify a covenant on the basis that the covenant is obsolete. That being

so, it is always wise to consider (a) applying for a modification of a covenant, rather than its discharge, and (b) choosing carefully at the outset the ground or grounds most appropriate for use in support of the application.

This bulletin has been produced by the Property Litigation team at Halliwells LLP. The team consists of six solicitors who specialise in Property Litigation advice and dispute resolution in relation to real estate portfolios.

If you require any further information in relation to the service that the team provides or have any comments about this bulletin then please contact any one of the following members of the Team: -

Paul Marco - Partner
0870 365 8191
paul.marco@halliwells.com

Rob Nicholson - Associate
0870 365 9456
rob.nicholson@halliwells.com

Gary Bird - Assistant
0870 365 9410
gary.bird@halliwells.com

Peter Hall - Assistant
0870 365 9434
peter.hall@halliwells.com

Paul Henson - Assistant
0870 365 8193
paul.henson@halliwells.com

Tom Seabrook - Assistant
0870 365 8014
tom.seabrook@halliwells.com

Should you wish to receive future bulletins by e-mail or wish to be taken from our distribution list please e-mail
claire.blythin@halliwells.com

www.halliwells.com