MAINLY FOR STUDENTS

Tenants will be unwilling to pay for replacing items from which they will gain little or no benefit

Landlords will want existing tenants to pay such costs while they still have a contractual liability

Open the door to conflict

Replacing M&E equipment is one of the most disputed elements of the landlord and tenant relationship. *Simon Edwards*, *Patrick Stell* and *Keith Firn* discuss the effect that the issue can have upon service charges

The replacement of base-build mechanical and electrical equipment (M&E) by the landlord of commercial premises is arguably the most contentious issue that can arise between landlords and tenants during the lease term. It can potentially lead to costly and disruptive works.

Unless the service charge is capped, or the lease contains exclusions on the items chargeable, tenants may have to pay substantial sums towards the replacement of items of which they might have been completely unaware.

Timing of replacement of M&E equipment

Understandably, a landlord will want to ensure that the M&E equipment in its building is kept in full repair and working order throughout the term of its tenants' leases.

When considering what work may be required to be carried out to the M&E equipment prior to lease end, landlords will examine the possibility that existing tenants could be asked to pay towards the costs of the repairs while they are still contractually liable.

The situation appears uncontroversial. A lease of commercial premises will usually enable the landlord to request its tenants to be liable for their share of the proposed works under their lease provisions.

Although leases frequently include such a provision when the property is let on institutional full-repairing terms, tenants will in many instances not be happy to meet the full costs of any proposed works.

Tenants' arguments

Tenants' advisers will often argue that the item in question should be repaired (at a lower cost) rather than be replaced.

However, such an approach requires professional advice from a surveyor, engineer and lawyer. If the sums involved are high, tenants should ensure that the replacement works are carried out only if they are absolutely necessary. Landlords, too, must always seek professional advice so that they are in a position to defend their actions, in some cases many years after the event.

Tenants will often object to contributing to building services items because they feel that they will be paying for works to the landlord's building from which they will not benefit.

They are of the view that if the items could be repaired rather than replaced, not only would the costs be lower but the M&E equipment (such as lifts, escalators and air-conditioning systems) would continue to provide the requisite service throughout the period during which the tenant is obliged to pay towards it, namely during the lease term.

Current case law

The leading case on the replacement versus renewal of building services close to lease end is *Fluor Daniel Properties Ltd* v *Shortlands Investments Ltd* [2001] 2 EGLR 103.

In this dispute, the landlord replaced the air-conditioning system towards the end of the tenant's lease. It charged the cost of around £2m to the tenant through the service charge. The tenant objected, contending that the previous system had not been in disrepair and should not have been replaced.

The High Court held that the full cost of the works could not be recovered from the tenant under the service charge and that the landlord would have to meet part of the cost. The logic applied by the judge was based upon the specific wording of the lease, which presupposed that the system would need to be defective or in disrepair before it could be replaced.

The judge explained his reasoning for the landlord being unable to recover the full costs of the works in this way:

> the standard of work to be adopted must be such as the tenants, given the length of their leases, could fairly be expected to pay for. The fact that an item of plant has reached the end of its recommended lifespan as suggested by industry guidelines does not mean that it would be reasonable for the landlord to want to replace it at the tenants' expense.

The landlord was therefore not entitled to remove and replace substantial items of M&E plant under the service charge provisions.

Another case that is often quoted by tenant advisers disputing the full recovery of service charge costs is *Scottish Mutual Assurance plc* v *Jardine Public Relations Ltd* [1999] EGCS 43. Here, the tenant held a three-year lease of a multi-let office building. The landlord was under an obligation, during the term, to keep the roof in repair. It did so by undertaking required works. However, it then carried out substantial repair works to the roof.

The landlord wanted to recover the costs of those works from the tenant. The tenant objected owing to the short length of its lease. It contended that it should pay towards repair works based upon the extent of its lease term and not the landlord's overall repairing obligations for keeping the roof in repair over a longer period, which the landlord had intended.

The High Court agreed with the tenant. It held that the tenant was liable to pay towards repair works based only upon the extent of its lease and not upon the landlord's long-term repairing obligations.

As in *Fluor Daniels*, the landlord and tenant therefore had to share the cost of the works. The landlord could not recover the full cost of the repairs from the tenant and had to meet part of the tenant's due contribution (with other tenants).

RICS code of practice

The RICS *Service Charges in Commercial Property* (introduced in April 2007) takes a different approach to the repair versus replacement issue from that of the courts'. The intention behind the code is to make the issue of replacement, repair and renewal less of a battlefield and more of a co-operative exercise between the parties.

It encourages greater conciliation in situations where the lease requires that an item cannot be replaced until it is in disrepair and, generally speaking, no longer carrying out the function for which it was designed.

Service charge moneys

Whether moneys collected by the landlord, but unspent, may be retained by it at lease end or should be returned to the tenant will depend upon the lease wording.

In *Secretary of State for the Environment* v *Possfund (North West) Ltd* [1997] 39 EG 179, the tenant was required to pay towards M&E items, including the replacement of the air-conditioning system. At lease end, the sum that the tenant had paid towards the cost of the new system had not been spent and the tenant asked for its return. The lease was silent on the return of such moneys and the landlord refused to reimburse the tenant.

The case went to court. The judge ruled that, under the terms of the lease, as soon as the tenant paid money to the landlord, that money became the landlord's absolute property. The lease did not contemplate a situation in which the money could be returned to the tenant. The landlord was able to retain the money and to carry out the works after lease end.

However, *Brown's Operating System Services Ltd* v *Southwark Roman Catholic Diocesan Corporation* [2007] EWCA Civ 164; [2008] 1 P&CR 7 took a different course. The Court of Appeal held that unspent moneys could be returned to the tenant at lease end, notwithstanding the fact that the lease did not expressly sanction this.

The position is therefore dependent upon what the lease says regarding the return of moneys. If it is unclear on the issue, it may be necessary to consider the other sections of the lease, which may indicate the intentions of the parties when drawing up the lease.

Simon Edwards and Patrick Stell are chartered surveyors at GK Stell Building Consultants and Keith Firn is a chartered surveyor at Barkers Associates. Their book Dilapidations and Service Charge Disputes – A Practical Guide *was published by EG Books in October 2008*

Why this matters

Tenants' outgoings are generally fixed, save for service charges. Rents are fixed until the next review (often every five years) and business rates change from year to year. Service charges, however, can rise dramatically during a building's financial year. Unless the lease imposes a cap or exclusions, these will have to be paid by the tenant.

In an era of shorter lease terms, the costs of replacing expensive items is more likely to be disputed than previously. Tenants were content to take longer leases knowing that they would have to pay towards the replacement of some, or all, such items during the lease term.

However, with leases now being for, say, 10 years or less with a break at the fifth year, landlords will want to be able to recover costs towards expensive M&E plant that will benefit the future rather than the current tenant, which is the one faced with the service charge bill. Failing agreement on these issues, the landlord will have to decide whether to pay the costs itself or try to recover them as a debt claim at a county court or the High Court (depending upon the amount involved).

A tenant's defence where works have already been carried out is that the liability to pay (a debt not a damages claim by the landlord) is not incurred under the lease because the works do/did not comply with its terms. It is interesting to compare service charge works with dilapidations disputes between the same parties. In the case of dilapidations, the landlord and tenant relationship has come to an end; service charges are part of a continuing relationship. When the lease ends, the tenant no longer has to pay towards service charge works; so all service charge disputes occur (or start) during the lease term or close to its end.

In today's market, where costs payable by tenants are under pressure, disputes over service charge issues will increase, particularly the large capital expenditure of replacing M&E equipment. Landlords and tenants must take early advice to protect their positions.

Further Reading

Case in Point – Dilapidations
Hunter J, RICS Books

Dilapidations and Service Charge Disputes – A Practical Guide
Edwards S, Stell P and Firn K, EG Books

West and Smith's Law of Dilapidations
Smith PF, (11th ed) EG Books