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CASE STUDY

A landlord of a building let to a variety of commercial tenants appoints a new firm of managing agents who discover that the service charge percentages contained within the leases of the property do not add up to 100%. The units within the building had been gradually let out over a period of time, and there is no explanation as to the basis upon which the service charges have been apportioned, nor why there was an error in their calculation.

The leases require the tenants to pay the percentage of the service charge referred to in their lease, or 'such other percentage as shall be reasonable in the opinion of the landlord's managing agent, and which shall be binding upon the tenant in the absence of manifest error.'

Can the landlord change the service charge percentages?

If so, how should they be re-apportioned?

Would it make any difference if there was a residential element to the building?

DISCUSSION

Introduction

1. The way in which service charges are apportioned between tenants varies from lease to lease. Older residential leases tend to provide for a fixed percentage to be recovered from each tenant whereas commercial leases more often provide for a fair or reasonable proportion to be recovered.
2. Where a fixed proportion has been specified, there is very limited scope for varying this unless the lease expressly gives the landlord a right to do so. On the face of things, the above provision does give a right for the service charge percentage to be varied. However, the question whether there can be a variation which binds the tenant is not as straight forward as first seems.

Can the Landlord vary the percentage?

3. The simple answer to the question “can the landlord can vary the percentage?” is no. The lease provides for the recovery of ‘such other percentage as the landlord’s managing agent decides’ and thus the landlord itself cannot change the percentage. But what if the landlord is also the managing agent? It seems that a variation made by a landlord who is also the managing agent will not be binding on the tenant.

4. In Finchbourne Ltd v Rodrigues [1976] 1 EGLR 51 the amount of a lessee’s contribution to the service charge was to be “ascertained and certified by the lessor’s managing agents acting as experts and not as arbitrators.” The landlord was in effect also the managing agent and the Court of Appeal held that a certificate given by the managing agent in these circumstances was not a valid certificate. The tenant was entitled to expect that where a certificate is to be given by the landlord’s managing agent it is to be given by someone other than the landlord himself. Browne LJ said:

“It seems to me that this provision [certification by the lessors’ managing agents acting as experts and not as arbitrators] can only mean that the amount of the contribution, as my Lord has said, is to be ascertained and certified by a third party, other than the landlord himself, acting as an expert. The intention clearly was that the tenant should be entitled to rely on the expertise of such a third person. On the judge’s findings of fact here, which are not challenged, the managing agents and the lessor were in fact the same person. Accordingly, I agree with my Lord that there is no valid certificate...”.

5. What if the managing agent is not the landlord? Can the landlord require the managing agent to vary the percentage?

6. There is nothing inherently repugnant about a provision to the effect that a determination by a third party expert acting impartially as to what is a ‘fair proportion’ of the service charge for the tenant to pay will be binding on the tenant. (See e.g. Nikko Hotels (UK) v MEPC [1991] 2 EGLR 103). However, whether the managing agent in this case will be entitled to make a binding determination is doubtful.

7. In Concorde v Andromeda SA [1983] 1 EGLR 53, a case concerning commercial property, a new managing agent was appointed and the amount of the service charge increased substantially and was thus challenged by the tenants. The lease contained a tenant's covenant to pay "a rateable or due proportion of [costs and expenses] ... such proportion in case of difference to be settled by the landlord's surveyor whose decision shall be final and binding on the parties hereto".

8. The service charges had been demanded by a firm who were both the landlord's managing agents and his surveyors. On the question of whether the certificate as to the amount of service charge was binding on the tenant Vinelott J said (at 55 F):

"The function of the landlord's surveyor under clause 2(3) is to decide a difference as to the amount of the contribution payable by the tenant. That function is essentially an arbitral one. The reason for choosing the landlord's surveyor to perform this duty is I think that the parties envisaged that the landlord would retain surveyors with general authority to keep the estate under proper supervision and to advise as to the state of the premises and any need for repair and on matters of that kind. They agreed to refer a difference arising out of clause 2(3) to the landlord's surveyor because in the course of performing his duties as surveyor he would acquire some familiarity with the property which would enable him to reach a decision more cheaply and expeditiously than if he came to the matter entirely afresh. It does not follow from the fact that the landlord's surveyor is chosen to perform this duty that his function cannot be an arbitral one. His position will be of some delicacy. Although he is the landlord's agent he must act impartially and hold the balance equally between the landlord and the tenant notwithstanding that the landlord is his principal and paymaster. He must not simply obey the instructions of the landlord ... the parties to the lease are entitled to rely upon him as a professional man to exercise an independent judgment."

9. In Concorde v Andromeda, because the landlord appointed the firm of surveyors to act both as surveyors and as managing agents, the result was that as surveyors, they could not perform the task required to be performed by the landlord's surveyor under

clause 2(3) and Vinelott J held that the landlord had to appoint other surveyors who could resolve the dispute.

10. The problem in this case is that it is the managing agent who is to make the determination. Any variation by the landlord's managing agent is thus likely to be susceptible to challenge by a tenant on the basis that the party making the determination is not independent.
11. Any variation to the percentages made at the direction of the landlord will be highly vulnerable to a challenge. Thus, the landlord under this lease wishing to secure a variation of the percentage contribution, rather than direct the managing agents to recalculate this on a fair basis, might sensibly instead consider pointing out the particular problem to the agents and invite them to consider this issue (without specifying the answer). The managing agent, in making a decision would then have to act not as the landlord's agent but as an independent expert and might wish to consider inviting representations from the tenants. If the wording of the relevant service charge provision permits it, the managing agents may even consider appointing a completely independent third party to advise it in fixing the percentage.

What would be a 'reasonable' basis to re-apportion the service charges?

12. There is no one formula which can be applied to calculate a reasonable or fair proportion of a service charge. In Jollybird Ltd v Farizone Ltd [1990] 2 EGLR 55, a case concerned with the amount the tenant should pay towards central heating, the court upheld the tenant's argument that its contribution should be the same as the area of the demised premises compared to the total lettable floor area supplied with central heating by the landlord. There is, however, no fixed rule that in order to be reasonable regard must be had to the benefit each tenant receives from the services provided, although this may, often be appropriate (see paragraph 16 below).
13. The way in which service charges are often assessed are:
 - a. by equal shares (e.g. the total cost divided by the total number of flats in the block);

- b. a percentage based on the total floor area of the premises demised relative to the total area of the whole property;
 - c. a percentage based on the rateable value of the unit in question compared to the aggregated rateable values of all the units in the development;
 - d. a percentage based on floor area but with a discount being given in respect of premises with larger floor areas (the weighted floor area basis).
14. Equal shares may not always be appropriate. For example, this is unlikely to be regarded as an equitable basis upon which to apportion costs in a building where the units vary in size substantially. Rateable value cannot be used for new residential property and may not be appropriate for commercial property where the rateable value of different parts of the building does not relate to the services provided to those parts.
15. The 'RICS Code of Practice – Service Charges in Commercial Property' contains guidance as to the principles which should be considered when apportioning service charges and includes some technical guidance at sections D4 and D5: D4 *Common methods of apportionment* and D5 *Apportionment schedules*.
16. This code provides that whatever method is being used, it needs to be demonstrably fair and reasonable and there needs to be a rational commentary on how an apportionment has been worked out. The guidance provides, amongst other things, that the apportionment is to be applied consistently throughout the property and that regard should be had to the physical size, nature of use, and benefits to and use by the occupier(s). The owner should meet the cost of any special concession given to any one occupier and bear a fair proportion of costs attributable to its use of the property.
17. An expert charged with determining a 'fair' or 'reasonable' proportion to be paid by a tenant would be well advised to follow the guidance laid down in this code.

Does it make any difference if there is a residential element to the building?

18. If there are residential flats in the building, the landlord may have an alternative means of varying the percentage contribution.
19. Section 35 of the Landlord and Tenant Act 1987 enables any party to a long lease of a flat to seek an order from a leasehold valuation tribunal varying the lease where it fails to make satisfactory provision in certain respects. A long lease is defined at section 59(3) and basically means a lease granted for a term certain exceeding 21 years, a perpetually renewable lease or a lease granted in pursuance of the right to buy. A long lease of premises consisting of three or more flats in the same building is not a qualifying long lease (neither are business tenancies under the Landlord and Tenant Act 1954) - section 35(6).
20. Section 35 does not apply to commercial premises. Thus, in a mixed development, this section would only be of use in relation to a potential variation of the residential leases.
21. The grounds upon which an application may be made to a leasehold valuation tribunal include where the lease fails to make satisfactory provision with regard to:
 - a. “the recovery by one party to the lease from another party to it of expenditure incurred or to be incurred by him or on his behalf, for the benefit of that other party or of a number of persons who include that other party” - section 35(2)(e)
 - b. “the computation of a service charge payable under a lease” –section 35(2)(f).
22. Section 35(2)(f) is augmented by section 35(4) which provides that:

“A lease fails to make satisfactory provision for the computation of a service charge if:

 - (i) it provides for the charge to be a proportion of expenditure incurred or to be incurred by or on behalf of the landlord or a superior landlord; and
 - (ii) other tenants of the landlord are also liable under their leases to pay by way of service charge proportions of any such expenditure; and

(iii) the aggregate of the amounts payable in any particular case by reference to those proportions exceeds or is less than the whole of the expenditure.”

23. Thus, where there is a service charge with a fixed percentage, and where the service charge payable by the tenants does not add up to 100%, this section may enable the landlord to vary that fixed percentage. This provision would enable a variation not only where the total percentage collected by a landlord is greater than 100% but also where it was less than 100%. An application may be made by any party to the lease and thus could be made by the landlord.
24. Where the landlord is recovering more than 100% and is making a profit from the service charge, whether or not the lease should be varied is likely to be uncontroversial. However, where there is a deficit in the amount recovered by the landlord, more difficult considerations arise.
25. There may well be a good reason why the landlord is only entitled to recover less than 100% of the service charge. The landlord may, for example, have agreed with one of the tenants that in return for the payment of an increased premium, the service charge payable under the lease would be reduced. If the landlord has agreed to limit his recovery in this way, why should this contractual position be subsequently altered? (See also section 38(6) of the Act).

Conclusion

26. In this case, the landlord itself will not be able to control the variation of the fixed percentage. The managing agents may vary the percentage but their decision is likely to be susceptible to challenge by the tenants unless it can be demonstrated that they acted wholly independently.
27. If the premises were residential, a variation might be possible under section 35.