

Client Note:

Decoding the Code - Service Charges in Commercial Property
RICS Code of Practice, Second Edition



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THE NEW CODE

On 4 May the RICS launched the second edition of its *Service Charges in Commercial Property Code of Practice*. The revised Code will come into effect on 1 October and replaces the first edition of the Code originally published in 2007. Like the original Code, the new version seeks to set out a framework of best practice for owners and management surveyors and states that its core principles remain as "communication, transparency and timeliness".

Those responsible for preparing the new Code have a wealth of experience in the industry. The main author is Peter Forrester, who is a director and head of service charge consultancy at Savills. He is well known for advocating best practice in the management and administration of service charges. His co-author and the Chair of the Pan Industry Service Charge Code Steering Group, is Chris Edwards of Commercial Property Advisors Ltd. Chris is also the Chairman of the RICS Service Charge working group and the RICS Commercial Market Board. Behind them was a Pan Industry Group representing landlords, tenants, surveyors and other service charge advisors and interested parties.

The object of the working group was not materially to change the principles behind the original Code, but to present it in a clearer format and to build on the experience gained from working with the Code over the last four years. One of the main complaints about the original Code was that, as it had 86 separate points of principle set out across ten pages of text which went into detailed points of practice, it was too cumbersome for practitioners to pick out the key issues. The new Code, by contrast, has just 26 points of principle and has been condensed into two and a half pages. Much of what was previously in the Code itself has now been moved into a separate section of the Code booklet which sets out the principles of best practice in detail. This replaces the previous section entitled "Technical Support". The new Code also includes a useful checklist for practitioners, a list of cost classifications and some sample reports for practitioners to use.

PREAMBLE TO THE CODE

Although the Code itself is now only two and a half pages long, the booklet containing it still runs to some 79 pages. It starts with a Foreword setting out the context for the second edition. One comment that will interest readers is a statement that "increased engagement with the legal profession is a key aspiration of the new Code". There is clearly a hope that practitioners will draft new leases to reflect the best practice set out in the Code.

Another key point made both in the Foreword and elsewhere in the Code, is the need for occupiers to be able to challenge service charge costs. The Code recommends that all leases should contain alternative dispute resolution clauses. This is in line with many aspects of the Code, which are aimed at cost efficiencies. My experience is that owners are increasingly regarding ADR as a sensible way of dealing with service charge disputes. Most owners would not, however, want to exclude the ability to resolve an issue in Court, if the issue in question merited judicial consideration.

A further point which the Foreword highlights is the use of Industry Standard Cost Classifications. These were introduced in the original Code and are increasingly used by owners. The new Code however places greater emphasis on their use, regarding adoption "as a must in services charges going forward". For lawyers drafting leases however, the cost classifications are not necessarily a user friendly way of setting out the list of services to be provided and there is no reason why they need slavishly to be followed, so long as the principles of the cost headings are followed. The list of costs is, however, a useful checklist for draftsmen.

Following on from the Foreword are the guidance notes which clarify that the status of the Code is that of a guidance note and that the recommendations set out are intended to embody best practice. The notes acknowledge that in some cases the advice set out in the Code may not be appropriate, but asks that managers be transparent in their departures from the Code. There is a cautionary note that whilst practitioners who do not follow the Code will not necessarily be negligent, the best practice set out in the Code may well be used as a benchmark in deciding on whether a professional has acted appropriately and competently.

There then follows a further "Introduction" which sets out the purpose of service charge provisions and includes the list of the items which should not be included as service charge costs. These were previously set out at Article 29 of the original Code and encompass the issues which most practitioners would now expect not to be included in the service charge costs, such as initial cost of construction, the cost of improvements above normal repair and maintenance or replacement, future development costs, cost of rent collection, enforcement of covenants and other matters which should be charged to individual tenants; and any costs associated with the failure of the owner or manager to perform its obligations.

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The Code itself is prefaced by a statement of aims and objectives, which are:

- To improve general standards and promote best practice, uniformity, fairness and transparency.
- To ensure the timely issue of budgets and year end certificates.
- To reduce disputes and provide guidance on resolving them.
- To provide guidance to solicitors, landlords, tenants and managers in negotiating, drafting, interpreting and operating leases in accordance with best practice.

THE CODE

The core principles begin with a quotation from Jonathan Gaunt QC sitting as a deputy high court judge in *Princes House Limited v Distinctive Clubs Limited [2006]*:

"Tenants who agree to service charge clauses under which they contract to pay against a surveyor's estimate or an accountant's certificate rely upon the professional people involved performing their roles with professional scrupulousness, diligence, integrity and independence and not in a partisan spirit, supposing their only task to be to recover as much money as they can for the landlord."

So what are the 26 core principles in the Code?

1-3	Service costs	These should provide value for money. Competitive quotations should be obtained or costs should be benchmarked. Owners should not profit from the provision of services, other than by charging a reasonable commercial management fee. Costs should also be transparent and management fees should be on a fixed price basis with no hidden markups.
4-6	Allocation and apportionments	Costs should be allocated to the relevant expenditure category and apportioned appropriately between tenants on a demonstrably fair and reasonable basis. Costs should be apportioned to those who benefit from the services. Managers should provide tenants with full details of the basis of calculation and apportionment of individual costs.
7	Certification	Certified accounts should represent a true and accurate record of costs and should recognise a duty of care to both owners and occupiers to act professionally, diligently and with integrity and objectivity.
8-10	Communication and consultation	Owners should consult with occupiers as to the standard and quality of services and to ensure services are delivered for the benefit of all occupiers. There should also be transparency on what occupiers should be expected to pay. Managers should also be transparent in showing how they comply with the Code.
11-12	Duty of care	Owners and managers have a duty of care to occupiers and managers have a duty to owners. There should be clear policies on how the service charge is to be managed.
13-17	Financial competence	Managers must demonstrate a high degree of competence, professionalism, integrity, diligence, objectivity and transparency. Statements of account should be non partisan. Moneys should be held in a discrete bank account and interest earned should be credited to that account. The recommended standard cost headings should be used in reporting budget and actual expenditure. Those cost headings are also set out later in the Code.
18-20	Occupier responsibilities	Occupiers are to pay service charge contributions promptly and where there is a dispute should only withhold the amount actually in dispute rather than the full amount due. Occupiers are also expected to assist owners in the operation of service systems in order to achieve value for

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		money. There is also a requirement that occupiers should ensure their representatives have appropriate authority to deal with service charge matters.
21-22	Rights to challenge/dispute resolution	New leases should provide for ADR. If a lease does not allow for ADR, the parties are reminded that they can still agree to use it.
23-24	Timeliness	Communication and consultation should be timely. Budgets should be issued at least one month prior to the start of the service charge year and final statements of account should be issued within four months after the end of the service charge year.
25	Transparency	This is stated to be essential to achieving good communication and in order to prevent disputes. Managers should notify promptly of any material variances to budgets.
26	Value for money	The stated aim is to achieve value for money and effective service, rather than lowest price. Services should be appropriate to the location, use and character of the property.

The core principles conclude with additional notes designed to encourage its use. This guidance rightly acknowledges that the Code cannot override existing lease terms, but encourages its use as a way of interpreting existing provisions. Occupiers and owners on lease renewals are encouraged to update service charge provisions to reflect the Code the parties are asked to "carefully consider the principles and requirements of the Code prior to entering into a new or renewal lease".

RECOMMENDED BEST PRACTICE

As mentioned earlier, the Code then sets out in some detail the recommended best practice to support those core principles. These again fall under a number of broad headings:

Administration	<p>This section looks at how managers should run their teams in order to provide effective value for money service. It addresses staffing issues and management charges, as well as some more controversial issues, such as a notional rent for management accommodation.</p> <p>The recommendation is that occupiers should not be charged a notional rent where the relevant premises could not be occupied beneficially for any other purpose or where the building has not been designed specifically to house a facilities management office. It does acknowledge that there may be an element of rent which should be chargeable if the management team is using accommodation which would otherwise be lettable. The extent to which such premises might otherwise be lettable remains a potential source of disagreement between owners and occupiers.</p> <p>This section also addresses methods of apportionment and suggests that floor area apportionment is the simplest. I doubt many would disagree. It makes it clear that rateable value apportionments are no longer recommended. Whilst new leases are unlikely to use a rateable value apportionment method, there will be many historic leases that still refer to them and the Steering Group would like to see them changed. That may well require the agreement of the owner and/or tenants of a property in order to be achievable.</p> <p>Another tricky issue addressed is management fees. The Code believes these should be reasonable and reflect the work done and requires that fees are dealt with on a fixed price basis rather than as a percentage of expenditure. Percentage calculations of management fees have traditionally been the favoured method of</p>
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	<p>calculation and this is one of the areas where there are likely currently to be more departures from the recommendation that compliance.</p> <p>Most owners would now accept that occupiers should not be responsible for costs attributable to unlet premises and that costs should be apportioned appropriately to those who benefit from the relevant services, for example splitting down costs between particular buildings on an estate with a separate estate charge or if they are mixed use premises attributing office, retail, leisure and residential costs appropriately to the services each one receives, so that office occupiers are not, for example, subsidising retailers for their service areas.</p> <p>A more tricky issue is what are referred to as owner's costs/profit centres. These are things like telecommunications masts, advertising hoardings, car parks and barrows in shopping centres. The view of the Code is that if that separate cost/profit centre generates income which the owner decides not to credit to the service charge account, then the cost of running it should not be allocated to the service charge account. Alternatively, costs can be allocated to the service account if income is also credited to it. There is logic to this approach, but again it is an area that owners will be wary of, particularly in relation to car parks.</p>
Communication and consultation	<p>This section reiterates the need to have clear communication and proposes regular meetings between managers and occupiers. It also highlights the separate consultation procedure which applies to residential premises.</p>
Dealing with new and existing leases	<p>Again, this reiterates some of the key messages from earlier and also reminds readers of the Code for Leasing Business Premises. It also addresses sweeper clauses - not surprisingly the authors are not keen on them, and emphasises that they should not be used to cover a cost which was erroneously omitted from the lease when drafted. Finally this section has an advertisement for PACT, Professional Arbitration on Court Terms, the scheme provided by RICS and The Law Society as ADR on lease renewal disputes.</p>
Financial controls and competencies	<p>This deals in some detail with the difference between certifying service charge accounts and auditing them. Simply, certifications are made by the manager to show that the service charge statements comply with the lease and that the costs are a true and accurate record of the expenditure incurred; an audit is undertaken by an independent external reviewer in accordance with International Auditing Standards. The Code suggests that a full audit will usually be disproportionate, but proposes as an alternative an independent accountant's report, which would effectively check the manager's certification. Best practice under the Code is therefore certification by the manager accompanied by an independent accountant's report. Clearly, however, if the relevant lease already provides for a full audit, then the requirements of the lease will have to be followed.</p> <p>This section also details the use of the Standard Industry Cost Classifications and provides guidance on preparing budgets and timing.</p>
Dispute resolution	<p>This sets out a description of some of the forms of ADR that owners and occupiers might wish to use and again reiterates the message that even if a lease does not contain ADR provisions, the parties can still agree to use ADR. Readers are directed to the RICS fact sheets on ADR, which can be found at www.rics.org/drtoolkit and www.rics.org/disputeresolution.</p>
Mixed use schemes	<p>The main point highlighted here is the particular requirements relating to residential elements of mixed use schemes and readers are directed to look at the RICS Service Charge Residential Management Code.</p>

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Provision for anticipated future expenditure	This explains the differences between sinking funds, reserve funds and depreciation charges and again readers are directed to further guidance from the RICS.
Initial provision, replacement and improvement of fabric, plant and equipment	This is often one of the more difficult areas, not necessarily in drafting service charge clauses, but in deciding whether a particular item of works constitutes true repair, or replacement of an equivalent, or incorporates some form of enhancement. It will usually be a question of fact and the message is for managers to ensure that sufficient information is provided to occupiers to enable them to understand what the works are and whether they fall within the service charge.
Environmental sustainability	Managers are expected to take a fair and reasonable approach to the inclusion of any items under the service charge which might affect the performance of the building, eg something which might otherwise be seen as an improvement, but reduces other costs in the longer term. The authors of the Code do not think that the cost of obtaining an EPC should be a service charge cost.
Additional best Practice Guidance for Shopping Centres	There are three additional areas relevant here: marketing and promotions, commercialisation and weighted floor area apportionments. The Code's position on marketing and promotion expenses is that they should be jointly funded by the owner and the occupiers through the service charge. Christmas decorations, however, should be treated as amenities or facilities and may be charged through the service charge. The comments on commercialisation broadly follow those in relation to owner's costs/profit centres; again, transparency of approach is a key requirement. There is also an example of how a weighted floor area apportionment might work

DRAFT SERVICE CHARGE PROVISIONS

In order to support the Code, the City of London Law Society, in consultation with the authors of the Code, has produced draft service charge provisions for offices and for shopping centres which reflect the Code's core principles and follow much of the detailed advice in the best practice guidance. They can be downloaded from the City of London Law Society website: www.citysolicitors.org.uk. These clauses also include detailed sinking fund provisions as an optional extra. Whilst practitioners could use the provisions in their entirety, they could easily be used instead by draftsmen as a reference point when trying to decide whether their own drafting is sufficiently Code compliant.

There is much useful information in the Code itself and anyone interested in looking at the full detail of it can download it from the RICS website or from www.servicechargecode.co.uk.

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