Remedying Fire Risks under a Service Charge Regime

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Since the awful events of the Grenfell Tower fire in June 2017, there has been extensive debate in the leasehold industry, as to who should pay the costs of remedying cladding and fire safety issues in blocks of long leasehold flats. Most recently, the Government has introduced two measures designed to assist with ensuring that some of the construction issues in some blocks are remedied. First, in the March 2020 budget, the Government announced that there would be a £1 billion Building Safety Fund to support remediation of certain types of unsafe cladding on residential buildings over 18m high, with the fund open for applications from 31 July 2020. More recently, in July, the Government published a draft Building Safety Bill intended to reform the building and fire safety system. The draft includes sections to be added to the Landlord and Tenant Act 1985, the effect of which is to imply into residential leases a landlord covenant to comply with building safety measures under the Bill, and a tenant covenant to pay a service charge for the landlord's costs of so doing. Yet the Government's new regimes will operate in the statutory scheme for residential service charges. This article looks at the interaction of those issues particular to cladding and fire safety with the long established service charge regime.

Introduction

The interaction between landlord works to remedy building defects, and the recovery of costs through the service charge, has long been an area of difficulty in service charge law, whether one views the issue from the perspective of landlord or tenant. Older style leases, in particular, are often drafted restrictively as to the landlord's maintenance regime, with the landlord's covenant restricted to remedying disrepair, a definition into which a pure defect in construction, or more extensive fire safety measures, may not fall. On the other hand, the statutory regulation of service charges, by the reasonableness limit imposed by s.19 of the Landlord and Tenant Act 1985, gives residential leaseholders far fewer arguments against the imposition of charges by landlords despite being in receipt of Government or other funding for remediation than one might expect. Residential leasehold law on building maintenance involves a complicated relationship between interpretation of leases, other common law duties, and statutory regulation. There is no simple linear path between the recognition of a maintenance need, identifying the person liable to remedy it, and recovery of costs.

The Building Safety Fund: failure to apply

The Building Safety Fund is to provide grants for the remediation of non-ACM cladding systems (that is cladding that is potentially unsafe, but is not made of Aluminium Composite Material (ACM): ACM cladding removal was the subject of a previous £200 million fund with a deadline to apply of 31 December 2019) on certain high-rise residential buildings which had registered their expression of interest by 31 July 2020. On first reading, this is a very helpful step for residential leaseholders in such blocks. There are, however, a number of issues about how the regime and service charge recovery will interact.

The first issue is who has control. Leaseholders themselves cannot apply. The applicant is to be the "responsible entity", that is, the organisation with the legal obligation or right to carry out the remediation works and to recover costs through the service charge. Landlords, and RTM, and lease-named management, companies are, therefore, included. Though leaseholders can, by submitting a form, notify the MHCLG team of a responsible entity which is failing to comply, and local authorities can take enforcement action if there is a refusal to remediate a high rise building with unsafe cladding, that will not immediately ensure works are done, nor that they are paid for. Moreover, a leaseholder whose lease imposes a landlord obligation to remedy defects of this type may sue its responsible entity for an injunction requiring works to be done.

That will not, however, remedy the loss of funds. What is a leaseholder to do if faced with a failure by his responsible entity to apply to the fund, who sought the costs of remediation through the service charge instead? If the new Building Safety Bill is passed, there will be a new s.17A in the 1985 Act implying into a long lease of a dwelling in a higher-risk building (to be defined in regulations) an obligation on a landlord to take all reasonable steps to apply for any relevant financial support for costs of prescribed building safety measures. It remains to be seen what this will mean.

In the absence of that new section, the leaseholder would have to argue, on a claim based on such a failure, that the responsible entity had a duty to apply to the fund, either as an implied term to provide the leasehold services with reasonable care and skill, or in negligence (because it was fair, just and reasonable for a landlord to have such a duty), that the failure to apply was a breach, and that he had suffered loss being his share of the costs of remediation paid through the service charge. That sounds attractive, but there are bumps in such a claim along the way. For example, the loss would be not simply be the service charge paid, but the loss of a chance that the fund would have paid out, which given the various hurdles, for example, the need for the responsible entity to submit a full cost funding application by 31 December 2020, could involve a complicated analysis.

The Building Safety Fund: failure to credit

What if the responsible entity does apply to the fund, and does receive payment from it, but does not apply that money to the service charge, and seeks to recover costs from the leaseholders? It seems obvious that cannot be permitted. The Government publications on the fund make it clear that the fund is not for the benefit of landlords but for leaseholders in the private sector who would otherwise incur the costs through the service charge arrangements.

Yet, any analysis of how it is that a landlord is prevented from double recovery of costs of maintenance works, when it has the benefit of a grant or insurance, or a successful claim for damages for defective construction against the building developer, for example, simply shows up a difficulty in the service charge common law and statutory regime. What is payable by leaseholders is dependent on what the landlord (or RTM or management company) has incurred.

If the landlord has incurred a cost and then recouped it, it is very hard to analyse legally why the recouped cost is not something the landlord can simply retain, despite the exhortation in *Oliver v Sheffield City Council* [2017] EWCA Civ 225; [2017] 1 W.L.R. 4473, that service charge provisions have to be interpreted to prevent double recovery.

The machinery in most service charge leases is based on the leaseholder paying a proportion of what his landlord has incurred in providing various services, for example, maintenance and repair of the structural parts of a block of flats. Often payment for service charges by leaseholders is divided into two stages. First, before or at the beginning of the service charge year, the landlord estimates the costs likely to be incurred by it during the year to come in providing the services set out by the lease. Each leaseholder has to pay his proportion, in advance. After the end of the service charge year, the landlord will determine what he has incurred, and the leaseholder will be repaid the difference, or will pay a balancing charge, based on the difference between the estimate and the actual costs. This regime under the lease is then regulated by s.19 of the 1985 Act. For advance service charges, "no greater amount than is reasonable is so payable" (s.19(2)). Under s.19(1), for incurred costs the landlord can seek costs "(a) only to the extent that they are reasonably incurred, and, (b) where they are incurred on the provision of services or the carrying out of works, only if the services or works are of a reasonable standard".

A likely payment to the landlord for the costs of works, via a grant or insurance or similar, can be taken into account when setting the advance charge. That is because what is payable as an advance charge is dependent simply on what is reasonable, and that wording, it was said in *Avon Ground Rents v Cowley* [2019] EWCA Civ 1827; [2020] 1 W.L.R. 1337; [2020] L. & T.R. 2 (where the NHBC had agreed they would pay out under a new build warranty), is intended to allow for flexibility. Thus if, by the date on which the leaseholder has to pay its last advance charge instalment, it is likely (beyond just hypothetical for example) that a third party will pay towards the costs, then it will not be reasonable for the landlord to charge as part of the advance charge the full cost not taking into account the third party's likely contribution.

What about the actual service charge costs used for example in calculation of the balancing charge? Now, if the landlord was paid by the third party before the costs of the works were incurred, that is before the landlord became liable to pay them itself, then there will have been no costs incurred, and thus nothing, for those works, to be recovered through the service charge. This may well be the case for most fund grants, if the fund is well administered and a work programme was not started before application to it.

The position is, however, much more complicated if the landlord incurs costs and is later repaid by a third party. Under the lease, since the costs have been incurred, they fall within the service charge. Costs do not cease to have been incurred because they have been repaid by a third party. That is because the landlord has incurred costs if it has a liability to pay them as set out, for example, in *Edozie v Barnet Homes* [2015] UKUT 348 (LC) at [62]-[66]. To conclude that what has been "incurred" does not include something for which the landlord is liable just because it has been later repaid distorts that word's normal meaning. It is only where the leaseholder's service charge is not calculated via a fixed percentage, but is to be 'a reasonable" proportion (as it was, for example, in *Oliver*, above) or "a fair and reasonable proportion" that it is easier to find room to analyse the service charge as excluding what has been incurred and repaid.

Despite it often being argued unsuccessfully to the contrary, the s.19(1) limit on the costs does not much assist any leaseholders who are seeking to ensure they benefit from the third party's payment, either. That is because the reasonableness limit in s.19(1) is not wide, as it is in s.19(2). The limit on the service charge is not what is reasonable (which would likely be enough to take into account a third party payment) but what is reasonably incurred. The question of

reasonableness for s.19(1)(a) is to be judged when the landlord incurred the costs. If works needed doing, the landlord incurred the costs of those works reasonably, irrespective of later repayment. It is only if the third party would have paid for the works without the landlord incurring costs, for example, under a guarantee as in *Continental Property Ventures Inc v White* [2007] L. & T.R. 4, that the argument that it was not reasonable for the landlord to incur the costs is easily available.

Thus, where the service charge proportion is fixed and the third party is not guaranteeing payment before any landlord costs are incurred, one likely has to look outside reasonableness for a reason why double recovery is not permitted. This is easier when the third party paying out is an insurer, where the insurance policy has been paid for by the leaseholders through the service charge since that gives the leaseholders, as set out in *Vural Ltd v Security Archives Ltd* (1990) 60 P. & C.R. 258, at least an implied right to the insurance monies independent of the service charge analysis, and/or imposes on the landlord a fiduciary duty to preserve the leaseholders' interests in effecting the insurance claim. One might in addition argue that the landlord's ability to have recourse to an insurance policy was subject to the statutory trust imposed by s.42 of the Landlord and Tenant Act 1987, because the insurance was paid for through the service charge, the landlord cannot retain the benefit of an insurance pay out. The landlord obtained the payout as the trustee under that trust and a trustee cannot retain a benefit from trust property. It is much harder to make such an argument in other cases.

The best one might say about a payment by the fund is that the Government's emphasis on the purpose of the fund, that it is for the benefit of leaseholders who would otherwise have to pay through the service charge, imposes a constructive trust on the responsible person for any grant paid out to it which requires that grant to be accounted for to the leaseholders in their service charge proportions. That is an attractive but not a straightforward argument.

The Building Safety Fund and the need for litigation

In the above, we have touched on moneys for works paid for by third parties. The third parties who might pay such moneys are insurers, or a contractor where money is paid under a warranty, or a developer post legal action against it, for example. It is a further requirement of the fund that the responsible person must, on application to it, demonstrate that it has taken all reasonable steps to recover costs from insurers, warranties, or legal actions. That is a burdensome requirement, unless the level of what is reasonable is set low. Legal action takes money, which may well not be readily available in particular where the responsible person is a lessee-owned management or RTM company. There are a number of recent instances in case law demonstrating the complexity of such litigation.

For example, there is the *Manchikalapati v Zurich Insurance Plc (t/a Zurich Building Guarantee and Zurich Municipal)* [2019] EWCA Civ 2163; [2020] B.L.R. 1, litigation by a group of leaseholders in a new build block against their insurer. They had to get to Court of Appeal level for a finding that there was not a maximum liability cap under their structural defects insurance policy which the insurer was saying would limit their claim to the combined purchase price of their flats, a sum considerably below the cost of remedial works needed including to remedy lack of fire protection in structural steelwork.

As for claims against developers, development companies are often dissolved after a major project has been carried out so there is no one to pursue. Moreover, even if there is anyone to enforce against, the recent successful summary judgment application by the developer in *Sportcity 4 Management Ltd v Countryside Properties (UK) Ltd* [2020] EWHC 1591 (TCC); [2020] 2 P. & C.R. DG 21 has illustrated the limitation difficulties faced in a claim under s.1 of the Defective

Premises Act 1972, often the only recourse where a claim based on negligent construction would fail as a claim for pure economic loss. Thus, complicated limitation extension arguments may well be needed, for an older block, such as deliberate concealment of relevant facts, a case pursued so as to defeat a summary judgment application in *RG Securities (No.2) Ltd v Allianz Global Corporate and Speciality CE* [2002] EWHC 1646 (TCC) (where the argument was that the lack of sign off by building control had been concealed).

Non-recoverability through the service charge

All of the above analysis of the fund is predicated on the costs of remediation being recoverable through the service charge. Indeed, that they are so recoverable is a requirement of qualification for application to the fund. That raises another question. What if the costs of remedial works are not recoverable through the service charge? If a block of flats has non-ACM cladding, or lacks suitable fire prevention measures, or poses a fire risk to its occupants, that will need remedy whether or not the fund can be accessed, or the works payable for through the service charge, if lives are not to be risked, and long leases not to become valueless to their owners.

The service charge regimes in many leases, particularly older leases, do not include wide enough wording to include defect remediation works within the landlord's maintenance obligations, or the costs of such works within the service charge. That is because if a landlord has covenanted to repair and maintain the structure of the building, for example, the replacement of inappropriate cladding added to the building when built will not be a work of repair. The cladding, though defective because a fire risk, is not in disrepair. Moreover, its replacement is unlikely to be an act of maintenance. The interpretation of "maintain" in the case law tends not to extend a landlord's obligations to remedy a construction defect. For a landlord to have an obligation to remedy a defect, and the leaseholders an obligation to pay, there must be a clear term to that effect. Similarly, unless there is a specific clause allowing recovery of the costs of fire precaution measures, for example updating doors or fire alarm systems, or having a warden in place, the cost of those useful steps will not be payable via the service charge (the costs of such works are often caught as the cost of landlord compliance with statutory requirements, so that the costs of, for example, of complying with the Regulatory Reform (Fire Safety) Order 2005 fall within the service charge, to the extent that that Order requires the landlord to do works to the common parts). The interpretation of residential long leasehold landlord maintenance obligations is much informed by case law on commercial tenant repairing covenants and, is for that reason relatively restrictive. The context, that leaseholders usually need their landlords to do necessary common works, has not allowed for wider construction of service charge clauses in the courts and tribunals.

That is where the other recent Government step comes in. The new draft Building Safety Bill includes provisions which, if passed, would add new sections to the 1985 Act including a section implying into long leases of the as yet undefined "higher-risk buildings", as well as a landlord covenant to carry out prescribed building safety measures, a tenant covenant to pay for the landlord's costs of so doing within 28 days of demand at the same proportion as under the lease's service charge, subject to those costs being reasonably incurred and services and works being of a reasonable standard, and subject to consultation. There has been much concern in commentary on the new Bill that this will simply impose more costs, as yet of unclear extent, on leaseholders for issues not of their making. There is much in that point.

Conclusion

There is, however, another perspective, relevant not only to fire risks, but to reform of residential long leasehold more generally, especially where the landlord is lessee owned, or is an RTM company. There is a need for blocks of flats to be safe, both statutory and moral. The funds for ensuring that happens must come from somewhere. It has long been a feature of residential landlord and tenant law, in particular where lessees manage their own buildings, that difficulties arise where the lease drafting includes too limited a regime to allow for sufficient service charge recovery for all the management and maintenance a building needs, and the lessees either have not or cannot redraft the leases. There is little way around it: costs for necessary management can be paid by the lessees through the service charge, which is regulated under the 1985 Act, as members of the company with much less opportunity for enforcement or oversight, or the building can lack proper maintenance for lack of funds. The kind of approach suggested in the Bill in its narrow context, of imposing, statutorily, sufficient standardising landlord and tenant covenants to remedy drafting issues seems, potentially, a useful way more generally to ensure the leasehold machinery is available for works which have to be done, especially for lessee-owned management.

It is true, however, that all of these measures, fail to address the perhaps more likely source of many of the building defect issues: poor construction by developers and contractors, and poor regulation of their work.

The law is stated as at 8 October 2020.