

Service charge – who bears the cost of social distancing?

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Last week Germany announced that it would start to allow shops of up to 800 square metres to re-open, leaving larger stores closed. Given its success in managing the pandemic so far, other countries may well follow Germany's lead in the limited relaxation of lockdown measures. If so, this could have implications for both landlords and tenants, particularly those of shopping centres.

The continued threat of Covid-19 means that retailers in particular will have to adapt to a new 'normal' when they are eventually allowed to re-open, not just so as to comply with government guidance but also to reassure customers that their premises are safe to visit. This will include measures we have seen introduced by food retailers such as social distancing, additional cleaning, limits to customer numbers in shops and probably the need for both staff and customers to wear PPE, such as face masks, whilst on the premises.

The landlords of shopping centres will need to ensure social distancing is practised in the mall areas, that the centre is clean to minimise infection and, to the extent that they are required, source and distribute masks to customers (which they may want to offer even if not obligatory). All of this will incur costs which raises the question as to who will pay for these necessary measures and, if it falls to tenants, when (in the absence of further government help) will they have to pay?

The obvious assumption is that the costs of such measures will fall to landlords albeit they will be recoverable from tenants pursuant to service charge obligations. However, the answer may not be so straightforward as it will depend on the terms upon which the tenants occupy their premises.

Who will pay?

Some leases require a tenant to pay a "fair and reasonable proportion..." of the service costs in a particular service charge year, whereas others will set out a fixed percentage which the tenant is required to contribute. Department store anchor tenants and other larger stores are usually liable for the lion's share of the service charge.

The larger stores may therefore feel aggrieved at paying for additional measures to support the opening of smaller stores when they are required to remain closed. If the lease states that a tenant is only liable to pay for services from which it derives a benefit, or is otherwise required only to pay a fair and reasonable proportion of the service costs, there is likely to be no liability for larger stores to contribute towards the additional costs whilst they remain closed.

However, if they are required to pay a fixed percentage of the costs and there is no requirement for the landlord to act on a fair and reasonable basis, they may well have to pay their share regardless of whether they are open or not.

Whilst the stores that are permitted to open may accept that they are liable to pay the cost of such additional services, they also need to appreciate that, as costs will be incurred in relation to the whole centre, they will be proportionately higher for individual stores than would usually be the case. Given that fewer transactions will be taking place as a result of social distancing and the lack of anchor tenant drawing shoppers to the centre, it raises the question as to whether they should have to meet this higher cost in full or is there an argument that the landlord should bear some of the cost in a way akin to the treatment of void units?

When will they pay?

Service charges typically operate over a 12-month period with tenants paying an estimated amount quarterly in advance and a balancing payment or credit at the end of the year. The cost to the landlord of the additional security and cleaning to comply with social distancing may not immediately be recoverable from tenants as they would still be paying the estimated service charge that was calculated at the start of the service charge year. The landlord can only recover additional costs straight away if the lease allows it to do so, perhaps through extraordinary expenditure or by revisiting the service charge budget. If the lease is silent, a landlord may not be able to recover additional expenditure until the reconciliation and balancing payment at the end of the service charge period which could take a year or more.

Can shops avoid the additional costs by choosing not to open?

The short answer is probably not. By refusing to open, a tenant would be in breach of any keep open covenant in its lease for which the landlord might be able to claim damages. In any event, the obligation to pay service charge, like rent, is not conditional on a unit being open for trade so the sums would still be due and payable. For some tenants it may be prohibitively expensive to re-open in which case we could see the demise of yet more retailers, which will not be in the long-term interest of the landlords. Commercial decisions may need to be made as to how to treat such charges.

Conclusion

It is too soon to say whether UK measures will be the same as those in Germany. However, in the event of a partial relaxation of the lockdown whereby some shops remain closed and others open, landlords and tenants would be well advised to consider in advance the impact of such measures on the service charge. Once the measures have been announced, it would be prudent for landlords to review leases to see whether they are able to increase the estimated service charge to cover unbudgeted costs. Tenants will need to factor in the additional service costs associated with reopening. It would then be sensible for parties to open a dialogue once they know what measures are in place so that costs can be discussed to head off the possibility of a dispute at a later stage.

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