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Briefing note May 2013

R22 refrigerants: Action needed on building air-conditioning systems

This briefing contains the text of an article by Bryan Johnston and Michael Coxall analysing the significant implications for the property industry of the imminent final phase out of the R22 refrigerant which is used in many air-conditioning systems. It was first published in Estates Gazette on 20 April 2013 under the heading "Don't get left out in the cold".

R22 is not the shortened name for Disney's new loveable droid created for the Star Wars franchise. It is instead an environmentally unfriendly hydrochlorofluorocarbon (HCFC) refrigerant used in heat pump, refrigeration and air-conditioning systems.

Use of virgin R22 became illegal in 2010 and use of recycled R22 will be banned from 1 January 2015 under European Regulation 1005/2009. This is critically important to property investors, owners and those with liability in respect of air-conditioning systems using R22 (common in pre-2004 systems). Air-conditioning systems are one of the most expensive M&E items in a building and one of the most significant elements of service charge liability – and potential dispute.

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While ultimately the replacement of equipment to use more environmentally friendly refrigerants is likely to be necessary, operators of R22 air-conditioning systems are adopting different approaches for moving away from R22, including: using R22 for as long as possible; using drop-in alternative refrigerants with or without system refurbishment; or complete replacement of systems (see box overleaf for the effects of the different approaches).

Investors

"R22 may become a negotiation point on price"

On a property investment acquisition involving an R22 air-conditioning system, the purchaser should consider who will bear the cost of R22 replacement/refurbishment and its potential effect on the property's value. This should form part of the initial due diligence, considering not only costs, but also potential disruption for necessary repair or upgrade works and the availability of suitable warranties. Where the property is let, the purchaser should check carefully to see if the costs of necessary works are covered by the tenants' obligations and whether the ability to recover exists (see below).

If the seller has already carried out refurbishment works, the purchaser should enquire as to the nature and quality of those works, the system's lifespan, whether warranty cover remains and whether it is possible to procure collateral warranties.

R22 may become a negotiation point on price. Purchaser concerns about potential liability could be resolved with an escrow arrangement if a price reduction cannot be agreed. Potential sellers will need to weigh up the cost/benefit effect on the

enhancement of value consequent on refurbishment or replacement compared to the effect on price from doing nothing and leaving a ticking R22 time-bomb.

R22 Solutions	
Continue maintenance with R22 for as long as possible	Until 1 January 2015 systems can be maintained/repaired/topped up using non-virgin R22 but the deadline looms and replacement/refurbishment of systems will take time to plan and implement.
Drop-in replacements / refurbishment	Compliant "drop-in" replacements might provide an easy alternative but could compromise system performance, cause leaks and increase energy costs. Refurbishment of system components is likely to be required and warranties will be affected. This is potentially a simpler solution (albeit temporary) for centralised chiller unit systems rather than for "VRF" systems where refrigerant flows through a pipe network between units.
Replacement of equipment with non-HCFC refrigerants	This option will initially involve the greatest capital outlay but ultimately it will achieve better performance and greater certainty upfront on overall costs.

New Leases

Again, due diligence by a prospective tenant of a lease of a building with an R22 system is important. The tenant will need to be aware of what its liabilities are and the landlord's intentions. If there is to be a major service charge outlay, this should be reflected in rental value.

The tenant should also consider other issues such as potential disruption while works are advanced and whether refurbishment works would be warranted. This will need to be balanced with the desirability of the property and the landlord's attitude to rental value. The tenant could consider negotiating for a service charge cap to limit its exposure or indeed, depending on the market and tenant covenant strength, requiring the landlord to replace the R22 system before the new lease commences.

In lease negotiations, it is unusual to see specific issues such as R22 being expressly included as a tenant or landlord liability in a lease. The responsibility for replacement, refurbishment and ongoing maintenance should be made clear, although it may be preferable to ensure this through strengthening general provisions on replacement/refurbishment rather than specific references to R22, to avoid causing problems for interpretation of the lease in other contexts.

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Dilapidations

In a standard FRI lease, tenants are likely to be responsible for replacement or refurbishment of R22 equipment after 2014 via the usual dilapidations and legislation compliance covenants.

In a standard FRI lease where tenants have an obligation to carry out repairs, the landlord will be able to recover the costs of repair if failure to repair diminishes the property's value. However, the R22 air-conditioning system may not be physically out of repair at the date of lease expiry, even if the R22 ban is in place. If the dilapidations provisions are drafted narrowly, the tenant may avoid liability, eg where the obligation is limited to repair alone, there is no disrepair and so the covenant is not engaged.

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Modern commercial leases tend to be widely drafted and include language such as "replace" or "renew", "keep in good working order", "maintain" and "keep in good condition". It is likely that an obligation to "replace" or "keep in good working order" will be sufficiently wide to oblige the tenant to carry out the requisite works. While it is arguable that the works are not strictly necessary prior to 1 January 2015, a prudent tenant would address such works as part of ongoing maintenance to keep the system in good working order. Tenants might be partially protected by a carve-out for "replacement" of equipment and their repair obligation might also be limited by a schedule of condition. They might still, however, be responsible for refurbishment if that was an option.

A "compliance with statute" obligation might assist the landlord although it should be checked for its coverage (eg does it cover European regulations?) It is unclear whether a functioning R22 system would be "in compliance with" statute after 31 December 2014.

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Where a lease expires after 31 December 2014, it will be difficult for a tenant to argue that it is not liable for the costs of refurbishment/replacement if the dilapidations provision is widely drafted. The argument may be stronger for a lease terminating before 1 January 2015 as it will be in compliance with the regulation at the point of lease expiry, although the landlord could argue that the system has not been kept in good working order given the imminence of the R22 ban.

Another potential dispute will be the extent of works required. This will involve consideration of replacement cost against refurbishment cost, factoring in any reduced performance, additional energy costs, increased maintenance and life expectancy of the refurbished equipment. If both options are viable, tenants will argue that refurbishment is appropriate whereas it is likely that landlords will seek replacement.

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Service Charge

R22 will also be controversial in the service charge context. This is similar to dilapidations except that the landlord generally has repairing responsibility, albeit at the tenants' cost. The language seen above applies equally in the service charge context and cases may well turn on specific lease wording used.

Disputes will arise as to whether or not the landlord can recover for replacement where refurbishment is an option or where replacement is considered to be an improvement. This will turn on the lease provisions and technical evidence. Tenants should consider the longer-term implications of refurbishment on service charge and energy costs as well as in the context of the extended lifespan. It may be more cost-effective to accept a replacement option sooner rather than later if the tenants risk being liable for ultimate replacement in any event.

Likewise, disputes will arise where a landlord seeks to recover the cost of R22 works from tenants where one or more tenants have a limited interest remaining in the property. If proposed works exceed what such tenants can be fairly expected to pay, the landlord must bear any additional cost.

In order to maintain a good working relationship, a landlord should communicate early with the tenants about its R22 strategy, explain the associated costs and seek their buy-in. A commercial solution in which the landlord shares some of the pain could head off unwelcome litigation (eg on service charges) and be in the landlord's interest by avoiding effects on the capital value of the property and on rent (see below).

Rent Review

A landlord cannot expect to recover the cost of the R22 works through the service charge without this having a negative effect at rent review. The greater the works and cost, the more likely it is that the rent will be adversely affected. Landlords should consider the effect of R22 if reviews are pending and ascertain whether seeking recovery of costs via the service charge is a cost-effective approach given the rental impact.

Where the tenant has R22 liability, "compliance with lease covenants" will be a standard assumption. If the works have not been done, the reviewed rent could assume the building has a new air-conditioning system. This will have a positive effect on rent despite the fact that the tenant has not carried out the works. This will leave the tenant with potentially increased rent as well as the liability to undertake the works.

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Renewal and Break Clauses

Lease renewal presents an opportunity to have liability determined for R22 works if the lease is unclear. As the R22 issue was unlikely to have been contemplated by the original draftsman, it is arguable that the renewal terms should be modified to address R22 liability if the position is unclear.

The renewal rent may be affected by R22 in a similar way to its effect on rent review.

A tenant faced with potential R22 service charge liability may not be keen to renew its lease. Similarly, if the tenant has the benefit of a break clause, it may seek to exercise it to avoid R22 cost liability if there are suitable alternative premises that comply with the regulation.

Don't delay, take action today

Due diligence on R22, establishing the cost of replacement or refurbishment of air-conditioning systems, and responsibility for them, are key issues in the context of investment property acquisitions and lease transactions. It would be sensible to address the issue sooner rather than later so that a refurbished/replacement system is operational prior to 1 January 2015 when recycled R22 will no longer be available. That way, no-one will be left out in the cold.

For more information on the technical issues, see Estates Gazette editions 12 November 2011 p92 and 17 November 2012 p118.

Authors

Bryan Johnston
Senior Associate
Real Estate Litigation Group

E: bryan.johnston
@cliffordchance.com

Michael Coxall
Senior Professional Support Lawyer
Environment and Planning Group

E: michael.coxall
@cliffordchance.com