

Limiting Dilapidations Liability

Dilapidations are breaches of covenant to repair a building contained in a lease. They are often overlooked by tenants seeking new premises. However, the liability to repair can have serious financial implications.

Dilapidations disputes create unnecessary angst and costs at the end of a lease. This can be avoided by the parties to a lease agreeing by documenting dilapidations responsibilities before lease commencement.

The most important document within a leasing transaction is the lease itself. It is therefore fundamental that the lease clearly sets out the landlord's and the tenant's obligations concerning repair, decoration, maintenance and reinstatement.

In addition to clear and plain English drafting within the text of the lease, the use of a Schedule of Condition at lease commencement and a Schedule of Dilapidations at the lease end is highly recommended.

BEST PRACTICE AT LEASE COMMENCEMENT

Before lease negotiations start between the parties' lawyers the parties should set out clear instructions stating who will be responsible for dilapidations at lease end.

Heads of Terms

Often the commercial 'Heads of Terms' entered into between the parties before the lawyers commence lease negotiations will set out those instructions.

The 'Heads of Terms' might also state that the parties to the proposed lease will document the condition of the premises before lease commencement. This is because the lease, unless drafted otherwise, will oblige the tenant to make good dilapidations at lease end and return the premises to the state of condition that they were in at lease commencement.

If the condition of the premises is not documented before lease commencement then this can result in a dispute at the end of the lease when the parties come to agree the extent of the dilapidations for which the tenant is responsible.

Schedule of Condition

The document used to set out the condition of the premises at lease commencement is a 'Schedule of Condition'.

The drafting of the dilapidations provisions under the lease will refer to a Schedule of Condition as the benchmark against which the tenant must make good the premises at the end of the lease.

This mechanism is particularly useful where parties are entering into a lease of premises that are not newly fitted out. In such circumstances it will be difficult for a tenant to prove the condition to which it must make good the premises back to at lease end unless a Schedule of Condition is provided.

Tenant's fit-out works

It is also important that, before lease commencement, the parties agree to what extent the tenant will be obliged to reinstate the premises at the end of the lease in the context of any tenant's fit-out works.

Often it is the case that the landlord will require the tenant to reinstate the premises at the end of the lease back to the condition that they were in before the tenant's fitout works were carried out. However, in the context of pre-let agreements (especially where integrated works have been undertaken by the landlord and the tenant) there is scope for negotiation.

It should be taken into account when negotiating commercial terms for a new lease that the costs of reinstating premises at the end of the lease, especially where extensive tenant's fitout works have been undertaken, can be very high.

What is a Schedule of Dilapidations?

A 'Schedule of Dilapidations' is a schedule documenting the state of repair of premises:

- A 'Final Schedule' is a Schedule of Dilapidations usually served no more than six months before the expiry of a lease (but may be served after expiry of a lease in relation to work to be done to the premises at the expiry or the earlier termination of a lease).
- An 'Interim Schedule' is a Schedule of Dilapidations detailing items of disrepair arising from a tenant's failure to comply with a repair covenant identified by the landlord during the term of a lease and which the landlord requires to be remedied during the term of that lease.

The preparation of a Schedule of Dilapidations supports a set of procedures which, when employed correctly, can better serve landlords and tenants under their leases.

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The 'Royal Institute of Chartered Surveyors' ("RICS") recommends that tenants "should be encouraged to be aware of and manage their responsibilities for end-of-lease dilapidations throughout a lease term. This can be achieved by the tenant carrying out an assessment of its dilapidations obligations during the course of the term. The preparation of an Interim Schedule will enable the tenant to comply with its repairing obligations during the term and reduce the risk of defaulting on its lease obligations."

What is the purpose of a Schedule of Dilapidations?

The purpose of a Schedule of Dilapidations is to identify alleged breaches of repair, decoration, maintenance and reinstatement covenants within a lease.

During the course of a lease term the tenant will be able to repair, decorate and maintain its demised premises in accordance with its rights and obligations under the lease. However, once the lease has ended the only form of remedy is damages.

Consequently, it is important that both parties enter into dialogue at an early stage before lease end. This enables both parties to consider and communicate their position clearly. It also enables the parties to discuss how best to resolve any dispute over the tenant's dilapidations responsibilities. This could be by means of a financial settlement in relation to the quantum or the quality of repair carried out by a tenant before lease end.

What is the process for preparing a Schedule of Dilapidations?

It is recommended that a chartered building surveyor is appointed for the process of preparing a Schedule of Dilapidations.

In doing so, the surveyor will have regard to the following:

- the lease in its completed form with all plans and other attachments;
- any deeds of variation to the lease;
- licences or other consents for alterations, with plans and specifications;
- any agreement for lease, if intended to survive the grant of the lease;
- assignments and consents to assign;
- licence agreements or subleases and the relevant consents;
- side letters or other written agreements;
- schedules of condition, together with appropriate photographs, or other documentation that establishes the condition of the premises at lease commencement;

- schedules of fixtures and fittings;
- any current planning consents or statutory notices relating to the premises.

WHAT IS THE LAWYER'S ROLE IN THE PREPARATION OF THE SCHEDULE OF DILAPIDATIONS?

Reviewing the Lease Terms

It will be necessary for the purposes of preparing a Schedule of Dilapidations to identify all clauses in the lease which have an impact on the obligations of the tenant in relation to the condition of the premises.

A lawyer will be able to provide an opinion in relation to the scope of each particular clause and the tenant's related obligations.

In preparing that opinion a lawyer will also have regard to all other agreements between the parties which may be relevant when interpreting the lease provisions.

Consider Re-instatement of Alterations

If the premises have been altered by the tenant during the term of a lease a lawyer will also be able to advise if, and to what extent, the tenant is obliged to reinstate the alterations.

PRE-LITIGATION NEGOTIATIONS AND CONDUCT OF THE PARTIES

Again, it is recommended that a chartered building surveyor is appointed for the process of negotiating dilapidations claims (i.e. a claim made by a landlord against a tenant in relation to dilapidations obligations under a lease).

However, the following is an overview of the pre-litigation negotiation protocol that it likely to be adopted:

- Service of claim letter by landlord
- Response to claim letter by tenant
- Negotiations between the landlord and tenant
- Disclosure of evidence substantiating each parties position under the claim
- Stocktake of outstanding issues before proceedings commence

ALTERNATIVE DISPUTE RESOLUTION

Most disputes involving dilapidations claims are settled between the parties out of court. However, a few do proceed to litigation. In such instances the court may encourage the parties to explore alternative dispute resolution procedures.

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LIMITING DILAPIDATIONS LIABILITY

There are a number of practical ways in which a tenant can limit dilapidations liability.

For example, in negotiating commercial terms for a new lease the tenant should try and ensure that its repairing liability is restricted to having to make good the premises back to the condition they were in at lease commencement (as apposed to accepting a full repair liability).

This is important because the word 'repair' includes a liability to renew in certain circumstances.

If the parties do agree to the repairing liability being limited the tenant should instruct a chartered surveyor to produce a Schedule of Condition. The Schedule of Condition will record decorative condition, any existing items of disrepair and any alterations carried out by a previous tenant.

Historic alterations and disrepair should also be considered carefully by a tenant considering taking an assignment of another tenant's lease.

In such circumstances, a proposed tenant should instruct a chartered surveyor in conjunction with its lawyer to identify any breaches of covenant which have occurred before the date of assignment. This is because following assignment of a lease the incoming tenant will become liable for the remedy of any outstanding breaches. If the breaches and alterations are identified before assignment of the lease, the incoming tenant might be in a position to negotiate a reverse premium with the outgoing tenant.

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Contact details

Jersey

Chris Renouf - Partner
+44 (0) 1534 504106
christopher.renouf@ogier.com

Peter Bertram - Partner
+44 (0) 1534 504111
peter.bertram@ogier.com

Jonathan Hughes - Senior Associate
+44 (0) 1534 504336
jonathan.hughes@ogier.com

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