K&L GATES

OVERRIDING INTEREST

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Highlighting developments and issues in the real estate industry

OVERRIDING INTEREST

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Dilapidations—How to Avoid Costly Mistakes

Introduction

Whether you are a landlord or a tenant of commercial premises, it is vital to think about the potential for terminal dilapidations well before the expiry of the lease. This may sound obvious but is something which is often left rather late.

The law of dilapidations is complex and, in terms of quantum, there are hurdles for the unwary landlord and tenant which, if not thought about and dealt with properly, can prove to be costly.

Since the introduction of the Dilapidations Pre-action Protocol there are even more steps which landlords and tenants and their surveyors need to comply with.

The Lease

The first, and one might think most obvious, consideration is to ensure there is a proper understanding of the contractual obligations imposed by the repairing covenant in the lease. However those obligations may not be easy to construe, particularly if there is wording which is slightly out of the ordinary, or the obligation is by reference to a schedule of condition.

All too often there is a mismatch of approach or understanding of the lease obligations between landlord and tenant or building surveyors and lawyers. This can be a recipe for an expensive dispute. Even if agreement cannot be reached, it is important to understand the respective approaches as early in the process as possible.

For the unwary tenant, relatively innocuous sounding repairing obligations can in fact be much more onerous than they had realised.

For landlords, well before the expiry of the lease careful consideration should be given to the obligations of the tenant and how those may be impacted by plans for the building after expiry of the term.

The Protocol

In good time the landlord's building surveyor should prepare a schedule of dilapidations, in a form compliant with the Pre-action Protocol, setting out what the landlord considers to be the breaches of the repairing obligations in the lease, the works required to be done to remedy those beaches and, if relevant, the landlord's costings.

The schedule should be sent within a reasonable time but that is generally within 56 days after the termination of the tenancy. The Pre-action Protocol imposes a requirement that the schedule be endorsed to confirm that the work set out in the schedule is reasonably required to remedy the breaches and that the landlord's intention for the property is being taken into account and that any costings are reasonable.

There are obligations on the tenant in relation to the timing and information to be included in the response. There is an obligation for the landlord and tenant (usually by their respective surveyors) to meet on a without prejudice basis with a view to trying to agree as many items in dispute as possible.

The protocol encourages alternative dispute resolution as the courts take the view that litigation should be a last resort.

Section 18(1)

The common law rule is that, if a tenant leaves property in disrepair, he will be liable for the cost of the repair and the loss of rent for the time it would take to do the repairs. However, common law damages for dilapidations are subject to two statutory

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limitations set out in Section 18(1) of the Landlord and Tenant Act 1927.

The first limitation is well known—but not always well understood—namely that damages cannot exceed the diminution in the value to the reversion caused by the disrepair. Diminution in value of the reversion is thought by some to equate to the cost of repair works but it can be much more complicated than that.

The second is that no damage shall be recovered for a breach of any agreement to leave premises in repair at the termination of a lease, if it is shown that the premises, in whatever state of repair they might be, would at or shortly after the termination of the tenancy have been pulled down, or such structural alterations made therein as would render valueless the repairs covered by the covenant or agreement.

To benefit from this aspect of Section 18, the tenant must demonstrate that the landlord had formed an intention to carry out superseding works by the termination date of the lease and had intended to do so "in whatever state of repair" the premises might be.

Supersession

Many tenants' surveyors will return a schedule of dilapidations denying liability for repairs on the basis of "supersession", i.e. that the works which the landlord is going to do render the repair works to remedy the breach unnecessary. This is not the get out of jail card which some tenants think and this is an area where great care needs to be taken both by landlords and tenants in assessing and deciding what works will be undertaken and when.

This can have a huge difference on the amount of damages for dilapidations ultimately payable. The well advised landlord will consider his options early but not necessarily commit to what works he will undertake. The wise tenant will find out as much as he can about the landlord's intention with a view to making a sensible offer which may give him costs protection should a sensible commercial resolution of the dispute not be achieved.

Careful use of Part 36 offers (without prejudice save as to costs) can be a valuable tactic to be deployed by landlords or tenants even before proceedings are issued. For a tenant it is a method of potentially displacing the otherwise inevitable costs obligation arising from a dilapidations claim. It is surprising how rarely this is used as it can place pressure on a landlord who otherwise is confident that costs will end up being picked up by the tenant.

A hotly disputed dilapidations case will often require the involvement of a surveyor with Section 18 valuation experience in addition to a building surveyor. These disputes are not cheap—hence the importance of considering Part 36 offers early.

Although the vast majority of dilapidations cases are agreed by negotiation between the building surveyors, there are an increasing number of disputes particularly where the tenant argues that the landlord is not going to carry out the works in schedule and has already decided to redevelop and generally involving supersession arguments.

For landlords with expectations of recovery of substantial dilapidations from tenants at expiry of their lease, great care must be taken not to commit to redevelop too early since this can afford the tenant an opportunity to deny liability on the basis of supersession. Supercession generally is an area which is fraught with difficulty and often leads to significant disputes.

Conclusion

Both landlords and tenants involved with leases due to expire and give rise to potentially significant dilapidations liability should seek advice early to maximise recovery on the part of landlords and minimise them where it is tenants who are paying. This is a complex area of the law and great care needs to be taken.

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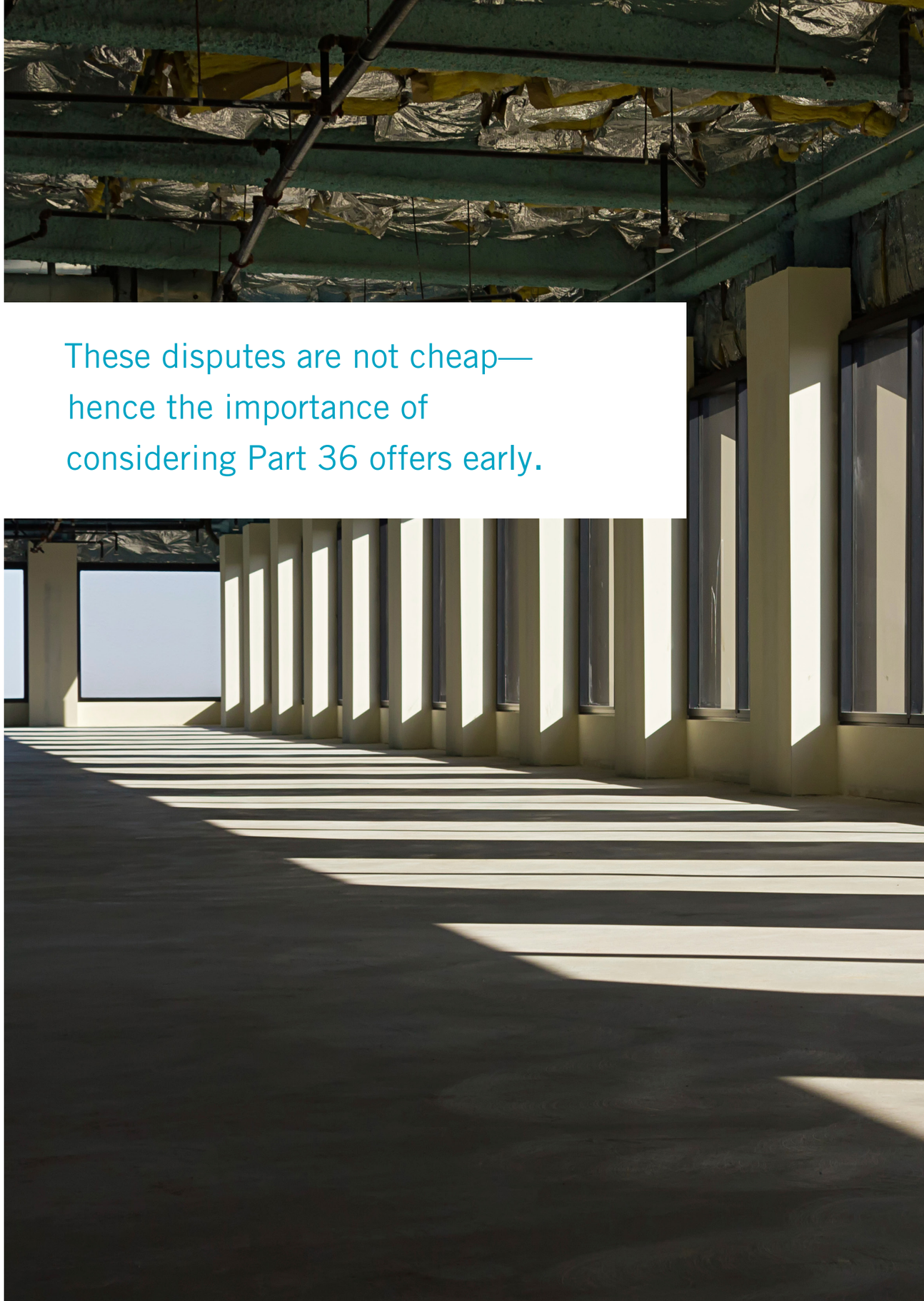

These disputes are not cheap—hence the importance of considering Part 36 offers early.

Global Real Estate Team MIPIM 2015

Members of the Real Estate, Planning and Finance teams will be attending MIPIM 2015 and hope to meet you there.

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MIPIM 2015, Cannes, France

10th—13th March 2015

MIPIM is the leading networking event for property professionals; its organisers describe it as a “market for international property trade”—25,000+ real estate professionals attend to view projects, assess profitable ventures, strike deals, discover commercial real estate opportunities and seek out market information. The European Real Estate, Planning and Finance teams are currently pre-planning for this year’s conference and we are looking forward to meeting with professionals across all international property sectors.

To arrange to meet with any member of the Team at MIPIM 2015, please contact a team member directly or get in touch with Bonny Hedderly *(bonny.hedderly@klgates.com).*

To learn more about our Real Estate Investment, Development, and Finance practice, please scan the QR code below.

Announcements and Events

New Joiners

Joanna Payne

London

Joanna is a senior associate in the firm's London office and is a member of the Real Estate practice group focusing on investment, development and management.

Her work includes the drafting and negotiation of sale and purchase agreements and associated documentation, the drafting of certificates of title for sales of properties and carrying out due diligence and drafting reports on title and advising on the risks involved on purchases.

Joanna has particular experience covering investments (acquisitions and disposals), management, development and corporate real estate.

Martina Triacca

Milan

Martina is an associate in the firm's Milan office and she works in the Administrative and Town Planning law department.

Martina has developed significant experience in the legal matters related to administrative law, focusing on the construction of private and public works, town planning, environmental and landscape issues, development of energy projects, infrastructures, regulatory compliance, commercial authorizations/ licences and public tenders, advising Italian and foreign clients with activities both in court and out of court.

Joanne McGilloway

London

Joanne is an associate in the firm's London office and is a member of the Construction and Engineering practice. Joanne has acted for major developers and institutional investors on real estate development work advising on construction–related matters. She has particular experience in non–contentious work which includes drafting and negotiating construction and engineering contracts. She also has experience advising clients in the nuclear, education and pharmaceutical sectors.

Recent and Upcoming Events

IPD EcoPAS – Q3 2014 Update

On 3rd December 2014, the London office hosted the IPD EcoPAS Q3 2014 Update breakfast seminar. This seminar was chaired by Ian Cullen of MSCI and included a presentation by Peter Hobbs, Head of Real Estate Research, MSCI on the latest results from IPD EcoPAS measurement service. The presentation was followed by a panel discussion by key investment and valuation professionals including Steven Cox of K&L Gates and senior representatives from Barclays, CBRE and Mayfair Capital. The panel discussed the direction of IPD EcoPAS and sustainability within the UK property industry.

For more information please contact Bonny Hedderly *(bonny.hedderly@klgates.com)* or Steven Cox *(steven.cox@klgates.com)*.

AFIRE 2015 Winter Conference

The Association of Foreign Investors in Real Estate (AFIRE) is a not-for-profit association representing the interests of nearly 200 investing organisations from 21 different countries.

Partners from our U.S. offices will attend the conference this year. The Winter Conference is an annual two-day meeting held on 11th and 12th February in New York. The topics featured are specific to the U.S., with a portion directly focused on New York City and the surrounding areas. Results of the AFIRE Annual Foreign Investment Survey and a member survey highlighting trends in international real estate investment are also presented.

For more information about AFIRE or the Winter Conference please contact Matt Norton *(matthew.norton@klgates.com)* or Mike Tomlinson *(michael.tomlinson@klgates.com)*.

Oxford Real Estate Conference 2015

On 18th March 2015, the K&L Gates London office will be sponsoring the first annual Oxford Real Estate conference 2015. The conference will assemble a group of over 25 global real estate experts to provide insight on "What will the real estate universe look like in 2025?". Andrew Petersen will be presenting at the conference. The conference is organised by The Oxford Real Estate Society, an Oxford Business Network, which is an organisation made up of real estate professionals and enthusiasts who share a common interest in the industry.

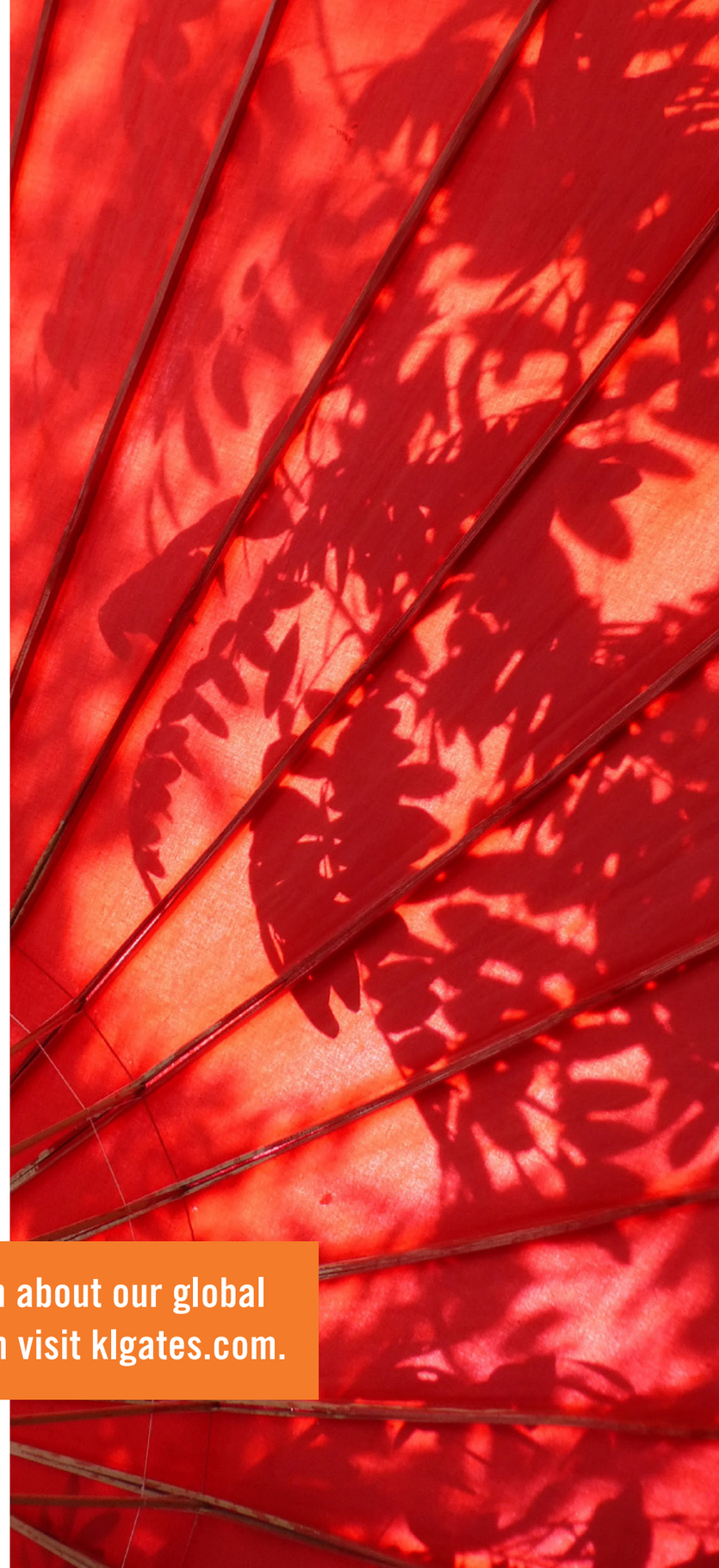
For more information please contact Steven Cox *(steven.cox@klgates.com)*.

CREFC Spring Conference

On 16th–17th April 2015, the K&L Gates London office is pleased to be host sponsor of the CREFC Europe Spring Conference 2015. This conference will be attended by more than 200 delegates over two days and provides a platform for commercial real estate (CRE) finance participants to come together to learn about and discuss the latest trends and challenges facing the industry.

The conference will be held at our offices in One New Change.

For more information please contact Andrew Petersen *(andrew.petersen@klgates.com)*.



For information about our global events program visit klgates.com.

We are proud to be advising Urbanist Hotels on this complex transaction which will involve revitalising this architecturally important neo-classical landmark building in the centre of Edinburgh.

Transaction Profile: The Old Royal High School, Edinburgh

K&L Gates Advises on Redevelopment of Landmark Edinburgh Building

K&L Gates is advising Urbanist Hotels on the development of the old Royal High School building on Calton Hill in Edinburgh. A landmark on the Edinburgh skyline, the building has been vacant for more than 40 years, having previously been earmarked as a site for the Scottish Parliament. The building is set to be developed into a luxury hotel by Duddingston House Properties and Urbanist Hotels.

Led by London partner Piers Coleman, the K&L Gates team is advising Urbanist on structuring and tax issues and investment arrangements. Other K&L Gates London team members include Stuart Borrie (Corporate Partner), Paul Beausang (Tax Partner) and Emma Tuppen (Tax Special Counsel).

David Orr and Taco van Heusden at Urbanist Hotels commented: *"We are excited by the opportunity to develop this key Edinburgh building, delivering what we believe will become Scotland's finest hotel. The team at K&L Gates project managed the transaction for us, providing us with both commercial and practical solutions."*

Piers Coleman stated: *"We are proud to be advising Urbanist Hotels on this complex transaction which will involve revitalising this architecturally important neo-classical landmark building in the centre of Edinburgh."*

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UK Real Estate Structures

Key Vehicles used to Hold UK Real Estate

This article gives a brief overview of typical vehicles that are used to hold UK real estate.

- limited liability companies, whether located in the UK or elsewhere. Where the vehicle is a "clean" special purpose vehicle ("SPV"), it will contain nothing except for the property and the rent, leases and other contracts, and any registrations and liabilities associated with that property. An SPV may be a convenient way of parcelling up the real estate in a discrete entity with its own legal personality, and which can enter into contracts, including to finance the property, manage the property and/or develop it. Recourse can be contained and limited to the assets of the SPV. The board of the SPV can exercise control and make professional appointments, such as of an asset manager. By buying the shares in the company rather than the property itself, a buyer may make significant savings by not having to pay Stamp Duty Land Tax ("SDLT").
- Jersey property unit trusts ("JPUTs"). These are constituted by trustees who are located in Jersey. Usually the trust instrument follows a well settled form as there are hundreds of JPUTs in existence holding real estate all across the UK. The income in the unit trusts belongs to the beneficiaries of the trust provided that the unit trust is approximately drafted so as to constitute a 'Baker Trust', and normally this is recognised for the purposes of UK tax on income. For capital gains tax purposes, the JPUT is treated as a company located in Jersey provided that it is correctly controlled and managed in Jersey. The transfer of JPUT units is not usually subject to SDLT.
- limited partnerships, registered under the Limited Partnership Act 1907. These protect the investing partners from liability provided they do not get involved in the control and management of the partnership. Accordingly, a general partner (usually a company with limited liability) takes full responsibility for the real estate and any investment strategy and makes all decisions (eg whether to lease the property, who to and on what terms). The general partner may be advised by an investment manager. Sometimes limited partnerships are used in conjunction with JPUTs. Partnerships can be more flexible than corporate vehicles because, for example, they do not have capital maintenance rules or strict rules on dividends. Partnership interests are usually considered to be real estate for the purposes of SDLT and accordingly the transfer of a partnership interest is subject to SDLT as if the partnership interests were land itself. Partnerships are tax transparent for most purposes, although not for VAT, though some tax filings are needed.
- REITs – Real Estate Investment Trusts. Only a small number of very large UK property investment companies have reconstituted themselves as REITs because the qualifying conditions are stringent. REITs are not used for structuring particular transactions in the UK real estate market.
- PAIFs - property authorised investment funds. These are designed for use where there is widely held ownership. PAIFs are open ended vehicles which are tax transparent. They have stringent conditions. The UK Government has been consulting during 2014 on the introduction of SDLT relief for the seeding of PAIFs, and for the transfer of interests in PAIFs.

A key tax issue on a number of these corporate-wrapped property entities is whether or not they are involved in *trading* in real estate in the United Kingdom or whether there is *investment* activity.

The level of finance for these structures is primarily a commercial matter and depends on the appetite of the investors for gearing, within prevailing market conditions. The debt arrangements may be structured so that there is limited recourse to the ultimate beneficial owner.

This article does not constitute legal advice on any particular situation. For a fuller version of UK Real Estate Structures, please contact one of the authors.

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The level of finance for these structures is primarily a commercial matter and depends on the appetite of the investors for gearing, within prevailing market conditions.

Legal Updates and Cases

Legal Updates

The New Electronic Communications Code Proposals have now been Withdrawn from the Infrastructure Bill by the UK Government

We have previously reported on proposals for a new Electronic Communications Code, which was intended to form part of the new Infrastructure Bill. That Bill would have introduced a reformed version of the Electronic Communications Code (Code). This would have been much welcomed by the real estate industry. The Code gives rights to providers of telecommunications networks to install and maintain apparatus in, over and under land. In February 2013, the Law Commission published a report with various recommendations as to how the Code should be revised. It was widely acknowledged that the Code was unclear, out of date, and inaccessible. Further to an announcement in January it now appears that the Code will remain in its current form, and no announcement has been made as to any proposed future reforms.

The 2014 Autumn Statement

The Autumn Statement announced a number of measures that are of interest to the real estate industry:

- the replacement of old "slab" system of stamp duty land tax (SDLT) on residential properties and its replacement with a number of bands with effect from midnight 3 December 2014 but an increase in the tax rates.
- a "root and branches" review of the business rates structure is promised.
- investment in infrastructure for roads, flood defences, and railways, particularly in the North with the intention of building a "northern powerhouse" in Manchester to rival London.
- reforms to the planning system.
- Commitments to increase the housing supply.
- Improvements to enterprise zones.

DECs and EPCs

The Department for Communities and Local Government will be publishing approximately 723,000 records of data from Display Energy Certificates and non-domestic Energy Performance Certificates in response to a request made under the Environmental Information Regulations 2004. It has given holders of non-domestic EPCs the chance to opt out of having their information published.

The records will be published at address level. The use of the data will be subject to conditions and re-use of the addresses for commercial purposes prohibited.

Flood Risk

The Department for Environment, Food and Rural Affairs has announced that it aims to establish Flood Re by July 2015. The European Commission has approved the scheme under the EU state aid rules. A draft scheme document is to be published shortly.

Cases

Repeat Guarantees in the Context of Excluded Assignments

A "new" lease had been granted to T1 and guaranteed by G. T1 then assigned the lease to T2 in breach of covenant. All the parties wanted the lease re-vested in T1 and G again guaranteed the tenant's obligations under the lease but were concerned that the anti-avoidance provisions of the Landlord and Tenant (Covenants) Act 1995 might prevent a simple re-vesting.

The High Court held that T1 could reassign to T2 supported by a fresh guarantee from G.

Comment: An issue left unclear by Goodharvest and KS Victoria has been clarified.

UK Leasing Brighton Ltd v Topland Neptune Ltd and Zinc Cobham Ltd v Adda Hotels (an unlimited company) [2015] EWHC 53 (Ch)

Rescission of a Contract for the Sale of Land and Damages

The sellers of a property claimed that they had been entitled to rescind a contract for sale on the grounds that the buyers had failed to complete in accordance with a notice to complete. They also claimed that they were entitled to recover the balance of the deposit under the terms of the contract and further damages for breach of a side agreement between the parties. The buyers claimed that they were entitled to rescind the contract as a result of (non-fraudulent) misrepresentation by the sellers, repayment of the deposit and damages for misrepresentation.

The court held that the sellers were entitled to rescind the contract and recover the balance of the deposit. They were also entitled to recover the sums agreed under the side agreement.

Comment: The judgment contains a useful summary of the case law on rescission of a contract for the sale of land.

Hardy and another v Griffiths and another [2014] EWHC 3947 (Ch)

Limitation Periods and Planning

A landowner sought to rely on the limitation period in enforcement proceedings. The court held that such reliance is subject to a public policy requirement of good faith confirmed by Secretary of State for Communities and Local Government and another v Welwyn Hatfield Council [2011] UKSC 15, which in this case the landowner had not met.

Comment: The court discussed how which the Welwyn principle may apply to various circumstances and so the judgment will be of general interest.

Jackson v Secretary of State for Communities and Local Government [2015] EWHC 20 (Admin)

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