Looming large

Dilapidations In the first of two articles, Dawn Reynolds and David Gilbert consider post-lease events and their effect on the level of damages that a landlord can recover


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Whatever the economic climate, the issue of dilapidations at the end of a lease is an emotive one for both landlord and tenant. In a difficult market, the parties' advisers face greater pressure to achieve the best results for their clients. Where landlords seek to recover every penny and tenants want to retain cash flow for what they believe to be more pressing business costs, it is tempting to draw into the assessment of the dilapidations claim events and situations that occurred after the lease expired. The aim is to create or increase a claim on behalf of the landlord or to reduce or extinguish the tenant's liability. Such attempts have increased over the past two years.

The effect of post-termination events on a dilapidations claim needs careful consideration. This article discusses such events and how they affect the level of damages. First, it is necessary to consider the relevant date on which the claim for damages is to be assessed.

When are damages to be assessed?

The relevant date for assessing damages in a dilapidations claim is the end of the lease term: see *Cunliffe* v *Goodman* [1950] 2 KB 237. This is the point at which the reversionary interest reverts to the landlord. Although the landlord may immediately relet the property, there will always be a point at which the reversion is in its hands: *Smiley* v *Townshend* (1950) 155 EG 110. At that point, the rules governing recovery largely follow normal contractual and common law principles, but damages relating to the breach of repairing obligations are subject to a statutory cap, imposed by section 18(1) of the Landlord and Tenant Act 1927. This requires an assessment of the diminution in value of the landlord's reversionary interest arising from breaches. The cap ensures that the level of damages recoverable at common law cannot exceed the diminution in value to the reversion.

It does not apply to damages for breaches of non-repairing covenants, although details of such breaches and the associated claim often appear in a terminal schedule of dilapidations. An examination of the common law principles that govern damages for breach of non-repairing covenants is beyond the scope of this article. However, the landlord will generally be entitled to recover any loss that is attributable to the breaches, but the test of reasonableness will play a central role in determining the basis of recovery: *Ruxley Electronics & Construction Ltd* v *Forsyth* [1996] AC 344. This objective test leads to a position whereby the costs of reinstatement will sometimes be recoverable or damages may be limited to the diminution in the value of the reversion.

The latter is measured by carrying out two valuations of the landlord's interest at the relevant date: the first assuming that the premises were then in the state they would have been in had the tenant performed its covenant and the second on the basis that the premises were then in their actual state and condition. Any difference between the figures represents the loss caused by the breach of covenant.

When carrying out the section 18(1) exercise, the "relevant date" is always the end of the lease (but such a strict position is not necessarily the case for covenants that fall outside section 18(1)). One line of argument, which can to a certain extent be supported by legal authority, states that post-termination events are not directly relevant to a section 18 valuation. However, this may be misguided. If the events are in motion or contemplated at the end of the lease, they may influence the value of the reversion on the premise that a hypothetical purchaser of the reversionary interest would have acted in a certain way, namely reduced or increased its bid, if it had knowledge of the event on the term date. Post-lease events may also have a bearing on the reasonableness arguments that pertain to other breaches of covenant in the terminal schedule of dilapidations.

If events that occur post-lease can determine how losses or diminution in value are quantified, how should the parties approach the most common of these events? How do events that are predominantly driven or caused by the landlord or the market affect the valuation?

Common events

- Redevelopment

If the landlord redevelops or carries out structural alterations at or shortly after the end of the lease, it is likely to lose part or all of any dilapidations claim. However, redevelopment does not automatically render a claim valueless if part of the demise is retained in the redevelopment. For example, where a landlord plans to refurbish a shop, including a conversion of the upper floors to residential use, and

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SECTION 18(1) OF 1927 ACT

Damages for a breach of covenant or agreement to keep or put premises in repair during the currency of a lease, or leave or put premises in repair at the termination of a lease, whether such covenant or agreement is expressed or implied, and whether general or specific, shall in no case exceed the amount (if any) by which the value of the reversion (whether immediate or not) in the premises is diminished owing to the breach of such covenant or agreement as aforesaid

the tenant is required to carry out repairs to the external envelope or services, such repairs do not form part of the redevelopment and are unaffected by the works. Failure to repair is likely to impose a residual liability on the landlord to carry out the works as part of its refurbishment. In value terms, the extra cost will affect the reversion and form part of its loss.

● Supercession and market circumstances

The market conditions for landlords are undoubtedly difficult. Certain types of property have little if any market value, but valuers have to assume a sale between willing parties at the valuation date. The problem is in establishing the future for the property. Parties should therefore obtain not only the views of the valuer but also of market experts in the form of agency reports.

A thorough independent review of the market for the property in and out of repair can help valuers to carry out their own assessments. The review may involve a forecast of any trend, whether upward or downward, following the end of the lease. This may be a factor in the hypothetical purchaser's bid in the valuation exercise.

The market for certain types of property may never return and only redevelopment or substantial refurbishment will guarantee its future. Many landlords may therefore face major expenditure to render a building marketable, notwithstanding a tenant's breach of repairing covenants. The tenant may argue that many of the breaches will be superseded by the landlord's refurbishment works. Thus, in so far as those works supersede items of disrepair they will not form part of the diminution: see *PGF II SA* v *Royal & Sun Alliance Insurance plc* [2010] EWHC 1459 (TCC). This can be achieved by excluding their cost from the out-of-repair valuation, reducing the difference between this and the in-repair value.

Many older buildings are likely to be converted to alternative uses. For example, older office blocks in some prestigious areas are being converted to residential use or hotels. In these cases, repair may have little or no relevance to market value.

● Reinstatement

In today's climate, landlords will not want to reinstate without a beneficial outcome. They will instead await the market reaction to the premises as left by the tenant. Thus, assuming that the landlord does not carry out any work, the tenant can justifiably refuse to recognise any loss unless proven.

Establishing the future of a property can be a problem for valuers in dilapdiations claims

In other cases, the request for reinstatement may be academic because the alteration will enhance rather than reduce value. Alternatively, the incoming tenant will expect a degree of strip-out to enable it to fit the demise to its trading style. A tenant's failure to strip out will have caused no loss and the landlord's claim under this head may be defeated. If items are to be left in place, it will be necessary to comply with any repair covenants. Building surveyors often overlook this point; they will have to undertake additional work to identify and quantify disrepair.

Valuers should be wary of betterment. For example, a retail tenant reinstates, by removal, a stairway in the Zone A area of a high-value location, and the ground- and first-floor areas are increased. Although the value of the upper floor may be lower because of inferior access, overall there may be a net increase in the total rental value.

Part 2 will appear in the issue of 2 April.

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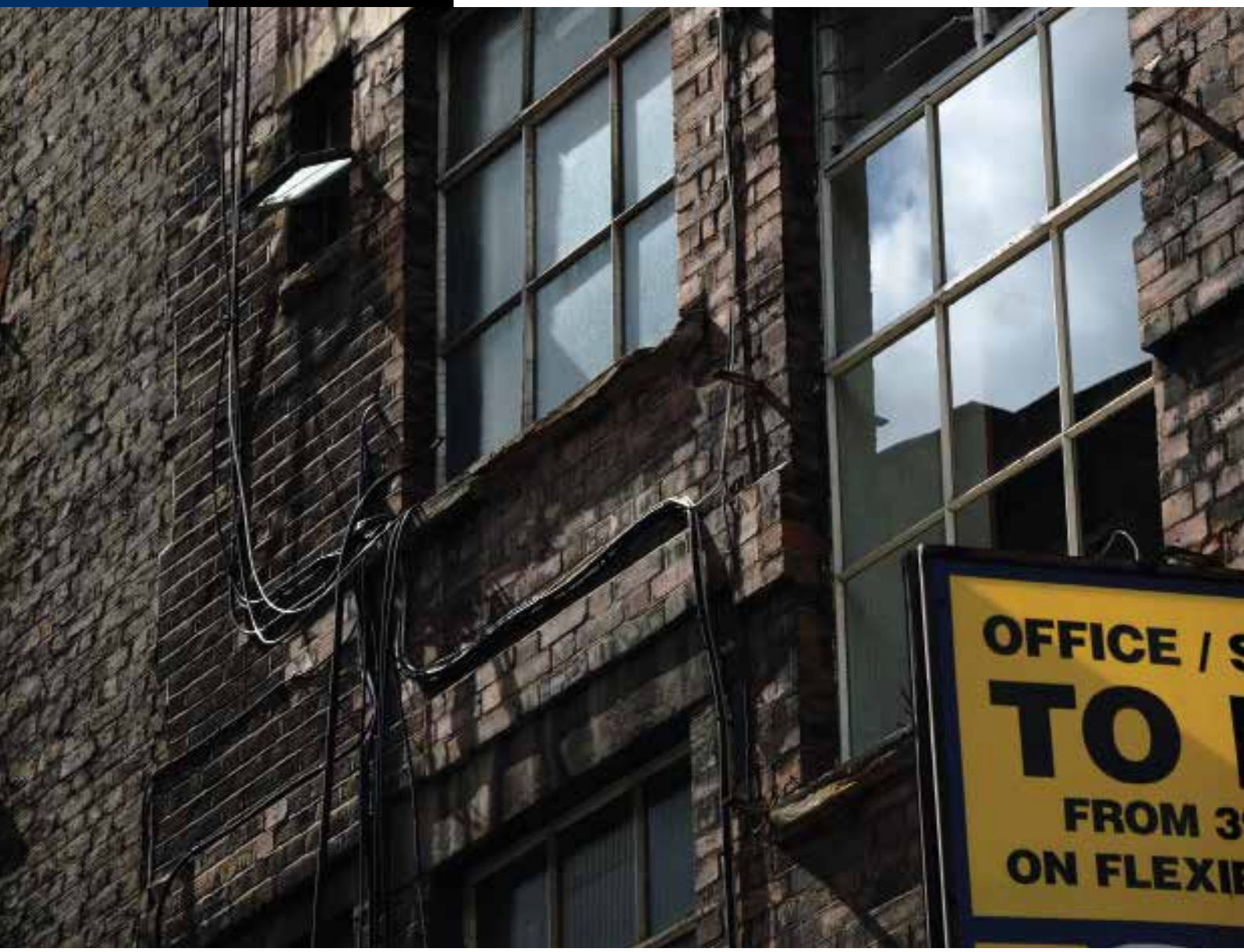

Causal links

Dilapidations In part 2 of their article, Dawn Reynolds and David Gilbert consider how events predominantly driven by third parties can affect a diminution in value assessment in a damages claim

What happens when the landlord lets premises and argues that the letting crystallises the loss? This may be quantified in terms of a rent-free or other incentive or the cost of works necessary to secure the letting.

In such cases, the losses incurred are often shown as a direct deduction from the reversionary value. Although in practice this may be the case, it is important to analyse what the incentives were, what they represented and how they are causally linked with the breach of the lease terms. In this scenario, tenants should ensure that all the letting details are provided, including side agreements.

For example, a landlord claims that it offered the ingoing tenant a rent-free period in lieu of repairs and in return for taking a full repairing lease. The first line of enquiry must be to establish the extent of the repairs and compare their cost with the rent incentive. Are they equivalent and is the alleged cost of repair reasonable? If not, an element of the incentive may relate to market inducements, which should not form part of the claim. Rent-free periods are the norm, so it is unlikely, save in the strongest of markets, that a tenant would not receive some form of this incentive on the grant of a new lease. The landlord's case may be stronger if there is a contract to carry out a schedule of works, perhaps within a specified period. This may be prima facie evidence of the new tenant's obligation, establishing a stronger causal link between the disrepair and the loss.

Topics of discussion

An area in which arguments often arise is the grant of a new lease on full repairing and insuring terms subject to a schedule of condition limiting the new tenant's repairing obligation.

In establishing the loss in these circumstances, the valuer is faced with a number of questions. These include the probability of works being required during the actual term and those for which the tenant is not liable at the end of the term in order to secure another letting. In the latter case, it may be necessary to consider the likelihood of future redevelopment to establish whether the landlord is likely to incur a loss that can be deferred to the valuation date.

Another topic of discussion between valuers is a comparison between the original and the new lease demise. It may

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be that the premises being demised are more or less than those contained in the initial demise. In other cases, the landlord may have had to carry out improvement works to enable a new letting to take place. In such instances, it is arguable that the new letting carries little weight in establishing the losses occasioned by the tenant's breach of repairing covenants under the old lease. The two demises may be so different as to render them incapable of being objectively compared.

This article does not cover the mechanics of valuation. However, skilled valuers can produce valuation models that account for landlord's improvement works in assessing values in and out of repair. It would be foolhardy to show absolute disregard for the letting of a demise that is different from that being valued.

Subtenant insolvency

A common event in recent times is a subtenant's insolvency. With no realistic chance of recovering its loss from the subtenant, the landlord will seek to pursue a dilapidations claim against the tenant. This may be presented to the tenant several years after it has vacated the property and possibly many years after the expiry of the headlease. If the tenant's covenants were contained in a deed, the landlord will have 12 years within which to bring a claim; if not, the limitation period is six years.

On receipt of such a claim, the tenant should consider whether, at the end of the headlease, the entire premises were occupied by the subtenant under Part II of the Landlord and Tenant Act 1954. If so, the subtenant would have become the direct tenant of the landlord when the headlease expired and be entitled to a new lease, which would be on the same terms as the existing tenancy. The tenant should consider whether this contained a repairing obligation that mirrored the headlease. The new rent would be fixed by the court without taking into account any disrepair attributable to the subtenant's breaches of the repairing obligations in the current subtenancy. The effect may be to reduce or extinguish damage to the reversion: see *Family Management* v *Gray* (1979) 253 EG 369.

However, each case must be considered on its facts; the likelihood of the subtenant taking a new lease and its covenant strength will be relevant factors that can influence the hypothetical purchaser's bid.

Reversionary leases

A reversionary lease is granted for a term that starts on a future date; it may be granted to a subtenant by the head landlord with the term to commence at the end of the sublease. Alternatively, it will be granted to a new tenant at the end of an existing lease.

The advice given to head tenants often states that a reversionary lease to a subtenant (or a third party) will extinguish the head tenant's liability if it contains a full repairing obligation. This is because the subtenant will assume responsibility for the existing disrepair once the reversionary lease term begins and the landlord has not suffered damage to its reversion.

Van Dal Footwear Ltd v *Ryman Ltd* [2009] EWCA Civ 1478; [2010] 1 WLR 2015 is a timely reminder of the point at which the tenant's liability for damages arises. The court found that the reversion means the property as it reverts to the landlord and any reversionary lease, whether made before or after the term date. Whether it was made with the same tenant or a different tenant is left out of account; what is to be valued is the freehold reversion at the moment it vests in the landlord unencumbered by the old or any new lease.

The existence of a reversionary lease will not necessarily allow a tenant to avoid or limit liability for breaches of the repairing covenant at the end of the headlease.

Rating and management

Landlords will, faced with an empty building at the end of a lease, attempt to mitigate their holding costs, one of the most significant of which is empty property rates.

In a number of cases, landlords are trying to remove buildings from the rating list by carrying out decommissioning works that, they claim, form part of an overall process of refurbishment. The success of such arguments in rating terms does not alter the fact that the works may result in changes to the structure or services that supersede alleged repair items in the terminal schedule of dilapidations.

Similar arguments may be made in respect of the decommissioning of building services or the removal of asbestos. The threat of legionella in an old empty office building, for instance, may necessitate the removal of elements of hot-water or air-conditioning systems, thus avoiding both health risks and reducing ongoing maintenance costs. In the case of asbestos, the landlord may take the opportunity to remove asbestos that the tenant left in a safe and satisfactory condition in preparation for other works.

Proof that such works, having been in the mind of the actual landlord at the termination date, were also in the mind of the hypothetical purchaser may limit the landlord's claim. It is important that tenants properly investigate all the landlord's actions and ongoing proposals at the termination date, not merely those that relate directly to repair, refurbishment or redevelopment. Equally, landlords should be aware that action unrelated to these issues may affect their ability to substantiate dilapidations claims.

Conclusion

Varied and numerous events take place after the term date of the lease. It is necessary to consider each event to evaluate whether it is relevant to the level of damages claimed for disrepair and other breaches of covenant. The essential question is whether it would affect the hypothetical purchaser's bid for the reversionary interest, thereby establishing a causal link between the losses claimed and the breach of covenant.

Blanket assumptions should not be made about the effect of post-lease events on the tenant's repairing obligations when advising the parties at the beginning or end of a term. Although it may be thought that this advice rests with the tenant's advisers, those advising the landlord should also consider the issues, to avoid leaving their client with unrealistic expectations.

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