

Lambert
Smith
Hampton

KNOW DILAPIDATIONS

AN OCCUPIERS' GUIDE TO DILAPIDATIONS



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WHAT IS 'DILAPIDATIONS'?

Dilapidations is a term which refers to the condition of a property during its occupancy or when a lease ends. It is linked to the occupiers obligations under a lease agreement to maintain and repair the premises.

Occupiers (or tenants) could stand to lose substantial amounts of money if their dilapidations obligations are not fully understood.

- Before signing a commercial lease an occupier should look to minimise their dilapidations liability, especially where a property is already in a poor state of repair.
- During the term of the lease, an occupier needs to plan for their repairing obligations well in advance of the lease expiry, or lease break, because these obligations could seriously affect a business' cash flow and the ability to break a lease.

- Near the end of the lease term, unless an occupier has completed all the repair work required under the lease, tenants will usually be issued with a schedule of dilapidations by the landlord. This outlines work the landlord says is required to comply with the tenant's obligations and which have to be completed before the end of the lease term.
- At lease expiry, if a tenant fails to return the property to the landlord in the condition required by the lease, the landlord will normally seek to recover the costs for such works through dilapidations as a claim for damages.

Disputes over what constitutes reasonable repair/reinstatement and the effect on value are one of the most problematic areas for leasehold premises and can ultimately end in court.

This document explains some of the key issues for commercial tenants in managing their dilapidations liabilities.

121 Shady Lane, Great Barr, Birmingham
19,000 sq ft industrial unit

53% saving

The relevant figures being:

Original landlord claim	£446,996.72
Settlement	£210,996
Saving	£236,000



WHY SHOULD YOU CARE ABOUT DILAPIDATIONS?

Dilapidations claims are vitally important to any occupier because:

1. Cost – the cost of fulfilling repairing and other obligations can run into millions of pounds
2. Reputational risk – dilapidations claims can end up in court
3. Time – managing a claim can take up significant time and effort
4. Limit your options – if occupiers do not plan properly for dilapidations lease break options can be voided

Before signing a lease

The principle of buyer beware holds as true for leases as for any other purchase. Occupiers should familiarise themselves with the repairing obligations under the terms of a lease and, as far as possible, limit their obligations prior to signing the lease. Tenants should consider:

- Whether the repairing obligation is fair or is the liability potentially onerous?
- If an occupier has negotiated a rent-free period in a lease to compensate for a building's poor condition, will the savings in rent be sufficient to meet their repairing obligations?
- What are the occupier's liabilities when the lease does expire?
- What proportion of alterations to the building will need reinstating, if at all?

- What repairs will need to be undertaken, and when, leading up to lease end?
- What needs to be redecorated and cleaned, how often and to what standard?
- Could the landlord's claim be capped by law?

Knowing the answers to these questions will enable an occupier to decide how much money they will need to set aside throughout the term of the lease to finance any repairs by lease expiry. It also avoids substantial and unbudgeted dilapidations claims.

During the lease

A landlord may be able to enforce repairing obligations at any point during the lease term. However, it may be possible for a tenant to negotiate relief from some of these repairs.

In addition, some leases allow tenants to exercise a break clause after a specified period of time before the lease expires.

A landlord may have imposed strict conditions under which this can be exercised, including compliance with the tenant's repair and other obligations.

At the end of a lease

Negotiating dilapidations is invariably an adversarial process so developing a strategy for a proactive approach to managing a potential claim, including opening an early dialogue with the landlord can help ensure a smooth exit at lease end.

At lease end, an occupier will need to:

- Determine what repairs need completing and how these can be implemented in the lead up to exit.
- Understand what the landlord wants done with alterations made to the building by the occupier and whether they need to be reinstated.
- Check the lease to understand what needs to be redecorated and cleaned, and to what standard.
- Assess whether the landlord's claim could be capped by law.

Schedules of Dilapidations are typically served by the landlord in the last six months of a lease (a 'terminal' schedule of dilapidations). These are intended to outline all the alleged breaches of the lease and stipulate the required remedies.

Unless an occupier has completed the work required under their lease obligations in advance of lease end the landlord will usually issue a costed schedule of dilapidations. This schedule will outline the works the landlord deems necessary and include a claim for damages (quantified demand).

Disputes frequently arise over whether all items identified by the landlord's surveyor really are a breach of the tenant's covenants and over what would be an appropriate remedy.



Boots, distribution centres

35,000 sq ft office space

Reduced liability by **46%**

across portfolio. Multi-million pound savings achieved

DEALING WITH DILAPIDATIONS THROUGH THE TERM OF A LEASE

Dealing with repairs at outset

For an occupier it is important to avoid adopting a potentially onerous repairing liability at commencement of a lease.

The most common way an occupier can limit their obligations is by recording the property's state of repair prior to the lease commencement in a schedule of condition. To be effective, this schedule must be agreed by both parties and annexed to the lease. These schedules provide a snapshot of the condition at commencement and are by no means infallible. The level of detail provided by the schedule of condition and subsequent deterioration during the term will determine liability in line with the wording of the lease.

A common misconception is that if a particular part of a property is in disrepair at the start of a lease, repairs are not required for that element. This is rarely the case: a tenant is often required to make good or 'put into repair' that element. If repair of the element is not possible, many leases require the occupier to renew it.

A review by a building surveyor of the draft lease could help to clarify, or even reduce, the tenant's future liabilities.

Repairs: during a lease

An occupier will also need to decide how much it would be prudent to set aside during the term of the lease to finance repairs on termination. Dilapidations is a relevant matter under International Accounting Standard 37. The Financial Reporting Standard 12 allows for future repairing liability to be treated as an expense, which can be included within the profit and loss account of the firm. It will then be excluded from the company's tax computation until it is incurred.

Repairs: lease break

Some leases allow tenants the option to exercise a break clause after a specified period of time, but before the lease expires, for example an occupier might be able to break a 10 year lease after five years.

A lease will often have conditions associated with the break clause, which might include vacant possession, payment of rent and compliance with the repair and decorating covenants. A landlord could refuse to accept the break if a tenant fails to comply with these conditions.

Dilapidations: lease expiry

At the end of the lease an occupier can be hit with a claim for all the tangible aspects the landlord believes are wrong with the building. This is listed in a schedule of dilapidations, usually compiled by the landlord's building surveyor.

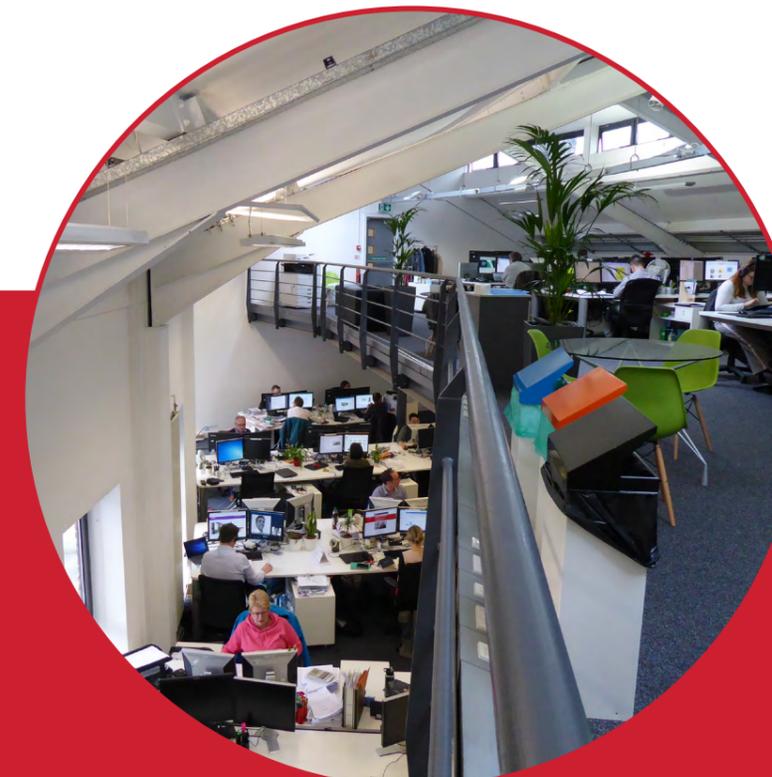
A landlord, however, is not obliged to serve a schedule of dilapidations before the lease expires so it would be prudent for the tenant to take advice from a chartered building surveyor on potential liabilities in time to carry out any necessary remedial works.

A landlord may serve a terminal schedule of dilapidations shortly before lease expiry and is likely to follow this up with an updated schedule accompanied by a quantified demand after lease end.

This includes details of what the landlord estimates to be the cost of the remedial works. It also outlines what the landlord considers to be additional losses as a result of the breaches of the repair and other covenants, which might include loss of rent while works that should have been undertaken by the tenant are undertaken.

It is often impractical for occupiers to carry out many of the repairs whilst still in occupation. However, if the landlord then proceeds to undertake all the repairs, the tenant may be liable for the costs and professional fees incurred, over which they have no control.

Occupiers should take advice on whether to complete the works themselves before the end of the lease or wait for the landlord to serve a terminal schedule of Dilapidations quantified demand.



Brewery Wharf, Leeds

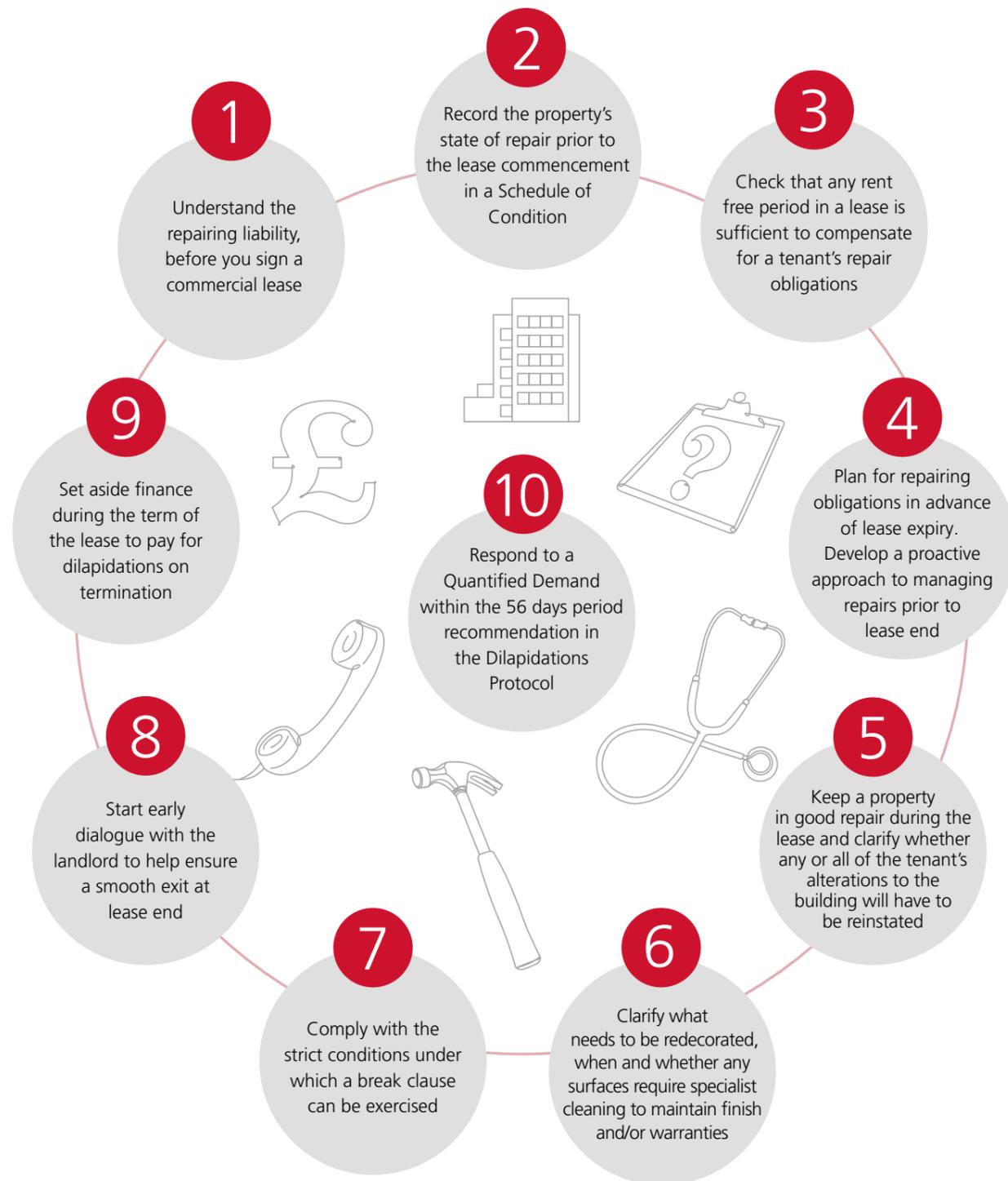
8,550 sq ft office

58% saving

The relevant figures being:

Original landlord claim	£237,000
Settlement	£100,000
Saving	£137,000

10 TOP TIPS FOR OCCUPIERS



THE DILAPIDATIONS PROTOCOL

The dilapidations protocol sets out the steps the court would normally expect prospective parties to have followed at lease end and prior to the commencement of proceedings.

It establishes a reasonable process and timetable for the exchange of information relevant to the dispute. It also sets standards

for the content and quality of the schedules of dilapidations and quantified demands and the conduct of pre-action negotiations. Its ultimate aim is to enable tenant and landlord to avoid litigation and agree a settlement of their dispute.

COMMON AREAS OF DISPUTE

Unless a tenant has completed the repair and other works required under their lease obligations the landlord will issue a schedule of dilapidations outlining the works required to be completed at, or before, lease end. A landlord may issue a schedule of dilapidations after lease end and claim damages in lieu of dilapidations accrued to the lease end date.

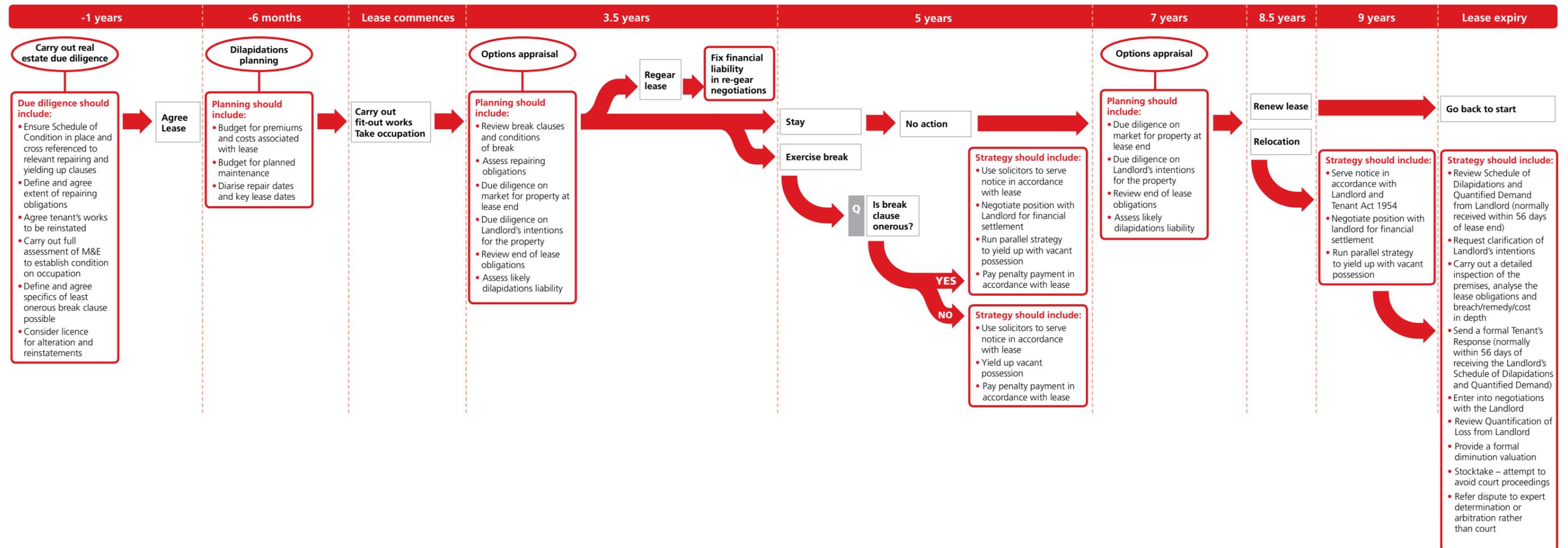
Disputes can arise over

- Whether the items identified by the landlord's surveyor are really a breach of the lease covenants.
- What repairs and other works will need to be undertaken?
- What constitutes an appropriate repair?
- What is an appropriate response for a tenant in repairing or renewing the elements that were in disrepair at the start of a lease?

- Whether any or all of the tenant's alterations to the building have to be reinstated.
- What needs to be redecorated or cleaned, with what materials and possibly in what colours?
- The circumstances under which a tenant can exercise a break clause and whether a tenant has complied with the break clause conditions.
- The landlord's estimates of the cost of the remedial works in the schedule.
- The value by which a premises has been reduced as a result of it being in disrepair.
- The impact of any future redevelopment of the premises on the tenant's dilapidations liabilities.

MANAGING DILAPIDATIONS – A STEP BY STEP GUIDE FOR OCCUPIERS

Based on a 10 year lease with options to break after five years



Our step by step guide shows each of the stages that an occupier should go through during the life of a lease to mitigate their dilapidations liability at lease expiry. Our example assumes a 10 year lease with an option to break at five years.

DIMINUTION AND THE CAP ON DAMAGES

A tenant's liability for dilapidations is limited by Section 18 of the Landlord and Tenant Act, 1927, and more generally by common law. If an occupier decides not to carry out works to remedy dilapidations, there are limits on what the landlord can recover from the occupier by way of dilapidations liability after the end of the lease term.

There are two aspects of the Act that have the potential to reduce a tenant's dilapidations payments:

- No repair costs can be recovered by the landlord if at, or shortly after, termination of the tenancy the building will be structurally altered in a way that would render the repairs valueless or the building is to be pulled down. Where a building is set to be redeveloped or undergo a change of use, the extent of the redevelopment may limit, or remove a tenant's liability for dilapidations.
- The value of repair costs claimed by the landlord shall not exceed the amount by which the value of the landlord's interest in the premises has been diminished, or reduced, by them being in disrepair.

Recent cases point to the landlord's loss being limited to diminution in its retained interest for all breaches not merely repair.

To calculate the landlord's loss as a result of disrepair or other breaches, a diminution valuation is required. This quantifies the difference between the value of the property assuming that the tenant has complied with its obligations and one reflecting the actual condition in which the property has been left.

This is notoriously difficult to do because the actual valuation will depend on the circumstances and the market for the premises at lease expiry, including such factors as: the condition and specification of the building, its location, future likely uses and the amount of similar space available in the vicinity. For example, in a difficult property market, if the costs of compliance total £100,000 but the difference in value between the two valuations is only £50,000, the claim by the landlord would be limited to £50,000.

WYG - 100 St John Street, London

35,000 sq ft office space

78% saving

The relevant figures being:

Original landlord claim	£930,000
Settlement	£200,000
Saving	£730,000



WHAT IF YOU CAN'T AGREE?

Tenants are expected to respond to the schedule of dilapidations and quantified demand within 56 days of receipt.

Normally chartered building surveyors appointed by the landlord and tenant will meet and attempt to narrow the differences between the two parties to arrive at a recommended settlement figure for their respective clients. In the significant majority of cases, surveyors will agree a figure. If all else fails and the case ends up in court, each party will need to have appointed expert representatives including a chartered building surveyor, lawyer and valuer. This is an expensive process and the court will usually direct the parties to Alternative Dispute Resolution "ADR".

Mediation – is arguably the most commonly used form of alternative dispute resolution and is often applied successfully to dilapidations disputes.

Arbitration or Independent Expert Determination – are becoming an increasingly popular approach to resolving dilapidations disputes as they are relatively cheaper than the courts. They also have the advantage of involving specialist practitioners who will have substantial experience in this field. Other landlord and tenant disputes – such as rent reviews and service charge disputes are all frequently resolved this way.



**Units 6 & 7 The Furlong,
Berry Hill Industrial Estate, Droitwich**
20,000 sq ft industrial unit

73% saving

The relevant figures being:

Original landlord claim	£660,440.37
Settlement	£269,402.50
Saving	£391,037.87

OUR SOLUTION

Lambert Smith Hampton brings together expertise across a range of disciplines, including Building Consultancy, Valuation, Lease Advisory and Agency to examine all available options, helping you identify which will produce the best commercial result for your business.

Our expert chartered building surveyors will ensure you understand your potential dilapidations liabilities before you serve a lease break or begin negotiations. We then work with you and your legal team to develop a strategy to manage risk and minimise your dilapidations liabilities, negotiating on your behalf.

Offering pragmatic, practical advice geared to your objectives

We provide pragmatic advice geared to achieving the outcomes you seek. Our dilapidations service will help you understand and mitigate your repairing obligations, minimising the costs and hassles of dilapidation claims.

Where a Section 18 defence is to be employed, our specialist diminution valuations experts provide accurate, independent advice on valuation in dilapidations disputes. Our valuers have

a comprehensive understanding of the legal framework, the property market and current values. We work closely with our agency teams in the local market to provide market-focused advice based on sound legal principles.

Delivering technical and commercial expertise

Our dilapidations experts are market leaders in their field, dealing with around 1,900 cases each year. With a deep understanding of commercial lease agreements we typically reduce tenant liabilities by 40%–50%.

All of our instructions are placed with a senior member of our team, providing direct, hands on experience gained over many years of working with public and private sector clients like BT, Babcock, Heineken UK Ltd and Henderson Global Investors.

At every stage, you can be confident of the technical expertise of our network of qualified chartered building surveyors and RICS Registered Valuers. Our building consultants have been assessed by a peer group of experienced professionals and judged to have the blend of technical and commercial skills necessary to operate at the highest level in today's property and construction markets.

GLOSSARY OF TERMS

Absolute compliance

Absolute compliance requires that the party covenanting as such complies with the requirements of the covenant in full. Where found in a break clause absolute compliance of certain conditions is the prerequisite of successfully satisfying the break clause.

Alterations

Alterations are works undertaken by the tenant which alter, cut, divide, relocate or modify the premises, which can include the building, partitions, mechanical and electrical services, or finishes.

Break clause

A break clause (alternatively called a 'break option' or 'option to determine') is a clause in a lease which provides the landlord or tenant with a right to terminate the lease before its contractual expiry date, if certain criteria are met.

Break notice

A break notice is the formal notification that one party wishes to exercise its right to terminate the lease (a break clause, option to determine or break option). Break notices must be served correctly and require a degree of care to ensure the right is successfully exercised. For example, the notice must be served the correct number of months before the break date and may require compliance with pre-conditions.

Break option

See "break clause"

Condition precedent

A condition precedent is a lease covenant including conditions which must be strictly fulfilled to satisfy the requirements of the lease.

Decoration covenant

Where there is an obligation to decorate, the decoration covenants within the lease will state when internal or external decoration is required. It may go on to define specific details, such as how many coats of paint are to be applied and when the decorations are to be applied.

Dilapidations

The term 'dilapidations' refers to the breaches of a tenant's lease covenants in respect of repair, reinstatement of alterations, and redecoration. It can be raised by a landlord during the term of the lease (interim dilapidations) or, more commonly, at lease expiry (terminal dilapidations).

Dilapidations protocol

There is a formal pre-action protocol for claims for damages in relation to the physical state of a commercial property generally called the 'dilapidations protocol'. This was formally adopted under the Civil Procedure Rules in January 2012.

Diminution valuation

A diminution valuation is a specialist's report prepared by an experienced valuer which takes into account Section 18 of the Landlord and Tenant Act 1927. Section 18(1) provides that the damages for breach of the repairing covenant may not exceed the diminution in value of the landlord's reversion caused by breaches of repair. The common law practice is now to produce a single diminution valuation reflecting all breaches of covenant (i.e. including reinstatement etc).

Disrepair

Many tenants will have obligations to repair their premises. An assessment of the condition of property is carried out which highlights areas where repair is required. Failure to repair in accordance with the lease is commonly referred to as disrepair.

Endorsement

This is the parties' signature of their documents being landlord's schedule of dilapidations and the tenant's response.

Final schedule of dilapidations

The final schedule of dilapidations is served after the lease has ended. The timescales for dealing with the dilapidations process is defined under the dilapidations protocol and RICS Dilapidations Guidance Note.

Interim schedule of dilapidations

The interim schedule of dilapidations - served during the lease term. The intention of an interim schedule is to identify breaches of lease and necessary works to remedy the breach within a set time frame.

Jervis v Harris clause

A Jervis v Harris clause within a lease provides for a landlord to re-enter the property to remedy breaches of the lease the tenant has failed to rectify after an express notice period. The landlord recovers the cost of repairs as damages thus removing some of the defences available to the tenant under dilapidations claims.

Licence for alterations

Licence for alterations will define the works which have been agreed by the landlord for the tenant to undertake. It will include additional covenants for the tenant to comply with in undertaking the works and may include reinstating the works at lease expiry. The Licence may also include provisions for the landlord to notify the tenant to reinstate such works including a timescale before lease expiry.

Loss of rent

Loss of rent is the term given to the rent a landlord has lost due to the tenant's breaches of the lease. The loss of rent may relate to the period of time it takes for the landlord to remedy the tenant's breaches of the lease after lease expiry. Some leases include provision for this to be paid in any event.

Material compliance

Material compliance is a legal phrase used to describe the extent to which the conditions in a lease must be met.

Part 36 offer

Part 36 offers are offers to settle a claim and can be made by both a claimant and defendant in a legal dispute. They relate to the section of the Civil Procedure Rules which govern court action. Part 36 offers are usually made 'without prejudice except as to costs' and are usually made by solicitors as they have to comply with the strict requirements of Part 36 rules of court to be effective.

Premises

The premises defines the property being let to the tenant under the lease. This is usually descriptive and often includes a floor plan clearly showing the boundaries of the tenant's occupation and limit of lease obligations.

Quantified demand

The quantified demand sets out all aspects of the dispute and quantifies the monitory sum sought for damages in respect of the breach detailed in the schedule as well as any other items of loss for which damages are sought. This should be issued after lease expiry and set out whether VAT applies or not.

Reinstatement

Reinstatement is the term used to describe the works required to return the premises back to its original layout or condition at the time of lease commencement, which can include the building, partitions, mechanical and electrical services or finishes.

Repair covenants

Repair covenants are the contractual obligations in a lease which identify the landlord's and the tenant's liabilities to repair. The wording of the repairing covenant will provide the standard to which the tenant or landlord will be required to keep the various elements of the property whether demised to the tenants or not in repair.

Repair notice

A repairs notice usually takes the form of an interim schedule of dilapidations. The intention of the repairs notice is to highlight to the landlord or tenant breaches of the lease during the term. They are frequently used in conjunction with *Jervis v Harris* provisions (see "Jervis v Harris").

Schedule of condition

A schedule of condition is a record of the condition of the premises at the commencement of a lease, usually including photograph as evidence.

Schedule of dilapidations

This is a list of outstanding repair and maintenance items (that a landlord has assessed) that have accrued under the terms of a tenant's repair and maintenance obligations.

Scott schedule

The Scott schedule is a document that enables the parties to compare their respective positions in relation to the landlord's original schedule of dilapidations. It comprises a series of columns in which each party sets out its response to the opposing party's contentions.

Section 18

Section 18 is a reference to Section 18 of the Landlord and Tenant Act 1927. The Act is split into two parts or 'limbs'. The first limb S 18(1) provides that the damages recoverable for breach of the repairing covenant, may not exceed the diminution in value of the landlord's reversionary interest (see Diminution Valuation). The second limb S 18 (2) that a landlord may not recover damages where it intends to demolish or carry out structural works to the property that render the tenant's repairs valueless.

Statutory obligation

A lease will generally include for covenants relating to the tenant's or landlord's obligations to comply with statute or regulations.

Substantial compliance

See 'material compliance'.

Supersession

Supersession is the process by which a landlord's actual or intended future works to a property render of no value a tenant's repairs. This is used as a defence to the landlord's claim.

Terminal schedule of dilapidations

The terminal schedule of dilapidations, served at lease end, is intended to address all breaches of lease, prepared following the recommended format in the dilapidations protocol.

Vacant possession

Vacant possession is a legal term denoting the empty state of a property on hand back to the landlord. Usually required in a lease the extent of compliance will be determined by the factual position at the date the premises are handed back.

Yielding up

The yield up clause sets out the conditions on which the property is to be handed back to the landlord, e.g. in accordance with the lease covenants and may impose additional obligations.

For our full commercial property glossary visit our website at

www.lsh.co.uk/commercial-property-glossary



**Tremco Illbruck, 6-10 Cullet Drive,
Isle of Sheppey**

40,000 sq ft industrial unit

66% saving

The relevant figures being:

Original landlord claim	£490,000
Settlement	£165,000
Saving	£325,000

ABOUT US

We are a commercial property consultancy working with investors, developers and occupiers in both the public and private sectors across the UK and Ireland.

AMAZON TO ZURICH

We have partnerships with the complete A to Z of the best organisations in Britain and Ireland.

TRANSPORT TO TELECOMS

We have experience with an extremely wide range of sectors.

CAPITAL MARKETS TO CONSTRUCTION CONSULTANCY

We serve an incredibly diverse range of commercial property disciplines.

We value lateral thinking and celebrate enterprise, with a focus on delivering more for our clients. By looking beyond the obvious, we consistently generate impressive results.

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