

Dilapidations claims

**Briefing paper
Section 18 Valuations
June 2013**

THE LAW - Landlord and Tenant Act 1927 Section 18(1)

This paper sets out two Limbs that may provide a defence under any dilapidations claim. Limb 1 states the damages for a breach of a covenant or agreement to keep or put the premises in repair shall not exceed the amount by which the value of the reversion in the premises is diminished owing to the suggested breach. Furthermore, the landlord is required to demonstrate it is mitigating any loss in this regard. This Limb effectively puts a cap on the repair, and sometime decorations, claim but not reinstatement.

Limb 2 states that no damage shall be recovered for a breach of any such covenant or agreement to leave or put premises in repair at the termination of the lease, if it is shown that the premises could at or shortly after the termination of the tenancy be pulled down or be the subject of structural alterations. This may include proposals to redevelop the property or to undertake substantive refurbishment works or changes of use and which would therefore render valueless the repairs covered by the repairing covenants or other agreement. In addition, the property may be demolished so as to avoid empty rates liabilities which have substantially increased since April 2008.

Therefore unless you carry out a Section 18 valuation then you may be aware unaware of the potential cap on your dilapidation claim (landlord) or the extent of any repairing liability (tenant), which is gauged by the diminution in the landlord's reversionary interest.

It should be noted that it is not the intentions of the actual landlord which should be considered, but those of the reasonable hypothetical landlord. It is therefore possible to consider the approach in making a bid for the property of an investor, a refurbisher, a developer or an owner occupier. In other words, what would the market deem to be a reasonable course of action for the property given its fundamental characteristics and the state of the local market at the relevant date. For example, consideration needs to be given to the occupational market and the potential to let the property in the current market in good repair.

THE DILAPIDATIONS PROTOCOL – The Property Litigation Association (May 2008)

This sets out the pre-action protocol for claims for damages in relation to the physical state of commercial property at the termination of a tenancy. The objectives of this protocol are:-

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- a) to encourage the exchange of early and full information about the prospective legal claim;
- b) to enable the parties to avoid litigation by agreeing a settlement the commencement of proceedings;
- c) to support the efficient management of proceedings where litigation cannot be avoided.

In essence the Landlord is required, in making their claim as to the damages it is seeking to remedy the breach of the repairing covenant (and in some cases redecoration) but not strictly speaking any reinstatement items, to quantify the loss by providing to the tenant a detailed breakdown of the issues and consequential losses. This may be based on either a formal diminution valuation or an account of the actual expenditure, or a combination of both. However, it should be noted that a landlord may not be required to produce a formal diminution valuation (Section 18) if it is reasonable not to.

If a tenant wishes to rely on a defence on the basis of diminution, it must state its case for so doing and provide a diminution valuation to the landlord. The tenant's diminution valuation shall be served within a reasonable time. A "reasonable time" will vary from case to case but generally will not be more than 56 days after the landlord has served his quantified claim.

LANDLORD'S CLAIM – Section 18 Valuation Approach

A claim for dilapidations may be made by the Landlord at any stage during the last three years of the lease term relating to breaches of covenant to repair which may have occurred by the Tenant during such term. The common law measure of damages for such a claim is the cost of undertaking the works to which the breach relates, however, this common law situation is modified by Section 18(1) of the Landlord and Tenant Act 1927.

A landlord may seek to substantiate a terminal dilapidation claim by supporting this with a Section 18 valuation in order to demonstrate the value of the property is being adversely impacted by the disrepair in accordance with the lease covenants. In preparing the valuation, consideration will need to be given to the interpretation of the repairing covenants, including repair and yielding up, although the impact of undertaking both reinstatement and redecoration works will also need to be reflected.

It should be noted that a claim made by a Landlord at the end of the lease is likely to comprise the following elements:

- Breach of covenant to repair
- Breach of covenant for internal/external redecoration
- Reinstatement costs which may apply either under the terms of the lease or within any specific subsequent licences
- Loss of rent during the period which may be required to actually undertake any required works
- Professional fees associated with above costs

In considering the first limb of Section 18 and any potential damage to the landlord's reversion, three questions need to be addressed:-

1. To what standard does the repair clause require the building to be repaired and yielded up at the end of the term?
2. To what standard has the building actually been left in repair/disrepair by the tenant at the end of the term?
3. Having submitted the differential between questions 1 and 2 above, to what extent, if any, is the Landlord's reversionary value affected by the disrepair?

In the preparation of a landlord's Section 18 valuation, the valuer should be aware of the potential impact of how a tenant may seek to defend a claim through an assessment of how the reasonable hypothetical landlord may choose to act, including possible bids from different types of purchaser. However, in essence the landlord's Section 18 valuation will consider the difference in value between the property being in repair and in its existing condition, with reference to the assessment of the cost of putting the property into the appropriate state of repair as required by the lease covenants, which should be prepared by a suitably qualified building surveyor.

TENANT'S DEFENCE – Section 18 Valuation Approach

The basis of a tenant's defence to a terminal dilapidation claim is through the principle of a landlord being required to mitigate its loss, which may be limited by demonstrating the value of the property has not diminished to the extent of the actual estimated cost of the repair. A Section 18 report considers the hypothetical landlords and purchasers for the property and the basis upon which they would seek to acquire the property and therefore assess their bid. The valuation report therefore considers whether the condition of the property would have had any detrimental effect on their bid. In addition, it considers in this context what would the hypothetical or reasonable freeholder do with the property if it was within their ownership.

There are two essential elements to Section 18, which may assist the Tenant in the defence of any claim made by the landlord.

- The first relates to a "cap" applied to limit the amount of damages which may be claimed by the Landlord, adopting the rationale that whilst the Landlord should be compensated for the disrepair, he should nevertheless not profit from it.
- The second limb of Section 18 extends protection to the Tenant where the Landlord is proposing to substantially alter or demolish the premises where it is somewhat immaterial whether the Tenant has or has not breached the covenant to repair.

In considering the above it is necessary to consider the following:-

- The occupational market for the property in the given location and the demand and supply ratio
- Recent trends in rental levels the estimated performance over the next 6-12 months
- The level of demand from owner occupiers and their rationale behind acquiring their own premises
- The level of demand from investors and their rationale behind acquiring the property
- The potential for development or changes of use
- The potential for refurbishment or alterations which would enhance re-letting prospects and value
- The extent to which any proposed works could be deemed to be an enhancement or even an improvement
- Whilst reinstatement itself is not normally subject to Section 18, the consequence of disrepair arising from its removal is generally accepted to fall within the tenant's repair and liability.

Therefore unless you carry out a Section 18 valuation for each individual lease end property then you may be aware unaware on the potential cap on your repairing liability, and where any works carried out may be proved to be totally unnecessary.

It should be noted that it is not the intentions of your actual landlord which should be considered, but those of the hypothetical landlord. In other words, what would the market deem to be a reasonable course of action for the property given its fundamental characteristics and the state of the local market at the relevant date.