Cobden House
CHAMBERS

Terminal dilapidations –
is the cost of repair invariably the measure of damages?

THE SCENARIO

The end of the lease looms. The landlord serves a schedule of terminal dilapidations which hits the doormat with a large thud. Every conceivable item of work or repair has been itemized by an overzealous building surveyor upon instructions from the landlord.

Months later there is no sign of any substantial works having been carried out to the majority of the premises and they are being marketed at the old passing rent OR the unit is being relet for a wholly different use following a major refit,

Paul Raeburn will look at the question of DV and how the current market is shifting towards a fresh, common sense application of principles of causation to the question of DV

I am going to look at the first stage in the process – the issue of repair and costs

- Lease is a contract
- Falls to be interpreted as a contract
- Breach and Damages which reasonably foreseeably flow from the breach – damages which would be in the contemplation of the parties

Up to that point in the argument one could certainly justify the conclusion that at whatever cost they may be, the cost or estimated cost of works should be the measure of damages – that is what the Tenant would have had to spend and that is therefore what the Landlord has lost.

But is that convenient and often persuasive link necessarily right. Yes, the Tenant has been spared the cost of the expenditure which he would have had to spend to rectify his disrepairs but what does that equate to in the hands of the Landlord?

It may – in a case where the Landlord has done the works and nothing more – give the best indication of loss since the Landlord has simply done that which the Tenant should have done. But in other cases it will not help at all.

The way in which I always think about these problems is to assume that what the Landlord has is a capital asset, the principle purpose of which is to give rise to a rental

yield in line with market forces.

Thus, one should be looking at the property asset from the point of view NOT of its state and condition by a minute examination of the covenants but instead by looking at whether what has been undertaken was equivalent to or in excess of what was actually necessary in order for the Landlord to get back a property which would allow him to achieve the market value rental. And it flows from that that where the Landlord has undertaken a wholesale remodelling or refurbishment then it is important to divorce the effects of the breaches of covenant from the extra works undertaken by the Landlord.

So let's revisit some of the basic propositions which often get forgotten about in terminal dilapidations cases.

SUMMARY OF APPLICABLE PRINCIPLES

- Is there a breach?
    - What do the covenants require
    - Is there more than fair wear and tear
    - Standard of repair
- If so what is the appropriate response to that breach?
    - Repair or renewal
    - Bringing items up to date
    - Excessive works and Supercession
- Cost of works or DV
- The measure of damages for breach of covenant to repair is the cost of the works necessary to remedy the breach

There is of course a statutory and common law gloss to put on this particular proposition

- Mr Justice Edwards-Stuart found in *Sunlife Europe Properties Limited v Tiger Aspect Holdings Limited (1) Tiger Television Limited (2) (2013)* that the measure of recoverable loss in a terminal dilapidations claim is the lower of:
    - The total of (a) the cost of remedying the defects and (b) any rent actually lost and other expenses actually incurred whilst the defects are being remedied; and
    - The diminution in the value of the landlord's reversion, as at the term date,

caused by the breaches – i.e the statutory cap contained in section 18(1) of the Landlord and Tenant Act 1927.

- This analysis must therefore be undertaken at 2 distinct stages
  - The calculation stage – calculate the costs of repair, assess the reasonableness of the works, take account of all elements of the damages claim including rent
    - The claim to loss of rent :
      - Is part and parcel of the claim for damages for breach
      - It must be proved
      - But it forms part of the first part of the equation and falls to be assessed as against the DV
      - In a stagnant market is often wholly spurious
  - Then apply to that the DV calculation

- A covenant to keep in good repair and condition is not engaged unless there exists a state of disrepair, that is a deterioration from some previous physical condition: see Post Office v Aquarius Properties [1987] 1 All ER 1055 and Fluor Daniel Properties v Shortlands [2001] 2 EGLR 103.
  - There is no breach unless and until something is out of repair
  - If something was acquired out of repair then unless there is an obligation to put it in repair, that will be its requisite condition
- If there is a state of disrepair it has to be established that the item is below the standard of repair contemplated by the covenant and, if so, what remedial work is needed to restore that item to that standard.
- The appropriate standard of repair is
  - Possibly as set out in a schedule of condition but failing that :
    - such repair as having regard to the age, character, and locality of the premises,
    - would make them reasonably fit for the occupation of
      - not perfection
    - a reasonably minded tenant

        - not an overly fussy perfectionist

    - of the class who would be likely to take them: see Proudfoot v Hart (1890) 25 QBD 42; Fluor Daniel Properties v Shortlands [2001] 2 EGLR 103; Mason v TotalFinaElf (UK) [2003] 3 EGLR 91.

        - You look to the realistic market for the particular premises in the area they are and assess whether the works constitute a breach against that benchmark

        - The standard of repair is an objective one which is to be ascertained by reference to

            - the circumstances at the date of the lease and

            - what a reasonably minded tenant would require to render the premises reasonably fit for use as a place from which to run its business; see Fluor Daniel Properties v Shortlands [2001] 2 EGLR 103.

    - The appropriate standard of repair must take account of the age of the building.

        - The obligation is not to return the premises to the condition that they were in at the start: see Mason v TotalFinaElf (UK) [2003] 3 EGLR 91.

        - The obligations acknowledge that there will be some deterioration by reference to user and the general passing of time

- The question is what would be required to make the premises reasonably fit for occupation, not what an incoming tenant would require at the end of the lease: see Westbury Estates v RBS [2006] CSOH 177 at [37]; Carmel Southend Limited v Strachan and Henshaw Limited [2007] 3 EGLR 15 at 17E.

    - hopes, expectations and aspirations are very different to the actual claim

    - behoves all professionals to apply a wholly independent assessment

    - BS v VS – makes settlement very difficult. LL sees the higher figure and tends to ignore the lower DV

- Where the requirement to put and keep the premises and fixtures in good and tenantable condition involves the replacement of plant that is beyond economic repair, the tenant is required to replace it on a like for like or nearest equivalent basis.

- The tenant is required to deliver up the premises in good and tenantable condition and with the M&E systems in satisfactory working order but not with new equipment or equipment that has any particular remaining life expectancy.

- The tenant is not required to upgrade it or bring it into line with current standards.

- The fact that an item has exceeded its indicative life expectancy so that it would or might be economic for a prudent owner to replace it does not mean that it is not in a good and safe working order repair and condition: see Fluor Daniel Properties v Shortlands [2001] 2 EGLR 103 at 111G and Westbury Estates v RBS [2006] CSOH 177 at [35-37].

- You can give back to your landlord an old, out of date but fully working item of machinery or plant even if that plant does not meet current safety standards applicable to a new installation

- The tenant is entitled to perform its covenants in the least onerous way open to it and this should be the starting point in any assessment for damages.

  - Where a reasonable surveyor might equally well advise either repair or replacement, damages are to be assessed by reference to the cost of repair unless replacement would be cheaper: Riverside Property Investments v Blackhawk Automotive [2005] 1 EGLR 1114: Carmel Southend Limited v Strachan and Henshaw Limited [2007] 3 EGLR

  - Replacement is only required if repair is not reasonably or sensibly possible: see Dame Margaret Hungerford Charity Trustees v Beazeley [1993] 2 EGLR 143 and Carmel Southend Limited v Strachan and Henshaw Limited [2007] 3 EGLR 15.

- The Court is not ordinarily concerned with what a claimant does with his damages; the claimant is perfectly entitled to claim the cost of repairs and then decide not to carry out the works and pocket the damages. But

  - Costs incurred are subject to issues of reasonableness in terms of assessing whether a landlord's response is a reasonable and proportionate response to the breaches alleged in light of the impact upon rental value in the hands of the landlord

  - Any claim by the landlord is subject to the general rules that: (a) he cannot recover costs that he could have avoided by acting reasonably; and (b) he

cannot recover the cost of remedial work that is disproportionate to the benefit obtained.

- Where there is a need to carry out remedial work, however, the fact that the landlord has carried out more extensive work than was necessary to put the Landlord back into the position where the rental stream could be maintained does not prevent the landlord from recovering such costs as would have been necessary to remedy the breach. But this is always going to be subject to the supercession argument – that what the Landlord has done has overtaken and rendered otiose anything that the Tenant would otherwise have done.

- Where market conditions at the end of the lease mean that some sort of refurbishment or upgrade is required to enable the landlord to re-let, a tenant is not liable for costs to the extent that such works would be rendered abortive by the need to upgrade or refurbish the building (i.e supercession).

    - What should the T have done

    - What has the LL in fact done OR what will the LL inevitably have to do to let the premises

        - Internal decorating v new shop fit

        - External pointing v exterior cladding

        - Floor finishes v re-carpetting

    - What is the extent of the overlap

ANALYSIS

A landlord with a comprehensive series of tenant covenants will invariably consider that he is entitled to an indemnity in relation to works carried out at the demised premises.

However, in a case where the landlord has undertaken the works of repair set out in the schedule of dilapidations, to what extent can the tenant challenge that cost?

Section 18 operates as a cap upon the common law measure of damages; it is not a measure of damages in itself. Implicit in that concept is the principle that the cost of repairs incurred may exceed the amount of the diminution in value and that accordingly the landlord's claim is limited to the latter.

A costed schedule of dilapidations of £150,000 may well have at its core repair works of £50,000 which it is both reasonable and fair to attribute to breaches by the tenant and which properly affect the landlord's reversionary value.

- However, take the case of the wholly superfluous outbuilding in the grounds of the demised premises which serves no practical purpose for the tenant but which nevertheless forms part of the demise and for which the landlord claims the costs of re-roofing.
- Take the case of the high street retail unit with three unwanted floors above. They form part of the demise but due to access problems no retailer would ever make beneficial use of those floors. Despite this the landlord claims the costs he incurred in redecorating and re-carpeting those areas. The landlord has incurred the costs and thus his surveyors argue that the cost of repair is the measure of damages.

There is in my opinion far too much reliance by some landlords and far too much willingness on the part of tenants and tenant's surveyors to accept without question the principle that costs of repairs equals the measure of damages.

There are 2 principles which, in my opinion, come into play when considering a landlord's costed schedule of works actually undertaken;

- firstly whether the works were reasonable ones to have been carried out bearing in mind the financial benefits and costs and

- secondly, at what point in the works, as one surveyor put it to me recently, the law of diminishing returns applies so that further expenditure is not necessary in order to maintain the rental yield from the demised premises.

Section 18 implicitly recognizes that the main objective of the landlord is to preserve the rental value and therefore the underlying investment value of the building in question. Any landlord believing that he has an open cheque book from an outgoing tenant will prefer to have every screw screwed and every nail nailed but the law recognizes that in seeking to maintain the balance between the landlord and tenant, the tenant should be chargeable with a maximum of the diminution in value.

Thus as a matter of valuation it is perfectly legitimate to seek to demonstrate that despite the fact that the landlord has incurred £150,000 worth of costs in repairing and redecorating, only £50,000 of those works actually had any effect upon value. The extra £100,000 was wasted in the sense that the landlord could have spent £50,000 only and still managed to get the self-same rental in the open market as he was able to achieve having spent an additional £100,000.

The law [but often not the LL] sees the rental property as an income producing asset. The aim is to ensure that the LL gets back something which allows him to continue to reap the appropriate market value from the asset by way of rental income.

When viewed as such, in my opinion the section 18 cap becomes entirely understandable. If, despite disrepair the LL is still able to achieve a new 5 year tenant at market rent, why does the fact that the windows are rotting or the toilet door catch

broken make any difference whatsoever.

Whether this is an application of the section 18 cap or is an aspect of the common law based upon the House of Lords decision in Ruxley is perhaps a somewhat unnecessary and arid debate. Either way, the law is recognising that for one reason or another it is an unreasonable response to the tenant's technical breaches of covenant to seek to charge the tenant with works which were [on the Ruxley basis] unreasonably incurred or [on the section 18 basis] capped by the diminution in value.

The important factor to note here, therefore, is that a landlord cannot expect to recover every penny of his costed schedule even where he has had the work out to tender and carried out. The schedule can still be subjected to detailed analysis by a valuer as to the point at which the costs incurred cease to have an effect upon reversionary value and become wholly superfluous.

It is submitted that in the current market a landlord should be led primarily but not exclusively by valuation evidence in making the decision as to what works should properly be undertaken in order to preserve the proper open market value rental from the premises. Excessive costs may leave the landlord with a shortfall. The Valuer will need to assess in conjunction with the Building Surveyor what costs which are prima facie claimable are actually features in the DV calculation and which are pure surplassage.

Indeed, it may even be the case that the landlord who upgrades the entire four floors in order to maximize the rental potential of the ground floor retail unit may well do himself a disservice in the market place – an incoming tenant may well see the level of finish imposed upon the premises by the landlord and be immediately put off by assuming that this excessive and unnecessary standard of repair is what the landlord will be looking for in 5 or 10 years' time.

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