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SECTION 18 (1) DIMINUTION VALUATIONS – A CONSTRUCT, OR COMMERCIAL COMMON SENSE?

Although enshrined in statute more than 90 years ago, and codified into the CPR more recently, it remains the case that the relevance of diminution valuations is little appreciated, and so they are under-used.

This Paper aims to shed some light on what is often referred to as the "dark art".

BACKGROUND

By way of brief background, section 18 (1) of the Landlord & Tenant Act 1927 is explained by way of referring to its two so-called "limbs" thus:-

Limb 1 of the Landlord & Tenant Act 1927 Act states:-

> "*Damages for a breach of covenant or agreement to keep or put premises in repair during the currency of a lease, or to leave or put premises in repair at the termination of a lease, whether such covenant or agreement is expressed or implied, 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 as aforesaid.*"

Limb 2 of the Landlord & Tenant Act 1927 states:-

> "*…and in particular, no damage shall be recovered for a breach of any such covenant or agreement to leave or put the 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.*"

The test under the "Second Limb" is ***subjective*** in that it is the actual intentions of the actual landlord as at the Valuation Date which are salient. In this regard, common sense dictates that any reasonably informed landlord will not carelessly create a paper trail as to its actual intentions (for example, making a Planning application) until it has first resolved any dilapidations outstanding against the former tenant.

As for the "First Limb" the test is ***objective.*** This can therefore successfully circumvent masked true intentions under "Limb 2", if a reasonably objective assessment of the open market position is such that the hypothetical purchaser would, on the balance of probabilities, pursue the course that it is suspected the actual owner might be mindful to do (under "Limb 2").

In paragraph 87 of his judgement *Hammersmatch Limited* -v- *Saint-Gobain Ceramics & Plastics Limited*[1], Ramsey J said the following about the two limbs of section 18 (1):-

[1] *Hammersmatch Limited* -v- *Saint Gobain Ceramics & Plastics Limited* [2013] 2 P&CR 18

> "*The first limb limits damages to the amount by which the value of the landlord's reversion is diminished because of the breaches of the repairing obligation. This considers, objectively, the reduction, if any, in the market value of the landlord's interest on the term date because of those breaches. The second limb extinguishes damages altogether where, on the term date, the landlord intends at or shortly after the term date to demolish the premises or carry out such structural alterations as would render the repairs valueless. This looks, subjectively, to the landlord's actual state of mind on the term date*."

Whilst the statutory cap of section 18 (1) only applies to repairing covenants, it is generally considered that the same principle (diminution in value cap) also applies to covenants both to reinstate, and decorate.

As regards **reinstatement**, *Dowding & Reynolds*[2] notes *inter alia*:-

> "*Although there are obvious similarities between a covenant to repair and a covenant to reinstate premises at the end of the term, they are not the same. In particular, the latter is not a covenant to put, keep or leave in repair, so that the provisions of section 18 (1) of the Landlord & Tenant Act 1927 do not apply to it.*
>
> *The measure of damages is therefore governed by the common law. Whilst…the common law measure of damages for breach of a covenant to leave in repair is the proper cost of the necessary remedial works, there is no analogy between this and a covenant to reinstate alterations (James -v- Hutton). It follows that the damages recoverable for breach of an obligation to reinstate are to be assessed by reference to the principles considered in paras 31-02 to 31-04 above* (principally these paragraphs state that "*there is no rule that damages for a breach of an obligation to carry out works are to be assessed in all circumstances by reference to the cost of carrying out those works – Ruxley -v -Forsyth. The true cost is that the damages recoverable will in all cases depend on what loss the landlord can be said to have suffered. In an appropriate case, that loss will equate to the cost of carrying out the works together with, where appropriate, an allowance for the time they will take to carry out; in others, it will be limited to the damage to the reversion, if any, as a result of the failure to carry out the works; in others it may be nominal or nil.) The question will be what, in all the circumstances, is the landlord's loss, and (where he claims the cost of reinstating) whether reinstate-ment would be reasonable. There is no rigid rule that damages are the cost of reinstatement (Westminster -v- Swinton).*
>
> *Equally, there is no principle that the cost of reinstatement cannot be given even where that exceeds the damage of the reversion.*
>
> *The overall question will be whether reinstatement is reasonable. However, it is thought that in most cases where the landlord has not reinstated, and does not intend to do so, the position will in practice be the same as that under the first limb of section 18 (1) of the 1927 Act, namely that damages are likely to be assessed on the basis of the diminution in the value of the reversion, if any, caused by the tenant's failure to*

[2] *Dowding & Reynolds* – "*Dilapidations:The Modern Law & Practice*" @ pp 772-774

reinstate. Equally, where the landlord has reinstated, or can satisfy the court that he genuinely intends to do so, damages will equate to the cost of the work together with, where appropriate loss of rent, unless the court thinks that in doing the work the landlord has acted, or is proposing to act, unreasonably. The fact that the cost of the work exceeds the damage to the reversion will not prevent an award of damages on this basis.

However, where the reversion has not been damaged (because the premises are more valuable in their altered state), the court will no doubt examine the landlord's evidence on reinstatement that much more carefully in order to satisfy itself that the cost of reinstatement properly represents what he has lost."

DIMINUTION VALUATIONS – PRACTICAL APPLICATION

It logically follows that if the diminution in value to the reversion is greater than, or equal to, the cost of the works, and other valid items of claim, then the cost of works and of the valid items of claim will be the measure of damages. Conversely, if the diminution in value of the reversion is less than the cost of works and other items of claim, then the lower figure will be the measure of damages.

Where the works are undertaken by the landlord, then the contractual claim is a helpful starting point in assessing diminution.

The application of section 18 (1) theoretically requires two valuations, namely:-

A. The value of the landlord's interest on the assumption the Property is in its covenanted state (condition) on that date (**Valuation A – Assuming Compliance**);

   and

B. The value of the landlord's interest in its actual state (condition) on the Valuation Date (**Valuation B – In Actual Condition**).

These two valuations can only be made independent of one another, if the valuer has access to open market comparable evidence of similar properties in each distinct state. It will be appreciated that this is straightforward for the covenanted condition, being any evidence from similar properties let on full repairing and insuring (FRI) leases. It is however near impossible in practice for the actual (dilapidated) condition at lease expiry, as this would require evidence from transactions involving physically similar properties with all but precisely the same breaches as to repair, decoration and reinstatement.

It will therefore be appreciated that in practice, valuers tend to arrive at Valuation A – Assuming Compliance by the traditional method of gathering and analysing comparable transactional evidence but then, absent true comparables in the Actual Condition, deduct the aggregated cost of (surviving) works (plus consequential losses) from Valuation A in order to arrive at Valuation B.

Valuation B differs significantly, if the landlord's valuer deducts the entirety of his building surveyor's costs, absent any scrutiny as to which may not be salient to lettability/value (having regard to "*age, character and locality*" and to the "*likely calibre*" of the occupier), where the tenant's valuer does reason and discern accordingly.

In both cases however, either valuation might reasonably be considered superfluous when in fact it is simply the aggregate of the items deducted (from Valuation A) which is required for the purposes of concluding the amount (if any) by which the otherwise full freehold reversionary value has been diminished axiomatic upon the breaches.

This so-called "two valuation approach" was criticised by the judge in *Simmons & Ors -v-Dresden*[3] in noting:-

> "…*the critical weakness of the method in a case such as the present, as it seems to me, is that the calculation assumes that which has to be demonstrated, namely that there has been a diminution in the value of the reversion. The calculation is not designed to test whether there has actually been a diminution in the value of the reversion, but on the assumption that there has been, to calculate what it was*."

Guy Fetherstonhaugh advocates the "pared back" approach (i.e. cutting straight to the DV figure being the aggregate of the "*value-affective*" costs and dispensing with the smoke screen of two valuations) in his Paper "*Landlords' Intentions and their Relevance*" to the *RICS Dilapidations Forum Conference* on 30 September 2014.

In considering the likely impact upon value of the breaches, it is firstly necessary to contemplate the likely type of hypothetical purchaser of the landlord's interest at the Valuation Date and how the bid of this hypothetical purchaser would be affected, if at all, by the disrepair to the Premises. The options for a purchaser of the Property at the Valuation Date could reasonably be narrowed to an investor, or owner occupier, as examples.

It is at this point that valuers can head off piste. A very impressive looking report – articulate and beautifully illustrated with photographs, tables and spreadsheet calculations – could, under closer scrutiny, be founded on straw.

The key question to establish an evidence of fact based answer to is "***would the property have truly had any market for the assumed use (hypothetical purchaser) as at the Valuation Date?!?*"**

(For the avoidance of doubt, the "valuation date" is the later of the contractual term end date, or the date vacated by the tenant. It is the crucial "snapshot in time" that the valuer must make his assessment at).

Examples of where valuers might go wrong at this fundamental point are common both in frequency and basis. To illustrate:-

- An older office block, some or all of the floors under one lease, now expired. Claim primarily one of reinstatement of partitions and making good, plus perhaps external

[3] *Simmon & Ors* -v- *Dresden* (2004) EWHC 933 (TCC)

repairing items (if an FRI lease, rather than IRI with service charge), plus full redecorations.

Spreadsheet valuations are produced by the landlord's valuer to show that retention as offices with minor upgrades (supersession – see later) on top of the dilapidations yields a greater return/profit than conversion to residential/student accommodation (under the Permitted Development Rights).

But examination of the detail of the office lettings market in the town in recent years shows:-

- Generally limited demand/few transactions;
- All are of notably smaller floorplates/suites than the Subject;
- All/most are of notably superior buildings i.e. modernised common parts, new windows, new services etc.

In other words, there is no evidence of any market for the entity being valued. The landlord's valuer has assumed a market for which there is no evidence. The comparables are effectively seeking to compare "apples with pears".

Similar scenarios can be envisaged for shops, industrial or indeed any commercial property genre which, upon detailed research into the actual, rather than assumed, local market activity demonstrates whether or not there is a market for the property if in repair, or if – on the balance of probabilities – it would have to be altered in order to evolve to meet modern market expectations and demand.

This evolution might simply be having to recognise that, even if vacated in perfect compliance, the property (as demised 15-25 years ago) is thus trapped in a time warp. "Brown" offices, with avocado toilets and vanity units; double-glazed windows nearing – not at – the end of their economic life such that no new tenant will commit to an unencumbered FRI lease; outmoded lighting no longer acceptable on new lettings.

It is also especially salient right now that with effect from 1 April 2018 the Minimum Energy Efficiency Standards (*MEES*) under the Energy Efficiency Regulations 2015 make it unlawful to let a building which fails to meet the minimum required EPC Rating of "E". Self-evidently, many properties fall well shy. Thus significant upgrading works creating supersession (see below) will inevitably be required.

Other examples might include:-

- A shop of an outmoded size, which must now be split to meet modern demand.
- An industrial unit with an asbestos roof which, whilst still strictly "in repair" will make for a far more lettable/valuable unit if replaced with profiled steel.

The above, and myriad other examples like those found at **CASE STUDIES** on our website www.radius-consulting.com (and as discussed at our regular CPD seminars presented at

clients' offices), illustrate that in most cases, many of the works which a building surveyor must identify and price as a breach, may well not end up being remedied in practice. That is because they have no bearing on value i.e. they are "*not value-affective*" ("*nva*").

In making the valuation judgement, it will therefore be appreciated that the valuer applies experience to filter out claimed items which, whilst appropriate at common law, are unlikely to survive two "filters" in the context both of the Property's likely use going forwards, and what is salient to recovering value. The first is commonly termed "supersession". This has been described as the "*term used where the need for an item of work is overtaken by the probable occurrence of another*"[4]

This term is not specifically referred to in section 18 (1) but is mentioned in a number of cases including *Latimer* -v-*Carney*[5].

The second "filter" is the application of agency (open market transacting) experience to remove items which, having regards to the "*age, character and locality*"[6] of the building in question, are unlikely to contribute to any recovery in full open market value. These items are termed "*not value-affective*" ("*nva*").

Some examples include:-

- Many upper floors to a shop, once used for stock, but now otiose due to minimum stockholding on site. Whether these redundant floors are simply safe and tidy (and wind & watertight) – but generally tatty – or rendered immaculate at great expense, will make no difference to lettability, hence value;

- Dirty and spalled brickwork and shrunken pointing – if simply aesthetic and out of public view (rear/side elevations) – are items which again are "*not value-affective*" ("*nva*");

- Minor dented cladding panels, bare concrete floor, minor corrosion to steel-work etc., in an old industrial unit of inherently low eaves and probably with an asbestos roof;

The law of diminishing returns invariably applies for most older properties (other than Listed). One reaches a point in objectively targeted expenditure beyond which one can keep on spending, but no more will be added to (or recovered in) value.

It will therefore be appreciated that more often than not, having regard to these two "filters" which the valuer should apply in order to reflect agency (transacting) experience in the real world, the diminution in value (if any) will be less than the common law (Cost of Works) assessment.

Loss of rent/consequential losses

As for loss of rent (or other mesne profits), such only applies if it can be:-

[4] *RICS Dilapidations Guidance Note*
[5] *Latimer* v-*Carney* (2006) 3 EGLR 13
[6] *Proudfoot -v-Hart* 1890 LR 25 QND 42 CA

"....*demonstrated* (that) *on the balance of probabilities*....*the carrying out of those repairs* (immediately) *after the end of the term prevented*.....*the letting of the premises for that* (works) *period*"[7]

It follows that where the landlord would not have been able to re-let the Property within the works period even if yielded up in repair, loss of rent will not be recoverable[8]

My experience of the foregoing in practice, is that loss of rent claims rarely succeed; limited to where an Agreement For Lease is in place at lease expiry, with that new tenant ready to occupy but for the delay necessitated purely by the repairs contract period.

THE VALUER AND THE BUILDING SURVEYOR

The building surveyor leads dilapidations assessments and negotiations. The valuer provides an invaluable service, subservient to this.

Whilst the valuer applies their "filters" so as to end up with fewer items than the (common law) Claim as surviving to be "*value-affective*", the valuer does of course rely on the building surveyor's expertise as to both appropriate remedies and costs.

CONCLUSION

Be it to rebut a claim against a tenant, or to support a claim for a landlord (as required by paragraph 9.4 of the Dilapidations Protocol when a landlord is not doing the works and/or if a former tenant alleges no loss without a supporting case), the valuer's role is fundamental in promoting settlement (in negotiations, or through mediation).

So long as the valuer thoroughly examines and reflects market reality in the Report, rather than leaving a thread to become its unravelling.

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[7] *Scottish Mutual Assurance Society Limited* -v- *British Telecommunications plc* (Unreported case, judgement given on March 18 1994)
[8] *Dowding & Reynolds* at 29-18