Dilapidations in challenging times, part II

Bill Hanbury and Paul Raeburn continue their look at the pandemic's impact on dilapidations claims, this time from a surveyor's perspective

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In part one, we considered some of the legal issues which arise from repurposing. These are issues that professional advisers are increasingly having to grapple with in the post-Covid era. Crucially, competently quantifying damages equally requires the distinct skill sets each of the building surveyor and valuer to ensure that the settled sum realistically reflects only the remedial costs likely to survive the property's evolution to its new, or repurposed, life.

The judgment in *Sunlife Europe Properties Ltd* v *Tiger Aspect Holdings Ltd* [2014] 1 EGLR 30 reflects how the two specialisms of surveyor should combine to best effect:

- The tenant is entitled to perform their covenants in the manner that is least onerous. In general, therefore, such performance should be the starting point for any assessment of damages.
- The tenant is obliged to return the premises in good and tenantable condition and with the M&E systems in satisfactory working order: they are not required to deliver up the premises with new equipment or with equipment that has any particular remaining life expectancy. The standard to which the building is to be repaired or kept in repair is to be judged by reference to the condition of its fabric, equipment and fittings at the time of the demise, not the condition that would be expected of an equivalent building at the expiry of the lease.
- Accordingly, 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: they are not required to upgrade it in order to bring it into line with current standards (unless required to do so by law or to comply with any necessary regulations). However, as with most obligations in commercial contracts, this obligation must be interpreted in a manner that accords with commercial common sense.
- Any claim by the landlord for the cost of repairs is subject to the general rules that:

(a) the landlord cannot recover for a loss which, by acting reasonably, they could have avoided; and

(b) They cannot recover the cost of remedial work that is disproportionate to the benefit obtained.

- By contrast, where there is a need to carry out remedial work as a result of the tenant's breach of their repairing covenants, the fact the landlord has carried out more extensive work than was caused by the breach does not of itself prevent them from recovering the cost of such work as would have been necessary to remedy the breach.
- Where market conditions at the expiry of the lease require upgrading or refurbishment works to be carried out in order to enable the building to be let to the appropriate type of tenant, a tenant in breach of a repairing covenant is not liable for the costs of any work to remedy the breach to the extent that such work would be rendered abortive by the need to upgrade or refurbish the building (ie where there is supersession).

Valuation filters

The pandemic has effectively accelerated changing patterns already in train in terms of how we use and occupy commercial and leisure properties. These shifts in the extent and nature of demand necessarily drive change in what is provided. Ever more properties require works, ranging from upgrades to wholesale repurposing, in order to be fit for the modern marketplace. By definition, these market-driven works override, or supersede, items otherwise claimed for remedy in dilapidations.

The high street bank which, by successive lease renewals (or initial sale-and-leaseback), was demised as a fitted banking hall (with 1970s counters, ATM plinth and all) is unlikely to see claimed redecoration and other internal works survive all but unavoidable repurposing works (gutting at landlord's expense, and leaving as a finished "white box"). There is no market for a "banking hall" these days.

So the valuer is effectively applying two filters to the building surveyor's costed remedies. The first being to remove items which, while breaches, will probably be superseded by works to evolve the property to fit modern demand. The second is based on the valuer's market experience, where they will only take account of items claimed which are value affective.

Not a landlord's lot

Landlords have not attracted public sympathy in the way others have since Covid-19 struck last year, but they have faced unprecedented levels of rent default and the normal procedures for enforcing arrears have been suspended until 25 March 2022. In this environment, a particular section of the Dilapidations Protocol is increasingly being used as a stick for tenants to beat them with.

Paragraph 9.4 deals with the common situation that the landlord has not carried out the repairs. It provides that:

"... where the landlord has not carried

out all the works specified in the schedule, and does not intend to carry out some or all of the works specified, then it (the landlord) should provide a formal diminution of value valuation unless, in all the circumstances, it would be reasonable not to."

When the protocol came into force in January 2012, the intention of this particular section included defeating opportunistic claims, or at least narrowing the landlord's opportunity to advance them. However, for an increasing number of landlords, remedial works are not being progressed for either or both of two legitimate reasons. First, sheer cashflow issues. Secondly, because, while some form of repurposing or refurbishment is accepted as likely, the market has yet to settle so as to inform which path is appropriate.

So while "diminution in value" is commonly used in conjunction with "defence" it is, in fact, increasingly relied on by landlords in support of the claim for damages.

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Quantifying diminution in value

The historic textbook method is to prepare "valuation A (in repair)", then "valuation B (in disrepair/as vacated)", with the difference between the two (if any) being the amount of diminution in value. The problem with this ideal is that while valuation A is ordinarily straightforward to perform (transactional evidence involving comparable properties, commonly on full repairing leases), there is no real likelihood of finding comparables for valuation B, which would not only need to be transactions of similar properties as to size, location, etc, but also of properties suffering almost exactly the same breaches. Indeed, in the modern context, comparables for the so-called valuation A are also now increasingly elusive, because the property – even if in repair – would no longer have a market.

What therefore evolved in practice was that the valuer would produce valuation A, then make a series of deductions from it – primarily the cost of works and assumed loss of rent – to arrive at valuation B. The amount of diminution in value is not therefore distilled from the valuation. Rather, the valuations are used to illustrate the amount of difference already assumed, or reasoned.

Anstruther v *Vidas Properties Ltd* (unreported, December 2010, Central London County Court) helps to illustrate the difficulties that arise in practice. The court rejected the landlord's damages claim on the basis that the works would almost certainly be superseded by total refurbishment and repurposing of premises which had not been renewed for many years. This is now the customary approach to diminution valuations – the valuer, in effect, applies the two filters listed above.

Loss of rent

As for loss of rent, while this is commonly blindly assumed, in *Scottish Mutual Assurance Society Ltd* v *British Telecommunications Ltd* (unreported, March 1994), deputy official referee Anthony Butcher QC said:

"If the loss of rent during the period needed to carry out repairs is to figure as a head of damages in a claim for damages for breach of the obligation to carry out such repairs during the currency of the term of the lease then it is, I consider, an essential prerequisite that it should be demonstrated on the balance of probabilities that the carrying out of those repairs after the end of the term has prevented or will prevent the letting of the premises for that period."

It is for this reason that claims for loss of rent generally fail in practice. More often than not, market evidence shows that the property was not likely to relet any quicker than the period required to effect the (surviving) dilapidations works. Moreover, that the time necessary to implement a probable (or actual) upgrade or repurposing works would be much the same as the time required for the remaining dilapidations remedies, which in any event could be carried out simultaneously.

The diminution in value cap

As we adapt in the way we occupy and use commercial and leisure properties, with greater hybrid working and an accelerated reliance on buying online – changes that have been accelerated rather than caused by Covid-19 – resolution of dilapidations claims is also having to evolve. Employing both of the disciplines of surveyor – valuer and building surveyor – provides a "sense check", both to better manage the expectations of landlords and to avoid building surveyors being left to carry the can for over settling for tenants. Is it feasible that the hypothetical purchaser of the property, as distinct from the actual owner, will do only the claimed remedial works? If market knowledge informs that the property would still then have little to no prospect of reoccupation, so making repurposing or at least extensive refurbishment in order to find a market probable, then the so-called "diminution in value cap" should be employed. To ignore it, especially in these times of flux, or at least fast evolution, would be folly.

A change in approach to dilapidations claims is therefore likely in the future, as post-Covid cases work their way through the court system in the coming months. As in so many other areas, the pandemic has accelerated long-term trends and forced the surveying and legal professions to come up with constructive solutions.

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