Dilapidations in challenging times

In the first of a two-part article series, Bill Hanbury and Paul Raeburn look at valuation and practice in relation to dilapidations claims following Covid-19

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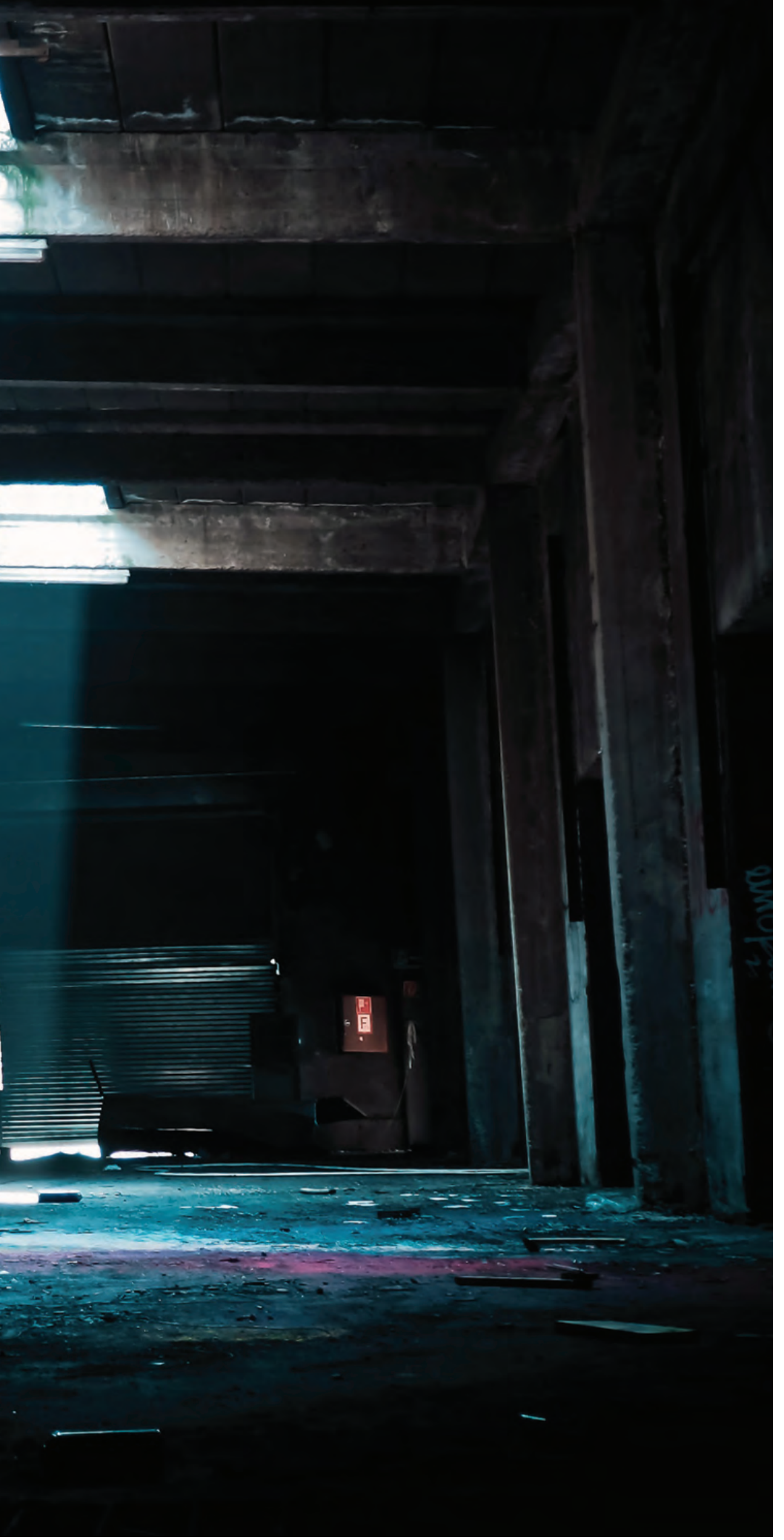

Covid-19 has both increased the number of dilapidations claims and shifted key factors determining damages.

As Emma Humphreys reported in EG on 31 July 2021 (https://www.egi.co.uk/legal/dilapidations-the-law-and-the-reality/), there is likely to be an increase in the volume of dilapidations litigation given the level of repurposing following the pandemic. This has also been driven by accelerating trends in the market, including the growth of online sales, the increasing demand for residential accommodation and the need for more energy-efficient accommodation.

Commercial property leases have shortened in length since the 2008 recession, with regular tenant-only break options becoming common. While leisure property leases have tended to remain relatively long, a number of those are at, or nearing, expiry.

The lockdowns of 2020/21 caused low overall customer numbers for many businesses and piled significant pressure on to commercial and leisure tenants. The pre-existing terminal decline of retail was accelerated. While older office buildings that were already nearing functional obsolescence, achieved it, the "flight to quality" among tenants seeking to take on leases of office premises has been accentuated. In the office sector there has been an increasing emphasis on amenity-rich workspaces in sustainable and efficient buildings.

Even the distribution and logistics sector has not been immune from the pressures of discerning tenants demanding high standards of specification and finish.

As tenants vacate at lease end or break – be that to cut costs by downsizing or relocating to superior space – the common theme is that a terminal dilapidations claim follows. Unfortunately, the landlord's costed schedule often has little regard to the property's value. This is because much of what is claimed will not actually survive the major refit that the property will be subject to.

This brings into sharp focus many of the issues that arise when a terminal dilapidations dispute arises, which we will look at from both the lawyer's and the valuer's points of view.

To repurpose, or to refurbish

Many properties are simply at or about functional obsolescence when they fall vacant. The world has moved on. There is no longer any demand for a purpose-built Argos department store or, generally, a large shop in a small town, for example. In many cases, entire shopping centres

built to meet retail requirements of the 1970s and 1980s are now all but obsolete and teetering ever closer to demolition.

Similarly, in many locations, there is no longer likely to be any demand from a single tenant for an entire office block or from one cinema operator to take on a multiplex. If the previous tenant could not make the site work, it is unlikely that another will.

It will thus be appreciated that simply attending to the dilapidations in such cases, remedying all of the breaches, will probably be a futile exercise. What results is a building "in repair" for which there is still no probable market. So, in many cases, wholesale repurposing is required in order to evolve the property to its new life. The shop can be converted to residential use upstairs with smaller (lettable) units on the ground floor. The department store, or office block, can be converted to residential use (in whole or part), and former multiplexes can be converted into a logistics distribution hubs. But how do those changes sit within the current legal framework?

The legal framework and the section 18 cap

The legal framework is set by section 18(1) of the Landlord and Tenant Act 1927 and the Dilapidations Protocol, which is now part of the Civil Procedure Rules (formally the Pre-Action Protocol for Claims for Damages in Relation to the Physical State of Commercial Property at Termination of a Tenancy). However, it is also necessary to have regard to the relevant RICS guidance, which represents best practice for parties looking to pursue or defend dilapidations claims. This aspect will be particularly important when the surveyor's viewpoint is considered.

Section 18(1) places the statutory "diminution in value" (DV) cap on the repair costs that may be claimed. There are also restrictions at common law on the extent to which a landlord can recover the costs of redecorating or reinstating after alterations.

In Scotland, the law has evolved to provide a similar, but limited, cap. No such cap applies in Northern Ireland.

Section 18 is not felicitously drafted, but has been held to fall into two limbs: first to put a cap on those damages recoverable at common law (which are awarded based on the repair costs) so that they are limited to the extent of diminution in value of the landlord's reversion; and, secondly, to bar the recovery of any damages where at the term date the landlord wishes to demolish or reconstruct the premises or unit of which the premises form part.

The two limbs, although in one sub-section, have always been treated as logically distinct, but in the more challenging times that we are now living, particularly for certain landlords, it is not clear to what extent this will remain the case. Many landlords who profess the intention to re-let to a similar tenant, and for the same or similar use, will in fact have to look at repurposing the premises. It is well known that the section 18 valuation involves looking at the value of the premises at the term date as compared with its value if repaired in accordance with the lease.

In many cases, the landlord will not want to be too honest about their own intentions, which may well include repurposing. This will often make the expenditure of substantial money on repairs by the landlord at the term date pointless. Yet it is often the starting point for the diminution figure as expenditure on repairs has been described in the authorities as "prima facie evidence" of the damage to the reversion (see *Culworth Estates* v *Society of Licensed Victuallers* [1990] 2 EGLR 36). A valuer is unlikely to find that the diminution measure is lower than this, but this is often used as a tactic by landlords to avoid scrutiny of their true intentions for the premises.

The second limb places the burden of establishing that the landlord subjectively intends to demolish the premises or carry out such structural alterations as would render the repairs "valueless". Even where the tenant surmounts that hurdle, it may well be the case that an element of the repair is recoverable, for example, unless the landlord wants to demolish the whole unit, the roof may still be in need of repair or replacement if it allows water to enter.

From the valuer's point of view, the distinction between the two limbs can appear academic. What matters is whether the landlord intends significant alteration works that will override, or

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supersede, repairs which are proposed in respect of the breached covenants.

In cases that do not involve repurposing, vacated properties that still have a life in approximately their current physical form nevertheless often require works to refurbish and modernise them and meet modern open-market expectations and requirements. For example, offices for which a market is still evident in terms of size and location (or, indeed, as ancillary to a distribution/logistics building), but which were fitted out prior to letting 15 to 20 years ago, will probably need gutting and refitting with modern ceilings, lighting, toilets, HVAC, and so on.

Indeed, on the topic of mechanical and engineering, the two dilapidations surveyors, the building surveyor and the valuer, should liaise closely to compare likely remaining life expectancy of these items at lease expiry/break, with what would be required from the best quality covenant of tenant in the open market. So, for example, if the dock levellers are found to be capable of economic repair so as to then have a reliable life remaining of circa five years, this would satisfy the judicial standard of repair and so, on its face, the repair cost survives as part of the total damages assessment.

However, if the market shows that, on the balance of probabilities, the best quality of new tenant that would take the property, thus maximising the investment value, would require at least 10 years (if not brand new), then the landlord will have to renew the dock levellers in any event. If not yet done in practice, this therefore falls to probable supersession to be advanced in negotiations.

Contractual foundations of the area

The concept of repair necessarily connotes a deterioration in the condition of the premises from a stated condition, whether when constructed, when demised or some other date (*Lurcott* v *Wakeley* [1911] 1 KB 905).

The starting point is the words of the covenant. A requirement for the tenant to "keep" in repair requires the tenant to "put" the relevant premises into repair (*Proudfoot* v *Hart* [1890] 25 QBD 42). As the Court of Appeal said in *Lurcott*, the tenant was required to deliver up the premises "... in thorough repair and good condition", although later authorities have distinguished between the state of repair of the premises and their condition and modern leases would be expected to deal with both concepts as well as other plant and machinery which make up modern accommodation.

But the tenant is not required to carry out alterations (and, indeed, is often prohibited from doing so). They need not carry out improvements unless they form a necessary part of compliance with the covenant (see *Sunlife Europe Properties Ltd* v *Tiger Aspect Holdings Ltd* [2014] 1 EGLR 30). This will often be the case where the plant or other equipment is the subject matter of the covenant and needs modernisation, as the covenant must be objectively construed so it accords with ascertainable commercial common sense. It is often said that commercial common sense does not suggest replacing a 1970s piece of plant with an equally dated, but similarly aged, piece of plant in working order.

The ratio of *Sunlife* acknowledged the variety of circumstances that might arise on a termination date. If a covenant against alterations is involved, it commonly represents an impediment to repurposing and may also represent a sticking point in new lease negotiations. In many cases landlords and tenants will want major fit-outs to take place to improve environmental efficiency, for example. Landlords carrying out major refits before re-letting the premises following expiry of the existing term are likely to face the argument that any repairs would be a futile waste, given that the landlord will want to remove anything that would be the subject matter of the repairing obligation in the event that a replacement tenant is found.

In next week's article, we will consider how surveyors are to approach the difficult task of applying the strict words of a repairing obligation to the increasingly varied circumstances on the ground. The difficulty is likely to be exacerbated where the circumstances show that the premises are likely to face wholesale repurposing.

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