Calculating cost and value in dilapidations claims

Paul Raeburn explains how the law operates to varying degrees around the country to cap dilapidations damages and shares an insight into the rationale behind so-called diminution valuations

As Oscar Wilde mused, a cynic is "a man who knows the price of everything, but the value of nothing". In dilapidations involving commercial and leisure properties around the UK and Ireland, it is crucial to know both cost and value when determining the amount of damages payable by an outgoing tenant to its landlord for breached repairing covenants.

Dilapidations events

Since the last recession, lease lengths across most commercial property genres have tended to be shorter (commonly five-10 years) and often with tenant-only break options, commonly operable within five years. While leisure property leases have tended to be longer (15-20 years), many of these are now at or close to expiry. With the well-publicised squeeze on casual dining in particular, many leases are not being renewed.

As a consequence, terminal dilapidations claims are steadily increasing in volume.

For those unfamiliar, in simple terms, these are commonly "served" by solicitors for the landlord on the outgoing tenant, by way of an Excel schedule prepared by a chartered building surveyor which itemises each breach of covenant – items to repair or decorate and alterations to reinstate – along with priced remedies. The total, plus fees and consequential losses (rent, rates, insurance, etc) is the amount of damages claimed.

The tenant appoints its own chartered building surveyor to negotiate. More often than not, negotiated settlement on a "cost of works" basis is achieved. Few cases litigate (less than 1%). Those which cannot be agreed are usually resolved at mediation.

Diminution in value

The law has long since recognised that damages should compensate the true loss by restoring you to the position you would otherwise have been in but for the subject of the claim. We are familiar with this in the context of insurance claims, for example.

As far back as in *Robinson* v *Harman* (1848) 1 Exch 850, this was explained as:

"The rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed."

So there is no set rule that damages for a breached covenant to carry out works must be quantified at the cost of the remedial works. Rather, what loss has the landlord truly suffered? That could be the cost of the remedial works; however, if it can be shown that the impact on the value of the property is less, it will be duly capped.

Jurisdictional distinctions

In England and Wales, this "cap" on damages for breached repairing covenants was codified by way of section 18(1) of the Landlord and Tenant Act 1927. As alluded to above, similar principles apply at common law to cap breaches of clauses to redecorate and to reinstate tenant's alterations.

On the Isle of Man, section 18(1) is repeated all but verbatim by way of section 12(1) of the Conveyancing (Leases and Tenancies) Act 1954. In Ireland, similarly, by way of section 65 of the Landlord and Tenant (Amendment) Act 1990.

In Scotland, however, there is no such statutory cap, but common law and RICS guidance notes have evolved to provide for reference to an alternative measure of loss by way of "diminished value", over cost of works, in some cases.

In Northern Ireland, there is no such cap, either statutorily or at common law, so damages in dilapidations claims are assessed solely on a cost-of-works basis.

Quantifying diminished value

While it is the training and discipline of the chartered building surveyor to identify breaches and to price remedies, it is the chartered valuation surveyor (valuer) who is qualified, in turn, to assess if and to what extent those breaches affect the property's open-market value.

Diminution valuations

The starting point is to appreciate some fundamentals. First, that "cost" and "value" are not one and the same thing. Secondly, that for most second-hand properties that are in some state of disrepair, a point is reached in objectively targeted remedial expenditure beyond which spending can continue, but no more will be added to, or recovered in, value. The law of diminishing returns all but invariably applies.

The theory behind preparing diminution valuations is simple – that the valuer prepares two valuations:

- Valuation A: of the property in its covenanted state ("in repair"); and
- Valuation B: of the property in its actual state ("in disrepair").

KEY POINTS

- In England and Wales, Ireland and the Isle of Man, statutes cap damages payable in dilapidations claims affecting commercial and leisure properties to the lower of (i) the cost of the remedial works, or (ii) the impact on the property's value.
- Commonly the impact on value is far less, and may be nil, or nominal.
- In Scotland, common law has evolved to provide a similar, but limited cap. No such cap applies in Northern Ireland.
- Chartered building surveyors commonly identify disrepair and price remedies, negotiating against a counterpart to settlement. It is only the chartered valuation surveyor (valuer) who is qualified to advise if, and to what extent, the cap applies.

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Preparing Valuation A is fairly straightforward, with commonly ready access to comparable transactions involving full repairing leases (thus, assumed in good repair). But preparing Valuation B is near impossible, as this would require contemporaneous transactional evidence involving similar properties with all but precisely the same breaches as to repair, decoration and reinstatement.

What has thus evolved in practice is the preparation of Valuation A and then, absent true comparables in the actual condition, Valuation B is arrived at by deducting the cost of works (plus consequential losses such as rent, rates, funding costs, etc).

It will therefore be appreciated that, rather than the outcome of this exercise being finding the diminution in value (if any), it is Valuation B. As such, the valuations are effectively superfluous when it is the aggregate of the deductions from Valuation A which is the amount by which the property's value has been diminished.

The skill of the valuer is therefore required to objectively assess and reason the components which aggregate to be deducted from Valuation A. To do so effectively, the valuer employs open-market transacting experience and local research to inform as to what the most likely hypothetical purchaser would do with and to the property. This will determine which (if any) of the claimed remedial works would be likely to be done, and which would not.

Two 'filters'

The valuer is effectively applying two filters to the building surveyor's costed schedule of works.

The first is termed "supersession" and applies to claimed items which would most likely be overridden, or destroyed, by works required to evolve the property to best meet modern open-market requirements. Examples range from decorating floors above a high street shop that are likely to be converted to residential, to repairs and decorations inside dated offices that are likely to be gutted and modernised, or also converted to residential.

The second filter requires the valuer to apply experience to judge which costs are, and which are not, likely to be "value-affective" by reference to the condition and presentation the local market shows is required and expected of similar properties.

A common example is repairing moderately dented cladding panels and painting the steels and floor of a 40-year-old industrial/warehouse building. While such breaches may well affect lettability and value of the modern equivalent, the likely tenant for which reasonably expects at or about new condition, a far lower expectation applies to the older building, so long as it is secure, safe and wind- and watertight. It is, of course, priced accordingly in the open market. Its value is inherently limited by fundamentals which accord with its age (low eaves height, poor thermal properties, asbestos roof, etc) so that attending to additional works is unlikely to have any positive impact on value.

This approach fits with the standard of repair expected judicially. "Good repair" is not the same thing as "perfect repair", with the standard commonly described as being that which fits with the age, character and locality of the property in question.

Consequential losses

A distinct head of claim, it nonetheless tends to follow that, where market evidence shows that a landlord would have been unlikely to achieve a reletting within the works period even if yielded up in repair, no loss of rent will be recoverable.

Landlords

It might seem that diminution valuations only suit tenants. But there are often cases in which landlords require them; not least, to rebut a seemingly opportunistic diminution valuation from a tenant. Also, under the Dilapidations Protocol, which applies in England and Wales, a landlord that is carrying out few (if any) of the claimed works is required to substantiate the claim by a diminution valuation, rather than on a cost-of-works basis. In other jurisdictions, a diminution valuation similarly assists in substantiating a claim where works are not (yet) being done.

Wilde was right

So while Oscar Wilde mused on greed and ethics, it is indeed the case that "cost" and "value" are not the same thing. As such, in most areas of the UK and Ireland, dilapidations settlements are optimised by using both the building surveyor and the valuer.

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