



Alexander Reece Thomson

DILAPIDATIONS DAMAGE TO THE REVERSION

WHAT DOES IT ALL MEAN?





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A Dilapidations claim is a claim in damages arising from the failure of a party to a lease, in respect of its covenants to repair, decorate and reinstate premises.

The starting point, before the application of the statutory cap imposed by Section 18 (1) of the Landlord and Tenant Act 1927, is the Common Law claim, which will normally include the following components:

- The cost of the works (including repair, decoration and reinstatement)
- Contractor's Preliminaries, Overheads and Profit
- Professional fees for supervision of the works
- VAT (where appropriate)
- Professional fees for Preparation and Service of the Schedule
- Professional fees for negotiation of the claim
- Loss of rent (mesne profits)
- Loss of empty rates
- Loss of insurance premiums and service charge

It is often frequently found that the value of the cost of works element of a Dilapidations claim is more than doubled, by adding the remaining heads of claim that flow from the breach of covenant.



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SECTION 18(1) OF THE LANDLORD AND TENANT ACT 1927

Section 18(1) of the Landlord and Tenant Act 1927 provides that whatever the amount of the Common Law claim, the amount of damages payable to the landlord shall not exceed the amount of the financial loss actually sustained by the landlord owing to the breach.

Section 18(1), which contains two Limbs, specifically states:

Limb 1

“Damages for breach of a covenant or agreement to keep or put premises in repair in the currency of their lease, or to leave or put premises in repair at the termination of the lease, whether such covenant or agreement is expressed or implied, and whether general or specific, 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 or agreement as aforesaid”

Limb 2

And in particular no damage shall be recovered for a breach of any such covenant or agreement, to leave or put premises in repair at the termination of the 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 remain therein as would render valueless the repairs covered by the covenant or agreement.

In essence, Section 18(1) imports the concept of fairness and equity to the dilapidations arena, in providing that, whatever the amount of the Common Law claim, a landlord cannot recover more than his financial loss as a result the breach of covenant to repair.

Whilst the statute relates specifically to the breaches of repair only, through the application of Common Law principles, the same concept applies to the other breaches of decoration and reinstatement.

Consequently when undertaking Section 18(1) valuations, these should more correctly be referred to as “Assessments of Diminution in Value to the Landlord’s Reversion” as strictly speaking, Section 18(1) applies only to repair.



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THE APPLICATION OF SECTION 18(1) AND DIMINUTION IN VALUE

In order to assess the diminution in value owing to the breaches of covenant, the process involves two valuations:

- **Valuation A - Assuming Compliance**

This is a valuation of the premises assuming the tenant had complied with its covenants.

- **Valuation B - In Actual Condition**

This is a valuation of the premises reflecting the breaches of covenant found as at the lease expiry.

The difference between these two valuations crystallises the amount of the landlord's loss owing to the breaches of covenant.

The valuations must reflect the intention of the actual landlord under Limb 2, or a hypothetical purchaser of the landlord's interest under Limb 2, for the building, in particular any potential or intention to make alterations or improvements to the building or, a change of use that might involve significant alterations or a complete redevelopment of the site.

In undertaking the assessment of diminution in value, the impact of any such intentions or proposals on the value of the tenant's breaches of covenant needs to be considered. An assessment needs to be made in respect of each element of the Schedule to determine whether any work within the Schedule of Dilapidations would be overtaken and therefore rendered valueless, or superseded by the landlord's intentions.



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QUESTIONS AND ANSWERS

I have detailed below answers to some frequently asked questions in relation to the application of Diminution in Value and Section 18(1).

What if the building is going to be demolished or refurbished?

Limb 2 of Section 18(1) specifically states that if the building is to be demolished, or substantial structural alterations made, then no claim can be sustained against the former tenant.

However, in comparatively few cases, tenants are fully relieved of their liability on account of the landlord's intention to entirely demolish a building superseding the breaches of covenant.

The application of supersession in limiting the tenant's liability is more often a matter of degree, dependant on the scope of the landlord's intentions for the building, whether this be a light or more comprehensive refurbishment. Each situation requires a detailed assessment of the extent to which the landlord's proposals reach into the claim in dilapidations to render valueless elements of work.

By way of example, if it can be demonstrated that the landlord intends to comprehensively refurbish an office building and perhaps add an additional storey and leave the only external walls of the original building, then the majority of the claim to fabric of the building would fall away, perhaps leaving only any repairs required to the walls that would survive the refurbishment programme.

By contrast, a lighter refurbishment would perhaps entail replacement of an old central heating system with a full VAV air-conditioning system and replacement of the lighting and suspended ceilings with a more modern equivalent. This work would render worthless the dilapidations claim for repairs to the old heating system, ceilings and lighting and perhaps some electrics. In other words, these

elements of the claim would be superseded by the landlord's intentions, on the basis that the value of the landlord's interest would not have been diminished, owing to the breach of the tenant's covenants in relation to repairing the old heating system and the ceilings and lighting.

Section 18(1) envisages a potential purchaser of the landlord's interest, who might have intentions for a scheme of improvement or upgrading the building, first assuming the building is in good repair and assessing the price that he would pay for this building.

It also envisages the same potential purchaser looking at a building in its actual condition, in knowledge of the cost of works required to remedy the former tenant's breaches of covenant. The application of Section 18(1) assesses the amount by which the purchaser would discount his bid for the building, assuming its actual condition and reflecting the fact that some of the works of improvement or upgrading that the purchaser intended to carry out, would render some of the wants of repair irrelevant or valueless.

What if the landlord carries out the works?

A number of authorities contain clear statements to the effect that where the landlord has done, or intends to carry out, the work, the cost of works is the best evidence as to the damage to the landlord's reversion. See *Jones V Herxheimer* (1950) and *Landeau V Marchbank* (1949).

Where a landlord has carried out, or demonstrated an intention to carry out work, and pays for it, it may be difficult to argue that he has not lost to the extent of the cost of the works. However, there is a requirement that the landlord acts reasonably.



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QUESTIONS AND ANSWERS

What if the landlord or a purchaser refurbishes after the lease expiry?

The negotiation and settlement of a dilapidations claim, can often extend some time after the lease expiry date. What if, some eighteen months after the lease expiry, with the claim still unsettled, the landlord undertakes a substantial refurbishment of the building, the effect of which has negated many of the repairs claimed in the landlord's schedule?

Section 18(1) requires that we consider the landlord's intentions and the market forces at play as "at or shortly after" the lease expiry date.

Whilst the fact that the building has undergone a refurbishment makes it potentially more difficult for the landlord to argue that he had no such intention to undertake a scheme of refurbishment as at the lease expiry, it does not necessarily prove that such an intention existed as the lease expiry. There remains the possibility that the landlord could demonstrate that, as at the date of the lease expiry he, or a hypothetical purchaser, would have adopted a different approach in dealing with the property.

Such a change in approach may have been brought about by a shift in the market place and the Court would consider the circumstances prevailing as of the date of the lease expiry, although the Court will consider the circumstances that may have unfolded after the event of the lease expiry and how these might have had an impact on the landlord's thinking as at the lease expiry date.

What is Supersession?

The term supersession is not to be found within Section 18(1) of the Landlord and Tenant Act 1927. Where an item of repair is overtaken by a landlord's improvement or alteration, it is said to have been superseded. By way of example, if a schedule of dilapidations specifies work of re-plastering and redecoration to a wall, which it is shown the landlord will subsequently demolish, this element of work is said to have been superseded and falls away because the landlord would have sustained no loss owing to the tenant's breaches.

Can I simply ignore the landlord in the hope that the matter will go away?

The Pre-Action Protocol for Dilapidations, which remains non-mandatory, directs that the landlord and tenant engage in an open manner and respond in good time.

If one party is seen to be dilatory and has necessitated the other to incur additional costs, the Court is likely to reflect that in awarding costs against the offending party.

In the majority of Dilapidations claims the tenant is normally liable for an element of the claim at least. However, until such time as the tenant makes a payment to Court or a Part 36 Offer, he will not have afforded himself any protection in relation to costs and if the Court awards any liability at all against the tenant, then the Court will normally make the tenant pay costs up to the date when such an offer into Court has been made.



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QUESTIONS AND ANSWERS

What if the landlord has re-let the property?

Where a landlord has swiftly re-let a building on full repairing terms, which render the new tenant liable for the obligations of the old tenant, the landlord may well have suffered no loss and there may be a good case for a nil settlement.

However, the terms of the new letting need to be considered carefully. The new lease may have incorporated a rent free period, linked directly to reflect the state of disrepair. A lower rent may have been achieved than would otherwise have been obtained, had the property been in repair, or the new tenant's repairing obligations may well be moderated by reference to a Schedule of Condition. The impact of such provisions needs to be considered carefully.

What if the building is un-let or un-saleable regardless of its condition and the landlord neither intends to demolish the building or carry out the works?

In such circumstances the disrepair of the building may have no effect whatsoever on the value of the reversionary interest. An assessment of diminution in value may demonstrate no shift in value on account of the disrepair.

However, such cases are likely to be few and far between. In *Craven (Builders) Ltd v Secretary of State for Health* (1999) the Court awarded damages of £40,000 in respect of a disused former textile mill of 64,000 sq ft, notwithstanding the fact that the repairs were not going to be undertaken, and the Court acknowledged that there were no buyers for the property as at the lease expiry. The damages reflected the potential loss that a prospective purchaser might perceive as impacting on the ability to generate short term lettings whilst considering redevelopment.

A variation to this concept arises in circumstances where a building in repair may have a negative value and in disrepair has a greater negative value.

This concept was considered in the case of *Shortlands Investments Ltd V Cargil Plc* (1995). In this case the Court held that the diminution in value was the difference between the two assessments of negative value and damages were payable.

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