

PRACTICE PAPER

Dilapidations in the UK – diminution valuations

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Abstract

Purpose – The purpose of this paper is to look at the practical considerations of valuations undertaken in the UK at the end of leases when the landlord and the tenant are negotiating on the dilapidations claim.

Design/methodology/approach – The paper is a review of current professional practice and highlights the salient issues to consider when looking at dilapidation claims.

Findings – The paper considers a fundamental principle of dilapidations. That is, how much has the market value of the landlord's interest diminished at the end of the lease by reason of the disrepair.

Research limitations/implications – The paper is based on the interpretation of current statute and case law. Diminution valuations are hotly contested and there is currently little professional guidance available to practitioners.

Practical implications – The paper guides landlords, tenants, building surveyors and their valuers on the thought process and practical approach to be adopted in assessing loss in dilapidations cases where the underlying assessment will be carried out on the basis of diminution in value.

Originality/value – There is very little written on the practical implications of diminution valuations when assessing dilapidation claims. This paper addresses that shortcoming.

Keywords Cost of repairs, Dilapidations, Dilapidations Protocol, Diminution valuations, Landlord's loss, Market value

Paper type Technical paper

Introduction

Dilapidations is the legal redress contained within a UK lease to ensure that the property, at the end of the lease, is returned in the condition that is required by the repair and related provisions in that lease. This could relate to:

- repair;
- decoration;
- reinstatement (returning the structure to its previous condition following an agreed (or not) alteration; and
- miscellaneous signage, cleaning, statutory compliance, etc.

Repair is defined as the restoration by renewal or replacement of subsidiary parts of a whole. In a lease document, the terminology may vary using language such as “keep in repair” (which includes an obligation to “put” in repair), “good repair”, “good and tenantable repair”, and “substantial repair”. Such terms often are embedded with additional wording that does not usually add anything. This paper looks at the process of assessing claims that arise due to disrepair.

The Dilapidations Protocol

When undertaking an instruction to settle a dilapidations claim in the UK, the courts have now formally adopted the Dilapidations Protocol. This Protocol has its origins in



the former Property Litigation Association Protocol but there are certain fundamental differences. These include such things as the Service of a Quantified Demand at the start of the process, and proper detailing of the landlord's claim. The Dilapidations Protocol, para 2.1, states that the protocol is adopted:

- to encourage the exchange of early and full information about the dispute;
- to enable parties to avoid litigation by agreeing a settlement of the dispute before proceedings are commenced; and
- to support the efficient management of proceedings where litigation cannot be avoided.

Time limits are incorporated being 56 days from the end of the lease for the service of the Schedule and the tenant's response 56 days thereafter. They are there as a means of facilitating the process. In considering this point, valuers must understand that the Protocol's purpose is the management of terminal dilapidations claims before the courts. It is not intended as a stick with which to beat the opposing side.

Diminution valuations

Diminution valuations are largely covered in Section 9 of the Protocol and hence it is inferred that they will not arise until the Quantified Demand has been issued by the landlord with a Dilapidation Schedule.

A Quantified Demand will, amongst other things:

- detail aspects of the dispute substantiating the monetary sum sought as damages;
- be limited to likely loss;
- avoid supersession;
- detail other losses;
- if work is not done, state what steps are being taken; and
- confirm the landlord/his surveyor will attend a meeting.

A Dilapidation Schedule will usually include:

- breaches separated into repair, reinstatement and redecoration;
- remedy;
- costing; and
- endorsement that landlord's intention has been taken into account.

The Protocol makes it very clear that the claim may be a combination of cost of works and diminution in value as appropriate. A diminution valuation is a statement of the difference between the market value of the property in compliance with the repair obligations in the lease and in its current state.

Diminution in value is particularly relevant where the landlord has not done, and does not intend to do, all of the works, or will do only part of them. In such circumstances there is a presumption in favour of providing a valuation.

In reverse, in the case of the tenant's reliance on a diminution valuation in its defence, it should provide this to the landlord within a reasonable period (generally 56 days). The Protocol makes it very clear that the valuation should be prepared by a valuer.

One of the issues with the current process is that details of the diminution valuation may not be available (or provided) until late in the day. This can be detrimental to the process as either the landlord's claim may fail at the last minute, or, conversely, the tenant's carefully drafted defence will suffer a similar fate; both after exceptional costs have been incurred. It is difficult to understand how a Quantified Demand can be served without one.

Whilst it is accepted that valuations, carried out properly, are not cheap, they are a lot cheaper than spending vast amounts on legal costs only to find that a claim or defence was not worth running in the first place.

The best advice is for the building surveyor, who is assessing the costs of repair, to liaise with a valuer from the outset. They can at least determine, at an early stage, if a valuation will not be required until later in the day, if at all. If nothing else it can inform investigations and negotiations enabling the building surveyors to concentrate on areas where the cost really will affect value.

The role of the valuer

In practice, the valuer's role is to assess the diminution in value of the landlord's interest consequent on disrepair.

The principles underlying damages for breach of repair were established in 1891 in the Court of Appeal judgement in the case of *Joiner v. Weeks*. In simple terms, this case established the common law position that the general measure of damages for disrepair is the cost of repairs plus loss of rent during the period of the works.

However, this case did produce the inequitable position whereby a landlord may be paid for repairs that it will not carry out because the premises will be demolished. Alternatively, they may be paid a sum which is far greater than the diminution in the value of its interest. It is this injustice that Parliament corrected by virtue of Section 18 of the Landlord and Tenant Act 1927. Section 18(1) places a cap on the amount of damages recoverable for breaches of repair; that cap being the diminution in the value of the landlord's reversion. It does not of itself change the common law position, save by virtue of the position on demolition or structural alterations.

In practice, though, it is too easy to dwell on this statute without considering the wider concept of damages for breach of contract. It must be appreciated from the outset that damages are now often assessed generally by reference to diminution in value in cases involving property. There is perhaps no better example of the common law at work in this respect than in the case of *Ruxley Electronics Ltd v. Forsyth* (1995).

In this case, the facts are simply that Mr Forsyth commissioned the construction of a swimming pool 7'6" deep. In practice it was built 6'0" deep and he sought damages equivalent to the cost of building it as originally specified. It was his avowed intention to reinstate the pool to the required depth despite the fact that it was still safe to dive into a six-foot deep pool. There was no evidence that the shallower depth reduced the value of the pool and given there was no disadvantage it was deemed unreasonable to rebuild the pool. Hence it was appropriate to award only damages for loss of amenity in the sum of £2,500.

In this regard there is also another analogy with dilapidations. That is, the cost of a new pool allegedly being £33,800 plus VAT was wholly disproportionate to the benefit to be derived from increased depth. It was therefore unreasonable to rebuild in such circumstances. We see this type of argument emerge in relation to buildings of nominal value where dilapidations claims are substantial.

Thus we have a balance struck between the cost of works, diminution in value and reasonableness/proportionality. All of these resonate in dilapidations cases and move valuers beyond the mere confines of Section 18(1).

This principle enables valuers to apply the principle of diminution to all breaches under the lease at termination, not merely to repair to which Section 18(1) refers:

Section 18 – first limb:

- Damages for a breach of a 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, 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.

Section 18 – second limb:

- 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 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 or be pulled down, or such structural alterations made therein as would render valueless the repairs* covered by the covenant or agreement.

Perhaps the most relevant description of the role of the valuer is that set out in the judgment in *Ravensgate Estates v. Horizon Housing Group Ltd* (2007):

It is important to bear in mind that a Section 18(1) exercise involves determining a difference in value. That in turn involves two imaginary sales – one of the property in repair and one of the property out of repair. One would often expect a Section 18(1) exercise to set out each figure, with justifications for each, so that the merits of each figure can be assessed by the judge and the relevant mathematical exercise carried out. In order to ascertain the two sale prices it will usually be necessary to identify the market and therefore the nature of the purchaser.

Where judgments refer to “S18 (1) or “S18 valuations”, the words “Diminution Valuation” can be substituted. But it must relate to “valuation”. In the recent case of *Baroque Investments v. Heis and Bewick* (2012) the High Court has dismissed a dilapidations claim for failure to provide a valuation in accordance with S 18(1). The landlord tried to use a rent free period given in lieu of dilapidations as its claim. In summarising his decision the Chancellor of the High Court said simply, “The alleged debt of £1,212,395 referred to by Mr Grey in his witness Statement identified in the preliminary issue has not been calculated in accordance with S 18(1) Landlord and tenant Act 1927 and, in consequence, is not provable”.

Likewise in *Smiley v. Townsend* (1950):

The diminution in value of the reversion at the end of the lease [...] the reversion meaning the landlord's interest in the premises [...] the question is therefore how much was the market value of the landlord's interest diminished at the end of the lease by reason of the disrepair [...].

This emphasises the need of the valuer to identify the value of the reversionary interest for which there is a hypothetical purchaser. To do this, the valuer needs to establish who the likely purchaser of the property is, both in repair and out of repair and assess what they would pay in each scenario.

That is the principle but arguments arise because the valuer of the landlord and valuer of the tenant are unable to agree on what constitutes the market for the building, in and out of repair and what the markets' reaction to price "out of repair" will be. This is relatively simple when the interest is freehold or long leasehold but can get inordinately complicated when it is a short unexpired term of only a few days. Who, for example, would buy four remaining days of a head lease, let alone one out of repair?

These problems with the market and identifying a purchaser are not new and vary according to the buoyancy, or otherwise, of the market. David Neuberger in *Craven (Builders) Ltd v. Secretary of State for Health* (2000) said:

[...] the fact that in reality a property may not have found a buyer, does not mean that it has no value [...] the valuation exercise required by S 18 [...] requires one to assume that there was a transaction.

Who would have been the likely bidder in the market for the building [...].

[...] common sense can be a dangerous, even misleading, guide in a case of an unusual and relatively undesirable building in a mediocre location in a poor market [...].

All of these comments ring an accord in the depressed commercial property market in which many current claims have their roots.

So the question when working in a highly theoretical world, something akin to rent review, is "Where can we get a guide to how we look at the market?"

The Royal Institution of Chartered Surveyors (RICS) definition of market value gives some guidance on this point:

The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

Other guidance on hypothetical markets can be found in a number of rent review cases. In "FR Evans" the judge said this:

[...] the landlord is an abstraction a hypothetical person with the right to dispose of the premises [...] As such he is not affected by personal ills such as cash flow crisis or importunate mortgagees. Nor is he in the happy position of someone to whom it is largely a matter of indifference whether he lets [...] or waits for the market to improve. He is in short, a willing lessor. He wants to let the premises at a rent which is appropriate to all the factors which affect the marketability in short we have a landlord who is not forced to transact but who will do so" (*FR Evans v. English Electric*, 1978).

In "Marklands" the judge looked at the fact that parties do not always agree in reality but said:

[...] in the real world, parties often do not reach agreement, since their individual aspirations are irreconcilable. But in the hypothetical world, they always reach agreement. Although each party may have alternatives it seems to me the only permissible alternatives are those within the framework of the hypothetical transaction thus the landlord can point to other tenants willing to take a lease of the property on the offered terms and the tenant can point to other properties that he will be willing to take" (*Marklands v. Virgin Retail*, 2004).

And in “Dennis and Robinson” it clearly places the responsibility for identifying the conditions in the market on the valuer:

It is not to be assumed that the willing lessee would pay more for the premises than the market required him to pay. It is for valuers to enquire into and determine the strength of that market (*Dennis & Robinson v. Kiossos Establishment*, 1987).

The valuation

A valuation is simply an assessment of what the valuer thinks the property will sell for at the valuation date in the then market and having regard to the characteristics of that property. The simplistic approach in the owner occupier scenario, assuming the property is “In Repair”, might be to assess the size and multiply it by a direct capital value per square foot.

The difficulty arises when the valuer moves to assessing the property in the “Out of Repair” state. Why?; because in normal circumstances there is no directly comparable evidence of properties in this state. Thus the valuer who tries to adjust price per sq ft, be it capital or rental, has to make a leap of faith by making a subjective judgement with no supporting evidence on which to rely. This is equally the case with any adjustment to the rate of return on an investment valuation.

In simple terms the valuer has to go back to basics and ask themselves, “What would the purchaser do in such circumstances?”. Experience shows that the purchaser will deduct the cost of doing works it deems necessary, allow for an element of contingency and interest on capital employed. They may also make an allowance for the time the property is not operational or income producing.

It therefore follows from this simplistic approach that if the valuer is to argue diminution in value from a position of strength they must rely upon the building surveying team to provide accurate data on the cost of works. Regrettably this is not always as easy as it may sound on face. If the valuer is asked to provide an accurate assessment of diminution too early, it is likely that the input will have little value if building surveyors will not have had the chance to narrow their differences. This can prevent a reasonable settlement.

It is worth reflecting at this point on the comments in *Smiley v. Townsend*:

- where the repairs have been, or are going to be done, by the landlord, cost may be a very real guide;
- where it is plain that the repairs are not going to be done by the landlord, the cost of them is little or no guide to the diminution in value; and
- where it is open to question whether the landlord will do the repairs, the cost may be a starting figure but it should be scaled down according to circumstances remembering that the real question is: what is the injury to the reversion?

This last point reinforces the point of “reasonableness and proportionality” as discussed in *Ruxley*.

Let us move on and assume the valuer has been brought in at a point when the building surveyors are more or less agreed on the breaches, remedy and the cost of rectifying them.

What the valuer should now do is to identify who the likely class of purchaser of the landlord’s interest will be. Often this fundamental point is simply not addressed. Aspirations will not be the same, and different purchasers will react differently to

taking the property in its condition at the valuation date. For example, an owner occupier will balance operation and utility. An investor will balance income with expenditure to provide maximum long-term return. A developer will probably look to profit and turnaround. Equally each occupier may require a different valuation method, not merely an underlying investment approach.

In some cases the valuation calculation will involve a straight forward investment approach. In others it will be more appropriate to go direct to capital value or a development appraisal. None of these are exclusive. The use of alternative methods of valuation did exercise the mind of the Technology and Construction Court in the more recent case of *Hammersmatch Properties (Welwyn) Ltd v. Saint-Gobain Ceramics and Plastics Ltd and Saint Gobain Abrasives Inc* (2013). In this case one of the bases of valuation was indeed a development appraisal.

With this in mind the valuer should take the Schedule and consider all of the items both individually and globally and identify if they will have an effect on value having regard to the most likely purchaser of the interest being valued. Some items may have no effect on valuation in isolation but if taken with others will have a cumulative effect.

An example of this point is minor repairs and decoration. As an individual item a poorly repaired and decorated door in an office building of 10,000 sq ft might have no effect on value. If all doors and surfaces are in poor repair and decorative order the overall impression on the purchaser will be negative. He will reduce his bid by at least the cost of doing the repairs and decorations or possibly replacing the doors entirely.

The real skill in all of this is in having a valuer who really knows the effect of breaches of covenant on the reaction of the purchaser to price. There are many breaches that frankly are unlikely to have any impact on value. It is equally important the valuer understands how markets change and react to various ages and classes of building. Lastly the valuer really must, in adopting this repair cost-based valuation approach, stand back and decide if it really stands scrutiny and is reasonable/proportionate.

Practical considerations

Experience has shown that the major disputes in dilapidations often hinge around a couple of areas. These are generally Mechanical & Engineering (M&E) issues, and where refurbishment by the landlord or a prospective purchaser is likely:

Mechanical & Engineering (M&E)

Most building surveyors are not M&E specialists and, likewise, M&E specialists are rarely dilapidations specialists. Neither of these are valuers. There is, therefore, a critical learning point, given that these big ticket items will generally feed directly into the valuation, assuming that refurbishment or replacement is not likely.

What the valuer needs to understand is the extent to which the M&E is defective, how that will affect the operation of the building, and how it can be resolved. This will vary with building type: for example the systems in a modern office building will be entirely different to a basic warehouse.

It may be that repair is required, but in practice it is not unusual for wholesale replacement of parts to be the only alternative. Experience suggests that in most purchasers' eyes any major defect will need to be addressed or price will be reduced. If replacements of parts are needed and the consequence is improved operation, this needs to be understood by the valuer. It is important that the valuer knows, in trying to judge the effect on value, what will ultimately be

presented to the market as a building in repair, and how a building out of repair will function. This point was considered in detail in *Sunlife Europe Properties Ltd v. Tiger Aspect Holdings* (2010).

This is not always an easy principle to grasp and it is good practice for the valuer to sit down with both Building Surveyor and M&E specialist to understand what an “In Repair” building will really look and feel like. Conversely the valuer needs to understand the shortcomings of the building out of repair in order to assess the reaction of the purchaser.

Refurbishment

This can be illustrated by reference to a simple example. Assume that the valuer is going to look at a 1980s’ office building and is required to identify the market for it and the likely purchaser. It is important to determine what the market purchaser would do with the property.

The valuer may decide that the purchaser will refurbish. So, for example, they may gut the core and common parts of an office and provide new ceilings to each suite. In consequence it is likely that the valuer will judge that disrepair of these parts of the building will not influence the purchaser’s bid, as he will have allowed for their replacement anyway. Thus, in carrying out the valuation, the valuer will allocate “no value effect” to these items. They will not appear in the calculation as part of the costs of remedying the breach in the “Out of Repair” scenario. This is in effect the valuation answer to supersession.

Loss of rent and related costs

“Loss of Rent” is usually included as a separate head of claim. Referring to *Joyner v Weeks*, it is very likely that, in circumstances where loss of rent is directly related to the period required to remedy breaches, that the valuer will have included it in their calculation. This is most likely represented by a deferment of the rent receivable through to completion of the works, together with any ancillary out of pocket expenses such as empty property rates (EPR). Valuers should therefore make sure that they ask the legal team if Loss of Rent and EPR have been included in the claim as separate heads to avoid double counting.

Conclusions

Post Ruxley “Diminution in Value” is more frequently seen as one of the guiding principles for damages for breach of the tenant’s obligations under a lease notwithstanding Section 18. The valuer’s role in the dilapidations process is multifaceted and requires them to be an advisor, a negotiator and an expert witness. But at all times, these roles are underpinned by their expertise in understanding the market for the building and its value. A diminution in value is merely a statement of the difference between these market values in the market subsisting at the valuation date. It has regard to the property assuming compliance with the lease terms and in its actual state at the end of the lease. A competent diminution valuer is required to determine both these values.

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