



kinneygreen

Damages for Dillapidations

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It is evident that the interest in dilapidations flows in inverse proportion to the strength of the property market. Less often is it now the case that a landlord at the end of a lease is faced with the decision to redevelop, rather than to carry out a major refurbishment. More careful judgement of the risks have to be made reflecting the need to give the market what it wants, to ensure lettability and saleability, but to do so at a price which ensures the landlord makes a return which makes economic sense whilst limiting its exposure to the risks involved as much as reasonably possible.

1.0 THE NEED FOR VALUATION

1.1 Generally

1.1.1 Breaches which relate to '*dilapidations*' may be grouped under one or more of the following broad headings:

- repair
- decoration
- reinstatement

1.1.2 Breaches of covenants or agreements relating to any of these matters may cause damages, and often trigger the need for valuations.

1.1.3 Although section 18(1) of the Landlord & Tenant Act 1927 relates to breaches of repair, today the common law position relating to decoration and reinstatement covenants is similar and for practical purposes that is adopted here.

1.2 Section 18 (1): First Limb: 'Cap'

1.2.1 "***Damages for 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 the lease, whether such covenant or agreement is express 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) is diminished owing to the breach of such covenant or agreement as aforesaid.....***".

1.2.2 This first limb provides an overarching cap insofar as damages relating to repair breaches cannot exceed the amount by which a landlord's reversionary value is diminished by reason of the breach.

1.3 Section 18(1): Second Limb: 'Negation'

1.3.1 "***..... 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.***"

1.3.2 This second limb relates to “negation”, although it is often referred to as “supercession”. No damages are recoverable if the property is to be pulled down or structural alterations made which would negate and so render valueless the repair for which a tenant would otherwise have been responsible.

1.3.3 Recently it has been argued in the TCC that the second limb reference to “whatever state of repair” the premises *might be*, may lead a tenant to claim that it would be entitled to benefit from its own breaches by ensuring that its premises were sufficiently out of repair that at the end of the tenancy the premises would have to be pulled down or that structural alterations would have to be made, negating the need for compliance with its repairing obligations and so rendering valueless any work of repair. A decision is awaited.

1.4 Assessment of Diminution in Value

The correct process is to assess the value in repair and compare it with the value out of repair in order to establish the cap and extent of negation, which is examined next.

2.0 THE VALUATION EXERCISES REQUIRED

2.1 It is necessary to value the property:

- (i) in repair, and
- (ii) out of repair.

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The need for the two exercises was emphasised by the Court of Appeal recently in *Van Dal Footwear v. Ryman Limited* [2009] EWCA Cir 1478.

- 2.2 The first exercise, of valuing the property in repair, will initially involve more imagination than the second exercise as it is to be assumed the breaches do not exist, but overall this first exercise will be a more realistic one, as lettings and sales of properties in repair are relatively commonplace, whereas lettings and sales of properties out of repair are relatively rare and may involve an 'Alice in Wonderland' trip. The lack or paucity of 'out of repair' evidence is at the heart of many diminution in value disputes.
- 2.3 It may be argued that the 'in repair' valuation exercise should assume that the breaches had existed but have since been remedied, *not* that they had *never* existed in the first place. Both scenarios involve hypothesis, but the assumption of the remedy having been made may be considered to be less indulgent.
- 2.4 The assumption for the 'in repair' valuation, that the disrepair has already been remedied, can have a significant effect on value, particularly when repair inescapably involves betterment. For example, disrepair of some items may involve the removal of asbestos. A property without asbestos may be more valuable than one with asbestos even if the asbestos is assumed not to be out of repair. Another example, where the effect on value may be significant, may



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be where repair of ceilings and lighting in an office building can only be done by replacing them with more modern (and better) equivalents.

3.0 **BASIS OF VALUATION**

3.1 **Market Reality**

"The market may be wrong, but the market is always right."

Markets are influenced by all manner of factors and each actual perceived or hypothetical bidder may be influenced by some or all of those factors in different ways. The Holy Grail is, and always will be, 'what the market does' even though the market may not always seem to act logically. Examples of factors which may be met with an illogical or imbalanced reaction from the market include:

- (i) asbestos,
- (ii) offer back clauses,
- (iii) VAT and its recovery,
- (iv) service charges, and
- (v) rates.

3.2 **Market Hypothesis**

Valuation, not least concerning dilapidations, is usually about forecasting the past, or in the unlikely event of dilapidations settlement before the lease end, forecasting the future. Either way the valuer must visualise the real world and assess its reaction in what are imaginary circumstances, and ignore what he or she knows

actually happened later in the real world (although the latter may give comfort). This skill of visualising and assessing is usually gained and developed over many years by valuers, but is not one with which all building surveyors are necessarily well experienced.

3.3 The Red Book

3.3.1 The RICS Red Book basis of *Market Value* (6th edition, PS 3.2) is:

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

3.3.2 Using the Red Book as the basis of market value can help to identify the general mindset of the parties to a transaction and of the marketing of an interest leading up to a sale. It would however be wrong to rely on the Red Book definition without careful thought.

3.3.3 For example:

(i) Although marriage value¹ and hope value² are *included* in the Red Book definition, any effect of a special purchaser³ is

¹ Marriage value may be described as the latent value which is or would be released by the merger of two or more interests. For example, two adjoining parcels may be worth more as one property than the aggregate of their separate values. Similarly two interests in the same property may have a greater value when merged than the sum of their individual values.

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excluded from the definition. Where any special purchaser effect exists, the effect could be significant and must be reflected in the dilapidations valuations.

- (ii) The Red Book basis requires the valuer to assume that “*proper marketing*” of the property has occurred, and so arguably the valuer need not consider what that would entail, what the audience would be addressed, and how long it might take to sell the property. These things need to be thought through by the valuer, not merely taken as read. They will have influenced the price achieved for comparable evidence and will affect the dilapidations valuations.
- (iii) The definition requires the valuer to assume that the exchange and completion of the sale contract happens simultaneously (and for which no discount is to be made). This may not match market reality, so the evidence needs to be studied and any necessary adjustment made.
- (iv) The definition also requires the valuer to ignore sale and purchase costs, even though in the real world such costs would

² Hope value may be described as that value over and above the existing use value, which reflects the prospect of some more valuable future use or development and is likely to take account of the uncertain nature or extent of such prospects including the time which would elapse before one could expect planning permission to be obtained or relevant constraints to be overcome so as to enable the more valuable use to be implemented.

³ A special purchaser is someone with a particular reason for acquiring an interest in a property because of his own special circumstances, such as someone who owns a different interest in the same property or who owns an adjoining property or whose special needs can be satisfied only by the acquisition of that interest in that particular property.

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be incurred, and need to be reflected in the valuations undertaken for dilapidations.

3.3.4 In summary, it is important to recognise that market evidence may not have been shaped by the assumptions required by the Red Book definition or at least not to the same extent, so valuers need to pick their way through market evidence, if it exists, with great care and adjust it as necessary. The key is to do what the market would do, even if it somehow involves walking through the Looking Glass to get there.

3.4 The Hypothetical Interest

3.4.1 The interest which is to be valued, both when it is assumed that the property is in repair and when it is assumed when the property is out of repair, is the immediate reversionary interest held by the immediate landlord. Sometimes the immediate landlord may have a very short reversion, possibly of only a day or two. The value of the immediate landlord's interest of the breaches should reflect the impact on its value of any superior reversionary interests.

3.4.2 When assessing the value of the interest when the property is out of repair it is necessary to assume a 'no claim world' to avoid any circularity which may otherwise exist. Plainly, if a hypothetical purchaser could rely on its claim for dilapidations it may not reduce its bid, or at least not reduce it as much as it otherwise would if the

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right to claim did not exist. To arrive at the diminution in value it is therefore essential that a 'no claim world' is assumed.

3.4.3 The 'no claim world' approach is not to be confused with the effect on value there may be if the reversionary interest is leasehold, in which case it is likely that the reversionary interest contains a *Jervis v. Harris* clause⁴. The impact of such a clause could be such that the limitation imposed by section 18 is never bridged.

⁴ [1996] Ch 195; 2 W.L.R.22.

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3.5 Hypothetical Parties

- 3.5.1 The Red Book states that both the buyer and the seller are willing parties. It does not specifically state whether the buyer is hypothetical; it states that *"the present property owner is included among those who constitute 'the market'"*, so according to the Red Book the buyer could be the present owner. The Red Book states however that the seller (owner) is hypothetical, which suggests some tension between the two positions: *"the factual circumstances of the actual property owner are not a part of this consideration (of the best price attainable) because the 'willing seller' is a hypothetical owner"*.
- 3.5.2 Some guidance can be drawn from rent review cases on the point about the abstraction of the parties. In *F R Evans (Leeds) v. English Electric [1997]* it was held that *"...the landlord is an abstraction – a hypothetical person with the rights to dispose of the premises as such he is not affected by personal ills such as a 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"*. It is clear from this and other authorities such as *Northern Electric v. Addison [1998]* and *Marklands v. Virgin Retail [2003]* *".... in the hypothetical world, they will always reach agreement"* (on the lease terms), the framework of the hypothetical transaction in dilapidations cases is wider than that normally contemplated in rent review clauses. As stated by Scott J in *Cornwall Coast Country Club v. Cardgrange [1987]* *"the open market*

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must be, so far as is possible, a market which corresponds with reality the various hypotheses must, in my view, be taken no further than their terms make strictly necessary. It is not necessary for the purpose of giving effect to the "vacant possession" hypothesis that Crockford's should be treated as a possible hypothetical tenant. On the other hand, so to treat Crockford's introduces hypothesis upon hypothesis. It requires Crockford's to be invested with hypothetical qualities and surrounded by hypothetical circumstances that do not correspond with reality. Thus the proposition that Crockford's is a possible hypothetical tenant requires the hypothesis that it will be in the market for 30 Curzon Street if 30 Curzon Street was vacant. That hypothesis is not a necessary (emphasis added) consequence of the vacant possession hypothesis. It is no more than an arguable one".

The Judge concluded that "..... Crockford's cannot be assumed to be a possible hypothetical tenant". Not least because that the particular case concerned a casino which would have involved the transfer of a licence and other matters, it cannot be concluded that in every case the tenant "cannot be assumed to be a possible hypothetical tenant".

- 3.5.3 Nor it seems can the same blanket assumption be made in respect of the actual owner of the interest being valued for the purposes of dilapidations. Circumstances could exist whereby if the actual owner did not own the interest it could be expected to be in the market to acquire such an interest, or others may perceive that possibility. In that respect the Red Book approach (that the present property owner is included among those who constitute the market) is correct.

3.6 Hypothetical Valuation Date

The valuation date is the date of the expiry of the lease where a claim is brought following expiry, but will be the date of the hearing if a claim is made during the term for the lease. It follows that a 'terminal schedule' cannot be finalised until at least the term end, not merely in respect of the breaches complained of, but for diminution in value purposes, and in respect of the quantum of any loss of rent.

3.7 Dateless Continuum

3.7.1 Although the valuation date is usually readily identifiable no instruction is given in section 18 as to what may have happened between the intending parties leading up to the hypothetical entering into of the contract for the interest being sold.

3.7.2 There are two schools of thought.

(i) First, a 'dateless continuum' may exist, during which period all that is necessary to secure a sale is undertaken in a 'dateless vacuum' on the valuation date and in this respect the Red Book definition requires the valuer to assume no gap between exchange and completion of the sale contract and so ignore any effect on value of there being no gap.

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(ii) The second school of thought is that marketing, negotiation and agreement of the Heads of Terms takes place in a manner *and during the period before* the sale contract is signed. The latter accords with reality and avoids the assumption of all events happening on one day when such things may never take such a short time, but it is unknown, of course, how long these processes will take.

3.7.3 In summary, it may be said that the date of assessment of value is either the date the new contract is signed or the date of settlement of Heads of Terms, which will almost certainly be earlier. Usually, Heads of Terms do not change materially between agreement and signature. A common practice is to take, as the date of valuation of open market transactions, the date Heads of Terms were agreed and not the date the contract was entered into. This time lapse may be months, which may prove significant if values are changing. The problem has led some to adopt the 'dateless continuum' theory. The key is to compare apples with apples.

4.0 METHODOLOGY

4.1 An obvious tension arises when one is asked to value an interest in circumstances which may not exist in the market such as letting a particular property out of repair. This tension may exist with most valuations of properties which are out of repair.

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- 4.2 The generally preferred approach is to rely on open market sales, but often there is little or no reliable evidence, and even then comparison is not always straightforward, as every property has its own particular characteristics and different levels of repair (and disrepair) and specification.
- 4.3 A common approach, but not one which applies in every case, is to assess what it takes to get the property into a marketable state. Such an approach may involve the use of development appraisal software. Development appraisals include a developer's profit, normally based on a percentage of the total costs of a scheme, *including* the purchase price. Here there may be disagreement amongst valuers as to whether or to what extent any such profit should apply. There is an understandable tendency for some valuers to see work of repair as something to which no risk premium ought to be attached – after all it is not 'development' or even 're-development' and merely puts the property back to the state in which it should have been left. Where, it may be argued, is the risk in that? There may be little or no risk if the repairs are inexpensive and not extensive. However, where that is not the case and especially where repairs are very extensive and form a relatively high proportion of the value of the property the risk can be considerable and should be reflected. The fact that the works may be 'repairs' instead of, say, 'improvements' may be neither here nor there if the risk profile is similar.

4.4 As to when work of repair involves the risk-taking found with a 'development' and as to when to apply 'developer's profit' has to be judged on a case-by-case basis, but it would be wrong to slavishly ignore 'developer's profit' or to apply it only as a percentage of the repair cost in all cases, rather than to apply it to the purchase price and other costs.

4.5 Whilst it is preferable to try to keep the valuation approach simple, particularly if going to court (not at all easy when development appraisals are involved), relevant influences must be properly addressed.

5.0 AN EXAMPLE OF A PROBLEM

5.1 Consider the example where a property is multi-let and all the leases fall in on the same date. None of the tenants have complied with their repairing covenants. When valuing each lease one does not assume that the other floors are in repair because that is contrary to reality, but if all the floors are out of repair an owner's solution for the whole building might differ than if that was not the case. How does one deal with that problem and how does one apportion the damage?

5.2 Assume a modern air conditioned and well specified 5 storey 50,000ft² office block let floor by floor (10,000ft² per floor), let for 10 years at £50/ft², each lease having a tenant's only break option at

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the end of the 5th year (21st June 2010) and each held on pro rata FRI terms, with rents reviewed upwards only after 5 years, all now agreed at nil increase. For simplicity, ignore acquisition and disposal costs.

5.3 Scenario 1

All in repair and no breaks operated, except the 3rd floor which is in repair and has already been re-let on the same terms as the other leases.

Value at 21st June 2010:

$$\begin{aligned} 5 \times (10,000\text{ft}^2 \times \text{£}50/\text{ft}^2) &= \text{£}2,500,000 \\ \text{YP at 6\% in perpetuity:} & \quad \underline{16.6} \\ & \text{£}41,666,650 \quad \text{Say: £}41,666,000 \end{aligned}$$

5.4 Scenario 2

All in repair except the 3rd floor break operated and the tenant has left damaged ceilings, lights, floor boxes and worn carpeting, costing £100,000 to repair/replace and 4 months to rectify, half the time being taken up with specification, tendering and lead-in.

Value as at 21st June 2010:

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Value as above:	£41,666,000
Less	
Repair/replacement as above	£100,000
2 months for works (lead-in etc during expiring lease) so:	
(i) loss of income during works: $2/12 \times 10,000\text{ft}^2 \times £50/\text{ft}^2$:	£83,333
(ii) empty rates:	nil
(iii) insurance, say:	£500
(iv) finance, say:	£500
(v) extra letting void, say:	nil
(vi) service charge loss, say:	£7,000
	<u>£191,333</u>
	£41,474,667
Say:	£41,475,000

The result is a diminution in value of £191,000.

5.5 Scenario 3

As Scenario 2, but every floor, not just the 3rd floor has had its lease ended by each tenant and each floor is left in a state of disrepair similar to the 3rd floor. In this example, the market reaction in those particular circumstances is not to repeat the 3rd floor remedial works, but to undertake an entirely different scheme on the whole building, negating all of the repair works otherwise applicable, so that there is apparently no diminution in value. In the example, had the 3rd floor been left in repair or not, given the disrepair of the remaining floors, the landlord would have carried out a scheme which negated all remedial works. In this example, the negation is solely caused by collective breaches of covenant in the leases held by different tenants. The landlord is out of pocket on a lease-by-lease basis, and collectively, but the s. 18 valuations indicate no diminution in value, which appears to give rise to an unintentional effect.

6.0 CONSEQUENTIAL LOSSES

6.1 By virtue of section 18 (1) loss of rent is only recoverable to the extent that it forms part of the damage to the reversion arising from lack of repair.

In Firlie Investments v. Datapoint International Limited [2000] EWHC 105 (TCC) it was stated that:

“If the landlord would not have been able to re-let the premises even if yielded up in repair or if, as here, the hypothetical purchaser would not have attempted to re-let until after the premises had been refurbished, no rental loss will have been caused by the breach of the repairing covenant unless the extent of the survival items [i.e. those repair works which would not be negated by the refurbishment] was such that, had they been done, the period reasonably required to carry out the refurbishment would have been reduced.”

6.2 The loss of rent exercise is not a diminution in value exercise, but is a head of claim where the section 18 cap does not apply. Why stop there? Other potential losses include such matters as service charge, insurance and financing costs, which are not always claimed when they might be.



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Such losses are listed in paragraph 7.12.1 of the RICS Guidance Note 'Dilapidations' (5th Edition), and are the type of losses reflected in 'development' appraisals, and are equally applicable to 'repair' appraisals.

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7.0 CONCLUSION

From a valuer's point of view the overriding principal is to do what the market does. The problem is that some dilapidations valuations involve the valuer undertaking a valuation which would not materialise in the market place and for which therefore there is no evidence, or at least none which is comparable or reliable.

That in turn has led some to misjudge or omit the risks, uncertainty and skills involved with schemes involving significant repair; such factors should be considered and included where appropriate.

Conversely, it is also evident that some landlords equate the level of marketability which may be produced by rectifying dilapidations, with the level of marketability required to produce the best economic return which may be available. That is not necessarily the case.