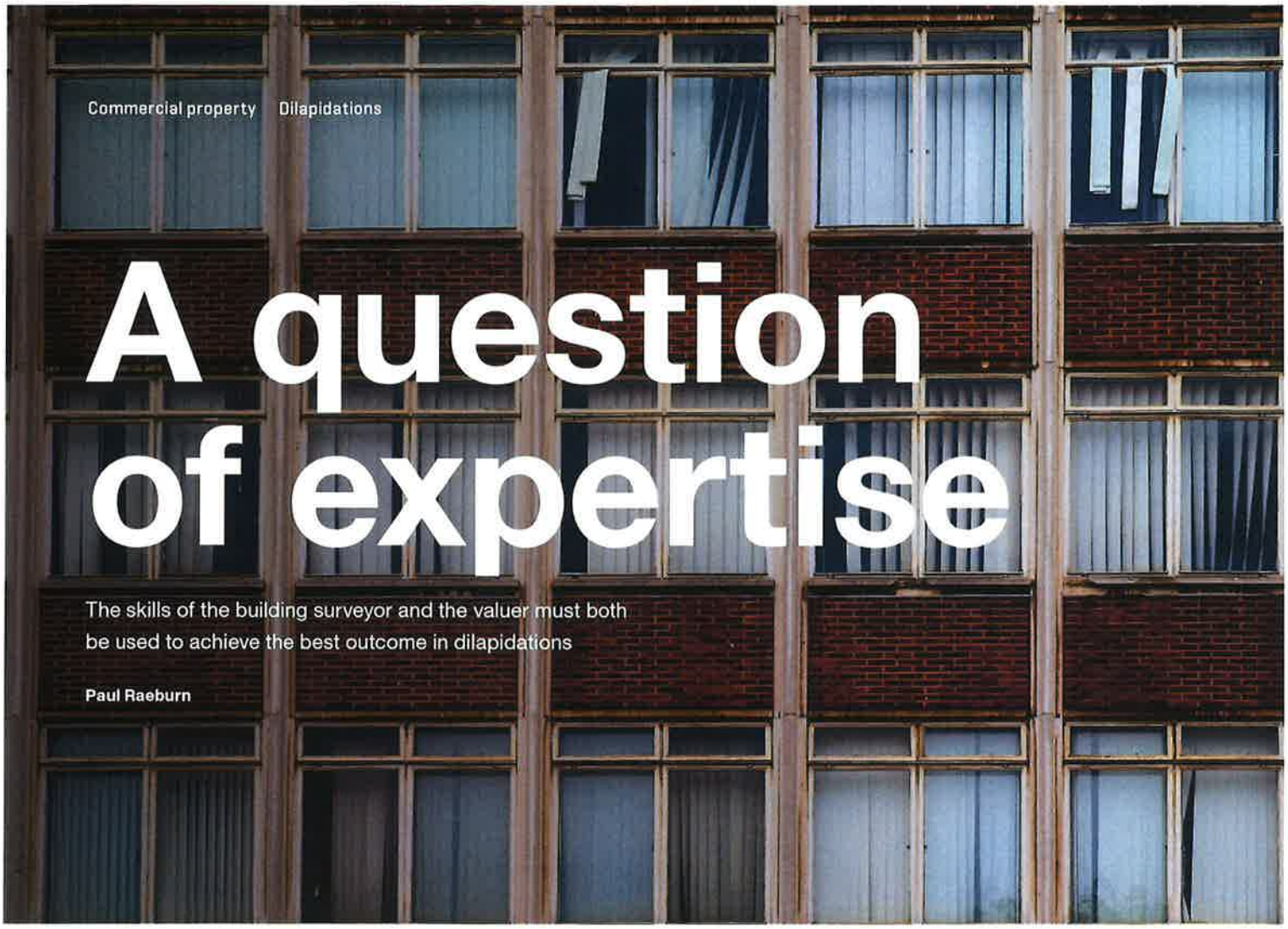

Commercial property Dilapidations

A question of expertise

The skills of the building surveyor and the valuer must both be used to achieve the best outcome in dilapidations

Paul Raeburn

All occupiers and owners of leased commercial and leisure properties will encounter dilapidations claims. In fact, the frequency of such claims is increasing as lease lengths have shortened and break clauses become common.

Laws in most jurisdictions around the UK and Ireland cap damages in dilapidations claims to the lower of the cost of remedial works or to the impact, if any, on the property's value (see box, opposite). Effective resolution of dilapidations claims therefore requires two distinct chartered surveying disciplines: first, the chartered building surveyor, who identifies breaches and prices their remedies; then, the chartered valuation surveyor, who assesses the impact on the property's reversionary value, which is often far less than the price of the remedy and sometimes zero.

For those unfamiliar with the process, dilapidations claims usually commence with a schedule being served by solicitors for the landlord on the tenant. This is prepared by the building surveyor, and identifies breaches of covenants to repair, decorate and reinstate alterations, along with priced remedies. The total, plus fees and consequential losses such as rent, rates and insurance, is the amount of damages claimed. The tenant appoints their own building surveyor to negotiate.

More often than not, a settlement on a cost of works basis is successfully negotiated. Fewer than one per cent of cases go to litigation, with those that cannot be agreed usually resolved through a mediation approach. The diminution in value (DV) defence that applies under various statutes and in common law around the UK and Ireland is, when used, invariably successful in reducing settlement figures for tenants. This is often mistakenly excluded, though, as the judgement is left to a building surveyor who, understandably, has limited knowledge of the open-market valuation factors in play.

The law has long since recognised that damages should compensate for the true loss by restoring properties to the condition in which they would otherwise have been; we are familiar with this in the context of insurance claims, for example. There is therefore no set rule that damages for a breached covenant to repair must be quantified at the cost of the remedial works. Instead, the consideration is what loss the landlord has truly suffered. Not every item of repair costed equates to the same amount lost in market value.

While the training and discipline of chartered building surveyors enables them to identify breaches and to price remedies to these, it is the chartered valuation surveyor, or valuer, who is in turn qualified to assess whether and to what extent those breaches have an impact on the property's open-market value.

Cost and value are not one and the same thing, though. For most tatty second-hand properties, a point is reached in objectively targeted remedial expenditure beyond which spending can continue without adding anything to value; the law of diminishing returns applies.

Preparing diminution valuations is, in theory, simple, subtracting from valuation A – representing the property in its covenanted state, in repair – valuation B, that of the property in its actual state of disrepair. Valuation A is fairly straightforward to derive, as there is usually ready access to comparable transactions involving full repairing leases, assumed to be in good repair. Preparing valuation B could be argued to be near impossible, however, as it would require contemporaneous transactional evidence involving similar properties with all but precisely the same breaches to repair, decoration and reinstatement.

What has thus evolved in practice is that valuation A is prepared and then, absent true comparables in the actual condition, valuation B is determined by deducting the cost of works, plus consequential losses such as rent, rates, funding costs and so on. It will therefore be appreciated that, rather than finding the diminution in value, if any, this exercise only determines a valuation B. The valuations are therefore effectively superfluous, when it is the aggregate of the deductions from valuation A that is the amount by which the property's value has been diminished.

Effective resolution of dilapidations claims requires two distinct chartered surveying disciplines

The skill of the valuer is therefore required to assess objectively the components that aggregate to the deduction from valuation A. To do so effectively, the valuer employs their open-market transacting experience and local research to assess what the most likely hypothetical purchaser would do with and to the property; this determines which works are likely to remain in place to affect value.

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 that would likely be overridden, or removed, by works required to bring the property up to the best requirements of the modern open market. Examples range from decorating floors above a high-street shop that are likely to be converted to residential use, to repairs and decorations inside dated offices that in fact require gutting and upgrading to offer any chance of reletting.

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

A common example is repairing moderately dented cladding panels of a 40-year-old industrial or warehouse building and painting its steels and floor. Although such breaches may well affect the lettability and value of the modern equivalent, where the likely tenant reasonably expects these to be at or about new condition, a far lower expectation applies to the older building. This is also the case for a claim requiring a vacated shop to be reinstated to its original shell, when in practice the most likely occupier might be a temporary trader requiring a turn-key unit. The standard of repair commonly described both judicially and by valuers as being required in the open market is that which fits with the age, character and locality of the property in question.

Consequential losses of rent, void rates and so on comprise a distinct head of claim. It therefore 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 handed back in repair – then no loss of rent will be recoverable.

While this situation might appear biased towards the tenant, there are in fact often cases in which landlords require DVs – not least to rebut a seemingly opportunistic DV from a tenant. Under the Dilapidations Protocol 9.4, which applies in England and Wales, a landlord carrying out few works must also establish loss with use of a DV (*bit.ly/DilapsPro*). In other jurisdictions, a DV similarly helps substantiate a claim where works are not being done.

Tenant and landlord need both building surveyor's and valuer's input to be sure that dilapidations cases are not over- or under-settled. Neither has sufficient knowledge of the other's expertise to make dispensing with one a sensible economy.

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Asset management, Valuation
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Jurisdictional distinctions

In England and Wales, the cap on damages for disrepair was codified in section 18(1) of the Landlord and Tenant Act 1927. Similar principles apply at common law to cap breaches of clauses for redecorating and reinstating tenants' alterations.

On the Isle of Man, this is repeated all but verbatim in section 12 (1) of the Conveyancing (Leases and Tenancies) Act 1954, as it is likewise in Ireland by way of section 65 of the Landlord & Tenant (Amendment) Act 1990.

In Scotland, however, there is no such statutory cap, but common law and RICS guidance notes have evolved to provide an alternative measure of loss by way of DV in some cases. In Northern Ireland meanwhile, there is no cap, either statutorily or at common law.