

Dilapidations On The Rise

James McAllister, Director of The Dilapidations Consultancy, discusses the trends that have fuelled the recent increase in Dilapidation Claims in commercial leasehold property.

Dilapidations is a fact of life in commercial leasehold property. As an area of Landlord & Tenant law, dilapidations, as a concept, has been around for hundreds of years allowing the courts to put to test everything from the meaning of repair to valuing the impact of disrepair, and an awful lot in between. In recent years, the volume of dilapidation claims has been on the increase, but so too have the efforts of those professionals who deal with them in promoting transparency and fairness; the objective being to reduce the number of claims proceeding to litigation and eliminate fraudulent abuse of the process.

The current economic environment is, of course, a major contributor to the recent uptake in claims, but the trend has been shifting for much longer than this, as landlords have seen it as an end-of-lease 'bonus' and tenants have become more savvy about curtailing their otherwise open-ended liabilities.

Over the last few decades, the length of commercial leases has diminished. The traditional 'institutional' 25 year leases, without an option to break mid-term, are all but gone. These leases have been superseded with 3-10 year terms, usually with an early option to terminate by way of a break clause. This, of course, is at the behest of nervous tenants who don't want to over-commit when the longevity of their business cannot be guaranteed. It also works for those few tenants in the fortunate position of anticipated expansion and not wishing to be saddled with a property they will soon outgrow. The frequency of dilapidation claims has therefore increased against the general backdrop of falling lease terms and the prevalence of break clauses giving tenants an early opt-out.

However, the economic downturn over the last few years has become a more significant catalyst for the volume of dilapidation claims in circulation. Struggling tenants who had the foresight to sign a lease with a break clause are opting to use this lifeline now more than ever. This is much to the detriment of the landlord who perhaps had naively assumed a consistent income stream over the full term. Those impecunious tenants without the luxury of a 'get out of jail' card only have the option of proposing a surrender, which will invariably be at the mercy of the landlord's terms. If the tenant is viewed as a strong covenant, then few landlords in the current climate will be agreeable to a surrender unless the deal on the table is too attractive to refuse, and where there is another suitable candidate waiting in the wings. On the other hand, landlords are faced with a more awkward decision when a tenant they see as a 'man of straw' neither has the funds to table a persuasive surrender proposal, nor the means to continue paying rent to the end of the lease term. If they disappear, the landlord will be left to do some wound licking as a dilapidations claim will be a futile exercise.

Break clauses, of course, do not come without warning. Several dilapidation claims arising out of the tenant's formal request to break from the lease have been put before the courts, where the successful operation of the break clause is subject to certain conditions, and where those conditions, in the eyes of the landlord (and his eager lawyers) have not been met. As such, tenants who labour under the belief that a quick lick of paint to the premises will suffice may be in for an unpleasant surprise when they learn of the conditionality of their break clause and the material nature of their outstanding covenant breaches. Failure to comply may mean the lease remains extant, an expensive mistake if the tenant has already signed a lease on new premises. Accordingly, 'conditionality' and 'materiality' have been the source of much debate before the courts, and as always, the precise wording of the lease in each case is central to the tenant being able to escape unscathed: *Fitzroy House Epworth Street (No. 1) Ltd v The Financial Times Ltd* [2006].¹

¹ [2006] EWCA Civ 329; [2006] 1 W.L.R. 2207; [2006] 2 All E.R. 776.

The above has considered Terminal Schedules of Dilapidations, which are prepared towards the end of the lease term, or where a break clause is being operated. This would also be applicable where the tenant is looking to surrender the lease, although a 'Dilapidations Assessment' is the usual tool to facilitate negotiations. In terminal dilapidation claims, the landlord's primary prerogative is to obtain a monetary settlement from the tenant as damages or await the tenant's yielding up of the premises in full compliance with their obligations under the lease. Any damages claim is, of course, subject to limitations, both at common law and under statute.

The common law assessment for damages is essentially the cost of undertaking the works: *Jones v Herxheimer* [1950].² However, few landlords reunited with their empty premises will wish, or have the means, to forward-fund the works they allege the outgoing tenant should have performed simply in order to substantiate their loss towards a successful claim in damages. So the usual outcome is that the landlord awaits the cheque from the defaulting tenant and then sets about implementing the works. More often than not, the landlord will bank the cheque and then place considerable pressure on his lettings agent to market the premises in its un-repaired state. The loss will inevitably be sustained further down the line, either by way of a reduced sale price or rental reduction, or other such inducements necessary to attract a would-be tenant to take a property in less than perfect condition. Notwithstanding this, few commercial landlords would presently pass up the option to have the flexibility and comfort of certain liquidity, leaving any concerns over the implementation of the repairs to another day.

Whilst the principles of damages are well established in that the landlord cannot recover what he has not lost, Section 18(1) of the 1927 Landlord and Tenant Act also states that the landlord cannot recover more than the amount by which the value of the property has been diminished by virtue of the repairs. This essentially places a ceiling on the value of any claim for damages pertaining to breach of the repair covenant. The second part of this section also states that if the landlord is to demolish, or substantially alter the building at or shortly after lease expiry, no damages shall be recoverable for those repairs 'rendered valueless'. The most common instance where this applies is when landlords seek to extend the remit of the 'dilapidation works' to include general enhancements to their property, often obviating the need for certain repairs claimed against the tenant nonetheless. This part of the Act affords tenants some protection by precluding any claim for those repairs now superseded by the landlord's wider proposals. Clearly, knowledge is power, so without incontrovertible evidence as to the landlord's intentions, a tenant claiming relief on this basis will be hard pressed to build a case.

In light of the economic downturn, landlords are also looking to simply protect their investment and force the tenant to observe their repairing obligations during the lease term, rather than wait to expiry to claim damages. This is particularly important where the tenant is indeed a man of straw and the landlord would rather they attend to the roof leak and the rotten window frames now than risk being left with the problem should the tenant fold. As such, Interim Schedules of Dilapidations are also more common now than ever, and landlords are increasingly making full use of the self-help provision commonly found in modern leases. This is often cited as a '*Jervis v Harris*' clause after the celebrated 1996 case,³ which gives landlords a seemingly cast iron fallback position should the tenant fail to adhere to the landlord's Repairs Notice. Usually served by the landlord's solicitor, and giving the tenant a strict timeframe for compliance (as stated in the lease), the onus is then firmly placed on the tenant to deal with the repairs within the stated timescale, or risk the landlord re-entering with his own contractors before sending the tenant the bill. The bad news for tenants is that this is charged as a debt rather than damages and can therefore be recovered as rental arrears. However, landlords (and their legal advisors) need to exercise caution, taking care to observe the specific terms of the lease and avoiding claims for non-repair items, or indeed requesting certain works that would be detrimental to the tenant's business: *Hammersmith & Fulham London Borough Council v Creska Ltd (No. 2)* [2000].⁴ This may involve the costly pursuit of an injunction for access and a potential counter-claim for breach of the 'quiet enjoyment' clause.

² [1950] 2 K.B. 106; [1950] 1 All E.R. 323.

³ [1996] Ch. 195; [1996] 2 W.L.R. 220; [1996] 1 All E.R. 303.

⁴ [2000] L. & T.R. 288.

Surveyors practicing in the preparation and negotiation of terminal dilapidations claims are now encouraged to abide by the Property Litigation Association's 'Dilapidations Protocol' (or to give it its full name: 'Pre-Action Protocol for Claims for Damages in relation to the Physical State of Commercial Property at the Termination of a Tenancy'). Whilst not mandatory, it would be unwise to stray from 'best practice' since compliance with this protocol is likely to be considered should a claim be litigated given that its principle objective is to promote transparency and efficiency in settling claims, thereby keeping them out of the courts.

Introduced in 2002, and now in its third edition, the *Dilapidations Protocol* has succeeded to some extent in reducing the number of exaggerated damages claims in dilapidations, however, those surveyors who 'dabble' in this complex area of property law often fail to grasp the primary purpose of a Schedule of Dilapidations, and what can and what can't be claimed. Accordingly, many inflated schedules and unsubstantiated claims remain in general circulation, perhaps seen by the ill-informed landlord as a sure-fire way of squeezing every last penny out of an already desperate tenant.

As landlords have become more aggressive in pursuing tenants, be it mid-term or at expiry, tenants have become equally robust in defending their position, or appointing a specialist dilapidations consultant to do so on their behalf. Those savvy tenants, who have usually had their fingers burnt in the past, are only too aware of the potential financial ramifications of shirking their obligations; so they will either comply or build a good case to defend their position. Those taking on premises in far from perfect condition will seek to mitigate the magnitude of any future claim by putting measures in place before the lease is even signed. This includes careful drafting of the repair, decoration and reinstatement clauses, and where the landlord is agreeable, engrossing a detailed Schedule of Condition (with photographs) to use as an evidential benchmark for the pre-existing condition. This must be referenced in the repair clause of the lease and is therefore pivotal to the standard of repair expected of the tenant going forward. Tenants who believe that their own collection of photos taken when they first occupied will serve the same purpose may be sorely disappointed. If the photographs, and any supporting text, are not referenced in the lease, it may be of little assistance in later defending their position.

In summary, the recent economic conditions have conspired to increase the frequency of dilapidation claims, but also polarise the respective positions of landlord and tenant as each becomes increasingly truculent in defending their stance, and indeed their business. After all, there can be a lot at stake. Dilapidations will continue unabated all the time tenants sign leases with a repairing obligation and then fail to do what is required of them. And disputes will continue all the time landlords choose to exaggerate claims seeking to recover more than they are entitled to. The key to keeping such disputes away from costly litigation is simply to appoint the right consultants to deal with the matter early on; that way, fairness and reasonableness might just prevail.

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