Dilapidations: Section 18(1) and a Landlord's Subsequent Works

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A commonly-encountered consideration in dilapidations cases is the extent to which the work a landlord (L) actually carries out to a property after the expiry of a tenant's (T's) lease impacts upon the damages L may recover for T's failures to comply with its repairing covenants.

The "Second Limb" of s.18(1) of the Landlord and Tenant Act 1927 provides that no damages are recoverable for breach of repairing covenants, *"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."*

So, in a simple case, the evidence will show that L had a firm intention, prior to lease expiry, to undertake certain works to the premises at or shortly after the lease expiry that would supersede the repair works which T was obliged, but failed, to carry out. For example, T may have had an obligation to leave the floors of the premises in good repair, but L, come what may, intended to strip out and replace the floors in order to upgrade the IT infrastructure beneath them. In such a case (and assuming that the floor works amount to "structural alterations"), the Second Limb prevents L recovering damages for T's breach of covenant.

In other cases the works that L carries out are dictated by the condition in which T leaves the premises. In such cases, the Second Limb will not operate. Considering the Australian equivalent of s.18(1)'s Second Limb, Latham CJ said in *Graham v The Markets Hotel Pty Ltd* (1943) 67 CLR 567:

> *"These words, in my opinion, are intended to cover a case where, even if the covenant had been fully observed, the premises would have been pulled down or structural alterations would have been made which would have rendered the repairs valueless. That is to say, the words 'in whatever state of repair they might be' mean 'irrespectively of the state of repair in which the premises might be'."*

Consider the following example: at the expiry of a 10 year lease of the ground floor of a block of offices, T delivers up the premises out of repair, in admitted breach of its repairing covenants. This floor could be converted to another use, namely a shop. Had the repairing covenants been complied with, this conversion (which, it is assumed, would have superseded *all* of the repairs) would not have been economically viable for L, and L would have re-let the premises with no further works. Out of repair, however, the shop conversion is the most economically viable option, and this is what L does.

For the reasons given above, the Second Limb does not prevent L recovering damages on these facts, and one (the "traditional") starting point in the analysis of what L is entitled to recover in damages is the amount that it would have cost to put the ground floor in "repair" – i.e. into the condition in which T could have left the property in compliance with its repairing covenants. This assessment should also take into account lost rent and service charges, professional fees etc., and possibly a discount for betterment.

It may today be too simplistic to refer to this amount as the "common law" measure of damages, or *prima facie* entitlement to damages, in light of suggestions in *Latimer v Carney* [2006] 50 EG 86 that, following *Ruxley Electronics v Forsyth* [1996] AC 344, the true common-law measure is diminution in value of L's reversion. See also the discussion in *PGF II SA v Royal & Sun Alliance* [2010] EWHC 1459. In light of the "First Limb" of s.18(1), the correct approach to the "common law" measure is likely to be unimportant in practice; the First Limb of s.18(1) either acts as a "cap" on common law damages, or now mirrors the common law position. Nevertheless, the language of a "cap" remains.

The s.18(1) "First Limb cap" provides that damages for breaches of repairing covenants, *"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."* The required exercise is as explained by Luxmoore J in *Hanson v Newman* [1934] Ch 298; *"you take the value of the reversion as it is with the breach… and you take it as it would be if there were no breach. And you provide that the amount of damage shall not exceed the amount by which the value of the property repaired exceeds the value of the property unrepaired."*

These competing valuations are carried out by considering what a "hypothetical purchaser" would be willing to pay for the property in and out of repair at the date of the expiry of the lease in a commercial, arm's-length transaction. That, in turn, requires a consideration of the plans which a hypothetical purchaser might have for the premises. Of course, there is no reason why L's plans should necessarily align with those of a hypothetical purchaser in the market at the valuation date. In a commercial setting as here, however, L's plans are likely to be persuasive evidence of what a hypothetical purchaser would do. As Arden LJ said in *Latimer* at [30]:

> *"[O]n general principle (…) subsequent events can be taken into account if they relate to the basis of valuation and thus throw light upon it. Such events would include refurbishment or sale of the premises after the term date."*

For simplicity, it is assumed that there are only two possible plans for the ground floor (let it out as an office, or convert it to a shop), and that the valuation evidence shows as follows:

(1) In repair, the level and immediacy of the rental income for the ground floor is such that the hypothetical purchaser would not consider shop-conversion economically viable, and would bid on the basis of letting the property as soon as possible in its "in repair" condition.

(2) Out of repair, the hypothetical purchaser weighs up three options: (i) convert the property into a shop before letting it; (ii) put the property into repair before letting it; and (iii) let the property immediately in its "out of repair" condition. The valuation evidence is that the hypothetical purchaser reaches the same conclusion as L - taking into account all relevant inputs, including the eventual rental yields, investment required and rental voids occasioned by the repair or conversion works; (i) is a more valuable prospect than (ii), which is in turn a more valuable prospect than (iii).

At the risk of oversimplification (ignoring, for example; void periods, holding costs, the impact of VAT, deferment of income, etc.), the following figures might assist in illustrating the competing scenarios. Again for simplicity, a 10% yield is assumed throughout.

(1) *In repair*, the ERV is £10,000. With a 10% yield, the valuation of the property is **£100,000**.

(2) *Out of repair*, three possibilities fall to be considered:

    i. <u>Convert to a shop</u>: Assume that this will lead to an enhanced ERV of £12,000, with the cost of works £25,000. In that case, the valuation of the property is **£95,000**.

    ii. <u>Put offices back in repair</u>: Assuming no betterment, the ERV remains at £10,000. Assume the cost of works is £15,000. In that case, the valuation of the property is **£85,000**.

    iii. <u>Let as offices out of repair</u>: Out of repair, the ERV is lower - say £8,000. There are no repair costs. In that case, the valuation of the property is **£80,000**.

As the shop-conversion is not economically viable in the "in repair" scenario, the present example is not a case where the only value of the property is in its "latent development value" (i.e. where the only economically viable option would render any and all repairs futile - see, e.g., *Firle Investments Limited v Datapoint International Limited* [2000] EWHC 105 (TCC)). In such a "latent development value" case, the hypothetical purchaser would be indifferent about the level of repair and the First Limb would bar recovery. (In yet other cases, it may be that the hypothetical purchaser would undertake *partial* refurbishment in any event. In such cases, arguments focus on the extent to which the repairs T should have carried out would survive refurbishment, and thereby affect the hypothetical purchaser's bids for the property in and out of repair. The present example is quite different; the options are full refurbishment or nothing.)

Instead, adopting the above figures, L's claim should be "capped" at £5,000 – this being the difference between the £100,000 "in repair" value and the £95,000 "out of repair" value, based on shop-conversion – which is what the rational hypothetical purchaser would do. This £5,000 recovery is lower than the "cost of repairs" T was obliged to carry out (£15,000 in this example).

More generally, the following considerations should be borne in mind:

(1) Where L carries out the repair works which it alleges T ought to have carried out, the court may infer the amount by which the reversion has diminished in value as a result of disrepair from the amount it cost to remedy the defects (as, if L was reasonable, it would not otherwise undertake the works): *Jones v Herxheimer* [1950] 2 K.B. 106. By reason of the shop-conversion, no such inference is available. Greater reliance on expert valuation evidence will be required.

(2) Adjusting the above figures would of course lead to differing results, and many of the inputs are likely to be the subject of disagreement between experts. If the value of the property "in repair" as opposed to a "shop-conversion prospect" is marginal, the First Limb will prevent all but nominal damages. If the value of the property "put in repair and let as offices" as opposed to a "shop-conversion prospect" is marginal, than the First Limb will have a negligible effect.

(3) If L had carried out the works which T ought to have carried out, the cost of these works may have provided some cogent evidence of quantum. Costs actually incurred following a commercial tender process, for example, may carry greater weight than cost estimates produced by expert quantity surveyors in the abstract.

(4) The relevance of detailed evidence of the cost of repairs might be questioned in a case like this, however. Indeed, some cases may benefit in their preparation and presentation from a consideration of the valuation evidence *first*. The "traditional" approach of arguing, first, about the exact cost of the repairs and then, second, about whether the First Limb "cap" operates may not be suited to all cases and may generate unnecessary expense, delay and complexity. The same observation may also apply in relation to arguments about the *standard* of repair T was required to meet.

(5) Finally, in the event that L decides to press ahead with the shop conversion before bringing a claim against T, it will be important for L and its advisers to ensure that a comprehensive schedule of condition at lease expiry is produced before work commences.

In summary, where the works L undertakes at lease expiry were genuinely occasioned by the condition in which T left the property, and would not have been undertaken had the property been left "in repair", the Second Limb will not operate, and damages are in theory recoverable. It is likely, especially in a commercial context, that L's works will be probative of what a hypothetical purchaser would have done, and will likely impact on the First Limb valuations. Where, if the property was left out of repair, a hypothetical purchaser, like L, would undertake substantial refurbishment, the First Limb (as well as, perhaps, common law principles) will limit recoverable damages to something less than the costs of repair (and ancillary costs). This limit may even be such as to render the actual cost of repairs of secondary importance.

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