Method that can fall short

Dilapidations In the final part of the series, *Keith Firn* and *Patrick Stell* consider the diminution in value approach to claims and warn that surveyors should not be overly formulaic

Surveyors acting on dilapidations cases are expected to appraise the possible damages arising from the tenant's alleged breaches of the lease, having regard to the common law principles of loss. During this process, surveyors must also consider the statutory cap on the level of recoverable damages imposed by section 18(1) of the Landlord and Tenant Act 1927. This is a stated requirement of the Property Litigation Association's Dilapidations Protocol and the latest draft RICS guidance note.

Section 18(1) is split into two limbs. These cap the damages that a landlord can legitimately claim at lease end. The first is summarised as follows:

> Damages for a breach of a covenant or agreement to keep or put premises in repair... shall in no case exceed the amount (if any) by which the value of the reversion... in the premises is diminished owing to the breach...

The method and manner of application of the first limb has been a point of debate and confusion for almost 80 years following the enactment of the original legislation. The confusion has given rise to some widespread practices among dilapidations surveyors that the courts have held to be ill considered, incomplete or irrelevant.

Section 18(1) and diminution valuations are probably the most misunderstood and feared area of dilapidations for surveyors. To address the confusion, an analysis of the history and the key principles of diminution valuation is required.

Parliament's intention

From around the 1850s, dilapidations common law developed in a way that generally favoured the cost of the works as being the measure of contractual damages. The courts stopped short of declaring this measure an absolute rule, having initially expressed that they were minded to do so.

By the 1920s, this preference was beginning to go into decline, owing in part to the courts' view that some landlord claims were verging on blatant exploitation.

By incorporating section 18(1), parliament sought to curtail this abuse of position. In the words of Major Owen MP, who spoke in the House of Commons during the passing of the bill, a landlord's claim for dilapidations would be "restricted to the actual loss" suffered. Section 18(1) can be viewed in its historical context as a well-meaning and fair-minded attempt to create a more equitable system of governing relations between commercial landlords and tenants. The subsequent effect upon dilapidations claims has been significant.

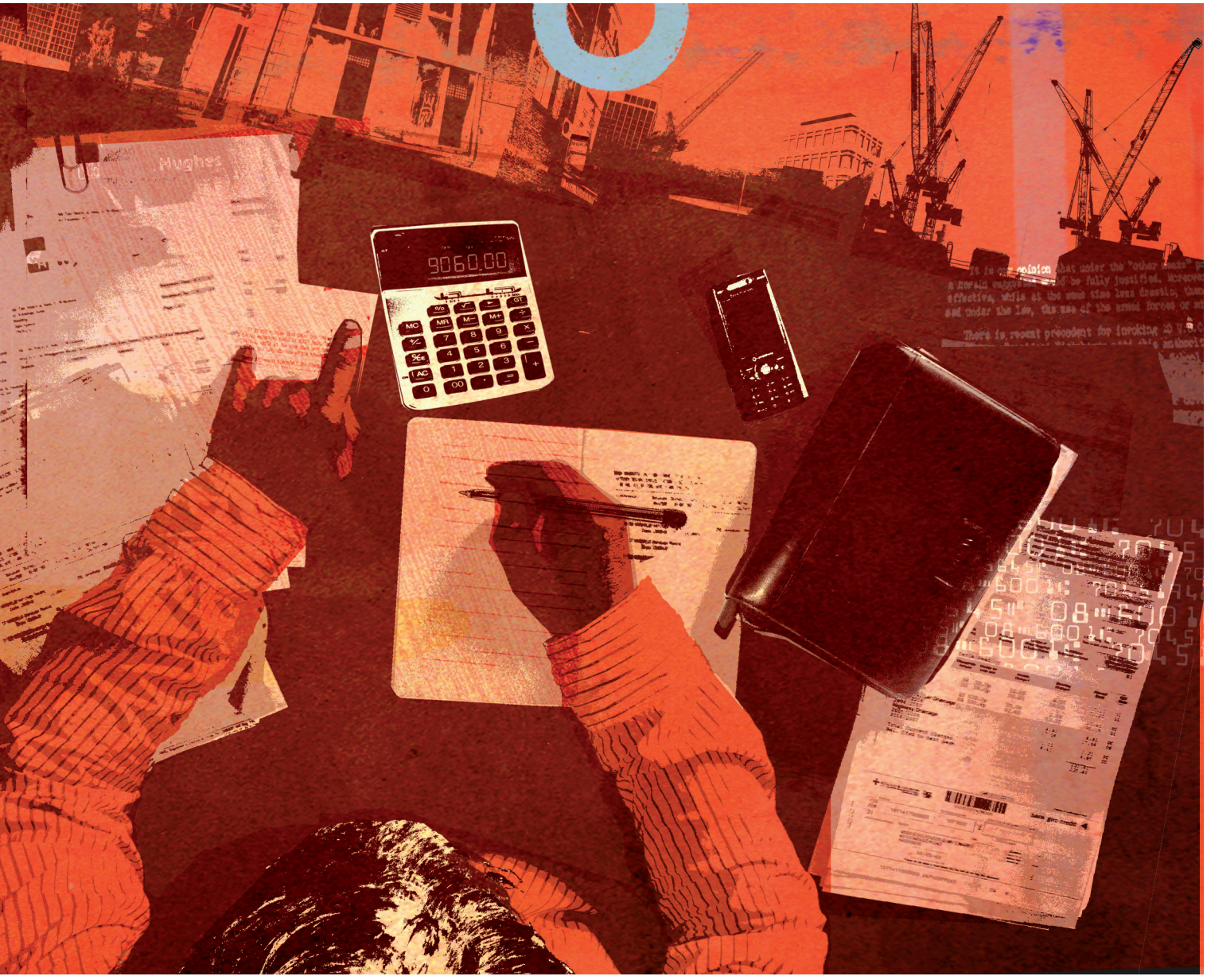
Value of the reversion

Numerous judgments have commented on the meaning of the word "reversion" and its relevance to property valuations and lease-end dilapidations. The Leasehold Advisory Service has provided a succinct definition:

> A Landlord's interest comprises, basically, the right to receive the rent and the right to have the property back at the end of the lease (this is known as the reversion, because the property reverts to the Landlord's ownership).

The term "reversionary value" is generally accepted as being the value of the interest that the landlord would receive at the end of the lease if it were to sell its interest on the open market. It is the net (residual) sum after deducting all costs and fees, assuming the existence of a willing and reasonable hypothetical purchaser.

The process of valuing the extent by which the reversionary value has been diminished following a breach is known as a diminution valuation. Valuation surveyors who deal with dilapidations will argue that valuation is not an exact science but an art. Valuers often face a lack of relevant evidence and must therefore rely upon their professional judgment, mixed with instinct based upon experience and knowledge of the market. Valuers' opinions may also be influenced – or tempered – by a building surveyor's technical consideration and opinions.



In an ideal world, the key influencing factors for a dilapidations valuer will be similar local and recent transactions that have completed. Commonly though, close comparisons are impossible and so-called "comparable evidence" is merely a guide and should not be deemed to be definitive.

Since no two properties are identical and diminution valuations are rarely straightforward, it is not surprising that surveyors, lawyers and the courts have sought a standardised process that can be adopted in the majority of lease claims.

In recent years, dilapidations surveyors have often adopted the diminution valuation approach appended to *Shortland Investments Ltd* v *Cargill plc* [1995] 08 EG 163. The *Shortlands* approach of appraising the value of the diminution of the reversionary interest relies upon the preparation of two valuations. It is a clear process and dilapidations surveyors and lawyers should be familiar with the ruling.

This method of appraisal requires an initial valuation (valuation A) to assess the open market value of the property at lease end with no breaches of the lease. A second valuation (valuation B) seeks to appraise the value of the property in the open market with allowances being made for tenant's breaches that would survive a hypothetical purchaser's future intentions for the property. The minimum difference between valuation A and valuation B is said to be the "diminution in value" of the reversion attributable to the tenant's breaches.

In theory, this seems straightforward. In reality, valuation issues on commercial property are often difficult to assess and surveyors seeking to adopt the *Shortlands* approach need to understand the risks

involved. This apparent lack of detailed comprehension frequently leads to dilapidations surveyors, valuers and lawyers adopting overly formulaic and inflexible or irrelevant valuation positions on some claims.

Weaknesses with the *Shortlands* approach

- The calculation used in the approach considers the issue from the hypothetical purchaser's viewpoint rather than that of the known vendor (the landlord/claimant).

The valuations start with an estimate of the capital value for the property based upon local market rents and yields. They then make assumptions on the deductions that the hypothetical purchaser would conceivably make for: acquisition expenses; refurbishment works and fees; surviving dilapidations (in valuation B); professional project-related fees; holding costs; and post-works marketing and reletting costs and fees.

The resulting valuation figure (the purchaser's offer figure) is often claimed to represent the reversionary value for the specific valuation scenario under consideration. However, that figure does not accurately represent the vendor's net reversionary value for the property.

The standard *Shortlands* valuation approach does not consider all the unavoidable costs and deductions that would be incurred by the vendor. These include: marketing costs; agent and solicitor costs; and tax implications, such as corporation tax or capital gains tax liabilities. Vendor costs and deductions can have a significant and material bearing on the valuation and should not be omitted if the net reversionary value is to be properly appraised.

- It is often asserted that the only information that changes between valuations A and B in a *Shortlands*-style valuation is that relating to the cost of the "surviving" dilapidations works (normally £0 in valuation A and the value of the parts of the dilapidations claim that "survive" supersession review in valuation B). However, does this approach stand up to close scrutiny?

The combined cost of the refurbishment works and the surviving works in valuation B may mean that the works are more complex. They may require or necessitate the involvement of more specialist consultants or statutory consent(s) than would be the case if simpler refurbishment works were to be undertaken in isolation, as allowed for in valuation A. Higher fees and costs will clearly have an effect upon the valuation calculation.

The overly hypothetical nature of the *Shortlands*-style calculation is potentially dangerous. The risk is further highlighted in the not improbable circumstances where

the works might influence the reasonable hypothetical purchaser's consideration to acquire the property. Marginally different market rents and/or investment yields may result between the two valuations.

Moreover, the increased value of the total valuation B works and the potentially longer project duration of such works may influence the terms, costs and availability of project funding. This in turn will invariably affect the hypothetical purchaser's allowances and deductions.

The different circumstances of the two valuation scenarios can affect more than the works value. Thus, each separate valuation should be carefully appraised from first principles and the various aspects should be impartially assessed.

- In *Simmons* v *Dresden* [2004] EWHC 993; 97 Con LR 81, HH Judge Richard Seymour QC stated that the *Shortlands* approach:

> was based upon the assumption that a purchaser of a building in disrepair will either incur expenditure in dealing with the disrepair, or, if he accepts the building in the condition in which it in fact is, will modify the price that he is prepared to pay to reflect the fact that the building is out of repair.

The judge highlighted that the "critical weakness" of the *Shortlands* method was that the calculation was based upon:
(i) an assumption of diminution; and
(ii) "the calculation is not designed to test whether there has actually been a diminution in the value of the reversion, but on the assumption that there has been, to calculate what it was". In other words, the routine adoption of the *Shortlands* approach often puts the cart before the horse.

- Surveyors often contend that the *Shortlands* approach quantifies the "true loss", although the common law principles of loss support this assertion only in limited circumstances.

Although the diminution valuations may identify a section 18(1) cap to repair related elements of the claim (including "decorative repair"), the cap may not necessarily apply to the entire claim. This aspect still depends upon whether the landlord's claim includes any non-repair-related breaches and damages. Surveyors must not forget separately and correctly to "apply" the diminution cap to the claim once it has been appraised.

Valuation issues on commercial property are often difficult to assess and surveyors seeking to use the *Shortlands* approach need to understand the risks involved

Is a formal valuation always required?

The consultation draft of the RICS *Dilapidations Guidance Note* (5th ed) places significant emphasis upon the need for the preparation of a formal diminution valuation at lease end. The judge in *Latimer* v *Carney* [2006] EWCA Civ 1417; [2006] 50 EG 86, however, restated the common law position that:

> this court (the Court of Appeal) in *Jones* v *Herxheimer* did not consider that it was necessary for there to be formal valuations done by experts in every case, and in addition expressly envisaged that the judge might not accept the evidence of an expert valuer and thus by implication reach a valuation on some other basis.

In circumstances where the landlord does not intend to undertake remedial works and when commencing the preparation of diminution valuations, surveyors must first consider whether there is evidence of any damage to the reversionary value that warrants the production of a set of valuations.

Specific to its circumstances

Where there are reasonable and proportionate grounds for preparing formal diminution valuations, due care and diligence must be taken to determine the damage to the vendor's reversion.

In some cases, inadequately considered diminution valuations may lead to the collapse of the damages claim or defence positions, with significant cost implications for the losing party.

Formulaic spreadsheet-based valuation approaches can be a suitable starting point and provide a useful partial checklist of valuation considerations. However, dilapidations surveyors and valuers must remember that each valuation has to be unbiased, carefully considered, and diligently prepared if it is to be relevant to the specific property and circumstances.

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