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Terminal Dilapidations

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Introduction

In tough times, dilapidations claims become more important to both landlords and tenants. Indeed it is a "booming business" and the RICS have estimated that the value of dilaps claims in England and Wales is around £3.36 billion per annum. This guide provides an introductory overview of the subject.

What is a "terminal dilaps" claim?

A terminal dilapidations claim (colloquially known as a 'terminal dilaps' claim) is a landlord's claim against a tenant for failing to return the premises at the end of a lease in the condition required by the lease. As the claim arises after the lease has ended, it is always for damages.

Guidance for landlords and tenants before signing a lease

Dilaps claims can be very substantial and both landlord and tenant should consider the issue carefully before the lease is completed. The parties' respective rights and obligations as regards to dilapidations are an issue for negotiation like any other and the parties' ultimate positions will be affected by considerations such as the type of property, the identity of the landlord and tenant, how the premises are fitted out, the length of the lease and market conditions.

Typically landlords will look to pass as much liability to a tenant as possible. However, landlords should still consider carefully what type of obligation is appropriate e.g. internal and external versus internal-only obligations and how alterations should be dealt with.

A well-advised tenant should:

- Have the premises surveyed to identify any potential problems and the possible extent of any dilapidations liability;
- Limit their liability if possible e.g. by reference to a schedule of condition and
- Consider making accounting provision to amortise the likely liability over the life of the lease – see Financial Reporting Standard 12.

Guidance to landlords and tenants as the end of the lease approaches

Typically, if a tenant is not staying on, a landlord will serve a dilaps schedule before the lease ends setting out the work which the tenant is expected to do. Whilst a landlord is not strictly obliged to do this, it is helpful and it also ensures that the landlord serves any necessary reinstatement notices before the term date. The schedule is sometimes costed as this enables the tenant to negotiate a financial settlement before leaving.

A tenant should also seek advice on what work should be done, so it has the option to undertake any necessary work before the lease expires. Doing this may avoid a claim altogether or at least mitigate the cost of the works and any consequential claims e.g. for loss of rent.

What is the tenant liable for?

This will depend on the obligations in the lease and there are myriad varieties of different obligations. However, typically, a tenant might be liable:

- To keep the premises 'in repair' and/or in 'good condition';
- To decorate the premises;
- To carpet the premises;
- To remove alterations and reinstate the premises to a previous condition; and
- To remove all the tenants' chattels/fittings.

A critical issue in assessing the tenant's liability will be to identify what the 'premises' is e.g. is it a whole building including the structure; is it an internal demise only; does it include structural parts of the building; does it include common parts; does it include 'M&E' such as lifts, aircon, building systems and so on.

An internal only demise (which does not include any M&E) will typically produce a relatively modest dilaps claim which is mostly centred on reinstatement of alterations and decoration. By contrast, a claim for a whole building (including external structure and M&E) can be very substantial indeed.

Common areas of dispute in relation to tenants' obligations

Arguments commonly arise over the following issues:

- Whether an item is out of 'repair'? E.g. is a lift which is very old but functioning or is a building with no DPC out of repair? The traditional answer is: no, if there is no physical damage or deterioration to the

premises. However this type of issue is rarer nowadays as modern leases usually expand tenants' obligations to cover this type of problem.

- Whether work proposed by the landlord goes beyond what is required? E.g. a roof may clearly be out of repair but the parties may disagree on whether wholesale replacement or patchwork repairs are appropriate.
- Whether a particular item e.g. air conditioning or floor screed forms part of the premises? If the relevant item is outside the premises, then the tenant will not be liable.
- Whether an item has to be repaired, removed or reinstated to a previous condition? This issue turns on a number of complicated issues such as whether the item is a "fixture" or "fitting" and whether the landlord has required reinstatement.
- Whether the tenant's obligation has been limited under the lease e.g. by reference to some earlier condition? Common problems arise here as to what the earlier condition was especially if a schedule of condition has been lost. Even where the obligation is clear, disputes can arise as to whether substantial works are still required because that is the only way to remedy the disrepair which has arisen since the grant of the lease.

What can a landlord sue for?

In theory, this is a claim for breach of contract and so a landlord can claim damages for his 'loss'. That said, there are special rules for determining 'loss' in dilaps cases which can be baffling for both clients and advisers. To simplify this, the following rules of thumb give a good practical steer to most situations:

- If a landlord reasonably does the work which the tenant should have done, his loss will be the reasonable cost of those works plus "consequentials" i.e. professional fees in monitoring the work, VAT, rates and loss of rent/service charge.
- If a landlord does not do the work (or it wasn't reasonable to do the work), his loss will be the diminution in the value of his reversion.

Common areas of dispute in relation to assessing damages

Arguments commonly arise over the following issues:

- Whether the landlord has suffered loss if he has undertaken a substantial refurbishment which 'supersedes' (in whole or part) what the tenant should have done? This 'supersession defence' is quite commonly run with tired offices that need modernisation and it can be very effective depending on the facts. The landlord may, though, be able to argue that he would not have done the refurbishment (or the relevant part of it) if the tenant had done the works required. If this is accepted, the landlord may still recover the cost of the works which the tenant should have done
- Whether the costs of the works are excessive?
- Whether the landlord has truly suffered a 'loss of rent'? Here the landlord must prove that he could have re-let the premises earlier if the tenant had done the necessary work. This can be very difficult to prove – especially in a depressed market.
- Whether the landlord can recover VAT on the works? This usually turns on whether the landlord can recover the VAT from HMRC. If yes, this is not also recoverable from the tenant.
- Whether the landlord has suffered any loss at all if the value of the premises has fallen for other reasons e.g. the recession?

The procedure for dilapidations claims and the 'Dilaps Protocol'

Most dilaps claims are negotiated between surveyors and settle without the involvement of lawyers. That is not to say that the negotiation process always runs smoothly. In fact, it is not uncommon for negotiations to become protracted and drag on for years after the lease ends. Equally the Courts have been critical of claims going to trial due to one or other side being unrealistic. In the infamous Business Environment Bow Lane Ltd v Deanwater Estates (2003) case, a landlord issued a dilaps claim for £414,932.56 which was ultimately settled on the door of the Court for £1,073.50. The landlord was ordered to pay the tenant's costs (which would have been very substantial) on an indemnity basis.

To address this, in January 2012, the Ministry of Justice adopted the 'Dilaps Protocol' as part of the Civil Procedure Rules. This sets out the pre-action conduct expected of parties in dilaps claims. In outline, it requires:

- The landlord/landlord's surveyor to serve a schedule of dilapidations and 'Quantified Demand' within 56 days of the termination of the lease.
- The tenant/tenant's surveyor to respond within 56 days.
- Thereafter, the parties to negotiate the dispute with a view to narrowing the issues and settling the claim. The parties are encouraged to use alternative dispute resolution e.g. mediation, if appropriate.
- Only if the claim does not settle after all these steps have been taken, should the landlord consider issuing a claim.

An important feature of the Dilaps Protocol is that surveyors must now endorse their schedules and responses to say that they are 'reasonable' and that they take account of the landlord's intentions. This is a device to stop clients/surveyors advancing wholly exaggerated or understated claims/arguments. Surveyors have to take great care signing such endorsements as they may be cross-examined on this at trial. It will be interesting to see how much impact the Dilaps Protocol will have in practice.

How are dilapidations claims resolved?

There are basically two ways to resolve a dilapidations claim:

By agreement: Typically this would be a deal under which the tenant agrees to pay a sum of money.

By Court determination: This would be a Court order following trial which (typically) would award damages to the landlord and also provide for interest and costs.

As stated above, most claims are negotiated successfully by surveyors. It is also becoming more common to use ADR, and especially mediation, to settle cases. This trend is likely to be reinforced by the introduction of the Dilaps Protocol which encourages the use of mediation.

Claims usually only get to Court if the sums in dispute are substantial and merit the cost of proceedings. Certainly dilaps claims can be very expensive if they go to trial as they will typically involve on both sides a legal team (with Counsel and solicitors) as well as a building surveyor, a valuer and possibly other specialist expert witnesses e.g. M&E consultants and agents. Costs are therefore an important strategic consideration and well advised parties will make Part 36/ settlement offers to get protection on costs and to put the other side under pressure. Such offers should always be drafted by lawyers.

Summary

The above gives an introductory overview of dilaps claims. We will be producing further client guides on dilapidations which will focus in more detail on various topical and recurring issues such as:

- The procedure for dilapidations claims and the 'Dilaps Protocol'
- The nature of tenant's repairing obligations.
- Reinstatement obligations.
- Replacement or patchwork repairs?
- Damages in dilapidations claims.
- 'Passing the parcel' – dilapidations claims in the context of head leases, sub-leases, and sub-underleases.
- Costs and ADR in dilaps claims.

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