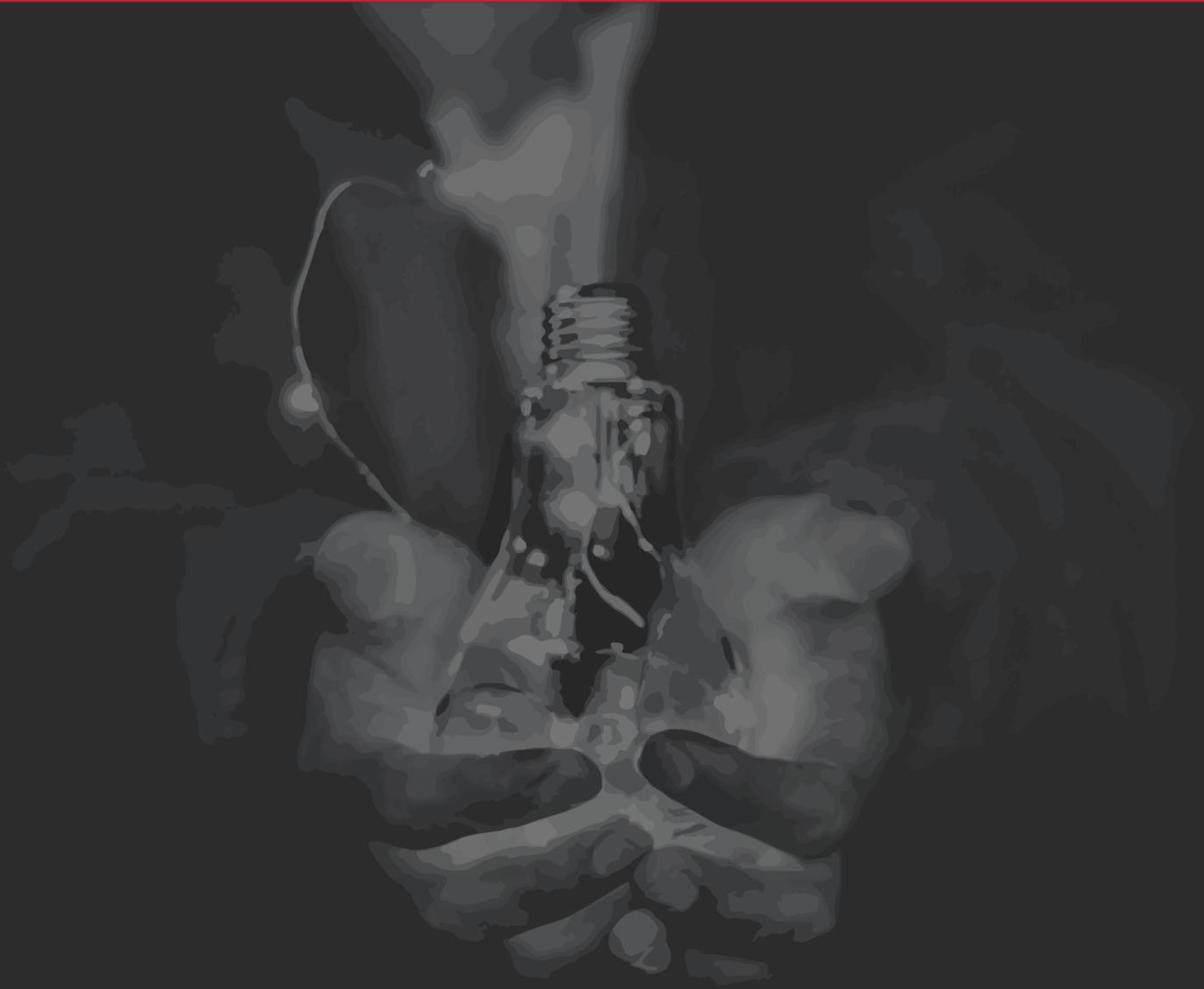


Lambert
Smith
Hampton

KNOW DILAPIDATIONS

A LANDLORD'S GUIDE TO DILAPIDATIONS





EVERYTHING YOU NEED TO **KNOW**

Many of our clients ask us to help them understand ‘dilapidations’, and since the cost of being unclear can be high we’ve created this booklet to explain everything you need to know.

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WHAT IS 'DILAPIDATIONS'?

The term 'dilapidations' refers to the condition of a tenanted property, both during its occupancy and when a lease ends. All lease agreements outline the obligations that occupiers have to look after their landlord's property, and dilapidations relates to breaches of this covenant to repair,

redecorate and reinstate certain elements. Landlords who fail to deal with the issue of dilapidations robustly can encounter serious financial implications. For example, you could lose substantial amounts of revenue through depreciation or by not being able to re-let premises that are in disrepair.

CASE STUDY 1

Pye Properties Ltd

LSH prepared a terminal schedule of dilapidations of the industrial unit, on behalf of the landlord, for service upon the outgoing tenant. The tenant elected to undertake the dilapidations works themselves and LSH monitored the process. This ensured the breaches of the covenant in the lease were remedied to the landlord's satisfaction to attract a new tenant. Upon completion of the works LSH negotiated the financial settlement of outstanding professional and legal costs providing a cost neutral service to the landlord. LSH's range of disciplines were demonstrated when the premises was subsequently sold through the LSH Industrial Agency team. By managing and monitoring the entire process LSH's approach maximised the value of the property for the landlord on the open market.



MINIMISING THE RISK

There's always a risk of dilapidations with any tenancy. The key to minimising those risks is to obtain professional advice at the earliest stage. You should consider the issue of dilapidations right from the start of a lease:

- When drawing up a commercial lease – make sure you define the demised premises and obligations for repair, redecoration and reinstatement
- During the term of the lease – make sure your tenants carry out repairs stipulated under the lease
- Approaching the end of the lease – check that the tenant has carried out all necessary works

- At lease expiry – if your tenant has failed to keep a property in good repair, or has not reinstated alterations, then - as long as appropriate preceding steps have been taken - you should be able to recover the costs of remediation and potentially claim damages for loss of rent while the works are undertaken.

Disputes over what constitutes reasonable repair and its effect on the property value are one of the most problematic areas for leasehold premises. If they are not managed carefully, they can ultimately end in the courts where significant costs and professional fees can be incurred.

Fortunately LSH have extensive expertise in assisting our clients stay on top of dilapidations from day one.

CASE STUDY 2

Umberslade Corporate Management Ltd

LSH were appointed as an expert witness for the landlord Umberslade. Despite the tenant's surveyor starting from a position of £nil liability, we were able to validate the landlord's contractual claim and agree costs in the region of £500k through a signed joint legal statement. By shoring-up our client's contractual position the legal dispute could focus purely upon the valuation issues.



GETTING IT DOWN IN WRITING

For landlords in England and Wales the issue of dilapidations is all about ensuring the value of your asset is maintained and that rental void periods are minimised when the lease ends. Dilapidations can be a complex field but the basis is simple: a landlord must be compensated if the tenant has breached the agreed obligations set out in a lease and the landlord has suffered a loss as a consequence. That's why it's so important that, as a landlord, you provide total clarity about what those obligations are from the outset – in writing.

Drawing up a lease

When drawing up a lease it is important to outline your tenant's obligations as clearly as possible. Your building surveyor will be able to define the extent of the demised premises. They can also advise on specific clauses to establish exactly what the tenant's repair, redecoration and reinstatement obligations should be through the term of the lease and at lease end. It is important that the lease provides clarity for both parties because any ambiguity can lead to cost and delay.

Leases typically require the tenant to 'put and keep' a demise in repair. This usually means the tenant must repair the property, even if it was out of repair at the start of the lease. Depending upon market conditions, where a property is in a state of disrepair at the outset, the tenant's surveyor will draw up a schedule of condition of the demise. The

landlord's surveyor will usually then verify and agree the schedule of condition so that the document can be annexed to the lease.

Similarly, where a tenant wishes to make alterations to the building, either before or during their occupancy, the landlord's surveyor can approve licences for the alterations. This enables the landlord's surveyor to properly document the reinstatement of alterations at the end of the lease.

A tenant is only usually responsible for the repair of the property and not for its improvement. For single buildings it's usually the tenant who is liable for all repairs. However, if the demise is part of a building, such as a floor in a multi-tenanted office building, the tenant is usually only responsible for the internal repair and redecoration. Responsibility for the structure, external and common parts usually lies with the landlord.

The length of leases are generally a lot shorter than they were 10 years ago. If a tenant wishes to remain in the property at lease end it is common for the same lease to be renewed for another term. At this point, to ensure the tenant retains responsibility for reinstating alterations granted under the original lease, it is important to document, record and review alterations. You also need to incorporate the appropriate reinstatement obligation within the new lease. It is equally important to deal with any alterations that have been carried out by the tenant without a licence prior to lease renewal.

BEING PROACTIVE

One way you can help minimise disputes at lease-end is by agreeing a planned maintenance programme at the start of the lease. You could even seek to proactively develop your asset by agreeing a wider maintenance and improvement strategy and, perhaps, even a tenant contribution to the strategy. Doing this ensures that, by lease end, the property is relevant to the market, minimising a potential void period.

This kind of strategic approach may be particularly relevant if your properties fail to meet Minimum Energy Efficiency Standards (MEES). This regulation means that you won't be able to sign leases or renewals for commercial buildings with Energy Performance Certificate (EPC) ratings below E from April 2018, except for a few exceptions. And from April 2023, the regulations will apply to all leased properties, not just new lettings.

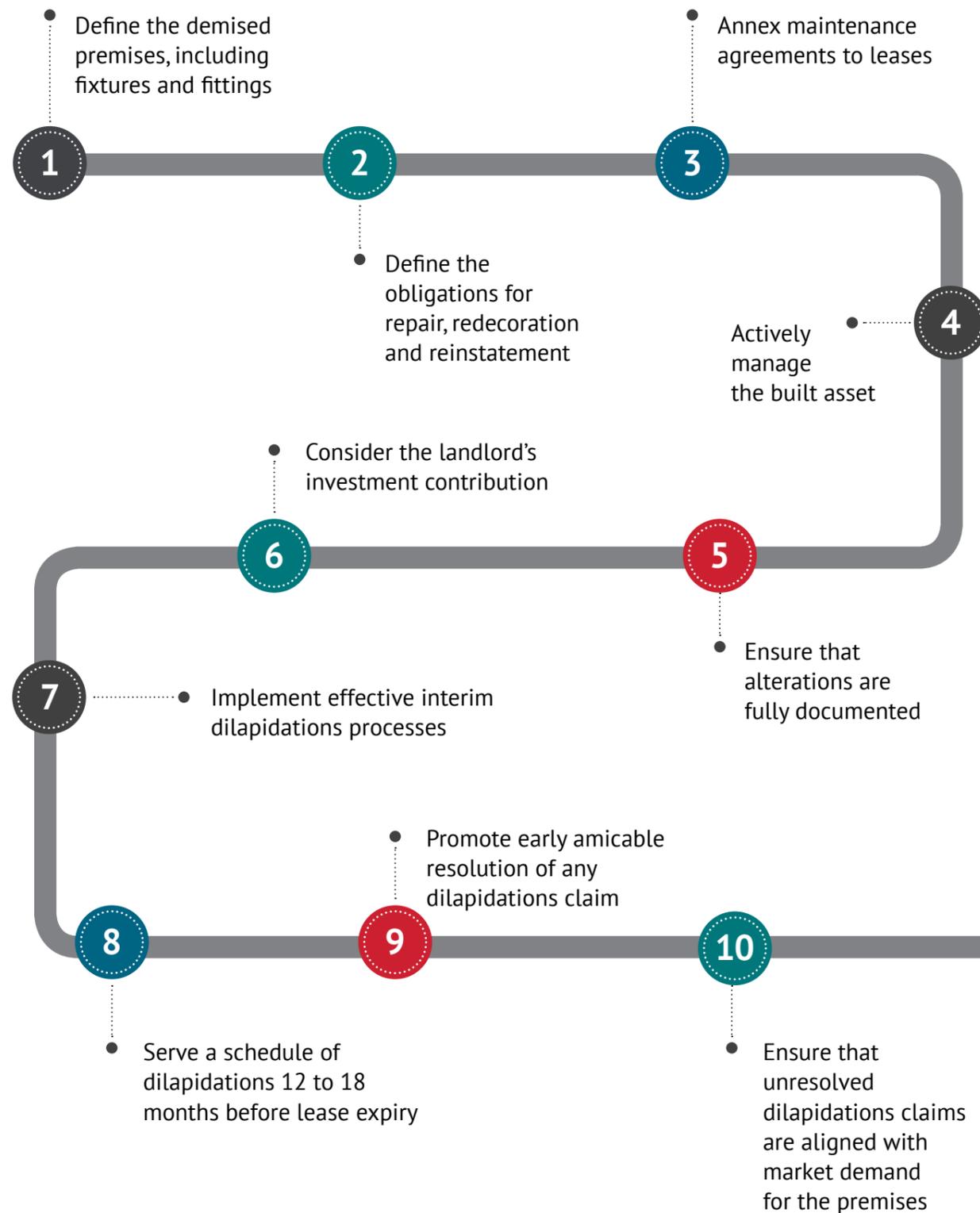
Since you will need to target energy efficiency improvement works on areas identified as having scored poorly within the EPC, carefully specified capital improvements can often be offset within the first year through enhanced capital allowances. The key, as ever, is to plan your MEES strategy early.

During the lease term

Tenants have an obligation to keep your property in repair throughout the duration of a lease and you can serve an interim schedule of dilapidations at any point during the lease term. This ensures that your tenant carries out repairs stipulated under the lease on time. Most commercial leases require the tenant to pay the cost of various enforcement actions, and this will usually include the cost of preparing and serving the schedule of dilapidations.

Most leases also include provisions for the landlord to take action against the tenant during the term of the lease when repairs are required. This includes recovering costs and professional fees incurred in undertaking enforcement actions. During the lease term, you should consider your future plans for the property. If you intend to re-let or sell, then the earlier a schedule of dilapidations is served on the tenant, the more time the tenant will have to carry out the works and the sooner you may be able re-let the vacant property.

Taking a proactive approach to dilapidations is a good way to minimise risk. If a tenant goes into liquidation, for example, then the outstanding works may be a lot less than if you had done nothing.



Repairs and lease break

Some leases allow tenants the option to exercise a break clause after a specified period of time, for example after five years of a 10 year lease. The risk to a landlord of a tenant-only break clause is the increased possibility of lost income through the premises becoming vacant. Break conditions usually include an obligation on the tenant to have paid rents due and to return the premises in the condition required by the lease. This will normally involve complying with the repair, redecoration and reinstatement obligations.

Your surveyor should draw up a schedule of dilapidations to be served on the tenant typically within the last 12 months of the lease. This will outline all breaches of the repair, redecoration and reinstatement obligations, and stipulate the remedies required. When they receive the schedule the tenant will normally instruct their own surveyor to validate the claim. At this point the tenant must decide whether to undertake some or all of the works during the lease, or to agree a financial settlement.

Unless a tenant has completed any work in advance of lease end, your surveyor will usually issue an updated schedule of dilapidations. This outlines all outstanding works deemed necessary to comply with the lease, and a quantified demand to cover the estimated remedial works. The quantified demand will usually also list consequential losses as a result of the breaches of repair and other covenants. This would include any loss of rent incurred while the works that should have been undertaken by the tenant are carried out.

Lease end

At lease end you will almost certainly be looking to return your property to market as quickly as possible to ensure that your rental income from the asset continues as normal. It is worth remembering that your tenant's responsibilities are only to repair the property – not to improve it to make sure it's attractive to new tenants.

As the lease is coming to an end you will want to appoint a chartered building surveyor to determine what repairs need to be completed and how these can be implemented in the lead up to your tenant's exit. This includes any alterations that the tenant made to the building that need to be reinstated.

AVOIDING DISPUTES

Negotiating dilapidations can be an adversarial process. Tenants frequently dispute breaches of covenant identified by the landlord's surveyor, and what is an appropriate remedy. So when you compile the schedule of dilapidations it is important to consider that market requirements may have superseded some, or all, of the tenant's repair obligations.

The business environment is changing in response to advances in technology, evolving customer needs and increasing globalisation. As a consequence, it is reasonable to assume that an office building that has come to the end of a 25 year lease is unlikely to be appropriate for today's ways of working.

This means that obsolescence is likely to have an increasingly major impact on any dilapidations claim you might have. Similarly, your intentions for a property need to be considered since redevelopment or improvement may well render any repairs required by the lease valueless. A common misconception is that landlords can profit from a dilapidations claim. The reasonable cost of works that the tenant should have carried out will help establish the amount of compensation you can seek. However, the law does not allow this to exceed the amount by which the property has been devalued.

If market factors lead you to undertake the repairs, then you will have a good chance of recovering the cost and professional fees incurred.

Diminution and the cap on damages

The level of damages that a landlord can claim at lease end is capped by Section 18 of the Landlord and Tenant Act, 1927, and more generally by common law. If a tenant decides not to carry out works to remedy dilapidations, there are limits on what you can recover in damages at lease end.

There are two aspects of the Act that could reduce a tenant's dilapidations payments:

- No repair costs can be recovered if when the tenancy is terminated (or shortly after), the landlord's building will be altered in a way that would render the repairs valueless, or the building is to be pulled down

- The value of repair costs claimed can't exceed the amount by which the value of the landlord's interest in the premises has been diminished, or reduced, by them being in disrepair

To calculate the loss caused as a result of disrepair or other breaches, you need a diminution valuation. This quantifies the difference between the value of the property in lease-compliant repair verses the actual condition in which the property has been left by the tenant.

The diminution in value is notoriously difficult to determine. This is partly because it depends on factors that shape the current market for the premises, such as age, character and locality, as well as condition and specification, demand, future potential uses and other available spaces.

CASE STUDY 3

Helical (Northampton) Limited

Lambert Smith Hampton prepared the schedule of dilapidations against the head lessee, subsequently undertaking the role of the contract administrator and principal designer. Dilapidations claims are being progressed against the head lessee using our original schedule of dilapidations; which evidences the breaches, updated with actual cost information and data gathered during the course of the works. Lambert Smith Hampton will assume the role of an expert witness if the dispute escalates to formal legal proceedings.



Before your dispute goes to court

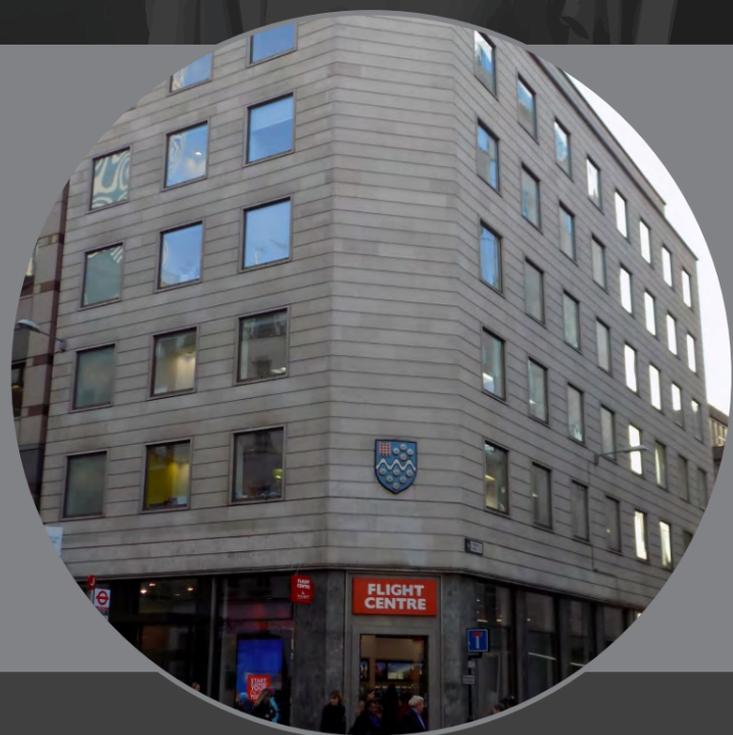
Sadly, many dilapidations disputes do end up in court, and because of this there is a dilapidations protocol. This protocol sets out the steps the court would normally expect prospective parties to have followed at lease end, before commencing legal proceedings. It establishes a reasonable process and timetable for exchanging information relevant to the dispute. It also sets standards for the content and quality of the schedules of dilapidations and quantified demands, and the conduct of pre-action negotiations. The ultimate aim is to give landlords and tenants a clear framework for avoiding litigation and agreeing a settlement amicably.



CASE STUDY 4

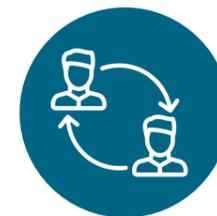
Eastcheap, City of London

Lambert Smith Hampton were instructed on behalf of clients of Mayfair Capital, as a landlord in securing a dilapidations settlement on the 3rd floor of a Central London office building and subsequently undertaking the role of contract administrator, delivering the refurbished spaces under budget, minimising void periods on all floors and working with the client's agents to ensure the specification could achieve a quick re-let.



If you still can't agree

Landlords should expect a response from the tenant to the schedule of dilapidations and quantified demand within 56 days of receipt. Normally, chartered building surveyors appointed by the landlord and tenant will meet and attempt to narrow the differences between the two parties to arrive at a recommended settlement figure, although there is no guarantee they will reach an agreement. If all else fails and the case ends up in court, each party will need to have appointed expert representatives, including a chartered building surveyor, lawyer and valuer. Since litigation is such an expensive process the court will usually direct the parties to Alternative Dispute Resolution (ADR) first.



MEDIATION

This is arguably the most commonly used form of alternative dispute resolution and is regularly applied to dilapidations disputes with success. Nevertheless, there are likely to be substantial costs involved in this process, albeit less than those incurred in going to court.



ARBITRATION OR INDEPENDENT EXPERT DETERMINATION

These are becoming an increasingly popular approach to resolving dilapidations disputes since they are far less costly than the courts. They also have the advantage of involving specialist practitioners with substantial experience in the field. Other landlord and tenant disputes – such as rent reviews and service charge disputes are frequently resolved this way.

Do remember that whichever legal route you follow, the value of your claim needs to be considered in the context of potential legal fees, and your asset may remain vacant until the dispute is resolved.

IN THE FUTURE

As the property market evolves the nature of leasing will change too. So it's possible that in the future dilapidations will no longer be a matter of fundamental dispute at lease end.

One development that's likely to grow in prominence is the gross, or all-inclusive, lease. Under this arrangement, a tenant pays the landlord an all-inclusive rent to cover all expenses associated with a property. This includes taxes, insurance, maintenance, utilities and even janitorial services - all in one single tenant-friendly rent payment. This approach makes it easy for the tenant to forecast their rent outgoings without any surprises.

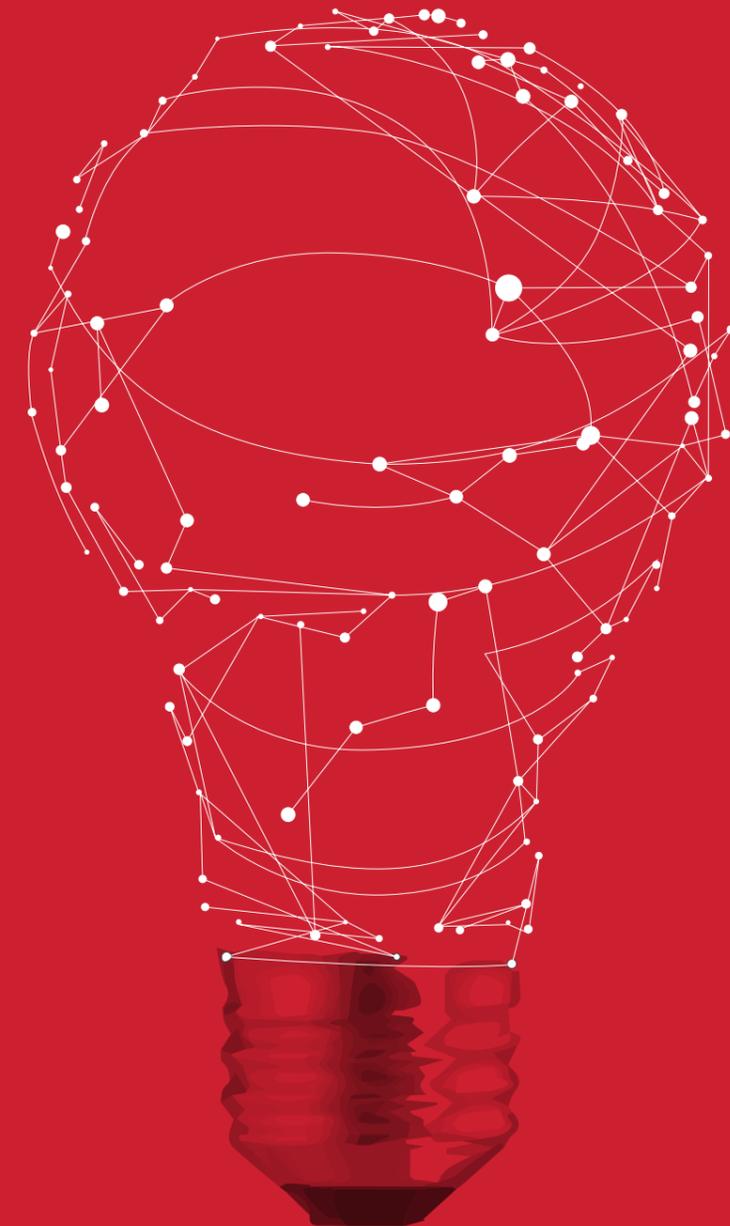
Another development set to increase in popularity is the capped dilapidation lease. This is very similar to many current leases, except that the tenant's exposure to dilapidations is capped at a predetermined figure, which could potentially be index-linked.

With our extensive network of property knowledge across the UK, LSH are able to keep you informed of all trends as they emerge, ensuring that you're well-protected with the best possible advice, now and into the future.

CASE STUDY 5

Broadshade Group

LSH were instructed on behalf of Broadshade Group to prepare three dilapidations claims and negotiate settlements on units at a tired office complex in central Bristol. Having recently purchased the site, the client had three tenants leave within a short space of time. Built in the early 1990's, the buildings needed upgrading to secure further tenants, but since the vacated tenants had outstanding dilapidations liabilities the landlord was able to utilise them. 100% of the final dilapidations costs were recovered in one unit, and 93% in two of the others. This assurance meant the client was able upgrade elements of the buildings in full knowledge of how much it would ultimately cost.



ABOUT US

We are a commercial property consultancy working with investors, developers and occupiers in both the public and private sectors across the UK and Ireland.

AMAZON TO ZURICH

We have partnerships with the complete A to Z of the best organisations in Britain and Ireland.

TRANSPORT TO TELECOMS

We have experience with an extremely wide range of sectors.

CAPITAL MARKETS TO CONSTRUCTION CONSULTANCY

We serve an incredibly diverse range of commercial property disciplines.

We value lateral thinking and celebrate enterprise, with a focus on delivering more for our clients. By looking beyond the obvious, we consistently generate impressive results.

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