



## Navigating the dilapidations pitfalls

**Dilapidations** The accounting treatment of dilapidations, the management of claims involving tenants and subtenants and disclosure of early advice, present less obvious issues for tenants taking tenancies and at lease termination, advises Simon Hartley

**T**erminal dilapidations claims can come as an unwelcome surprise for an inexperienced tenant. The cost of rectifying disrepair may not have been accounted for in a corporate tenant's accounts and, if no provision has been made, a corporation tax deduction will only be available when the liability is settled.

Well-advised tenants will have long anticipated the claim. Accurate accounting minimises the effect of dilapidations liabilities on financial reporting. Tenants are allowed to provide for future dilapidations liability under Financial Reporting Standard 12: Provisions, Contingent Liabilities and Contingent Assets or, if it is a public listed company, under International Accounting Standard 37. This can potentially lead to greater flexibility regarding the dilapidations costs' tax treatment and avoid a large one-off reduction in profits at lease end.

Such provisions are made before lease end, at which time the landlord's intentions for the premises at termination will not be known. It may be that the landlord chooses not to pursue a dilapidations claim following a decision to demolish or substantially refurbish the premises or a successful reletting. If so, the tenant may be keen to remove the liability from its accounts.

### Drawing a line under a liability

Tenants are often surprised that there is no reliable means of drawing a line under dilapidations liability. Landlords who are prepared to confirm that they will not bring a dilapidations claim are rare. They may be prepared to do so for a modest payment in exchange for the release and tenants often prefer this to keeping a provision on their books potentially for six years while the limitation period on the claim runs out. However, approaching a

landlord can be risky. Landlords who were previously prepared to overlook weak dilapidations arguments may change their view once a tenant's wallet comes out.

One way to accelerate matters is to apply to court for a declaration that the landlord has no claim. Unfortunately, this is a relatively expensive and potentially time-consuming process, which may encourage a dilapidations claim that the landlord might not otherwise have pursued.

The landlord would only need to establish a modest recovery to claim its legal costs should the tenant not protect its position with an early settlement offer at a sensible level made in accordance with Part 36 of the Civil Procedure Rules (the CPR).

This problem may be addressed at the outset of a tenancy by the parties agreeing an express limitation on the right to claim dilapidations beyond a specified period after lease end. This would be unattractive

to landlords and could increase the likelihood of a dilapidations claim being issued as a protective measure to preserve a landlord's rights.

### Landlord's intentions

A landlord's intentions on the date of termination for the premises at lease expiry or shortly thereafter may be important to its claim. If a decision has been taken to demolish or substantially refurbish, no damages will be recoverable (see the second limb of section 18(1) of the Landlord and Tenant Act 1927). The *Pre-Action Protocol for Claims for Damages in relation to the Physical State of Commercial Property at the Termination of a Tenancy* (the Protocol) adopted on 1 January 2012 requires a landlord's surveyor, or the landlord itself, to sign an endorsement on any schedule of dilapidations to confirm that a full account has been taken of the landlord's intentions for the premises. The RICS' *Dilapidations Guidance Note* (the Guidance Note)

expects parties to carefully set out their positions and surveyors must ensure that they make all reasonable enquiries to justify their position. These developments, together with the risk of criminal action for fraud by false representation under section 2 of the Fraud Act 2006 or of a claim under the tort of deceit (see *Eco 3 Capital Ltd v Ludsin Overseas Ltd* [2013] EWCA Civ 413), should reduce recklessness regarding dilapidations representations. However, tenants may still wish to look behind endorsements.

The landlord's intentions will almost certainly have been recorded somewhere. Disclosure is a useful tool, which provides tenants with the ability to review early communications between landlords and their advisers. This may take the form of standard disclosure in court proceedings or an earlier pre-action disclosure application. Documents for disclosure purposes include e-mails, information on mobile phones and tablet computers and deleted and back-up electronic files. Confidential

advice provided by surveyors when litigation is not yet in prospect will have to be disclosed even if it covers legal issues (see *R (on the application of Prudential plc) v Special Commissioner of Income Tax* [2013] UKSC 1).

Surveyors' fee arrangements are also subject to disclosure and may potentially be used to attack the strength of their evidence.

The landlord could have taken steps to reduce the risk of unwanted disclosure by restricting its use of written records and communicating some messages verbally. If lawyers are involved at an early stage it may be that legal advice privilege can be exercised in relation to some documents. Such measures are also available to tenants, but often the best approach is for parties and their advisers to simply prepare pre-action documents on the basis that they will eventually be disclosed.

*Simon Hartley is a partner at RadcliffesLeBrasseur*

## FURTHER ISSUES WHERE THERE ARE SUBTENANTS

The Protocol does not cater for a situation in which a tenant has sublet the whole or part of its premises under a sublease that terminates shortly before the expiry of the lease.

The Protocol requires the service on the tenant of a schedule of dilapidations in one of two prescribed forms. On its face, the Protocol requires two or more schedules: one as between landlord and tenant and separate schedules between the tenant and each of its subtenants. Parallel procedures, including separate meetings and potentially ADR, would follow.

The Guidance Note expects parties to make genuine endeavours to settle the matter in a proportionate manner. Whilst it may be aimed at discouraging a procedural box-ticking approach if there have been more than simply technical failures to comply with the Protocol a party faces the possibility of serious costs penalties even if it is eventually successful: see [1.5] of the Protocol. There is no prohibition on amalgamating procedures and this writer understands that the absence of any specific reference to subtenants was not a policy decision by the Protocol's authors (per Jacqui Joyce, the Property Litigation Association debate, 23 October 2012). However, the omission means there is no comfort for those concerned about the risks of deviating from strict compliance.

In *PGF II SA, PGF II (Lime) SA v Royal & Sun Alliance Insurance plc, London & Edinburgh Insurance Company Ltd* [2010] EWHC 1459 (TCC); [2010] PLSCS 250, the court noted that the subtenant was not

technically in breach of the draft Protocol by failing to respond to a pre-action letter from the head-landlord, although the judge said that he should have expected a response.

If the tenant can meet the dilapidations claim, the landlord may simply wish to proceed against the tenant regardless of any rights it may have against the subtenants under the direct covenants in any licence to sublet. The tenant is unlikely to want to wait until the resolution of that claim before looking to its subtenants. If proceedings are issued, tenants are likely to join their subtenants into proceedings under CPR 20.

The fact that the tenant's liability will almost inevitably be different from that of the subtenant's without express wording to that effect, will not prevent the claims being heard together (see *Dowding and Reynolds*, 4th ed, [24-07]). The court will only consider ordering multiple trials regarding dilapidations in relation to the same premises in exceptional circumstances.

The court may be prepared to stay proceedings to allow for compliance with elements of the Protocol as between the tenant and the subtenants, but it is unlikely to provide for the full timetable.

Almost all dilapidations disputes are settled before court, but if that is not possible, having a sublease that ends near the expiry of the lease will lead to higher than usual legal and expert costs if both the subtenant and the tenant vacate.

With potentially multiple experts on each

side, the court is likely to consider hearing their evidence concurrently ("hot-tubbing") to help save time.

### Adopt an amended approach

To reflect the approach that the court has demonstrated, it is suggested that parties should consider modifying the Protocol procedure and adopt an amended form of schedule of dilapidations as follows:

- The landlord serves a schedule on the tenant;
- The tenant serves an expanded version of the schedule on each subtenant identifying the breaches it claims the subtenant committed, the relevant provision of the sublease and/or other basis for liability, the remedial works necessary and the associated costs that would be properly incurred;
- Each subtenant serves a response on a copy of the schedule on the tenant stating in relation to each item alleged to be its account whether the alleged breach is admitted, not admitted or denied and why, whether the submitted works are appropriate and whether the stated costs are reasonable;
- The tenant serves a final version of the schedule on the landlord and the subtenants stating in relation to each item whether the alleged breach is admitted, not admitted or denied and why, whether the submitted works are appropriate and whether their costs are reasonable.

It would be consistent with this approach to hold multi-party meetings and to consider ADR on the same basis.