Understanding Dilapidations

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Most commercial tenants understand that they will have to keep the property in repair throughout the term of the lease. However very few understand the extent of that liability and there is a common misconception that this just requires them to make good any physical damage caused to the property. Unless the lease specifically sets out that this is the only requirement, the general obligation to keep a property in "good and substantial repair and condition" goes far beyond that and may also include an obligation to put the property into repair. Failure to understand the extent of your repair liability can also lead to unexpected and often substantial costs at the end of the term, known commonly as dilapidations.

What are dilapidations

Dilapidations in the context of commercial leases refers to items of disrepair in the premises. As well as complying with the repair obligations during the term of the lease a tenant will also be required to hand the property back to the landlord in the condition required by its repair covenants. This includes not only the repair obligation but also compliance with statutory requirements such as having up to date service records for plant and machinery, an up-to-date asbestos management plan (if applicable) etc.

Failure to comply with this obligation will entitle the landlord to serve a financial claim on the tenant in respect of what is known as "dilapidations" for the cost of putting the property into repair and dealing with any outstanding statutory compliance. This is not simply a question of making good any physical damage caused, putting a fresh coat of paint on the walls and cleaning the carpets, and the extent of the tenant's repair liability will not be dependent upon the condition it was in when the tenant took up the lease (unless the lease specifies this). Instead, it is judged by reference to an abstract idea of keeping the property in tenantable repair, i.e. in a condition that a new tenant would be prepared to accept it in as well as having up to date service records and statutory reports.

Although dilapidations claims are usually made at the end of the lease, a landlord may seek a dilapidation claim at any point during the term, if it feels that a tenant is not properly looking after the premises. The landlord can serve an interim schedule of dilapidations or a repair notice on its tenant requiring the tenant to carry out the necessary works to remedy the disrepair. If the tenant does not complete the work within the required timeframe, the landlord may have the right to enter the property to undertake the works itself and seek reimbursement of its costs from the tenant.

More commonly a landlord will make a dilapidation claim at the end of the lease term ("a terminal dilapidations claim") to ensure that the property is left or put in to repair with all tenant's alterations removed before the property is relet. This article looks at the question of terminal dilapidations.

Tenant covenants that relate to dilapidations

Although the term "dilapidations" is used to refer to the remedying of items that require repair in the premises, there are several other tenant covenants in a lease that may be relevant to a landlord's dilapidation claim:

- The repairing covenant will detail the tenant's obligations to put or keep the property in repair. This covenant usually includes an obligation to keep any service conduits exclusively serving the property in working order and to keep the property tidy. There are different levels of repairing covenant depending on what was negotiated at the grant of a lease and the obligation will also differ depending on the extent of the demise. Please refer to our factsheet "Repair – FRI/IRI/SOC" for further details.
- The decoration covenant will normally require a tenant to decorate the property either at set intervals or as often as reasonably necessary during the Term. In addition, there is usually a requirement to redecorate the property within the last six to three months of the term. This provision may also require the tenant to replace any carpets or other floor covering, depending on the term of the lease.
- The Yield Up clause (or other reinstatement covenants) will deal with the manner in which the tenant must leave the property at the end of the term. This will usually require the tenant to hand back the property at the end of the term with vacant possession, repaired in accordance with the terms of the lease and with all alterations reinstated.
- The Alterations covenants will detail the extent of the tenant's right to alter the property and will usually include a reinstatement obligation, requiring the tenant to remove any alterations carried out during the Term and to reinstate the property to the layout it was in before the alterations were undertaken. This usually comes as a surprise to tenants who often believe that where their fit-out works have improved the premises, they will not have a dilapidations liability. Whilst a tenant's fit-out might improve the property, it is often very specific to the tenant and its business and may not be useful to a new tenant wishing to occupy the property. As such, the landlord may have to remove such fit out works in order to be able to relet the property . It will therefore oblige the tenant to remove these alterations under the terms of the lease and failure to do so will also be included in any dilapidations claim.
- Covenant to comply with statute - notwithstanding that the tenant will be under a statutory duty to comply with the law generally, the lease will usually require compliance specifically in relation to the tenant's use and occupation of the property. A landlord will want to ensure that the tenant hands the property back with all statutory obligations complied with. For example, a landlord may require the tenant to hand over any health and safety files it has complied during the term of the lease, together with up to date electrical or gas certificates and up to date service reports for all plant and equipment in the property.

There may be other obligations outside of the lease relating to repair or reinstatement of the property for example, obligations in any licence for alterations; deed of variation; supplemental agreement or side letters.

The Terminal Schedule of Dilapidations

There is no legal timeframe for serving a terminal schedule of dilapidations (other than the statutory limitation period for bringing a claim for breach of contract) and in particular no requirement to serve this before the lease term ends, although the lease may limit the landlord's right to recover its professional costs in preparing and serving a Schedule of Dilapidations to a set period after the lease expires. However, landlords should consider initiating the process well in advance of expiry of the lease to avoid any unnecessary delay in re-letting the property.

From the tenant's perspective it will be useful to engage with the landlord as early as possible so as to establish the landlord's reinstatement requirements and have an opportunity to carry out the works required itself, thereby reducing the cost of any dilapidations claim, but this will depend upon where the tenant is moving to and whether it is able to vacate the property sufficiently in advance in order to carry out the required works. If the tenant cannot carry out the works before the lease expires, it will not have the right to go back into the property following expiry of the lease, to carry them out. In this situation the landlord will have to carry out the works and the tenant will have to pay the costs incurred by the landlord for any works undertaken. The landlord is also entitled to claim a sum equal to rent for the period that it will take to complete the works following the expiry of the lease.

A landlord can prepare, serve and negotiate the schedule of dilapidations itself, but it is an area that is subject to deadlines and

restrictions, so it is recommend that a landlord instructs an expert surveyor. A surveyor will review the tenant's liability pursuant to the lease and any supplemental agreements and inspect the property to establish the extent of any dilapidations. The landlord's surveyor will then prepare the schedule of dilapidations.

- A schedule of dilapidations would normally include:
- details of the property and the lease;
- the specific provisions in the lease or associated documents that relate to the tenant's repair and yield up obligations;
- details of which of the tenant's covenants are in breach;
- a list of the works required to remedy the breaches;
- the quantified demand/cost of the works required – it is a requirement of paragraph 3 of the Dilapidations Protocol that a terminal schedule must be costed and in the form prescribed by Annex B or Annex C to the Dilapidations Protocol (depending on whether the landlord or the landlord's surveyor has prepared the schedule); and
- a reservation to serve a further schedule of dilapidations if the landlord establishes any further breaches following the service of the schedule.

The schedule of dilapidations must be formally served on the tenant in writing in accordance with the notice provisions in the lease. This can be undertaken by the landlord, the landlord's surveyor or the landlord's solicitor. The landlord should also consider the requirements of the Dilapidations Pre-Action Protocol.

The Dilapidations Pre-Action Protocol ("Dilapidations Protocol") is a code of conduct that a landlord must follow, pursuant to the Civil Procedure (Amendment No. 3) Rules 2024 ("CPR"), if it wants to issue a claim for terminal dilapidations before the Courts. It includes detailed procedures that must be observed and a timetable for service of the landlord's terminal schedule of dilapidations, the exchange of information by the parties and without prejudice negotiations. The aim of Dilapidations Protocol is to reduce disputes between the parties before a claim reaches the Court, encourage parties to share information, narrow the issues between the parties and reduce costs. If the parties fail to substantially comply with the Dilapidations Protocol, then they could face cost consequences as a Court may take a negative view of a party's failure to comply with the Dilapidations Protocol and order a costs award accordingly under CPR 44.2(5)(a).

The steps that a landlord must follow pursuant to the Dilapidations Protocol are beyond the scope of this article and compliance is only required if a formal claim is made to the Courts but the Dilapidations Protocol is considered a fair process and the parties are encouraged to follow this in any event, in case the matter does end up before the courts.

The Landlord's Remedies

Depending on whether the term of the lease has expired before an agreement is reached between the parties the tenant can either:

- carry out the works required to put the property in repair and in compliance with all yield up and statutory obligations or
- agree a financial settlement with the landlord.

(i) **Carry out the works** - It is very difficult for a tenant to avoid a dilapidation claim in its entirety as it is hard to return the property to the landlord in the specific condition required by the lease, especially after a long period of continuous occupation. However, the tenant does not have to accept the position set out in the landlord's terminal schedule of dilapidations and can put forward a counter position and once the dilapidations are agreed can mitigate the claim by carrying out some or all of the works itself. If the landlord will not engage with the tenant before lease expiry to allow this, then the tenant could engage its own dilapidation surveyor for advice in this respect and serve its own schedule on the landlord, setting out the works it proposes to carry out and then carry them out. Whilst this will not prevent the landlord from serving its own schedule of dilapidations later, a court is unlikely to look favourably on the landlord in this situation.

(ii) **Financial Settlement** - Where the landlord brings a claim for breach of the tenant's repairing covenant after expiry of the lease the parties will only be able to agree a financial settlement. The starting point for calculating the measure of damages is the reasonable cost of carrying out the repair works together with loss of rent for the period it takes to complete the works (Joyner v Weeks [1891] 2 QB 31). The landlord may also seek to recover the cost of any professional fees which should be expressly provided for in the lease.

Again, the tenant does not have to accept the landlord's assessment of the financial liability or items of disrepair/non-compliance and can put forward a counter position. The parties can negotiate direct or appoint surveyors to do this for them until a figure is agreed upon. Once agreed the financial settlement should be recorded in a dilapidation settlement agreement confirming that the amount paid is in full and final settlement of all damages and compensation for all past present and future tenant obligations in the lease.

Section 18(1) of the Landlord and Tenant Act 1927 ("LTA 1927") limits the damages available to a landlord for a breach of the repairing covenant to the diminution in the value of the landlord's reversion caused by the breach. Therefore, if the damages exceed the decrease in the value of the landlord's interest, the damages will be limited to the decrease in value and not the full level of damages being claimed. Furthermore, Section 18(1) of the LTA 1927 provides that if the landlord intends to demolish the property or undertake structural alterations after the expiry of the lease, so that the repairs are valueless.

There may be circumstances where a tenant is not required to repair the property and reinstate its alterations. As referred to above, section 18(1) of the LTA 1927 limits the landlord right to recover any damages, if any repairs would be superseded by the landlord's proposals to carry out structural alterations to, or demolition of, the property at or shortly after the end of the term. In addition, if the landlord is selling the property on the open market and the disrepair has not impacted the sale price of the premises, then the landlord cannot claim a loss. Similarly, if the landlord is reletting and the new incoming tenant is taking on the accrued dilapidations liability of the existing tenant then there would be no loss for the landlord to claim. The landlord or its surveyor must certify that it is not aware of any intention to redevelop or carry out substantial alterations when preparing the schedule of dilapidations but the tenant or the tenant's surveyor should as a matter of practice make enquiries with the landlord of its plans for the property following the lease expiry upon receipt of any schedule of dilapidations claim.

Understanding the scope of your repair liability is fundamentally important and it is something that tenants should familiarise themselves with before the lease is entered into rather than leaving this until the end of the term. Ideally a tenant should make an allowance in its accounts/an accrual in respect of any potential dilapidations liability that it may incur at the end of the term so as not to be faced with an unexpected financial liability that it is unable to meet.

The above is just a summary of the issues arising in respect of terminal dilapidations. Different rules and remedies apply where there is disrepair during the term and legal advice and the advice of a surveyor should be sought by both landlords and tenant when serving or receiving an interim or terminal schedule of dilapidations. At Moorcrofts we work closely with local and national surveyors to whom we can make a referral. We can also review and advise the parties on the relevant obligations in the lease relating to dilapidations and negotiate dilapidation settlement agreements to document any agreed financial settlement.

Moorcrofts' commercial property team provides legal advice to owners and occupiers of commercial property. We specialise in tenant representation and have extensive experience advising corporate occupiers on all aspects of leasehold acquisitions and disposals. If you would like legal assistance with your commercial property needs, please contact our Partner and Head of Commercial Property – Julia Ferguson.

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