IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
MANCHESTER DISTRICT REGISTRY

The Civil Justice Centre,
1 Bridge Street,
Manchester.

Case No: 6MA90479

Thursday, 11th December, 2008

Before:

HIS HONOUR JUDGE PELLING QC
(Sitting as a Judge of the High Court)

BRUNTWOOD 2000 FIRST PROPERTIES LTD. — Claimant

-v-

BRITISH TELECOMS PLC — Defendant

MR. S. JOURDAN (Instructed by Messrs. DLA Piper appeared on behalf of the Claimant.

MR. S. HORNETT (Instructed by Messrs. Addleshaw Booth) appeared on behalf of the Defendant.

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J U D G M E N T
(Approved)

Thursday, 11th December, 2008

JUDGE PELLING QC:

1. Down to 29th March 2004 the claimant was the lessor by assignment and the defendant was the lessee by assignment of an office building at 1 Portland Street in Manchester. The lease contained a covenant by which the lessee covenanted to leave the building good condition, decorated and with any partitioning removed. It is common ground that the defendant vacated the building without complying with these repairing obligations. It is also common ground that the reasonable cost of doing what should have been done by the defendants at the relevant date, 29th March 2004, was £1,020,00.

2. In these proceedings the claimant seeks as its principal remedy damages for breach of covenant. It is common ground that at Common Law damages for breach of this type of covenant is measured by the cost of repair, plus, where appropriate, the loss of rent and other outgoings, subject, however, to a statutory cap imposed by Section 18(1) of the Landlord and Tenant Act 1927 by which the sum recoverable is capped at the amount by which the value of the reversion in the building is diminished by reason of the breach of covenant.

3. In fact, the claimant embarked upon a substantial refurbishment or redevelopment of the building following the end of the lease at a cost of in excess of £4m. The claimant's case is that it should recover by way of damages for breach of covenant the sum of £852,883, which it maintains is the difference between the net value of the property following refurbishment (£5,903,125) and the value that the building would have had if it had been delivered up in covenanted condition when, following a much more limited refurbishment of the ground floor at a cost of £261,332, it would have had a value of £6,756,008.

4. The defendant's case is that no-one in position of the claimant would have undertaken the hypothetical scheme the claimant maintains would have been undertaken if the building had been delivered up in covenanted condition and that a hypothetical purchaser of the building would have undertaken the full scale refurbishment in fact undertaken by the claimant irrespective of whether the building was delivered up in covenanted condition or not. In consequence, the defendant alleges that the claimant's claim for damages is limited to the difference between the value of the property fully refurbished, having been delivered up in covenanted condition, which the defendant

alleges would have been £10,592,936, and its value fully refurbished having been delivered up in the condition it was delivered up in, which the defendant alleges was £10,305,336. This approach, if adopted, results in the damages claim being quantified at £287,600.

5. In addition to the principal claim the claimant claims the costs of preparing the schedule of dilapidations pursuant to clause 4.36 of the lease. By the end of the trial this claim had been agreed in the sum of £6,500 and I need say no more about it.

6. The final claim made by the claimant was a claim made pursuant to clause 4.11 of the Clause. The sum claimed is the agreed costs of what are called the "survival items". That is the cost of that element of the works that should have been carried out by the defendant and which if carried out would have survived the refurbishment of the building by the claimant following delivery up. This sum has been agreed at the sum £421,998, though the claim itself is disputed.

7. The trial took place between 24th and 27th November 2008. I heard oral evidence on behalf of the claimant Mr. Christopher Oglevy, the Chief Executive Officer of the claimant, Mr. John Marlon, a Director of the claimant, and an expert valuer called on behalf of the claimant, Mr. Peter Beckett FRICS. The only witness called on behalf of the defendant was an expert valuer, Mr. Mark Walsh MRICS.

8. In relation to the principal claim the question that has to be addressed is the amount by which, if at all, the market value of the claimant's interest in the building had been diminished at the end of the lease by reason of the failure of the defendant to comply with the covenant. Diminution is to be assessed as at the date of the termination of the lease, here 29th March 2004. In consequence, as a matter of law, events occurring after the end of the lease cannot themselves enhance or reduce the damages the lessor can recover, although such events may in appropriate circumstances be relied upon as throwing light on the correct valuation of the reversion at the relevant date. The exercise I am required to carry out necessarily involves identifying a hypothetical buyer who notionally would purchase the property on the relevant date. This in turn involves identifying the relevant attributes of the hypothetical purchaser and the price which such a purchaser would pay for the site. It is agreed between experts that this figure is to be arrived at using the residual method of valuation. Usually the application of this method will involve the comparison of

the same scheme, assuming the building is delivered up in covenanted and in actual condition. Here, however, the claimant maintains that a different scheme would have been used if the building had been delivered up in its covenanted condition.

9. In this case it is common ground that the notional purchaser would not purchase simply to let out again. This is agreed because the net value to such a person of the building whether in its covenanted condition or not would be substantially lower than the value of the building following refurbishment whether fully or in the limited way the claimants contends would have been adopted in the event the building had been delivered up in its covenanted condition.

10. It is common ground that the notional purchaser of the building would be a developer investor - that is someone who would purchase the building to refurbish and then hold the building over the medium to long-term. The alternative would have been a developer dealer, who would redevelop and then sell. This gives rise to a critical difference between the parties' valuers for Mr. Walsh contended that in those circumstances it is wrong in principal to take into account the costs of sale when striking net value, whereas Mr. Beckett contended that when adopting the residual method of valuation sale costs must always be taken into account when striking net value.

11. Where, as is common ground here, the hypothetical purchaser is likely to refurbish the building it is possible that the pre-existing condition of the premises will be relevant only to the extent that the covenanted work, which should have been done but which had not been carried out, would survive the likely post-acquisition refurbishment. In such circumstances, as Arden LJ put it in *Latimer v. Carney* [2007] 1 P & C R 213 at 225:

> "The landlord would have to show that the repairs caused damage to the reversion and this may in the circumstances be difficult. Alternatively, he will have to show that the refurbishment would be incorporate some of the repairs the former tenant should have carried out, ie, that specific repairs would survive the refurbishment. The question whether the repairs to be done by the former tenant in any particular case survive may raise difficult issues of fact and judgment but no specific examples of difficulty have been suggested to us".

Two points arise from this: First, in this case the reasonable cost of the survival work has been agreed so that the difficulty highlighted by Arden LJ does not arise in this case. Secondly, Arden LJ recognises that proving damage to the reversion, other than by reference to the cost of survival work, might be difficult. This highlights the critical first issue that has to be resolved in this case, namely, whether the claimant, on whom the onus of proof rests, has proved that if the building had been delivered up in covenanted condition the hypothetical purchaser would have embarked upon the hypothetical limited refurbishment scheme contended for by Mr. Beckett, which is referred to in appendix 1 to this judgment and was referred to at trial as the 'A3 Scheme'. It is only if the claimant establishes this on the balance of probabilities that it can succeed in recovering damages for a sum in excess of costs of survival work. For reasons that will become apparent my conclusions on this issue must be regarded at this stage as provisional only.

12. I start, first, by setting out a little more about the building itself. The building was constructed in the 1970s. It is located on the corner of Piccadilly and Portland Street in Manchester. This area is outside what is or was in 2004 conventionally recognised as being the Central Business District ("CBD") of Manchester but was within Central Manchester, in an area where significant efforts were then being made to develop and improve the area as a business location. It is convenient for Piccadilly Station and is within a short walk of the Central Business District. The building itself consists of a basement, ground floor and with six other storeys. It was constructed from reinforced concrete slabs and columns with glazed certain walling. It had a slab to slab dimension of 2.7 metres. This last point gives rise to an issue between the valuers relevant to the estimated rental value ("ERV") of the office element of the building. Mr. Beckett considered the dimension to be a factor likely to depress rental value. Mr. Walsh considered that to be an outmoded approach. Such thoughts were driven by the need to accommodate air conditioning and cabling under suspended floors and ceiling, modern equipment took up less space than before and thus the distance between slabs had ceased to be significant. The building consists of offices, apart from part of the ground floor, which prior to the end of the lease was sub-let by the defendant to a travel agent, which, however, had vacated the building prior to the defendant. The building had 19 car parking spaces and was located close to a modern multistorey car park. It was single glazed throughout. It was described by both experts in summary as

being functional but old-fashioned.

13. Against that background I turn to the claimant's case as to what I have called the "A3 Scheme". The A3 Scheme in essence consists of assuming that a hypothetical purchaser purchasing the building in covenanted repair would convert the ground floor to retail space, create a new and more attractive reception area serving the office accommodation on the upper floors but otherwise leave the upper floors unaltered. Attached to this judgment at appendix 1 is a document entitled "Diminution in Value: Summary Adjusted for Additional Reception Costs". This document was prepared by Mr. Beckett and shows how he arrived at his valuations in summary form. His value of the A3 Scheme is set out in column A3 within appendix 1. At appendix 2 is a summary prepared by Mr. Walsh of his valuation. As will be apparent from that document, he has made no attempt to put a value on the A3 Scheme. I should add for the avoidance of doubt that appendix 1 uses what Mr. Beckett calls virtual (or, as I prefer, adjusted) rent rates as opposed to what were referred to in the hearing before me as headline rent rates. This is a matter in issue between the parties' respective valuers. Mr Walsh contends that the proper course is to refer to the headline rental values, that is the rent paid per square foot by a tenant once all rent free periods have expired. I return to this issue later in this judgment. Appendix 1 should be read subject to this caveat but also subject to the caveat that there is a dispute concerning the area of letable space for the office accommodation, to which issue I also return later in this judgment.

14. As is apparent from the costs of works line within appendix 1, the cost of the A3 works was assessed by Mr. Beckett, inclusive of the cost of refurbishing the reception area, at £261,332. This includes an estimated £50,000 for the costs of carrying out works to the reception area. This is an estimate to which Mr. Beckett was prepared to agree in cross-examination. It had been omitted by him from earlier versions of the document that is now appendix 1 to this judgment. Mr. Jourdan, counsel for the claimant, considered this was something for which the defendant should be criticised since it was not put in issue at any stage prior to the cross-examination of Mr. Beckett. I agree that if a modest degree of co-operation had been displayed by Mr. Walsh in applying himself to the figures used by Mr. Beckett in relation to his A3 Scheme this problem could probably have been avoided. However, by the same token, it seems to me that Mr. Beckett ought to have made sure that this item was included within his figures at a much earlier stage. As matters rest I am

satisfied on the evidence before me that Mr. Beckett was right to concede the point, which he readily did in the course of his cross-examination and I adopt his figures for the cost of refurbishing the reception area in the absence of any other evidence on the point.

15. Within Appendix 1, column A2 refers to the scheme actually carried out by the claimant but on the assumption that the building was delivered up in covenanted condition. Column B2 refers to the scheme actually carried out to the building in the condition the building was actually delivered up in. The claimant accepts that the net value difference between Schemes A2 and A3 were not great - the A3 Scheme would result in a value of about £500,000 odd better than the A2 Scheme, assuming that Mr Beckett's figures are otherwise correct. It is said that the A3 Scheme is not dissimilar to one in fact being considered by the claimant at the time as an alternative to the full redevelopment scheme in fact ultimately undertaken and the conclusion that the A3 Scheme would be adopted if the building had reverted in covenanted condition accords with commercial and common sense because no-one would spend just short of £4m (the estimated costs of the full refurbishment on the building if it had reverted in covenanted condition) as to opposed to £261,332 unless the A2 Scheme could be shown to result in a substantially better value than the A3 Scheme.

16. The defendant's response is to contend that no hypothetical developer investor would have adopted the course advocated by Mr. Beckett. Mr. Walsh's evidence on this issue is contained in paragraph 3.2 of his first report where he says:

> "Mr. Beckett and I agree that when considering the diminution in value caused by dilapidation the valuer is seeking to identify and evaluate those parts of the valuation which would be affected by the dilapidations keeping the others constant. For this reason I disagree with Mr. Beckett's approach of comparing hypothetical partial refurbishment to the non-refurbishment and full refurbishment scenario.
>
> The fundamental difference of opinion between Mr. Beckett and myself is whether the property should be valued as a full re-development or a partial re-development. My knowledge of the market and valuations lead me to the unequivocal conclusion that the property I have valued could be achieved with a full refurbishment. Therefore, my assessment of the diminution in value attributed to dilapidation is

> full is based on comparing the difference in value between the full refurbishment of the building in covenanted condition and a full refurbishment of the building in the condition left by the defendant. Since the claimant undertook a full refurbishment the difference in values reflect the actual diminution".

However, in my judgment what is said in that paragraph is at odds with what he says at paragraph 4.1.1 where he says in the first line:

> "As with any building with development potential, the landlord has multiple options."

His point that there were other options not considered by Mr. Beckett is itself an irrelevance in my judgment simply because no other options were put forward by Mr. Walsh that would invalidate the A3 Scheme as an alternative to the A2 Scheme. Mr. Walsh's position is that the only scheme that would be considered by a developer is that ultimately undertaken by the claimant. Thus, Mr. Walsh considers and only considers what in effect are the A2 and B2 schemes referred to by Mr. Beckett but in the case of Mr. Walsh applying a methodology that is in a limited number of significant respects different that adopted by Mr. Beckett.

17. Mr. Walsh's analysis is set out in appendix 2 to this judgment. It suggests that the net value of the property following refurbishment from covenanted condition according to Mr. Beckett's A2 Scheme would have been £10.6m odd and refurbishment from actual condition equivalent to Mr. Beckett's B2 Scheme would have been in excess of £10.3m odd. However, this does not show that a hypothetical purchaser would have preferred the A2 Scheme over the A3 Scheme. That could only be demonstrated if Mr. Walsh had applied his methodology to the A3 Scheme. However, he has chosen not to carry out that exercise. The difference between Mr. Walsh's methodology and that of Mr. Beckett is in truth one which turns upon matters of valuation detail; principally the estimated rental value that is to be applied, the net letable area that must be utilised and the yield figure (the multiplier to be adopted which when applied to the annual rent gives a capital value of the building) that is adopted. The differences between the valuers also concern, as I have said, whether sale costs should be included as part of the costs required to be deducted in order to arrive at net value and also a difference as to the profit rate that a hypothetical developer investor would require to be built

into the cost figures in order to arrive at net value.

18. At trial the attack advanced on the A3 hypothesis on behalf of the defendant focused on attempting to demonstrate that the out turn difference between the A2 and A3 schemes was much less than asserted by Mr. Beckett by seeking to attack the various constituent elements I have referred to above and in addition two others, which I refer to in detail below. Whilst in principle I see the attraction of this approach, since ultimately what a developer will be concerned about is net value, in my judgment, the difference in net value would have to be substantial because from a commercial perspective much the most significant factor is likely to be the cost of the works. Assuming a cost of £4m for the A2 Scheme, and a cost of £261,000 odd for the A3 Scheme, means that the value to be achieved for the A2 Scheme would have to be very substantially greater than for the A3 Scheme before it could have any commercial logic.

19. Although Mr. Walsh in effect asserted that it was obvious that an investor developer would not consider a lesser scheme than the one in fact undertaken, irrespective of whether the building reverted in covenanted condition or not, in my judgment that point is not self-evident. In fact, the evidence makes it abundantly clear that in fact the claimant considered for many months an alternative scheme, albeit not that advocated by Mr. Beckett, which alternative scheme involved a partial redevelopment rather than a total refurbishment of the building. In my judgment, a developer investor would carry out a detailed valuation exercise of the sort undertaken by the experts, would consider a number of different options and would in the end select the option that would deliver the best value for the least capital cost in the actual conditions that applied. It is for this reason that it is necessary for me to consider the differences of detail between the valuer experts both in relation to the A2 and B2 schemes on the one hand and the A3 Scheme on the other. For that reason the conclusions that I have expressed so far concerning the preferability of the A3 Scheme over the A2 Scheme must be regarded as provisional and must be read subject to the directions I give at the conclusion of this judgment. This is so because the conclusions I set out hereafter concerning the differences in principle between the respective valuers will have to be input into a complex valuation grid requiring software not available to me and which will generate a document similar to one or other of those attached at appendix 1 and the appendix 2 to this judgment. Thus, having set out my conclusions on the valuation issues between the parties, it will

necessary for the there to be a further hearing at which the consequence of those conclusions are worked out.

20. Before turning to the issues between the valuers I must set out my conclusions concerning the voracity of the expert evidence adduced before me. I make clear at once that save for two issues I preferred the evidence of Mr. Beckett over that of Mr. Walsh. There was one issue where for reasons I give below I preferred the evidence of Mr. Walsh over that of Mr. Beckett and one further issue where I considered that each had adopted too extreme a position. My reasons for reaching these conclusions are primarily specific to the issues concerned. However, in my judgment, Mr. Beckett was for the most part the most satisfactory witness. He conceded points without equivocation where they needed to be conceded, was objective in the answers he gave in cross-examination throughout and generally his approach appeared commercially sensible. Mr. Walsh is undoubtedly the more experienced of the two experts in the office building market in Manchester, something Mr. Beckett readily accepted. However, in my judgment, his approach to critical issues was broad brush and he resorted to techniques which would not be justified on examination. I deal with these issues further below. Thus, whilst on balance I preferred the evidence of Mr. Beckett over that of Mr. Walsh, I prefer to consider each of the issues on the merits of the evidence relevant to each particular point.

21. I turn first to the sales costs issue, as to which I am satisfied that Mr. Beckett is right and Mr. Walsh is wrong. The rationale of Mr. Walsh's evidence on this issue is that a developer investor would sell, if at all, only in the medium to long-term. In my judgment this is an immaterial consideration. The valuation exercise that I am concerned with involves attempting to ascertain the realisable value of the development. The development cannot be realised without incurring sale costs. Precisely this approach is supported by the valuation textbooks relied upon by Mr. Beckett - see Modern Methods of Valuation Johnson & Ors. 2000 at 166-167 and the Income Approach to Property Valuation Barnes & Ors. 2006 at 213). Furthermore, it seems to me that Mr. Beckett's approach is self-evidently correct once it is recognised that the purpose of the exercise is to establish a net realisable value.

22. When pressed on this point Mr. Walsh was driven to justify his position by saying that property developer investors would not approach the exercise in that way. This

assertion was not particularised, no evidence other than Mr. Walsh's assertion was produced to support it and commercially it seems to me it is incomprehensible once it is accepted that the exercise that I am concerned with is identified net realisable value. Taken to logical extremes, there would be no commercial point or at least it would be commercially risky to develop a building which, once sales costs have been taken into account, would have no or would have a *de minimus* net value. Mr. Walsh's approach to sale costs ignores this point entirely and his approach to this issue generally was one of the reasons why I lost confidence in his evidence. Counsel for the defendant suggested in the course of his closing submissions that if sale costs were to be taken into account then so must receipts of rent over the period pending sale. This point was not put to Mr. Beckett, was not advanced by Mr. Walsh and in my judgment is plainly wrong for the purpose of the exercise with which I am concerned is to arrive at a net realisable value on the relevant date, that is the date the lease came to an end.

23. I now turn to estimated rental value. Mr. Walsh adopted a rate of £20 per square foot for the office accommodation. Mr. Beckett has adopted a rate of £16 per square foot, which he describes as a virtual rent and £17.50 per square foot, which he describes as being the headline or the equivalent headline rent. As will be apparent from this summary, the issue has been complicated by the fact that Mr. Walsh has adopted headline rate, that is the rent, as I have said, that would be paid by a tenant for the area rented after all rent free periods have been enjoyed, whereas Mr. Beckett has adopted an adjusted rate, being the headline rent adjusted by applying the proportion of rent fee to rent payable time over the lesser of either the duration of the term or until first rent review, whichever is the lesser. Both the rate and the correctness of adjusting the rate in this way are in dispute.

24. I turn first to the appropriate headline rate to be applied to the A2/B2 Schemes. Mr. Walsh based his conclusion that the correct headline rate to adopt was £20 per square foot on his experience of local market conditions. His basis for saying that his evidence concerning rate is correct in summary was this; (a) the subject property was marketed by the claimant at a rate of £21.50 per square foot following redevelopment, (b) the first let in November 2005 was at a rate of £21.00 per square foot and (c) at the date of valuation the headline rents number at 1 Piccadilly, a building in proximity to the building were £23.50 per square foot. Mr. Beckett's

approach has been to arrive at a figure by reference to pre-valuation date comparables. He readily accepted that he did not have the same level of practical experience in the Manchester office market as Mr. Walsh. However his conclusion in his report was as follows:

> "It can be seen from appendix H1 of the draft agreed statement that an average of £18.72 has in fact been achieved at a virtual rent level. However, I suggest that a purchaser anticipating that level in 2004 would have been over optimistic. The best rent he would be able to have identified in the PPA was £17.00 at St. James' House, Charlotte Street, again, a headline rent requiring downward adjustment for incentives. Given that there was no other support for rents that high for the PPA as opposed to the CBD where such rents and higher have been achieved I would think he would have been more cautious and used a rent for the scheme of £16, which is £5 per square foot higher than with offices in their covenant condition. As I have suggested, the schedule of availability at appendix N would have been somewhat discouraging to my proposition, namely that £16 per square foot was the right ERV for purchaser's calculation in March 2004, as per Scheme 2."

By "discouraging" Mr Beckett was referring to the fact that appendix N suggests that there was a surplus of space available on the market. At 6.35 Mr. Beckett said this:

> "Someone asking himself the question: 'What is the best rent I can reasonably expect for the Scheme 2 accommodation' would have been brave indeed to answer: "'More than £16 square foot'. There is no sound evidence for that in the PPA. I think it is reasonable to take £16 as ERV for the enhanced building"

25. In my judgment on this issue the evidence of Mr. Beckett is to be preferred. I reach this conclusion for the following reasons: First, Mr. Beckett's evidence is based on comparable evidence leading up to the valuation date and applicable to the relevant area. In appendix 12 to his report Mr. Beckett lists a number of potential comparables. His evidence in relation to the first three entries, two in relation to 5 New York Street and one in relation to York House was:

> "It will be seen from the schedule that the first three transactions listed, all of which are fitted out to A2 specification, would therefore support the

view that the rental value of the property in its grade A2 state was £17.50 headline or thereabout and £16 virtual. However, as I have suggested, the location of these three comparables in New York Street are significantly superior to the location of the property. It is not necessary for me to quantify the difference, suffice to say that the £16 per foot virtual figure I have built into my valuations at scheme 3 is therefore optimistic rather than pessimistic. It also means that Mr. Walsh's £20 psf is out of range".

Each of the comparable transactions took place prior to the relevant valuation date and each was in a location which, if anything, was better than the location of the index building. Mr. Beckett maintained that 5 New York Street was a better building because of the deep slab to slab measurements. Although Mr. Walsh maintained that this was no longer a significant factor it is difficult to see why this matters for present purposes. Even if Mr. Walsh is correct it does not mean that the rent for the buildings with a lesser slab to slab measurement will command better rent. At best it means the point is neutral. In relation to York House Mr. Beckett said that the building was slightly inferior to the index building in its fully refurbished state but was in a notably better location.

26. In my judgment, some support for Mr. Beckett's approach can be obtained from the contemporaneous judgment made by the claimant as to the likely rental values that would be achieved for the building. The claimant is part of a very substantial property owning group of companies with substantial office accommodation holdings throughout central Manchester. The internal board documentation shows that the claimant's board were considering likely rents as follows: On 15th October 2003 £15 per square foot fully refurbished; on 28th January 2004 £15 per square foot fully refurbished; on 28th July 2004 £15-£16.50 per square foot (£16.50 being described as "a very full rent") and on 10th March 2005 a rate of £16 per square foot was described as being a rent likely to be obtained Although the defendant placed reliance upon the fact that in a Section 25 notice served in March 2003 on the defendant by the claimant a rent based on £25 per square foot was sought, I think that is immaterial. It was a starting point for negotiations made without any real expectation that the defendant would renew either at that rent or at all.

27. Mr. Walsh first expressed an opinion as to the correct

estimated rental value for present purposes in an undated letter which was written in 2006. In relation to ERV he said at paragraph 10:

> "Estimated Rental Value. Although the building is now being marketed by GVA Grimley at £21.50 per square foot we have assumed that an appropriate ERV at the material date would be £19.50 per square with a combined marketing and rent free period of 12 months to achieve a letting. This compares to the asking price of 1 Piccadilly at the material date of £22.50 per square, a rent of £2,250 per car parking space has been assumed."

In the course of his cross-examination in relation to other aspects of this letter Mr. Walsh accepted that he had in mind the position in 2006 rather than 2004 but in any event I find that 1 Piccadilly was not a relevant comparable. Aside from the fact that the relevant letting to which he refers occurred after the relevant valuation date, 1 Piccadilly was in any event a very different building; it had large floor sizes, it had an atrium, it had high slab to slab measurements, it was new and was substantially better in every respect than the index property.

28. Mr. Walsh's approach involved making assumptions as to the growth of ERV over the period when the development was to take place. In my judgment, that is an inappropriate approach. Although Mr. Walsh suggested that this reflected the approach of the developers in practice, no specific examples were produced that supported this approach. Mr. Oglevy, whose evidence I accept, said in his evidence that the claimant never factored market growth to rental values when undertaking its appraisals. This seems to me to be obviously correct since such an approach would be an extremely dangerous one. That the approach advocated by Mr. Walsh is not an appropriate valuation practice is made clear by the relevant textbooks - so in "Income Approach to Property Valuation" the learned authors say this at page 78:

> "Whenever the investment method is to be used, whether in relation to tenant occupied property or owner occupied property, an essential step is the estimation of the current rental value of that property. If the property is already let this allows the valuer to consider objectively the nature of the present rent realm. Initially, the most important task must be the estimation of rental income. If the property is owner-occupied then it necessary to

> assess the imputed rental income. This assessment requires analysis of current rents being paid, rents being quoted and the vacancy rate of comparable properties. This assessment should be carried out in accordance with RICS definition of market rent set out in the Red Book as follows: 'The estimated amount for which a property or space within a property should lease/let on the date of valuation between a willing lessor and a willing lessee on appropriate terms in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion'"

At page 212 under the sub-heading: "Rent and Yield" the authors say this:

> "In the case of most commercial industrial buildings the completed development value will be calculated using the investment method valuation. This will require an estimation of the rent of the development and likely investment yield. Both will be based on current market evidence. The rent is normally based on the letable area for the completed development, this will usually be net internal area. It should be noted that in a residual appraisal it is the current rent which is used, notwithstanding the fact that rental levels may have been changed by the time the development is completed. It would be extremely dangerous to base an appraisal on inflated future rent as there can be no guarantee that these will be achieved. The possibility of rental increase/decrease over the period of the development is something which can be reflected in the risk of profit allowance".

Thus, I reject the suggestion that ERV is to be fixed by reference to anticipated future rent rate inflation as wrong in principle for the reasons identified in the quotation set out above.

28. All this leads me to prefer the evidence of Mr. Beckett over that of Mr. Walsh so far as the level of achievable rent is concerned. Thus, I conclude that the achievable rent at the relevant date was a headline rent of £17.50 per square foot or £16 per square foot adjusted.

29. I now turn to the question whether the appropriate rate to adopt is headline, with a suitable balancing adjustment in respect of interest to reflect extended period when the building would be let but non-income yielding, or

adjusted. In relation to this issue Mr. Walsh says at paragraph 3.1.3 to 3.1.4 of his report:

> "An assessing the ERV the valuer needs to deal with the incentives which will usually be offered to tenants. Mr. Beckett advocates assessing the net rent after incentives. Investors and developers view tenant incentives in a different manner, they adopt the headline rent (rent after incentives) and incorporate the incentive as a rent free period into their valuation. This method is preferred as it reflects the reality of the situation whereby the rent free incentive is the cost of the development as opposed to an element of the ERV. By adjusting the ERV to net the impact of any rent free is magnified by virtue of it being multiplied by the yield to determine the capital value. If the landlord decides to sell the property after it is fully let the value achieved will be based on the rent that the purchaser will actually be receiving, which is the headline rent. The impact of using a net rent is best illustrated by an example. Imagine a commercial investment where the headline rate is £200,000 per annum and a rent free of six months is given to the tenant as an incentive. The exact costs of the rent free to the landlord is £100,000. If we use a yield of 7.5 per cent on the headline rent the resulting capital value is £2,666,000 from which the actual cost of £100,000 should be deducted to reach the value of the investment, which in this scenario is £2,566.
>
> If we use Mr. Beckett's net approach and (inaudible) the six months' rent free period equating to £100,000 over say five years to establish the net rent the result is £180,000 per annum. If we apply the same yield of 7.5 per cent to this net rent the resulting capital value is £2,399,400 per annum sic. Therefore despite the actual costs of the rent free period to the landlord being £100,000, it is magnified by Mr. Beckett's approach to £267,266.".

Mr. Beckett's response to this is set out paragraph 2.3.5 to 2.3.15 of his supplement report. It seems to me that the key point that emerges from this evidence is that the headline as against adjusted rent question cannot be viewed in isolation from the yield multiplier value that is adopted. As Mr. Beckett says at paragraph 2.3.6 of his supplemental report:

> "Obviously in principle one can do either, it would

ultimately be a matter for comparable evidence. A simplified example me help to illustrate what I mean by this. If, for example, an office building was let at a headline rent of £100,000 pound per annum and it sold for £1,000,000 that would be analysed at a yield of 10 per cent based on the headline rent. If true virtual rent was £900,000 per annum and the purchase would be analysed at a yield of nine per cent based on the virtual rent. Thus, in using that yield in a valuation if one was capitalising a headline rent one would use a yield of 10 per cent but if one was capitalising a virtual rent one would use a yield of nine per cent."

This, as far as it goes, provides an answer to the point made by Mr. Walsh at paragraph 3.1.4 of his report. Clearly what he says would be correct if the same yield multiplier is used irrespective of whether headline or adjusted rent is being used. However, if the yield adopted is that appropriate to an adjusted rent it would plainly be inappropriate for use with a headline rent. As Mr. Beckett says at paragraph 2.3.10 of his supplemental report:

"The yield used to capitalise the rents is what valuers call an 'all risk' yield. It reflects the totality of the investor's views about the investment, its attractions as well as its potential problems. The expression is misleading because the yield reflects the positive aspects of the investments as well as its risks. One important component in all risks yield is the investor's perception of prospective growth in his rental income over the years to come. The growth in rental income will be realised either through the operation of rent reviews or on lettings".

As he says at paragraphs 2.3.11 to 2.3.13"

"It is instructive to take an example from the schedule of actual lettings at appendix H to the draft agreed statement. Suite 5A was let at a headline rent of 22 per cent per square foot and a virtual rent of a little over £19.50 per square foot. That letting involved an upwards only rent review after five years.

Suppose the investor assumes he will get five per cent per annum rental growth, this means that the by the time he gets to the end of fifth year he ERV is £24.89 per square foot and the investor will get a

rent review to that level, a 13 per cent uplift on headline rent at £22 per square foot, which over the five year period amounts to annual compound growth of only 2.5 per cent. If, on the other hand, he would start from £19.50 per square foot the increase would be 27.6 per cent per square foot compound annual growth of five per cent per annum. What this demonstrates is that if you start with a headline rate you will get about one half in that example of the rental growth you will get if you start with virtual rent.

Applying a yield derived from purchases of property where the virtual rent is being paid to capitalise headline rates will therefore produce an overestimate of the value of the building. So if an investor is prepared to accept a 6.875 per cent yield on the basis that his income will rise at a compound annual rate of five per cent he will look for a significantly higher yield if he only expects a 2.5 annual increase. It follows that for consistent we must use virtual rents not headline if we employ that yield. Obviously those figures are less stark if the growth is higher is if the incentives are lower."

The key phrase in all of that analysis it seems to me is in the final sentence where the key phrase is "if we employ that yield".

30. Thus, the questions really depends upon whether the yield figure that has been agreed is one that is appropriate for an adjusted or headline rent. As to this, although the rate is agreed Mr. Beckett says that what has been agreed is appropriate to adjusted not headline rent. Mr. Welsh has approached the yield issue by reference to what he calls standard analysis and has applied the agreed yield to what he considers to be the correct headline rent. As I have already said, I prefer Mr. Beckett's evidence as to the correct rental level. However, in relation to the headline as against adjusted issue I prefer Mr. Walsh's evidence because I consider he is likely to be correct when he says that his approach is one that a developer investor would take for the reasons he gives. In any event, I am not satisfied that the evidence shows that Mr. Beckett is correct when he says that the relevant comparables support his approach.

31. In those circumstances I have to consider next what the likely period would be that would be adopted by a hypothetical purchaser as being the likely average rent free period for which allowance ought to be made. In my

view, the correct period to adopt is one of five months. This is supported by appendix 12 to Mr. Beckett's supplemental report where three comparables are referred to which each predate the relevant date and average at five months. Given the limited circumstances in which it is appropriate to refer to post-valuation date events it is probably inappropriate to refer to the rent free periods that in fact were negotiated in late 2005 and 2006 through to 2007. For what they are worth, they are set out in appendix H1 to the joint statement. The value to be attributed to this material is limited by reason of the expiry of time between the relevant date and the date of the lettings referred to in that schedule. However, ignoring the lease to the British Transport Police, the average appears to be about four and a half months. However, an analysis of the information contained in that schedule suggests broadly that the rent free period lessors were prepared to concede tightened in the back half of 2006 and into 2007 with, however, isolated exceptions. On balance and for what it is worth therefore, I consider that the information contained in appendix H1 supports the conclusions I have arrived at by reference to appendix 12 of Mr. Beckett's supplemental report and that is that it is appropriate to adopt an assumed rent free period of five rather than three months when carrying out calculations.

32. In summary, therefore, I conclude that headline rather than virtual rents should be adopted. There will have to be a consequential adjustment for interest charges and in my judgment that adjustment must be carried out by reference to an assumed average rent free period of five rather than three months.

33. Two issues remain in relation to the A2 and B2 schemes. There is a dispute concerning the appropriate letable space which should be adopted in carrying out the calculation and there is a dispute concerning how a developer's profit should be incorporated within the calculation. As to the first of these points Mr. Walsh adopts a figure of 53,509 square feet for the office space, which is the net letable space set out in the claimant's letting brochure for the refurnished building. This obviously increases net value. Mr. Beckett has, however, adopted a figure of 52,108 square feet in his schedule. As I understand it, this figure is the net letable area as let and reflects the fact that there had been a sub-division of some of the floors of the building so as to allow parts of floors to be let to different tenants.

34. In my judgment both these positions are extreme. Mr. Walsh's position fails to take any account of the foreseeable risk that some sub-division might be necessary if the building is to be fully let. By the same token, Mr. Beckett has taken as his start point something that could become known only after the relevant valuation date, which is not a permissible approach. In my judgment a hypothetical purchaser would have been bound to take account of the risk that with a property of this sort it might be necessary to lease out part of a floor and thus suffer a reduction in letting capacity. The evidence does not suggest that a hypothetical purchaser would have ignored this possibility. Doing the best I can with this issue, I take the view that the safest way to proceed is by taking the average of office letting space, that is to say the average between Mr. Walsh's 53,509 square feet and Mr. Beckett's 52,108 square feet. The average is 52,808 square feet, which is the figure which in my judgment should be adopted when carrying out the relevant calculation.

35. The final issue that arises in relation to the A2 and B2 scheme concerns developer's profit. If no allowance is made for profit the developer would be undertaking the development for nothing. However, in the nature of things profit will be a variable because it will affect net values and therefore the price that will be offered for the building by the potential developer. If too aggressive a view taken of profit then the developer will run the risk that he will be out bid for the building but, on the other hand, if it is foreseeable that the development will take a long time or letting might be or become problematic then the profit element may well be increased to compensate for the risk implicit in those elements.

36. Mr. Beckett's position is that profit is to be calculated for the A2 and B2 scheme at the rate of 17.5 per cent of gross development value but adding a further 2.5 per cent for what he describes as planning risk. This is in marked distinction to schemes A1 and B1 where no planning risk arises at all and schemes A3 and B3 where it has been assumed that no planning risk would arise. Mr. Walsh's approach is different. He adopts what he has called a developer's return approach. Mr. Beckett defines what he understands to be a developer's return approach in paragraph 5.14.6 of his initial report where he describes such an approach in these terms:

> "In my view it is more efficient as well as more explicit to separate out profit as an item. An

> alternative approach is 'a developer's return' approach. If I buy a development project expected to produce a rent of £100,000 per annum and which I expect to be able to sell on a yield of eight per cent at the end of the day at £1.25m I might instead look for a 10 per cent developer's return on the total cost of the project producing an end value of £1m. The difference between the £1m and the £1.25m is my anticipated profit. This is a common approach among developers who intend to retain their investments. However, for forensic purposes it is important to understand that the higher developer's return compared to the yield is just another way of representing my 20 per cent profit on gross development value. This is one of the reasons for thinking that the residual approach which I have used is more reliable and more explicit than taking a developer's return approach which tends to bury the concept of profit behind calculation rather than making it explicit. It also justifies the view that it does not matter whether the developer intends to retain the investment or not, it is market value that he is concerned with and the target market value is found of on completion of his lettings."

Mr. Walsh asserts that this is what he has done in the calculation that he has carried out but in fact in my judgment that is not so. As is apparent from appendix 2 to this judgment what Mr. Walsh has done is to take a developer's return of 10 per cent and apply it to the gross value struck after deducting everything except profit. Mr. Beckett says that this is heretical as a valuation approach because valuers always apply the profit percentage to either GDV, that is the value of the finished product where typically a lower percentage rate or multiple will be adopted, or, alternatively, to the costs incurred to produce the finished product, treating the developer as in effect a management contractor where a higher percentage or multiplier will be adopted.

37. The effect of adopting Mr. Walsh's approach is to apply the multiplier which he adopts at 10 per cent not to the total costs of the project or to GDV but to a much lower multiplicand, which is in effect GDV less all costs save profit. This results in a much lower profit figure than would be conventional. I prefer Mr. Beckett's approach over that adopted by Mr. Walsh. Aside from the points already made, Mr. Beckett's approach is supported by the standard texts on valuation put before me and in my judgment accords with commercial and common sense. I found Mr. Walsh's oral evidence on this issue to be

profoundly unconvincing. His approach means that profit could be eroded by minute changes in things like increases in building costs and unexpected delays in the building process, which would have the effect of increasing interest charges as well as market alterations to ERV. If profit is taken as either a percentage of the gross value of the finished product or as a percentage of the cost of constructing the project then these risks are eliminated. Mr. Walsh accepted that he had never seen the approach he advocates adopted in practice, though he maintained it would be used routinely by development contractors. It was not clear to me how that assisted given that it was to be anticipated that the hypothetical purchaser in this case would be a developer investor. Aside from that, however, I cannot see how rationally a contractor could the approach advocated by Mr. Walsh for the reasons I have given concerning commercial risk.

38. The rate adopted by Mr. Beckett appears to be conventional and in those circumstances in principle I prefer the approach of Mr. Beckett and accept his application of a rate for GDV as appropriate. I consider, furthermore, that 17.5 per cent is an appropriate starting rate to adopt subject to a planning issue, to which I now turn.

39. In essence the justification for the 2.5 per cent uplift on profit is to reflect the risk of delay in getting planning permission. Such delay would prevent the start of the development, would therefore mean that the period when the building remained empty would be increased. In cash terms the uplift which has been applied by Mr. Beckett appears to equate to £387,214 odd. This is the equivalent of 58 days' interest at the daily rate applied to the acquisition costs referred to by Mr. Beckett in his schedule, which in round terms is a period of about two months.

40. It is common ground that planning for the full refurbishment scheme had not been obtained at the valuation date. However, the reality is that planning was always going to be granted eventually because of the nature and location of the site and the interests of the relevant planning authority in the development of the site strategically, as I described earlier in this judgment. The planning issues in dispute were matters of detail only and as soon as the claimant sought to engage with the Local Authority to resolve these issues they were revolved fairly quickly and amicably. Nonetheless, there was a foreseeable risk at the valuation date of delay due to the resolution of outstanding planning issues and overall therefore I conclude that one per cent, referred to by Mr.

Beckett his oral evidence, adequately reflects that risk. Thus, I conclude that the profit figure to be taken is one of 18.5 per cent of GDV.

41. In summary therefore my conclusions in relation to the issues in dispute concerning the valuation of the A2 and B2 schemes are:
(A) Sale costs have to be deducted before net values can be calculated and should be deducted at the rate of two per cent.
(B) Mr. Beckett's ERV of £17.50 per square foot headline should be adopted for the purpose of valuing the property.
(C) The ERV which should to be adopted is headline rather than adjusted rent rates.
(D) Account should be taken of the rent free period by adopting an assumed period of rent free occupation of five months.
(E) Valuation at the A2/B2 schemes should be on the assumption that the net letable space is 52,808 square feet so as to cater for the risk that at least some of the office floor would have to be divided between different tenants.
(F) Profit should be accounted for at an assumed rate of 18.5 per cent of GDV.

42. Finally, I turn to the valuation to be placed on the A3 scheme. As I said, Mr. Walsh has chosen not to advance any positive case in relation to this scheme and, thus, the only issues that arise are points which were advanced in the course of cross-examination. In the end the points that arose were two in number, namely (a) whether Mr. Beckett was wrong to adopt an ERV of £11.50 per square foot for A3 when he adopted a rent of £11 per square foot for the A1 scheme and (b) whether his yield figure of 7.875 per cent was to be criticised because it was simply an arbitrary uplift of one per cent from the agreed yield applicable to the A2 and B2 schemes.

43. The question concerning virtual as opposed to headline rents is one that I have already addressed in detail and need say no more about. What I said in relation to that issue in relation to the A2 and B2 schemes applies with equal force it seems to me to the A3 scheme. As to the appropriate rental level issue that arises in relation to the A3 scheme I can take this issue quite shortly. Mr. Beckett justified his figure by reference to two comparables, the St. James's House property and 111 Piccadilly, The point made by Mr. Beckett was that in his opinion the availability of air conditioning in the subject building made it more valuable in rent valuation terms that the competitors. It seems to me likely that a

modified reception area, which would be more attractive and more in keeping with modern requirements is (with the availability of air conditioning) likely to have an upward effect to a slight extent on rental values.

44. This being so, I accept that the rent per square foot for the A3 scheme would be slightly greater than for the A1 scheme. I accept Mr. Beckett's evidence as to the amount, not least because there is no other evidence before me from which I can draw alternative conclusions. Thus, subject to adjustment to reflect the headline as opposed to adjusted issue, I consider his rental figure to be an appropriate one to be adopted.

45. I now turn to yield. It is important to remember what yield is designed to identify. It capitalises the rent that the hypothetical purchaser anticipates he will achieve on a complete letting of the property. The appropriate yield rate for the building in its A2/B2 condition was agreed at 6.875%. The issue now under consideration concerns a building in serviceable but basic condition. Unlike a fully refurbished building, a building of the A3 variety can be expected to get progressively out of touch with modern occupiers' requirements over time. The tenants which will be attracted will by definition be of lesser quality than would be the case following a full refurbishment, which in turn highlights the risk resulting from insolvency of tenant and the difficulty of then re-letting and it also makes more likely that letting terms will be shorter and void periods longer and more frequent, particularly in the longer term. All of this leads to the conclusion that a raised yield would be required by a hypothetical purchaser so as to enable him in effect to get his return more quickly.

46. Mr. Beckett's opinion was that this justified a one per cent spread between the yield adopted for A3 and the yield to be adopted for A2 and B2. This issue was not addressed by Mr. Walsh in his reports at all. It was suggested to Mr. Beckett in cross-examination that a yield figure of over eight per cent might be appropriate. However, I accept that this is ultimately classically a matter for valuation judgment. I also accept that it is impossible to be precise. Indeed, the agreed yield rate adopted for the A2 and B2 schemes was the result of an agreement between the experts which reflects this reality. Mr. Beckett was unshaken in his view that it would be appropriate to increase yield by one per cent but not more than one per cent over that which had been agreed as the compromise yield for the A2/B2 scheme and I am satisfied

by his evidence that this is the appropriate way to proceed.

47. There remains for consideration the Clause 4.11 debt claim. It arises from the terms of the further proviso to clause 4.11 of the lease of the building. It provides as follows:

> "...provided further that if the tenant shall fail to leave the premises in such condition as aforesaid then and in such case the landlord may do or effect all such repairs, renovations and decorations for which the tenant shall be liable hereunder and the costs thereof shall be paid by the tenant to the landlord on demand and the certificate of the landlord's surveyor certifying the cost to the landlord should be final and binding on the tenant and the tenant will also pay to the landlord mean profits at the rate of the rent payable hereunder immediately prior to the said expiration or determination during the period reasonably required for carrying out such work and the amount of such mean profits should be added to the cost of carrying out such work as aforesaid, save in the case of such delay being attributable to the landlord".

As I have indicated, there is no dispute as to the sum due under this provision, if it applies. The dispute concern is one of principle as to applicability in the circumstances of this provision.

48. In answer to the claim made pursuant to Clause 4.11 the defendant submits, first, that on true construction the clause did not apply to a claim for survival items in the context of a landlord undertaking a major refurbishment. This is said to be supported by the reference to " … all such repairs, renovations and decorations for which the tenant shall be liable … " which is used in the clause itself. Secondly, it is submitted that concurrent claims for debt and damages for diminution cannot be maintained because the landlord must elect between such remedies. Thirdly, it is submitted that the claims have been advanced by reference to a formal demand which was for too great a sum in the events that have happened. As to the these points the claimant submits (a) that there is nothing in Clause 4.11 which requires that the landlord must do all the work in order to be able to maintain a claim under the clause; (b) there is nothing in clause 4.11 or elsewhere in the lease that suggests a claim under the further proviso precludes a claim in damages for any loss suffered by the landlord being made in addition to a

claim under the clause and any double recovery is avoided by any payment recovered under the clause being credited against the damages claim and (c) it is not accepted that the demand has to be accurate in order to be effective but in any event without prejudice to that contention a revised demand was sent to the claimant's solicitors by letter dated 21st November 2008 which eliminates that issue.

49. As to the first and second of the points identified in my summary of the claimant's response set out above in my judgment both as a matter of true construction of the lease and in principle the further proviso can apply only where the landlord does all and not just some of the work for which the tenant is liable under the repairing covenant, at any rate where such is combined with a redevelopment scheme. As to construction this is the effect of the words actually used in the clause that I have highlighted above. Had it been intended that the clause was to apply in cases where the landlord had partially executed dilapidation works then the clause could with ease have been drafted so as to say precisely that. However, the more fundamental point is that in principle this is the correct outcome for the purposes of the clause is to enable the landlord to take remedial action himself to avoid any loss being caused by the tenant's failure to repair and recover the cost with relative ease and at moderate cost. If the landlord carries out the work the value of his interest in the property is restored. As Millet LJ said in *Jarvis v. Harris* [1996] Chan. 195 at 203:

> "The landlord is out of pocket but that is because he has carried out repairs not because the property is in disrepair."

If the claimant is correct in its analysis then potentially difficult legal and factual issues would arise which are avoided if a clear distinction is maintained between the landlord either (a) carrying out the whole of the work necessary to make good the dilapidations and making a claim under the clause or (b) making a claim in damages for diminution whether or not the landlord has carried out the whole of the works necessary to make good the dilapidation. Accordingly, I conclude that in the circumstances of this case the claimant is confined to its claim for damages for breach of covenant.

50. As to the damages claim at the end of the trial it was recognised by all parties that it would not be possible for me to carry out the calculations that follow from the

conclusions I reached on the valuation issues between the parties because I did not have access to the relevant software necessary to enable me to carry out the calculations. Accordingly, it was left that there would be a further hearing at which these issues could be resolved. I recognise too, as I have already said, that the conclusions I have reached may have an impact on the comments I have made concerning the approach of a hypothetical purchaser of the building in covenanted condition to the adoption of the A3 as opposed to the A2 scheme, although I suspect this is unlikely. Neither parties' counsel has been able attend today's hearing. For these reasons I propose to adjourn the trial to a resumed hearing at which:

(a) any further submissions either party wishes to make concerning the A2 A3 issue can be heard in the light of the conclusions I have reached on the other issues between the parties,
(b) following, if necessary, a final judgment in relation to issue (a) above, the terms of the order will be settled; and
c) all questions concerning interest and costs and any application for permission to appeal can be determined.

For the avoidance of doubt therefore I adjourn the trial pursuant paragraph 4.3(b) of the Part 53 Practice Direction so as to preserve the rights of the parties to make an application for permission to appeal if so advised.

51. I direct that prior to the resumed hearing the parties shall use best endeavours agree the valuation effect of the conclusions I have reached and to lodge that formulation using the form adopted by Mr. Beckett, that is to say the form of appendix 1 to this judgment, by no later than two clear days prior to the hearing, together with skeleton submissions, which, if agreement cannot be reached as to the valuation effect of my conclusions, should then annex the formulations contended for. The skeletons should of course address the other matters mentioned above as being the business of the resumed hearing.

_____

AT THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
MANCHESTER DISTRICT REGISTRY

Order No. 6MA90479

The Civil Justice Centre,
1 Bridge Street West,
Manchester.

Tuesday, 27th January, 2009

BEFORE:

HIS HONOUR JUDGE PELLING Q.C.
(Sitting as a Judge of the High Court)

IN THE MATTER OF:

BRUNTWOOD 2000 FIRST PROPERTIES LIMITED — CLAIMANT

AND

BRITISH TELECOMMUNICATIONS PLC — DEFENDANT

Both parties were represented by Counsel

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A P P R O V E D J U D G M E N T

HIS HONOUR JUDGE PELLING Q.C.

1. This ruling is supplemental to a judgment delivered by me in these proceedings on 11 December 2008. The claim is for damages for breach of a covenant, by which the defendant was bound to deliver up the premises, an office block at 1 Portland Street in Manchester in good condition, decorated and with any partitioning removed. My earlier judgment was concerned with various disputes of detail as to how the claim was to be valued.

2. At trial, both experts were agreed that in arriving at a valuation of the building, it was necessary to apply an all risks yield multiplier to arrive at a valuation figure.

3. Initially there was a dispute between the parties as to the appropriate multiplier to be applied. Mr. Walsh, the expert called by the defendants, contended that the correct multiplier was 6.75%, whereas Mr. Beckett, the claimant's expert, contended that the correct figure was 7%. In the end, as part of the issue narrowing exercise, the experts agreed a yield multiplier of 6.875%. This agreement was not in any sense qualified.

4. As will be apparent from paragraphs 29 to 32 of my initial judgment, there was an issue between the parties as to whether what was called in the proceedings the headline, or what Mr. Beckett called the virtual rent, should be adopted in arriving at the valuation of the premises.

5. The need for this debate arises, because it is necessary to take into account the effect of rent free periods granted to tenants following refurbishment

when valuing a building such as the subject premises in circumstances such those as arise in this case. As will be apparent from what I say in the judgment, if a virtual rent approach is adopted, the effect of the rent free period will be exaggerated unless the yield figure is also altered in order to adjust out this mathematical exaggeration.

6. Following the hand down of the judgment, this hearing was fixed, in order to address various issues that it was anticipated might arise out of my various conclusions as to the issues in dispute between the parties. The issue I am now concerned with is that identified by Mr. Jourdan at paragraph 34 of his skeleton submissions for these present proceedings in the following terms:

"The claimant also asks for permission to appeal in relation to the decision to use headline rents. The recollection of the claimant's legal team is that MW", (that is Mr. Walsh) "accepted, in cross-examination, that the agreed yield which was derived from the investment sale comparables discussed in PB's and MW's reports, was one appropriate for use with market rents, rather than headline rents. If that recollection is correct, then the decision in paragraph 30, that the agreed yield should be applied to headline rents, was against the weight of the evidence."

7. The relevant part of the transcript of the evidence that has been identified in support of that application appears at page 23 of the transcript for Thursday 27 November 2008, between letters B and E, where the following appears:

"Question: Would you not accept that taking the yield comparables as a whole, they are yields based on market rents, not headline rents? Answer:

Er, yes, correct. Question: And on that basis Mr. Beckett must be right, must he not that you …. There are two ways you can do it. You could either adjust the yield to reflect that fact and then capitalise a headline rent, or you would have to adjust the headline rent to a virtual rent and a market rent, and then capitalise that. You have to do one or the other, do you not? Answer: You can look, as I say, there's no dangers to ..... Valuation is not a precise science, as Mr. Beckett has said before. You are looking at the investment transactions to form an opinion. My opinion was based on headline rent, so I made an adjustment. We have no, we didn't have any grades, comparable evidence in relation to the investment values. We didn't have an identical development opportunity to look at, so .... Question: Now --- Answer: But the other thing coming out of that is obviously you will look at things, and my sensitivity analysis covers the situation where I look at virtual rents. So if I adjust it to put virtual rent in, that would be £19 a square foot, and that falls within my sensitivity analysis."

8. Before me, Mr. Jourdan accepted that the quality of the evidence I have just referred to, did not justify me in reopening the case, which was something he contemplated in paragraph 37 of his skeleton submissions ahead of this present hearing, and he so conceded, even though it was accepted, as I say, that in principle I could reopen the case to deal with the point. Nonetheless, Mr. Jourdan submitted that the material that I have just referred to, justified in him applying for permission to appeal on the basis identified in paragraph 34 of his skeleton submissions.

9. In my judgment, permission to appeal should be refused on this point. The experts were at odds as to whether headline or virtual rent should be used as

the basis for the valuation. I preferred on this issue the evidence of Mr. Walsh. At no stage was it suggested by either expert that a different yield figure should be adopted depending on whether I preferred the headline or virtual rent approach. The evidence relied upon by the claimant does not, in my judgment, support the assertion that the conclusion as to headline or virtual rent was to be informed by the agreement as to yield, which was a compromise figure of 6.875%.

10. Mr. Walsh said in his oral evidence that he had made an adjustment to reflect his use of the headline rent approach. It would have been absurd, in my judgment, for Mr. Walsh not to have done so, given what he sets out in paragraph 3.1 of his report, (TB3/482), on the headline as opposed to the virtual rent issue.

11. The real difficulty here has been caused by the agreement between the experts. However, in my judgment, the only proper inference to be drawn from the fact that a) they differ as to the use of headline as opposed to virtual rent as a starting point for valuation, and b) have agreed an all risks yield multiplier as a compromise, is that each was prepared to accept that the agreed yield multiplier could be used, whichever rent value approach was adopted. Had the compromise figure been thought appropriate only for headline or virtual rent, then one at least of the experts could have been expected to say so; they did not.

12. Mr. Jourdan relied heavily on the comparable investment property material, asserting that it was all based upon market rents, which he treated for all practical purposes as equivalent to the virtual rent, for which Mr. Beckett contended. However, that material was used by both experts to arrive at their respective conclusions as to yield, which they then compromised without reservation.

14. For these reasons, I decline to recall the judgment, assuming without deciding that I could do so, and I refuse permission to appeal. The question of whether to adopt headline or virtual rent could not properly be decided by reference to the yield figure agreed, given the unqualified nature of the agreement, and the acknowledged continuing differences between the experts as to whether headline or virtual rent should be adopted.

15. I direct that if any application is made to the Court of Appeal for permission to appeal on this point, that a transcript of these remarks should be attached to any such application.

AT THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
MANCHESTER DISTRICT REGISTRY

Order No. 6MA90479

The Civil Justice Centre,
1 Bridge Street West,
Manchester.

Tuesday, 27th January, 2009

BEFORE:

HIS HONOUR JUDGE PELLING Q.C.
(Sitting as a Judge of the High Court)

IN THE MATTER OF:

BRUNTWOOD 2000 FIRST PROPERTIES LIMITED — CLAIMANT

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A P P R O V E D J U D G M E N T

HIS HONOUR JUDGE PELLING Q.C.

1. This is the second of two judgments, which are supplemental to that delivered by me in these proceedings on 11 December last. I need not explain again the background; it is clear from my earlier judgments. However, as I said at paragraph three of my December judgment,

"The claimant's case is that it should recover by way of damages for breach of covenant, the sum of £852,883, which it maintains is the difference between the net value of the property following refurbishment, £5,903,125, and the value that the building would have had if it had been delivered up in covenanted condition when, following a much more limited refurbishment of the ground floor at a cost of £261,332, it would have had a value of £6,756,008."

2. The relevant schemes are known in these proceedings as the A2, A3 and B2 schemes. The A2 scheme was the refurbishment as carried out, but assuming the building was delivered up in a covenanted condition, and the A3 scheme was the much more limited refurbishment scheme I referred to in the paragraph of my initial judgment quoted above. The B2 scheme was the refurbishment scheme actually carried out.

3. A perusal of my earlier judgment and the appendices thereto, will reveal that whether the claimant was entitled to succeed in recovering anything other than what are referred to as "the survival items", that is, the element of the covenanted work that should have been but was not carried out by the

defendant and which would have survived the refurbishment works actually carried out, depends upon whether the value of the building following completion of the A2 scheme, would have exceeded the value of the building if the A3 scheme had been carried out.

4. I was required to decide various issues between the valuers, which was then to be input into a valuation matrix, in order to demonstrate whether the A3 scheme would have resulted in a greater value building than the A2 scheme. One of the issues that had to be resolved by me was whether what were referred to as the headline, as opposed to the virtual rents were to be used, in order to calculate the ultimate value to be attributed to the building.

5. I concluded that headline rather than virtual or adjusted rent values should be used. In relation to the A3 scheme, I considered that headline rather than virtual rents ought to be used, but accepted the evidence of Mr. Beckett, the expert valuer called by the claimant, as to the rate to be adopted.

6. As I said in paragraphs 43 and 44 of my initial judgment,

"As to the appropriate rental level issue that arises in relation to the A3 scheme, I can take this issue quite shortly. Mr. Beckett justified his figure by reference to two comparables; the St. James's House property and 111 Piccadilly. The point made by Mr. Beckett was that in his opinion, the availability of air conditioning in the subject building, made it more valuable in rent valuation terms than the competitors. It seems to me likely that a modified reception area which would be more attractive and more in keeping with modern requirements is, with the availability of air conditioning, likely to have an upward effect to a slight extent on rental values. This being so, I

accept that the rent per square foot for the A3 scheme, would be slightly greater than for the A1 scheme. I accept Mr. Beckett's evidence as to the amount, not least because there is no other evidence before me from which I could draw alternative conclusions. Thus subject to adjustment to reflect the headline as opposed to the adjusted rent issue, I consider his rental figure to be an appropriate one to be adopted."

7. Thus, the issue that remained to be resolved was the conversion of the virtual rent adopted by Mr. Beckett to the headline rent, with consequential adjustments to take account of the rent free period of five months, which I also refer to in my judgment and which I considered should be assumed when arriving at valuation figures. I had hoped this would be a matter for agreement between the valuers. Unfortunately that has not proved to be the case.

8. Mr. Beckett's position is that he arrived at his virtual rent by reference to two comparables, being the St. James's House and 111 Piccadilly properties I referred to in my initial judgment. This much I acknowledge, as I said in paragraph 43 of my earlier judgment. Thus, Mr. Beckett says that the headline rents for the two comparables were respectively £13 per square foot and £12.50 per square foot. He says that he deducted £1.50 from £13.00, to arrive at his virtual valuation of the A3 scheme of £11.50 per square foot. Thus, he says the correct headline equivalent of the virtual rent he adopted is £13 per square foot.

9. That the headline rents of the two comparables is as stated, is clear from the material before me and that was before the court at the trial, leading to my

earlier judgment - see in this regard, TB 2/447 in relation to 111 Piccadilly, and TB 3/660 in relation to the St. James's property.

10. That Mr. Beckett applied a deduction of £1.50 to the headline figure of £13 per square foot is most clearly apparent from paragraph 2.2.7 of Mr. Beckett's supplementary report at TB 3/637 and following, and that he adopted £13 as his headline rate is apparent also from paragraphs 2.3.16 of that report and appendix 14, referred to in that paragraph.

11. The reason Mr. Beckett adopted this approach of deducting £1.50 per square foot, was because it appeared to him to be broadly correct. However, in truth, one cannot arrive at an adjusted rent, simply by applying the same proportional deduction, regardless of the property's state and condition. The deduction that has to be applied will vary from case to case. Thus, the technique that Mr. Beckett adopted for converting headline to virtual is probably, strictly speaking, wrong. However, that does not alter the point of departure. Nor does it make the point of departure wrong. It merely invalidates or may invalidate the end result.

12. Here I am concerned with headline rent, and if as I accept, Mr. Beckett started from a headline figure and devalued to get to a virtual figure, then I am concerned with the point of departure alone. This, as I have said, was £13 per square foot.

13. I repeat what I said in my judgment at paragraph 43. The improvement of the reception area, justified an increase in rent per square foot over the building unmodified, but returned in its covenanted condition, the A1

scheme. Mr. Beckett attributed an increase of 50 pence per square foot to this factor, and there is no reason to suppose that he was wrong to do so. That alone justifies an uplift from £12.50 to £13 per square foot, where £12.50 per square foot was the lowest relevant comparable headline rent.

14. He also made the point that the comparables that he relied on were inferior, in the sense that they each lacked air conditioning, and his evidence was that that justified taking a figure of £13 per square foot, which is the figure that he started from.

15. The defendant's approach to this exercise is a bottom up approach, which involves taking £11.50 per square foot, which in any event and as is common ground is inaccurate, and adjusting for five months rent for occupation, which results mathematically in the figure of £12.55 per square foot, for which they contend.

16. As I see it, there are a number of difficulties about this approach. First, there is no evidence from Mr. Walsh as to what in his opinion the correct headline rent figure ought to be. The only evidence on that issue comes from Mr. Beckett, and that is that the correct figure is £13 per square foot. That alone, it seems to me, is enough to dispose of this point, since I accept Mr. Beckett's evidence, there being no other.

17. Secondly, however, as I explained, Mr. Walsh's approach seeks to take advantage of Mr. Beckett's erroneous approach to devaluing from headline to virtual, which invalidates the process adopted in relation to the issue I am now considering by Mr. Walsh and by the defendants.

18. Thirdly, although Mr. Walsh says in his supplemental report prepared for this hearing at paragraph 2.8,

"It is wrong to simply add £1.50 per square foot to different levels of virtual rent to establish headline rents",

that is not what Mr. Beckett has done, as I have explained already.

19. Although the point was made on behalf of the defendant by Mr. Hornett, that mathematically the conclusion that the headline rent should be £13 meant that one was allowing for the equivalent of seven as opposed to five months' rent free, that is only so if the mathematical application of a proportion is adopted to the exercise under consideration. Irrespective of whether that is correct or not, it fails to give any sufficient weight to the comparable evidence that Mr. Beckett relied on as justifying his £13 per square foot figure.

20. In those circumstances, I have no hesitation in concluding that the figure contended for by the claimant of £13 per square foot, as being the appropriate headline rent on which to base the outcome of this case. The net result is, therefore, that the net value of the property if the A3 scheme had been adopted, was £7,192,734, and the net value of the building following the carrying out of the B2 scheme, was £6,718,658, and there is therefore a diminution in value, being the difference between the two, in the sum of £474,076.