FITTING OUT CONCESSIONS AND INDUCEMENTS

by Nicholas Dowding QC

A Paper delivered to Denton Wilde Sapte on 21st May 2002

INTRODUCTORY

1. Save in special cases, commercial premises are never let in a condition in which the incoming tenant can simply more in and trade from day one. In practice, some degree of fitting out will always be required. The precise extent will depend upon the degree of finish when the premises were let and the particular tenant's requirements. An office tenant's fit out may include the provision of reception areas, partitioning, IT and other cabling, raised floors, suspended ceilings, carpeting and supplemental air conditioning. Shop tenants will generally require to install display shelving or racking and shop fronts.

2. The incoming tenant will generally be given a rent free period ("a fitting out rent free period") to cover the time that he expects to spend fitting out. In addition, depending on market conditions, he may also be able to negotiate some form of inducement in return for entering into the lease (or entering into it at a particular rental level). Although the structuring of a deal in the real world will often not distinguish between (i) fitting out rent free periods and (ii) inducements (for example, the tenant may get a single rent free period, of which part is for fitting out and the remainder is

an inducement), nonetheless for the purposes of rent review the two are conceptually quite distinct and require to be looked at separately.

3. It is important to appreciate the practical context in which issues concerning fitting out rent free periods and inducements generally arise in rent reviews. Nearly all review clauses require the valuer to fix the rent that could reasonably be achieved on a hypothetical letting of the demised premises on the open market on the review date on stated assumptions and making certain disregards. In practice, the valuer will make his assessment by looking at rents agreed for comparable properties around the valuation date and making such adjustments as he thinks are necessary to compare like with like. It is in relation to these adjustments that the question of fitting out rent free periods and inducements often arises. This is because, in order to compare like with like, the valuer must first identify, and then allow for, those differences between (i) the hypothetical transaction contemplated by the review clause, and (ii) the comparable transaction. Thus, if (for example) the review clause requires the valuer to assume that the hypothetical tenant is getting a rent free period for fitting out but nothing else, any comparable transaction in which the tenant was given an inducement as well must be adjusted so as to "strip out" of that rent the element attributable to the inducement[1].

4. Central to this process is to identify what assumptions the review provisions require the valuer to make in respect of fitting out and inducements. This is where the lawyer comes in, both at the drafting and at the litigation stage. The answer is, of course, a question of construction

[1] The resulting figure (i.e. the rent which the tenant under the comparable transaction would have paid had he been given a fitting out rent free period and nothing else) is sometimes known as "the net effective rent".

of the particular review clause, but it is possible to identify from the decided cases a number of principles of general application. The object of this paper is to examine those principles and look at some aspects of their application in practice.

FITTING OUT

(a) Fitting out costs

5. The need to fit out will result in the incoming tenant potentially incurring two types of cost:

   (1) The capital cost of the work itself;

   (2) Loss of use of the premises whilst fitting out is going on.

6. In most cases, the tenant will have to bear the first head of cost himself[2]. This will include not only the capital cost of the work but also interest on that sum. However, as has been explained, he will generally get a fitting out rent free period to cover the second. The length may be arrived at by reference to how long fitting out is likely to take, or it may equate to a generally understood market norm as to how long fitting out for that type of premises generally takes. In many cases, although the period will be described by the parties as being for fitting out, the length will be quite arbitrary and may on analysis include an element of inducement. Where this occurs in relation to a comparable transaction, the valuer will need to consider for comparison purposes to what extent the overall rent free period contains an element of inducement.

(b) The treatment for review purposes of the first head of cost (the capital cost of fitting out)

(i) Generally

7. The correct treatment of the first head of cost will depend on whether the premises being notionally let are to be assumed to have already been fitted out by someone other than the hypothetical tenant. There are three main possibilities:

   (1) The premises must be assumed to contain the actual tenant's fitting out work. In that event, the hypothetical tenant will obtain the benefit of that work. Whether he would offer any more rent than he would otherwise have done would depend on whether it is of any value to him[3];

   (2) The premises must be assumed to have been fitted out by the hypothetical landlord at his own expense to the hypothetical tenant's requirements. In that event, the incoming tenant will not have to fit out himself and can be expected to offer more rent than he would if he had to incur the cost of fitting out himself;

   (3) The premises are not fitted out so that the hypothetical tenant must carry out and pay for his own fitting out.

[2] Although sometimes a capital contribution to fitting out costs will be given by way of inducement to take the lease: see below.
[3] Note that in many cases, particular in relation to retail premises, the actual tenant's fit out may be of no use to an incoming tenant, with the result that its presence will have a detrimental effect on rent because it will have to be removed before any fitting out can start.

8. The answer in any particular case depends on the drafting, but for the reasons which follow, the correct analysis in most cases will be (3). As a result, comparable transactions in which the tenant likewise paid for his fitting out himself will not have to be adjusted.

(ii) The actual tenant's fitting out

9. Save in special cases[4], the subject matter of the hypothetical letting will be the demised premises. As a general principle, the premises must be valued in the state in which they actually exist on the valuation date[5]. On the face of it, therefore, they will include any improvements (including fitting out work) carried out by the actual tenant since the grant of the lease. If one were to stop at this point, it would follow that the actual tenant's fitting out work would be part of the premises being notionally let.

10. However, the above principle is subject to three well established exceptions (which are in practice more important than the principle itself):

    (1) The premises will be assumed to be in the state they would be in if the tenant had complied with his repairing covenants as at the review date[6];

    (2) Most review clauses require the premises to be valued with vacant possession. One result of this is that the actual tenant will be

[4] For example where the review clause requires the valuation of a hypothetical building.
[5] Ponsford v H.M.S. Aerosols [1979] AC 63.
[6] Harmsworth Pension Fund Trustees v Charringtons Industrial Holdings [1985] 1 EGLR 97. A well drafted review clause will generally contain an express assumption to this effect.

assumed to have removed all his chattels brought onto the premises during the tenancy and any tenant's fixtures which he is entitled to remove[7];

(3) Rent review clauses invariably contain an express disregard of tenant's improvements.

11. In practice, the effect of the second and third of these exceptions will generally be that the premises being notionally let will not include the actual tenant's fitting out work.

(iii) Whether the premises have been fitted out at the cost of the hypothetical landlord

12. Where the review clause is silent as to fitting out, the right conclusion will be that no artificial assumption that the hypothetical landlord has fitted out at his expense is permissible.

13. However, many rent review clauses contain an express assumption that the premises are "fit for immediate occupation and use" or words to that effect. The historical background against which such provisions came to be included in leases is considered below. Landlords sometimes argue that provisions of this sort require the valuer to assume that the premises have been fitted out by the hypothetical landlord at his cost, with the result that the incoming hypothetical tenant will not have to incur the capital cost of fitting out.

[7] New Zealand Government Property Corporation v H.M. & S. [1982] QB 1145; Young v Dalgety [1987] 1 EGLR 116; Ocean Accident & Guarantee Corporation v Next [1996] 2 EGLR 84.

14. Such an approach is contrary to the well established presumption of reality, because in the real world the landlord did not pay for the tenant's fitting out work and it is not fair that he should receive a rent which assumes that he did. The decided cases make it clear that, in the absence of very clear words, assumptions of this sort will not be construed as requiring an artificial assumption that the premises have been fitted out at the landlord's expense. The cases include the following:

(1) Orchid Lodge (UK) v Extel Computing[8], in which a licence authorising a new use provided that rent reviews would be conducted on the basis of the new use "the Assignee hereby acknowledging that the premises are fit for use and occupation therefor";

(2) Iceland Frozen Foods v Starlight Investments[9], in which the reviewed rent was to be "the rent at which the premises might reasonably be expected to be let as a whole or in parts upon the terms of the lease, assuming that the premises remain in existence and are ready for immediate use and occupation";

(3) Pontsarn Investments v Kansallis-Osake-Pankki[10], where the assumption was that the premises were "vacant but fit for immediate occupation and use";

(4) London & Leeds Estates v Paribas[11], in which the assumption was that "the demised premises are let for immediate occupation and

[8] [1991] 2 EGLR 116.
[9] [1992] 1 EGLR 126.
[10] [1991] 1 EGLR 148.

use and in a state of good repair and condition and that all fitting out and other tenant's works required by such willing tenant have already been completed";

(5) Ocean Accident & Guarantee Corporation v Next[12], where the assumption was that the premises could be used for certain uses and that "the Demised Premises have been fully fitted out and equipped so as to be ready for immediate use and occupation by such willing tenant for such a use".

15. The landlord's argument in all of the above (put in various different ways) was that the assumption required the valuer to assume that the premises had been fitted out by the hypothetical landlord, so that the tenant would pay an enhanced rent to reflect that fact. The argument was rejected in all cases. As a result, it can be relatively safely assumed that, in the absence of clear words, provisions of this sort will be held to mean either simply that the premises are free from defect and ready to receive the incoming tenant's fitting out[13], or that, if they have been fitted out, this has been done at the hypothetical tenant's own expense[14].

16. However, as always, the above will yield to clear contrary words. The tenant's adviser should be alert to any attempt to introduce wording which might produce a different result (e.g. an assumption that the

[11] [1993] 2 EGLR 149.
[12] [1996] 2 EGLR 84.
[13] As in Iceland Frozen Foods v Starlight Investments and Pontsarn Investments v Kansallis-Osake-Pankki.
[14] As in London & Leeds Estates v Paribas and Ocean Accident & Guarantee Corporation v Next. One important effect of this is that the hypothetical tenant will be assumed to have been given, or not to want, a fitting out rent free period: see below.

premises have been fitted out to the tenant's requirements by the hypothetical landlord at his own cost).

(c) The treatment for rent review purposes of fitting out rent free periods

(i) Historical background

17. As has been noted above, most review clauses provide, expressly or impliedly, that the hypothetical letting is with vacant possession, i.e. that the actual tenant and his sub-tenants have moved out. The hypothetical tenant will therefore be a new occupier who has to move in and fit out. In the real world, he would get a fitting out rent free period. If the review clause requires it to be assumed that the hypothetical tenant will likewise get a fitting out rent free period, all well and good. If, however, the review provisions contain no such assumption, then the reviewed rent will generally be discounted to reflect the absence of a fitting out rent free period. Rents derived from comparable transactions in which fitting out rent free periods were given would have to be adjusted downwards in accordance with the 'like for like' principle already referred to.

18. It is popularly thought that this consequence of the vacant possession assumption had been overlooked by draftsmen until the decision of Lloyd J. and the Court of Appeal in 99 Bishopsgate v Prudential Assurance Co[15]. That case concerned a thirty storey office building in the City. The arbitrator found that the likely tenant would have wanted to occupy only part of the building and would have sub-let the remainder. In the market conditions as they then were, he would have been able to negotiate a 16

[15] (1984) 270 EG 950 and [1985] 1 EGLR 72.

month rent free period to cover the time needed to find sub-tenants and the rent free periods he would have had to give them to fit out their premises. The review provisions did not provide for any such rent free period to be assumed to be on offer to the hypothetical tenant. It followed that the rent would have to be discounted from that which would have been paid by a tenant whose activities were up and running or who was getting a fitting out rent free period. Lloyd J and the Court of Appeal held that this was a necessary consequence of the assumption of a letting with vacant possession.

19. The above undoubtedly produces an unfair result for landlords. In reality the actual tenant has already fitted out and does not need to do so again at the review date. It is not fair that the reviewed rent should be depressed on the fiction that the incoming tenant would have an expense which the actual tenant does not in fact have. Nonetheless, where the review clause is silent as to any assumption regarding fitting out, the position remains that the rent will be fixed on the assumption that the hypothetical tenant is not getting a fitting out rent free period.

20. In recognition of the unfairness of the '99 Bishopsgate effect', draftsmen began to insert express provisions aimed at counteracting it. The common form of assumption already considered above (that the premises are fit for use and occupation etc.) was conceived for this reason. The difficulty with it, however, is that it operates as an assumption as to the physical state of the property rather than one specifically about a fitting out rent free period. As a result, (i) not only have landlords sought to use it in the manner already discussed (i.e. as meaning that the premises have been fitted out at the hypothetical landlord's expense), but (ii) where it says no

more than that the premises are fit for use and occupation (as opposed to going further and providing that they are fitted out to the willing tenant's requirements or something to that effect), it may be held to be insufficient to exclude the 99 Bishopsgate effect (because its effect is only that the premises are ready to receive the tenant's fitting out[16]).

(ii) Drafting

21. It follows that in order to eliminate the 99 Bishopsgate problem, it is necessary to make it clear either that the rent payable by the hypothetical tenant is that payable after the expiry of an appropriate fitting out rent free period or that the hypothetical tenant must be assumed already to have had the benefit of such a period. Two examples from a leading drafting textbook are as follows:

> "Market Rent means the highest rent which would become payable immediately after the expiry of a rent-free period of such length as would reasonably be required for fitting out the demised property on a letting of the demised property between a willing landlord and a willing tenant in the open market on the review date ..."
>
> "... assuming that the hypothetical tenant has had sufficient access to the demised property before the relevant review date during a period in which he did not pay rent for the purpose of enabling him to fit out to his requirements"[17]

22. The Denton Wilde Sapte main office lease precedent deals with the problem by defining "Market Rent" as follows:

[16] See Iceland Frozen Foods v Starlight Investments and Pontsarn Investments v Kansallis-Osake-Pankki, above. Contrast London & Leeds Estates v Paribas and Ocean Accident & Guarantee Corporation v Next, in which the form of words was held to prevent the tenant from arguing for a discount to reflect the absence of a fitting out rent free period.
[17] 'Drafting Business Leases' (6th Edn) (Kim Lewison QC) examples 5:27 and 5:28.

> "…. the yearly rent which could reasonably be expected to become payable for the Premises after the expiry of a rent free or concessionary rent period (or the receipt of a sum by way of contribution or other inducement in lieu of the same) which might be negotiated in the open market for fitting out purposes"

23. The draft also contains the following assumption:

> "that the Premises are ready and fit for immediate occupation and use for any use permitted by this Lease and that all Utilities and other facilities necessary for such occupation and use are connected to and immediately available for use at the Premises"

24. The combined effect of the two is that (i) the premises are fit and ready to receive the incoming tenant's fitting out; (ii) the tenant will get a fitting out rent free period (or the financial equivalent) to cover the period of his fitting out; but (iii) the tenant must carry out and pay for his own fitting out.

(iii) The correct approach to construction in cases of doubt

25. The unfairness to landlords of the 99 Bishopsgate effect was recognised by the Court of Appeal in Co-operative Wholesale Society v National Westminster Bank[18], in which Hoffmann LJ said in his judgment:

> "So, in the case of [fitting out rent free periods], it is each to see why the parties should not wish to allow the tenant a reduction simply because the fiction of vacant possession entails that the incoming tenant would have the expense of moving in and fitting out. A clause which excludes the assumption that he would have this expense is more in accordance with the presumption of reality than one which does not."

[18] [1995] 1 EGLR 97.

26. In accordance with this, it is likely that the court will in practice try if it can to construe review provisions as requiring an assumption that the hypothetical tenant is getting, or does not need, a fitting out rent free period. A good example is Co-operative Wholesale Society v National Westminster Bank[19] itself, in which the review provisions required the valuer to make the following assumption:

> "... that any rent-free period or concessionary rent or other inducement whether of a capital or revenue nature which may be offered in the case of a new letting in the open market at the relevant date of review shall have expired or been given immediately before the relevant date of review"

27. The argument before the Court of Appeal turned on whether this required the valuer to fix a headline rent[20]. The Court of Appeal held that it did not. However, both Hoffmann and Simon Brown LJJ held that the effect of the provision was to prevent the tenant from arguing for a discount on account of the absence of a fitting out rent free period[21].

28. A further example is St Martin's Property Investments v CIB Properties[22], in which the review clause required the following assumption:

> "... that the said willing tenant or tenants do not seek a rent free period nor any reduction in rent to allow them the equivalent of a rent free period and in considering any comparable rents the existence of any rent free period or reduction in rent calculated to allow for any rent free period shall be ignored"

[19] Above.
[20] See below.
[21] See Hoffman LJ at 100F-G and Simon Brown LJ at 102C.
[22] [1999] L&TR 1.

29. Again, the issue between the parties was whether this required the valuer to fix a headline rent, and again, the Court of Appeal held that it was limited to requiring the assessment of a rent which would be payable at the end of a period of fitting out (i.e. a rent arrived at on the assumption that the hypothetical lessee was getting a fitting out rent free period).

(iv) The relationship with the disregard of improvements

30. It should perhaps be pointed out that there is no inconsistency between an anti-99 Bishopsgate provision and the disregard of the actual tenant's fitting out work already referred to. The valuer notionally removes the fitting out work carried out by the actual tenant so as to return to the premises to the stage in which they were when let. He then makes an artificial assumption that the incoming hypothetical tenant has carried out his own fitting out work and has already been given a fitting out rent free period in which to do it. The combined effect of this will in most cases be to replicate the initial bargain between the parties.

INDUCEMENTS

(a) Introductory

31. In particular market conditions, landlords may be prepared to offer inducements, over and above a fitting out rent free period, in order to persuade the tenant to take the lease, or take it at a particular rental level (indeed, one purpose of offering inducements is to keep up the apparent value of the rent so as to avoid giving the appearance that rents have fallen). Such inducements may take a variety of forms, including:

- an additional rent free period (i.e. a rent free period over and above the fitting out rent free period)

- a concessionary rent period (i.e. a period during which rent is payable at a lower rate)

- a capital sum (sometimes expressed as, or even calculated by reference to, a contribution to fitting out costs)

- taking an assignment of the tenant's lease of his existing premises so as to relieve from further rental liability under it.

32. Whether and to what extent inducements are available will depend upon the strength of the market. They will rarely be offered in a strong market in which a large number of tenants are competing for a limited amount of space. However, in a weak market (such as that of the early 1990s) they may be of considerable value.

33. All other things being equal, a tenant who gets an inducement over and above a fitting out rent free period will be prepared to pay more rent that one who does not. The rent so payable is generally known as "the headline rent".

34. In practice, the difference between a headline rent and a rent payable by a tenant who gets no more than the usual fitting out rent free period can be substantial. A good example can be found in the findings of the arbitrator

in Broadgate Square v. Lehman Bros[23]. On the valuation date (25th December 1991) a total rent free period of 30 months would have been granted to an incoming lessee, of which 6 months would have been for fitting out leaving 24 months as an inducement. That inducement would have increased the rent which the tenant would have been prepared to pay (for two City office buildings) from £5,281,365 pa and £3,931,795 pa to £7,033,316 pa and £5,236,046 pa, an increase of about a third.

(b) The treatment of inducements for rent review purposes

(i) History

35. It has already been explained that following 99 Bishopsgate draftsmen began to include in review clauses provisions aimed at eliminating the argument that the hypothetical tenant would make a discount to reflect the absence of a fitting out rent free period. A number of such provisions were widely drafted, and on the face of it, went beyond simply requiring an assumption that the hypothetical tenant was getting the usual fitting out rent free period. At the time, the difference between fitting out and inducement rent free periods may not have been thought sufficiently significant for the valuer to need to trouble himself with it[24]. In the market conditions of the early 1990's, however, inducements became very significant, and landlords began to argue that the effect of such provisions was that the clause required the fixing of a headline rent. Clauses which had this effect became known as "headline rent clauses".

[23] [1995] 1 EGLR 97 (the facts are more fully set out in the judgment at first instance at [1994] 1 EGLR 143).
[24] See Co-operative Wholesale Society v. National Westminster Bank, below, per Hoffmann LJ.

(ii) Where the review clause is silent as to assumed inducements

36. Where the review clause contains no assumption as to inducements, the right conclusion will be that the hypothetical tenant cannot be assumed to get any such inducement and hence will not pay a headline rent. In consequence, rents derived from comparable transactions in which headline rents were payable will need to be adjusted downwards so as to strip out the element attributable to the inducement[25].

(iii) Headline rent clauses

37. The earliest reported case on a headline rent clause was the decision of Aldous J. in City Offices v. Bryanston Insurance[26], in which the review clause contained:

- a provision that the rent was to be the rent payable "after the expiry of any rent free concession or fitting out period which might be given to the Tenant if a letting of the demised premises were negotiated in the open market"

- a disregard of "any notional rent free concession or fitting out period for which allowance would or might be given to the Tenant if the demised premises were let in the open market with vacant possession"

38. The arbitrator had approached his award on the footing (on leading counsel's advice) that the provision on its true construction related only to fitting out rent free periods and not inducements. Aldous J. disagreed,

[25] See below.
[26] [1993] 1 E.G.L.R. 126.

holding that the words referred to any rent free period, whether for fitting out or otherwise. However, he went on to hold that the provision and the disregard were, in effect, self-cancelling, with the result that the rent payable was not a headline rent.

39. City Offices was an undoubted early warning that judges would take a lot of persuading to construe a rent review clause as producing a headline rent. Two years later, in 1995, this reluctance was ringingly endorsed by the Court of Appeal in four appeals heard together, in all of which the issue was whether the review clause in question required the determination of a headline rent. These were: Co-operative Wholesale Society v National Westminster Bank; Scottish Amicable Life Assurance Society v Middleton Potts & Co; Broadgate Square v Lehman Brothers; and Prudential Nominees v Greenham Trading[27].

40. The general principle which emerges from the judgments is that a review clause which requires the determination of a headline rent is contrary not only to the presumption of reality (because in the real world the actual tenant is not getting an inducement), but also to the basic purpose of rent review provisions (which is to fix a market rent rather than something in excess of it). As a result, unless the clause clearly and unambiguously points to a headline rent, it should not be construed as having this effect. Indeed, according to Simon Brown LJ, "it is only the most unambiguous" of clauses that will be held to produce a headline rent. Having acknowledged in his judgment that "the more obvious reading" of two of the clauses was in favour of a headline rent, he nonetheless went on to hold that neither clause had this effect. This represents something of a

[27] All are reported [1995] 1 EGLR 97

departure from the conventional approach to construction, in which an ambiguity is resolved by looking at what, having regard to the words used and all the material, is more likely to accord with the intention of the parties. In headline rent cases, the mere existence of an ambiguity (other than a far fetched one) will tip the balance in favour of the tenant.

41. The strength of this approach is shown by the way the Court of Appeal dealt with the four appeals before it. Although the clauses in all four cases can fairly be regarded as having been aimed at producing a headline rent, in only one case was this object held to have been actually achieved. This was Broadgate Square v Lehman Brothers, in which the reviewed rent was to be:

> "... the best yearly rent which would reasonably be expected to become payable in respect of the premises after the expiry of a rent-free period of such length as would be negotiated in the open market between a willing landlord and a willing tenant ..."

It was held to be "impossible" to confine the relevant words to fitting out rent free periods only, such that there was "no escape" from the conclusion that the reviewed rent was to be a headline rent[28].

42. The review clauses in the remaining three appeals were held not to give rise to a headline rent. In Scottish Amicable Life Assurance Society v Middleton Potts & Co, the reviewed rent was to be:

> "... such sum as shall be agreed by the Lessor and the Lessee or determined as representing the best yearly open market rent (at the rate payable following the expiry of any rent free period or

[28] For a further example of a headline rent clause, see Currys Group v. Martin [1999] 3 E.G.L.R. 165.

> periods as concessionary rents which might be granted on a new letting of the Demised Premises or of comparable premises on the relevant review date) at which the demised premises might reasonably be expected to be let in the open market on the relevant Review Date ..."

43. At first instance Arden J held that "a new letting" meant a letting to a new tenant who needed to move in (as opposed to a renewed letting to a tenant already there), so that the rent free period to which the clause referred was one which was attributable only to the letting being new, i.e. a fitting out rent free period. It did not include a rent free period granted as an inducement since this would be just as much a characteristic of a renewed letting to a tenant in occupation as of a letting to a new one. Her decision was upheld by the Court of Appeal.

44. In Prudential Nominees v Greenham Trading the review clause required the valuer to fix "the best rent at which the whole of the premises might reasonably be expected to be let in the open market on the relevant review date ..." on the assumption that:

> "No reduction or allowance is to be made on account of any rent free period or other rent concession which in a new letting might be granted to an incoming tenant."

45. The reduction or allowance prohibited by the assumption was held to refer only to the rent that would have been fixed in accordance with the earlier part of the clause, i.e. the open market rent determined without reference to rent free periods. What the assumption did not do was to allow the valuer to increase that rent. This reasoning can perhaps be criticised on the grounds that it appears to deprive the assumption of any sensible meaning whatever. Nonetheless it is helpful as an illustration of

the length to which the court will be prepared to go to avoid holding that a review clause produces a headline rent.

46. The relevant assumption in Co-operative Wholesale Society v National Westminster Bank has already been set out above. It was held that it required the assumption that any rent free or concessionary rent or other inducement had expired before the hypothetical bargain was struck. Since his inducement had already been enjoyed, the tenant would not agree to pay the same rent as one who was bargaining to receive an inducement in the future. As has already been pointed out, however, the words were held to have the effect that the hypothetical tenant was to be treated as already having moved in, so that he could not argue for a discount on the grounds of the absence of a fitting out rent free period.

47. The question of a headline rent arose again in the subsequent case of St Martin's Property Investments v CIB Properties[29]. The relevant assumption is set out above[30]. The Court of Appeal, applying the general approach laid down in the Co-operative cases, held that the provision was insufficiently unambiguous to produce a headline rent.

48. The above decisions illustrate the considerable degree of ingenuity which the court will, if necessary, employ in order to avoid holding that a review clause produces a headline rent. The result in practice is that a draftsman who wishes to achieve a headline rent must either adopt the form of words in Broadgate Square or produce something so clear and unambiguous that no other meaning is possible.

[29] [1999] 1 L&TR 1.

49. Even where the clause does produce a headline rent, however, there is a further point to be considered. This is that if the review clause in the hypothetical lease also contains the same headline rent provision, it will be open to the tenant to argue that in formulating his bid the hypothetical tenant will take into account not only the advantage of the inducement but also the disadvantage of having to pay a headline rent on his first and subsequent reviews[31]. Some valuers argue that this leads to a circular or self-cancelling effect, the result of which is to take much of the sting out of the headline rent provision. Whether this is right in any particular circumstance will depend upon the particular facts. It is, however, something to be borne in mind by landlords contemplating inserting a headline rent provision.

ADJUSTMENT OF COMPARABLES

50. It has already been pointed out that in practice much of the argument regarding fit out concessions and inducements turns on the proper adjustment of comparables. By way of conclusion, it is perhaps worth highlighting the principal cases which are likely to occur in practice.

51. If the review clause, construed in accordance with the above principles, requires the valuer to assume a hypothetical bargain which is (so far as concerns the capital cost of fitting out, fitting out rent free periods and inducements) the same as the comparable transaction, then no adjustment to the comparable rent is necessary. All other things being equal (which they rarely are), the valuer can simply take that rent derived from the

[30] See para. 28.
[31] The same point can be made where the hypothetical lease prevents sub-letting save on terms which include the same review clause as the actual lease.

comparable transaction, make any other adjustments he regards as necessary, and then apply it to the subject premises.

52. Where the hypothetical bargain is not the same as the comparable transaction, then the latter must be adjusted. Two types of cases are common in practice. The first is where the hypothetical tenant gets no fitting out rent free period or inducement but the comparable transaction included a fitting out rent free period. In such a case, the rent agreed for the comparable must be adjusted so as to arrive at the figure which the tenant would have paid had he not got a fitting out rent free period. The second is common in office rent reviews, and occurs where the hypothetical tenant must be assumed to get a fitting out rent free period but no inducement, whereas a relevant comparable transaction involves not only a fitting out rent free period but also an inducement (i.e. the rent payable was a headline rent). In such a case, the valuer must adjust the rent derived from that transaction so as to arrive at the "net effective rent", i.e. the rent that would have been payable had the inducement not been given.

53. Adjusting so as to eliminate an inducement involves a number of stages. The first is to separate out the fitting out rent free period and the inducement. This causes no difficulty where the inducement takes the form of something other than a rent free period, but where it consists of a rent free period over and above a fitting out rent free period, the valuer must decide how much of the overall rent free period was attributable to fitting out. The next stage is to arrive at the rent that would have been payable in the absence of the inducement. Where the inducement consists of a rent free period, this is done by spreading out the value of the rent

free period over a particular period so as to arrive at an annual equivalent and then deducting it from the headline rent so as to arrive at the net effective rent.

54. It is common practice to devalue the rent free period on a straight line basis, but some valuers may prefer use a discounted cash flow basis. The former practice was to spread the value out either to the next rent review or the end of the term (the tenant's valuer arguing for the former, the landlord's valuer for the latter). The more common practice is now to adopt the middle ground and spread the inducement over an intermediate period (such as 10 years).

PRACTICAL IMPLICATIONS

(a) Non-contentious property lawyers

55. It will be important to decide at the outset precisely what assumptions as to fit out concessions and inducements are to be built into the review clause. General points are:

(1) In a perfect world, it is sensible to review the draft in consultation with the client's valuer, and to "road test" the clause so as to ensure that there are no hidden problems which might otherwise emerge later;

(2) A draft which advantages the client in particular market conditions may rebound to his disadvantage if the market changes[32];

[32] A notorious example from recent history is the long (25 year) hypothetical terms which were provided for in the 1980's in the belief (true at the time) that such a term was more

(3) Avoid drafting which mixes up the willing tenant and the actual tenant. The latter is usually referred to in the lease with an upper case "T", and an assumption which refers to him instead of the hypothetical tenant may be deprived of its intended effect[33].

56. Points to watch out for when drafting on behalf of landlords include:

(1) The actual tenant's fitting out work may have a negative effect on rent (because any incoming tenant would remove it), so that an assumption the effect of which is that the premises being notionally let have the actual tenant's fitting out work may not work to the landlord's advantage;

(2) If a headline rent provision is to be included, it must be drafted sufficiently clearly as to leave no room for argument;

(3) The possible self-cancelling (and other) possible adverse effects of a headline rent clause must be borne in mind[34]. If the review clause is to contain a headline rent assumption, the draftsman should consider including a further assumption that the review provisions in the hypothetical lease do not include a similar assumption.

57. Tenants should resist agreeing any assumption which produces or might produce a rent over and above that which would be paid after the expiry

valuable than a shorter one. Such clauses became a serious disadvantage in the early 1990's when tenants began to require short flexible terms.

[33] See for example Parkside Clubs (Nottingham v. Armgrade [1995] 2 E.G.L.R. 96.
[34] See above.

of a fitting out rent free period. Particular care should be taken with any form of words which might lead to an argument that the premises must be assumed to have been fitted out at the expense of the hypothetical landlord or that the reviewed rent is a headline rent. Danger signals include anything which suggests that the rent free period or concession might extend beyond fitting out. It must be made absolutely clear that any such rent free periods etc. are in respect of fitting out only, since otherwise the reference may be held to include all rent free periods, including those granted as an inducement[35].

58. As a general point, it should be borne in mind that it is not usually enough to be confident that a proposed form of words is unlikely to be construed as having a detrimental effect. In practice, as litigators know only too well, the mere existence of a respectable contrary argument can have an adverse effect on the client's interests later on (for example, it may be used in negotiations; it may delay the determination of the reviewed rent; or it may lead to extra legal or surveying costs). For this reason, the draftsman should if possible strive for clarity.

(b) Litigators

59. By the time litigators get involved, the client will generally have obtained advice from his valuer. Part of that advice will have consisted of at least a preliminary identification and adjustment of comparables. The litigator may well be asked for advice on what assumptions the review clause requires in relation to fitting out rent free periods and inducements so as to assist the valuer in making his adjustments. Even where advice on this is not specifically sought, the litigator should review the valuer's

[35] See Broadgate Square v. Lehman Brothers, above.

adjustments so as to satisfy himself that the valuer is not proceeding on a legal misconception as to what the review clause requires.