

## Rent Review

Leases of commercial buildings can prove to be complex documents, governing the relationship between landlord and tenant for terms which commonly extend to 25 years. Arguably, the most complex provisions of the lease are those relating to rent review. It is an area that has taken up considerable court time and expense to determine disputes between landlords and tenants regarding the amount of rent passing at various stages throughout the life of a lease.

To minimise the risk of unwelcome resistance, delay and expense when the rent is being reviewed, both landlords and tenants ought to ensure that they are fully aware of the rent review provisions of a lease when taking an existing lease of commercial premises or that they ensure that time is taken to carefully negotiate those provisions on the grant of a new lease.

This article aims to give those who may be new to, or unfamiliar with the commercial lettings market, a brief insight into how rent review operates today. In addition, it highlights why they should seek advice when letting their premises or when taking a lease and the potential pitfalls of neglecting to do so.

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### Why include rent review provision in a commercial lease?

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Rent review enables the rent payable under a lease to be varied at intervals during the course of that lease. It is clear to see why a landlord would wish to include such a provision in their lease. Depending on the type of mechanism used, it may allow the landlord to benefit from an uplift in market rental values or, to stipulate at the outset stepped increases that are to take place through the term of the lease.

Similarly, tenants will have a keen interest to have rent review provisions carefully drafted or fully reported to them. The introduction of The Code for Leasing Business Premises ("The Code") does appear to mark a shift towards more flexible, shorter term leases. Flexibility is encouraged especially in the area of rent review. The Code encourages landlords to avoid insisting on provisions that allow upwards only rent reviews and attempts to allow both the landlord and tenant the ability to start the review process. In modern leases and with the introduction of The Code, it may be that tenants are becoming better placed to negotiate more favourable terms. Notwithstanding this, the Code remains voluntary and tenants who fail to address this area when taking a lease may suffer rents regarded as unfair and higher than they may have anticipated.

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## How does rent review take place and how often?

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Rent review can take place in various ways. It is for each individual lease to determine the mechanism used. Common forms of rent review include stepped increases, those linked to a tenant's turnover or a rent set in accordance with a prices index. Whilst these methods may prove to be less cumbersome, the most common form still remains an open market rent review. Although complex, this type of review does allow the rent to be set at a level that is in-line with market conditions at the time of the review. That said, despite The Code, it is common for open market rent review provisions to be drafted to provide for upwards only reviews meaning that on review, the landlord will either retain the level of rent payable or benefit from an uplift. It will depend upon the bargaining positions of the parties at the outset, as to the terms that are negotiated but, it may be that in the current economic climate following the onset of the "credit crunch" in the latter part of 2007, tenants may find that their advisers are in a stronger position to secure a rent review provision that may go up as well as down.

When the time comes for the rent to be reviewed, the procedure can be commenced either by notice or by the parties entering into negotiations. It is common for a lease to stipulate that a rent review will take place every five years. However, a trend towards more flexible, shorter leases has seen rent review increasingly taking place at three year intervals. Again, this remains a matter for negotiation between the landlord and tenant but it should be borne in mind that the more frequent the rent reviews, the greater the costs especially where agreement cannot be reached. Consideration will need to be given to whether more regular rent reviews are worthwhile considering the costs involved.

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## What if the parties cannot agree?

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Where the rent cannot be agreed, the matter will be referred to a third party expert or arbitrator, resulting in increased costs and delay for both parties.

Where a third party becomes involved, they will have regard to the property itself in addition to comparables to arrive at a valuation for that particular letting. However, the ultimate determination of the rent will be decided by reference to the abstract concept of the "hypothetical lease". The hypothetical lease can be viewed as an instruction manual for the valuer in how to carry out the valuation. It is a mirror of the actual lease with certain assumptions and disregards being made regarding the letting in question.

To understand the reasoning behind this concept, one must have regard to the actual letting. If the valuer was asked to determine the rental based on the actual property, it may lead to unfair consequences either for the landlord or for the tenant. For example, where the tenant has failed to comply with their repairing covenants, the poor condition of the property would lead to a depression in the rental value on the open market. The tenant would therefore be benefiting from their failure to adhere to their obligations. In this scenario, a landlord would wish to ensure that on review the rent review provisions are drafted to ensure that the valuer assumes that the tenant has complied with their covenants.

Similarly, the tenant will have an interest to ensure that the rent review provisions are drafted carefully. If the tenant moved into premises and during the period up to the first rent review date, built up substantial goodwill among its clients and gained a good reputation within the area, this would lead to the market value of the premises being inflated. The tenant however, would not wish to be penalised due to the goodwill they have managed to generate during their occupation and tenant's advisors must ensure that the tenant's goodwill is disregarded at review. This would be the same where the tenant has made improvements to the premises. The tenant would firstly have to pay for the cost of making the improvements and then suffer an inflated rental increase on review unless the improvements that the tenant had made are disregarded on review, avoiding the tenant having to pay twice, once for the cost of the improvements and then again for the increase in rent as a result of them.

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### Will rent review provisions be the same in all leases?

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The extent of the assumptions and disregards that may be made are extensive and will vary from letting to letting. For example, they may need to deal with the tax status of the tenant. Where the tenant is a bank or building society, the tenant would want to resist an assumption that they can fully recover VAT. Banks are unable to become registered for VAT and such an assumption would mean that the hypothetical bidder would pay more for the lease than the bank may be prepared to, resulting in an inflated valuation and increased burden in terms of rent for the tenant bank. Further, the use to which the property can be put is an issue that tenant's advisors must be wary of. Where the landlord inserts provisions in the hypothetical lease that are wider than those in the actual lease, this will artificially inflate the rent. A hypothetical bidder would bid more for a lease where the use is not restricted. However, in reality the tenant may only be permitted to use the premises for a specified use and suffer higher rents due to the contents of the hypothetical lease on review.

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### Problems of failing to address the issue

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Where the parties fail to properly negotiate the lease at the outset, they increase the risk of disputes arising. Where disputes fall to be determined by the courts, they have adopted an approach known as the presumption of reality. Where the lease provisions do not clearly set out the intentions of the parties, the matter will be determined based on the actual letting. This can be problematic for either party where the assumptions and disregards of the hypothetical lease and the provisions dealing with the mechanics of review are not clear. Drafting should therefore be clear and tailored to the specific landlord and tenant in order to achieve a review procedure that is agreed and fair.

Timing of the review can also be problematic. It is not only the hypothetical lease that is to be considered, the parties must be wary of the provisions relating to when the review is to take place. Parties should ensure that time is not of the essence. Fortunately, case law dictates that this is presumed subject to it being displaced by the presence of a sufficient intention. Where time is of the essence, even a slight delay by a party can deprive them of the right of review. Further, a lease will often provide for a penultimate day review. Where the tenant is holding over, at the end

of the fixed term, the landlord can benefit from increased rents. Therefore, timing provisions within the lease can affect both the landlord and the tenant significantly. The landlord may find that in a lease where time is of the essence, they will need to comply with the provisions in the lease strictly to benefit and where a lease provides for a penultimate day review, it may mean that that tenant's liability in rent is significantly increased pending negotiations for lease renewal.

When entering into a lease therefore, it is important that the parties have in mind the future of the letting. Neglecting to consider the rent review provisions of a new lease or those contained in a lease being assigned at the outset could, in addition to significantly impacting upon the rent payable under the lease, cause considerable delay and expense to both parties. Landlords and tenants should ensure that they do not neglect to address these issues as to do so could have an adverse impact on all those involved, which is far from hypothetical!

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Please feel free to contact us if you would like further information on any aspect of our work.

Our friendly team is always on hand to help and advise you. We can be contacted directly on:

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