

## IT'S THE LAW:

# Commercial Leases: Rent Review



### What's this all about then?

Leases of commercial premises are complex documents. They govern the relationship between a landlord and a tenant, which can extend to 25 years or more. Well over a third of marriages don't make it that long. Arguably, the most complex of the complex provisions relate to the future review of rent. The landlord will want the rent to increase as much as possible as time goes by. The tenant will want the opposite.

Rent review clauses became commonplace in the UK after World War II, once people acknowledged that inflation was here to stay. In the 1960s rent reviews were often set at seven or fourteen year intervals, but things have moved on. It's now far more common for reviews to take place every five years. Every three years is not unheard of.

### A cornucopia of possibilities

Rent review clauses can take many different forms. Some leases provide for pre-determined stepped increases at set dates through the term. Others link the rent to the tenant's turnover – the more they sell in their shop, the more they pay their landlord. A common method is to calculate rent increases by reference to the Retail Prices Index. However, by far the most common form still remains an open market rent review. At set intervals, the rent will be reviewed and re-set to what the open market rent would be at that time.

### Onwards and upwards

The theoretical advantage of an open market rent review is that it allows the rent to reflect market conditions throughout the term of the lease – something that would be impossible to predict at the outset. The landlord receives what their premises are worth and the tenant doesn't pay over the odds. But it doesn't always work like that. And, in fact, almost all review clauses state that they are upwards only – so, if the market is rising, the rent will rise with it. But if the market falls, the rent will stick. That doesn't sound very fair on the tenant. And it isn't. But that's the way of the world.

### Procedure and process: the first step

Generally, the first step when the review date comes around is that the landlord serves a notice on the tenant stating what they think the new 'market rent' should be. Discussions (sometimes quite full and frank) then ensue. Landlords will typically base their proposed new rent on what has been secured by other landlords on the most appealing similar properties in the neighbourhood that have recently been on the market (known as 'comparables'). Tenants will argue that the landlord has unfairly selected properties that are better than theirs. Battle will commence. Ready the horses.

If the landlord and tenant reach agreement then they'll both sign a statement (called a Memorandum of Rent Review)



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and, hey presto, there's a new rent.

### But what if they don't agree?

If the landlord and tenant can't agree the new market rent between themselves, a market rent review clause will usually provide for an independent surveyor to be appointed. The surveyor will look at the premises, the market and the lease terms and come to a view as to what an ordinary tenant would be willing to pay if that deal was put to the market. They, too, will usually look at comparables in the area - but they are expected to be fairer in selecting which other deals to look at.

### The devil is in the detail: assumptions and disregards

That's all still sounding quite simple. But the devil comes in the detail. The review clause will almost certainly list a series of assumptions and disregards. We'll explain that by way of two examples:

Say the tenant had been failing to comply with its covenant to repair the property. The property is now looking sad. The roof is leaking and the door doesn't quite shut properly any more. This would probably lead to a decrease in the rent that a new tenant would be willing to pay on the open market. So, not only does the tenant not bother to repair, it then benefits from a deflated rent in the future! Clearly no landlord is going to put up with that. So the review clause will tell the independent surveyor to pretend that the tenant has complied with its obligations, even if it hasn't. That's an assumption.

Imagine another tenant, a better one. Not only have they complied with all of their obligations as to repair, they've actually done quite a bit of work to improve the premises. They've put in a nice new staff kitchen and a sparkly new shopfront. Now when the independent surveyor pops round to undertake a valuation, he can easily see that this is 'one hot property'. But from the tenant's perspective that's a tad unfair. They are paying twice. Firstly, they've paid for all the works. Secondly, they are being asked to pay a higher rent to the landlord. Clearly no tenant is going to put up with that. So the review clause will tell the independent surveyor to pretend that the tenant hasn't done those improvement works. That's a disregard.

The 'assumptions and disregards' is a list of instructions like this which is given to the independent surveyor. They are agreed when the lease is being negotiated and form part of the rent review clause. They can be tricky to get right because you are trying to imagine what you'd want to assume and what you'd want to disregard in the future – an unknown place. But they are vital and can have an

enormous effect on the rent – whether fairly or not and whether intentionally or not.

### Other common assumptions and disregards include...

**That the property is vacant:** In assessing what a new hypothetical tenant will pay, it will be assumed that the current tenant has moved out, so that the new tenant can move in.

**That if the property has been damaged or destroyed, then it has been rebuilt and reinstated:** If the property has been damaged in a fire, the lease will almost certainly deal with who should have insured it and who should carry out the repairs needed to bring it back into good repair. Usually it will provide that the tenant doesn't have to pay any rent whilst the repairs are being carried out. Clearly, the amount someone would pay to rent a burnt out shell is going to be less than what they would pay for a fully functioning building. If the fire occurred the day before the rent review, it would be odd to depress the rent for the next five years until the next rent review. So, instead, the independent surveyor is asked to ignore the damage.

**That goodwill is to be disregarded:** If the tenant operates, say, a popular restaurant which has queues down the street every lunchtime, then a new restaurant operator might be expected to offer a higher rent to get their hands on the premises (since the restaurant comes with a ready supply of eager customers). But generally, it is considered unfair to penalise an existing tenant by charging them a higher rent because they run their business well. So the independent surveyor is instructed to ignore that.

### CAUTION!!

Rent review provisions can be tricky. One word can change the whole result. Wording to the effect that the rent will be reviewed to the *'best rent that can be obtained on the open market'* can produce quite a different result than wording that refers to the *'rent that the landlord can reasonably be expected to secure on the open market'*. Words matter! So come and talk to us.

### The tiny print

This is one of a series of leaflets published by Devonshires Solicitors LLP's Real Estate & Projects Department aimed at our property owning clients. No action should be taken on the matters covered by this leaflet without taking specific legal advice.

Find out more

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