

# Inducements

## “Buy one and get one rent free?”

For many of you this article may seem a little dry. The world of inducements in rent reviews is not generally thought to be novel or cutting edge and may not even feature in many practitioners' lives. However for some, like me, it is often a very important element of the rent review process and, dare I say it, quite interesting. I still see many clauses which are ambiguous and require the determination by a third party or the Court. This article looks at 2 types of clauses practitioners often come across and the potential arguments available, before suggesting alternatives to clarify the ongoing uncertainty.

### ***Inducements in the Real World***

Inducements are offered to many potential tenants when they consider whether to take a lease of new premises. In some instances, a capital contribution might be offered by a landlord to help the tenant with what can be substantial and expensive fit out works in order to tailor premises to their specific needs. However, more often than not, landlords will not offer to pay for the cost of fitting out – these tend to be borne by the tenant. Instead, they offer an initial rent-free period.

The rent-free period was intended as a one-off concession at the start of a lease. Initially, the idea of rent-frees was so that the tenant did not have to pay rent while it was unable to carry out business from the premises. Things have come on a bit since the early days of rent-free periods for fitting out.

Historically, an inducement package may have been based on the likely time it would have taken to fit out the premises but in weakening market conditions, landlords started to grant longer initial rent-free periods to maintain rental levels artificially. In many recent office lettings in Central London, inducements tend to be based **not** on the likely time it would take to fit out the premises but on different factors such as the length of the lease or term certain (if the lease contains breaks), the quality of the space, the market conditions prevailing at the time and so on. It has become a general horse deal between agents and an overall inducement package is then agreed.

### ***Treatment in the Hypothetical World***

Rent review clauses in leases granted in the 1980s did not factor in rent-free periods which were granted at the time. This gave tenants an opportunity of seeking a discount at each rent review to reflect the absence of the usual package - the hypothetical tenant was paying rent from day one of the hypothetical lease and therefore should pay a lower rent in compensation for its absence.

Attempts were made by landlords in the bull market towards the end of the 1980s to establish a headline rent at rent review (i.e. the rent after the expiry of the entire inducement package). One case succeeded out of many, for fairly opaque reasons when compared to the other cases heard at the time, and it has now become accepted by many that headline rent clauses may be onerous in the hypothetical rent reviews ahead (if there are any), which operates to neutralise the positive impact it may have had.

So, it became the custom (and remains so) for practitioners to draft rent review clauses to arrive at a rent after the expiry of a fit out inducement. This was considered fair as the tenant did not receive multiple discounts at each rent review for fitting out at the beginning of the actual lease and the landlord did not receive a windfall gain at each rent review for choosing to extend the rent free period beyond the time it would take to fit out, in order to maintain rental levels.

In identifying the rent at each review, it is usual practice for valuers to consider comparable transactions on a headline basis (i.e. the rent after any inducements) and make appropriate adjustments to reach a figure or band of figures to reflect the headline rent for the subject premises. They then analyse the inducement package which the market suggests is appropriate for a letting of those premises; they identify the overall package, deduct the fit out element and then devalue the headline figure by taking off the remaining "pure inducement" element to indicate the net rent they are directed by the review clause to find. There are other methods of valuation in a rent review but they are outside the scope of this article.

For a number of years, valuers in rent reviews have been doing their best to work out the likely length of the overall inducement package which would have been given, had the lease been on the market at the valuation date, and the "fit out element" of it, in order to distinguish between the two parts of the inducement package. In large rent reviews, this is often calculated with the help of a quantity surveyor who is experienced in programming fit out in the market.

The starting point when looking at the treatment of inducements in a rent review is to consider the words in the lease which direct the valuer as to how he or she should determine the appropriate period. There are usually 2 ways in which the valuer is directed to determine the period attributable to fitting out:

1) Example 1 (the "time it takes" clause), where valuers are directed to arrive at a rent after the time it would take to fit out the premises has expired:

*"the rent after the expiry of a period which is usual on the grant of a new lease of similar premises with vacant possession properly to reflect the time required for the Tenant to carry out its fitting out works to the Premises"*

2) Example 2 ("the market" clause), where valuers are directed to arrive at a rent after the expiry of a period of time which would have been agreed in the market for fitting out:

*"the rent after the expiry of a period or concessionary rent which would freely be negotiated in the open market on the grant of a new lease of similar premises for the purposes of fitting out only"*

If the clause is a time it takes clause, a debate can arise as to when the hypothetical tenant is able to assemble his team to prepare to fit out the premises. In reality, it may depend upon the market as to how many options there may be for a potential tenant to consider. If there are many, that tenant may not decide to incur the expense of space planning each option in advance of taking the lease. If there are few, it may.

In reality, tenants often agree to a pre-let or an agreement for lease. In those circumstances certain works often commence (and in some cases can even have completed) before lease grant and fit out plans might have commenced even before entering the pre-letting agreement.

There can be quite a debate as to how much preparation the incoming hypothetical tenant would be assumed to have carried out. This may impact significantly on the overall period it would take for a hypothetical tenant to fit out the premises. Does it make a difference? In large office lettings it can make a significant difference to the overall level of rent and, ultimately, the reversion. Further thoughts on this are set out below.

If the clause is a market clause, difficulties can arise because in today's market, agents agree an overall inducement package and will not distinguish between the element attributable for fitting out and the pure inducement element. These are most likely alien

terms to surveyors outside of the landlord and tenant department and the esoteric world of rent review. The reality is that market agents rarely pay any attention to the time it may take for the incoming tenant to fit out the premises. Taking the clause literally, it could be argued that the answer is that there is no period "*which would freely be negotiated in the open market on the grant of a new lease of similar premises for the purposes of fitting out only*".

Alternatively, some argue that there is little difference between the 2 sample clauses - the valuer is directed to determine the period attributable to fitting out and that period is calculated as the time it would take to fit out the premises.

### **Calculation of Fitting out Period**

The time taken to fit out premises may vary, depending on the criteria adopted, such as whether the hypothetical tenant would like open plan or cellularised occupation. There may be issues with access or complicated plant to install, specific to a particular building, which may alter the length of time it would take to fit-out. Specific types of occupier may have different and more time consuming requirements to the norm.

One key element for the QS to consider is when he is to assume the hypothetical tenant commences his preparation for fit out. In the rent review hypothesis, it could be argued that no steps would be taken by the prospective hypothetical tenant, before hypothetical lease grant, to prepare to fit-out the premises to the hypothetical tenant's needs. A hypothetical tenant may only be assumed to start thinking about fitting out once the hypothetical lease is agreed and completed.

Some practitioners believe some thought would have gone into fitting out but that no steps which involve a financial commitment may be assumed to have been carried out until completion of the lease - presumably by the instruction of architects and quantity surveyors on the first day of the lease. This would mean the fit out period in the rent review is likely to start later than it would in the real world.

Taking this argument to its logical extreme, the analysis of the inducement package would produce a reduced "pure" inducement period for the hypothetical letting, which is beneficial to landlords. This is probably best illustrated by way of an example:

#### **Reality:**

- overall inducement package for a comparable lease = 24 months;
- time to fit out comparable lease in the real world = 10 months so "pure" inducement = **14 months**;

#### **Rent Review:**

- in a hypothetical letting, overall package = 24 months (same as reality);
- valuer is directed to assume fit out from midnight on the valuation date - advised by QS this would be 12 months;
- valuer analyses total package to reveal "pure" inducement = **12 months**.

On the other hand, even if this approach is right, it could also be argued that the hypothetical parties would bear in mind the (extended) fit out period and therefore negotiate additional fit out inducements to compensate for this, without reducing the element of "pure" inducement.

It might be argued that the negotiations, agreement for lease and completion are carried out, not in the 24 hours of the notional letting date, but in the "dateless continuum of time" referred to by Peter Gibson J in **Daejan Investments Ltd v Cornwall Coast Country Club [1985]** 1 EGLR 77.

If so, it may further be argued that the preparations by the tenant prior to commencing its fit out, are carried out in that context such that all organisational work preparatory to completion, such as mobilising the team, placing appropriate orders, reaching a level of design to enable the tenant to seek consent from the hypothetical landlord and so on, is also carried out in that context. If that is an appropriate approach, then only the physical work requiring possession of the premises (the construction period) is to be carried out from hypothetical lease grant. This is beneficial to tenants in a rent review.

In the real world, construction work is often commenced after the agreement for lease and prior to completion, so this argument may be extended even further, as HH Judge Rich suggests in **Co-operative Wholesale Society Limited v National Westminster Bank plc [1994]** 1 EGLR 154:

"It is, in my judgment, into that dateless continuum of time that any rent-free period that would be offered in the case of a new letting in the open market is packed immediately before the review date, by reference to which the valuation was to be made in the present case; and the valuation is to be made on the basis that by that date of review such period shall have expired..."

The other aspect which has not been debated at length yet concerns the date of completion of a tenant's fit-out. Some would say it is when basic Category B works are finished. If so, what does finished mean? Others would say it is when the tenant has installed its furniture, computer systems and other trade fixtures.

This remains an area of some uncertainty and it is, in my view, a matter of time before someone takes an extreme position and seeks determination through the Court. It may be that arbitrators/independent experts would prefer an analysis which reflects market practice based on sensible assumptions which do not operate to exaggerate the position for either party.

### ***Where do we go now?***

There have been suggestions that market agents in the real world should be programmed to distinguish between the fit-out and pure inducement elements of the inducement package, within the Heads of Terms they agree, to assist valuers in analysing the time it takes and market period clauses. This is probably not be the most realistic of suggestions. The treatment of inducements at rent review is still a fairly abstruse area to explain in the heat of the moment to parties wanting to get on with a deal.

Alternatively, a period might be specified in the lease for valuers to assume for fit out works in hypothetical lettings at subsequent reviews. This may be a more palatable option but I suspect, as with many things, that this will only appear once the Court has taken a view which forces the issue - but that requires a bold view to be taken by someone to bring it to their attention.

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