What is a geared lease?

1. A geared lease is usually a long lease, often granted for 125 years or more and usually in consideration of a substantial premium paid by a developer who goes on to construct buildings on the demised land and then grants rack rented leases to occupational tenants. In return for enhancing the value of the Landlord's interest, the tenant does not pay a full market rent but, instead, often a percentage of that rent.

2. For the purposes of this paper, a geared lease also includes a shorter term lease where the rent paid by the tenant consists of an element which is assessed on a periodic basis in the usual way plus a further amount in addition, which may be fixed or a percentage of the assessed sum.

What is the rent review issue?

3. The "problem" with leases drafted in this way is encountered at rent review when a decision has to be made as to whether or not the hypothetical willing tenant, who is taking a lease of the premises at the review date on the same terms as the actual lease, is taking a lease with the gearing provisions in it. If so, to what extent is the rent, which is assessed at the review date, to be influenced by the existence of the gearing? A simple example illustrates the point: if a lease is granted for 125 years on the basis that a tenant will pay 50% of the open market rental value, what happens on a five-yearly review when the review clause requires the ascertainment of "open market value" on the basis of a lease identical to the actual lease? Does one ascertain the open market rental value and then require the actual tenant simply to pay 50% of that open market value? Alternatively, is the fact that the actual tenant is only liable to pay 50% necessarily to be taken into account in determining the open market value? To put it another way, does a hypothetical willing tenant who knows that it will only ever pay 50% of open market value put in a higher bid than he would if the lease obliged him to pay the full open market value?

4. Similarly, if the lease requires the actual tenant to pay an additional amount to the market rental value, how does that impact upon the rent review? If the review is to open market, does the hypothetical willing tenant bid that figure or bid a lower figure to take into account the additional (say) £20,000 which it knows it will have to pay throughout the term?

5. The logical answer to these questions must surely be that one must ignore the gearing because taking it into account produces a circular effect which defeats the purpose of requiring a review to open market rent. So, if the open market rent is £50,000 per annum without any form of gearing, it should not be distorted by the existence of that gearing. If the task is to ascertain the open market rent at the review date, then that is £50,000. If the actual lease provides that the actual tenant will pay an additional £10,000, it is entirely self defeating to deduct that £10,000 from the open market rent so as to produce an actual liability of £40,000 plus £10,000. The intention of the parties was surely that the tenant should pay the open market rent of £50,000 plus the additional £10,000. Equally, if the actual lease provides that the tenant will pay 50% of the open market rent, that is surely 50% of £50,000 and the open market rent can not be inflated to £100,000 to reflect the fact that the tenant will only pay half of it.

6. The logical conclusion requires the existence of the 50% gearing to be excluded from any consideration of the revised rent payable on review. To put it another way, the fact that the tenant in the real world pays only 50% of the annual rent at which the demised
premises might reasonably be expected to be let has to be rendered irrelevant to the process of determining that annual rent. This can only be achieved by concluding that the hypothetical lease, in respect of which the willing tenant will make its rental bid at the review date, is a lease which does not contain the 50% gearing. That way, the process of determining an open market rent remains “pure”.

The decided cases

7. In Lister Locks Limited v TEI Pensions Trusts Limited [1982] 2 EGLR 124, the court was considering a lease granted for 25 years with five-yearly reviews. It reserved a basic initial rent and an extra initial rent. Only the former was to be reviewed - to the then current market rent. The extra initial rent was to be increased pro rata to any increase in the basic initial rent. The issue for the court was whether or not the hypothetical lease should, or should not, include the obligation to pay the extra initial rent. On a literal interpretation of the rent review provisions, the Judge thought that it must. The hypothetical lease was to be subject to similar covenants and conditions. However, it was held that, in order to give business efficacy to the lease, it was necessary to imply a term so as to exclude the extra initial rent obligation from the hypothetical lease.

8. In Guys 'n' Dolls Limited v Sade Brothers Catering Limited [1984] 1 EGLR 103, the rent was to be reviewed to the fair rack rental market value plus £7,500. The same issue arose: should the hypothetical lease contain the obligation to pay the additional £7,500? The Court of Appeal concluded that it should not, whether or not one got to that conclusion by a process of implication, as had happened in Lister Locks, or by a process of construction.

9. In Buffalo Enterprises Incorporated v Golden Wonder Limited [1991] 1 EGLR 141, a similar scenario arose. The lease reserved a basic rent plus an additional rent of £9,000 per annum. The review mechanism related only to the basic rent and, as in Lister Locks, the additional rent was to be increased on a pro rata basis. Hoffmann J, as he then was, held that the obligation to pay the additional rent had to be disregarded completely when ascertaining the basic rent, which was expressed to be the market rental value at the review date.

10. In Prudential Assurance Company Limited v 99 Bishopsgate Limited [1992] 1 EGLR 119, a lease for a term of 98 years had seven-yearly rent reviews. The rent payable on review was to be the greater of the passing rent and 50.6% of the yearly rental value of the premises at the valuation date. That yearly rental value was to be ascertained having regard to the provisions of the existing lease “(other than the rent hereby reserved)”. Again, the court decided that the gearing had to be ignored in ascertaining the yearly rent value.

11. The issue was revisited much more recently in Watergate Properties (Ellesmere) Limited v Securicor Cash Services Limited [2005] EWHC 3438. Here, the lease provided for the tenant to pay a supplementary rent of £11,230 per annum during the first 15 years of the term. That sum was not to be subject to review. An arbitrator was appointed to determine the rent and he held that the hypothetical lease should be assumed to include the requirement to pay the supplementary rent. As a result, he deducted that amount from his determination of the yearly rental value of the property. On appeal Lewison J disagreed with the arbitrator and varied his award so as to leave the market rent at the original figure without any deduction of the supplementary rent.

12. In giving his judgment, Lewison J considered all of the above cases and held that, in the absence of any contrary indication, a fair market rent had to be assessed in the light of the terms of the rent review clause as they subsisted at the date of the rent review. To achieve the commercial purpose of the lease in question, the hypothetical lease had to
reflect the fact that the supplementary rent was no longer payable by the rent review date - this was because the initial 15 years of the term of the actual lease had expired. More generally, he observed that, in cases involving long leases, where an additional rent was payable by the tenant, the court had consistently held that the hypothetical lease for the purpose of determining a fair market rent should be deemed not to contain an obligation to pay any additional rent.

13. Lewison J concluded that one had to exclude from the hypothetical lease not only the actual amount of the rent reserved but also the gearing provision.

Is there an alternative view?

14. There are two other cases which might be said to point to a different conclusion.

15. One is *British Railways Board v Ringbest Limited* [1996] 2 EGLR 82. In that case, upon review, the rent was to be fixed at the greater of the passing rent or 84.0253% of the open market rent. An arbitrator held that the hypothetical lease contained the gearing provision. The then Vice Chancellor refused permission to appeal against the award on a point of law. However, he did not make any finding as to whether or not the arbitrator had got it wrong or right. He simply concluded that there was not a strong prima facie case that the arbitrator had erred in law.

16. What the case does not do is hold that the arbitrator's decision was unquestionably correct. Indeed, it seems highly probable that, were the same question to come before a court again, a different conclusion would be reached. It is also noteworthy that none of the earlier cases cited above appear to have been considered by the court.

17. Equally, the Vice Chancellor was not influenced by the existence of the decision in *Norwich Union Life Insurance Society v British Telecommunications plc* [1995] EGCS 148. In that case, Knox J held that the gearing formula should be taken into account on reviews and applied to rent reviews under the hypothetical lease. It appears that the Judge felt constrained in the process of construction, and came to this conclusion despite, as he put it, there being an element of illogicality about it. What he could not find, however, was anything like the "self-cancelling absurdity" described as "Alice-in-Wonderland" reasoning in the *Guys 'n' Dolls* case. That being so, he shied away from what he concluded would be a rewriting of the parties' agreement rather than the proper interpretation of it.

18. This decision is clearly out of line with the thrust of the other cases, including the decision of the Court of Appeal in *Guys 'n' Dolls*. In those other cases, a similar process of construction was not considered to be an impediment to reaching the logical conclusion. Unfortunately, the very short case summary does not reveal why Knox J felt so constrained.

Conclusion

19. The case is a useful reminder that the language used by the draftsmen will be the important starting point in any construction exercise. The wording may be so unequivocal that it permits of no alternative conclusion. That said, taken as a whole, the cases illustrate that it is highly probable that a gearing provision will be disregarded on review.

20. It is comforting that such a conclusion has the merit of being entirely logical and commercially sound. To take into account the gearing provision when ascertaining an "open market" rent is a contradiction. In the absence of very clear words to the contrary, therefore, the starting point should always be that the gearing (upwards or downwards) must be disregarded when ascertaining the open market value of the premises at the
review date - even when the hypothetical lease is expressly stated to be on the same terms and conditions as the actual lease.

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