# Modick RC Ltd v Mahoney

Court of Appeal
23, 24 May, 24 June 1991
`ooke P, Hardie-Boys, Gault JJ

*Arbitration – Rental assessment – Motor vehicle premises – Case stated to High Court as to approach to take having regard to lessee's profitability – Appeal*

A vehicle dealer carried on business in premises leased from the appellant. The rental was reviewed on the third anniversary and the relevant clause provided for reference to arbitration. The improvements made by the tenant to make the premises suitable for its business were to become part of the demised premises and the property of the landlord who was to refund the cost up to a maximum amount by way of deduction from the rent. The arbitrator stated a case for the High Court to set the approach to take in terms of the lease to have regard to the lessee's profitability to the extent appropriate. The Chief Justice held that the arbitrator should take into account all considerations existing at the review date pertinent to the demised premises and the relationship of landlord and tenant that would have affected the minds of reasonable persons.

In an earlier case involving the appellant, the High Court held that the arbitrator should have taken into account in fixing the rent for the second term that the tenant had spent an amount over the maximum on improvements for which it could receive no reimbursement. The subjective approach was appropriate and the profitability of the tenant's business would be relevant if reasonable. The correct interpretation of the rent review clause was again in issue.

**Held,** 1 It could not be said that the profitability of the lessee was necessarily irrelevant to the decision the arbitrator was required to make. In certain circumstances and for limited purposes the accounts of trading of the business conducted in the premises can be relevant (as where there is no evidence of truly comparable rents) and it is for the arbitrator to determine whether such accounts are relevant. The arbitrator cannot make his assessment in blinkers or in a vacuum.

2 The approach to rental valuations which have prevailed in the past with major emphasis on `mparative rentals must be followed with care to ensure that the comparisons continue to be valid . changing conditions.

3 The lease did not stipulate market rent, but it may be that there is no practical distinction between such a rent and that which would be agreed between reasonable parties.

**Cases mentioned**
*ARC Ltd v Schofield* [1990] 38 EG 113.
*Arnold v National Westminster Bank plc* (unreported 25 April 1991).
*Duvan Estates Ltd v Rossett Sunshine Savouries Ltd* (1981) 261 Estates Gazette 367.
*Harewood Hotels Ltd v Harris* [1958] 1 All ER 104.
*Jefferies v RC Dimock Ltd* [1987] 1 NZLR 419.
*Lear v Blizzard* [1983] 2 All ER 662.
*Ponsford v HMS* Aerosols Ltd [1979] AC 63.
*Thomas Bates & Sons Ltd v Wyndhams Lingerie Ltd* [1981] 1 All ER 1077.
*WJ Barton v Long Acre Securities Ltd* [1982] 1 All ER 465.

**Cooke P:** The lessor in an agreement to lease dated 22 April 1982 for a term commencing on 28 May 1982 and expiring on 27 May 2003 appeals from a judgment Sir Thomas Eichelbaum CJ, delivered on 14 December 1989, on an award by an arbitrator in the form of a special case stated dated 27 July 1989 under s 11 of the Arbitration Amendment Act 1938.



Source: New Zealand Institute of Valuers (1993). Land valuation cases 1965-1992. Hutcheson Bowman & Stewart Ltd, Wellington.

The lease is of premises at 103 Great North Road, Auckland, on which the lessee through a subsidiary company carries on a vehicle dealer's business. The adjacent land is owned by the lessee and the business of the Giltrap Group is carried on there, but nothing turns on this for the purposes of the appeal.

Clause 3.13 of the agreement to lease provides:

> 3.13 The rental hereinbefore provided shall be the rental for the first three years of the term hereof. The rental hereunder shall be reviewed on the third anniversary of the commencement of the term and at every subsequent third anniversary thereof. The rental fixed at each review shall be such rental as is agreed upon by the Landlord and the Tenant and if they cannot agree to be determined by Arbitration in the manner herein provided but not in any case to be a rental less than the rental chargeable immediately prior to such review. During the fourth, fifth and sixth years of the term hereof, the rental payable each month shall be reduced by an amount calculated on the formula a/b x c where:
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> a is the amount to be refunded by the landlord to the tenant in accordance with clause 1.17 hereof reduced by the amount actually paid in terms of that clause as at the rent day concerned.
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> b is the total value of the demised premises fixed by the valuation on which the rental for three years commencing on 20th April 1985 is established.
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> c is the rental for the demised premises as established by the foregoing valuation.

Clause 1.17 provides:

> 1.17 Notwithstanding anything contained in Clause 1.10 hereof, the Tenant shall forthwith proceed with partial demolition and reconstruction of the building forming part of the demised premises in accordance with plans prepared by Sinclair Johns Consultants Ltd and initialled by the parties hereto for the purposes of identification. The Tenant shall as soon as possible submit detailed plans and specifications to the Landlord for approval, such approval not to be unreasonably withheld. The Tenant shall have the work completed in a good and tradesmanlike manner and in accordance with the Auckland City Council by laws and regulations. Such work shall include electrical and plumbing services, painting and decorating, and the formation and paving of the forecourt. The completed structure including partitioning, fencing and electrical fittings but not including carpets and drapes shall be the property of the Landlord. The Landlord agrees to refund to the Tenant the cost of such work not exceeding $200,000, payment of such refund shall be made by the Landlord to the Tenant without interest by equal monthly instalment during the fourth, fifth and sixth years of the tenancy hereby created.

Thus the improvements made by the tenant to make the premises suitable for the tenant's business were to become part of the demised premises and the property of the landlord; but the landlord was to refund their cost up to a limit of $200,000 such refund to be made by way of deduction from the rent, according to the agreed formula, during the fourth, fifth and sixth years of the tenancy. In fact the tenant's expenditure on reconstruction and modifications was $479,222. In *Jefferies v R C Dimock Ltd* [1987] 1 NZLR 419 or an earlier award in the form of a special case stated, Barker J held that the rent review clause required what in the relevant line of authorities is sometimes called a "subjective" assessment by the arbitrator, by which is meant an assessment taking into account all the considerations that would have affected the minds of the parties if they had been negotiating the rent themselves. The authorities indicate that in some cases a figure so assessed will not be the same as a market rent. That, however, is not necessarily the case; I shall return to this point.

Applying that approach, Barker J held that the arbitrator should have taken into account in fixing the rent for the second three-year term the fact that the tenant had spent $279,222 on improvements for which it was to receive no reimbursement. Without a deduction on that head the rent had been assessed by the arbitrator as $189,400. The arbitrator had arrived at an alternative figure of $162,900 if the tenant's extra expenditure ought to be taken into account. The parties agreed that the two assessments correctly represented the alternative possibilities. Barker J held accordingly that the rent should be the $162,900.

On the second rent review (for period from 28 May 1988 to 27 1991) the valuers from whom the arbitrator heard evidence agreed a market rental assessment for the leased premises at $353,700 per annum and an adjustment for the tenant's improvements in accordance with the judgment of Barker J reducing that figure to $308,500 (exclusive of GST). Paragraph 1.7 of the award states:

> 1.7 In advising the rental figure of $308,500 the valuers also stated to me their assessment and agreement as in the above mentioned rental figures and not have regard to the particular business operation on the premises, but rather, to the premises, that is the land and buildings, by comparison with other known lease rentals.

The arbitrator heard evidence, however, from a representative of the tenant that the tenant's business on the premises, was operating at a loss, though a breakeven result was forecast for the 1989 March quarter and thereafter the same or slightly improved results were forecast. The landlord contended that this lack of profitability of the tenant's business should not be taken into account; the tenant contended that it should; the arbitrator fixed the rent at the $308,500, thereby apparently adopting the landlord's contention, but stated the following questions for the Court:

> (i) In fixing the rental on a rent review under the lease between the First and Second Respondent must any regard be had to the profitability or otherwise of the actual business conducted on the leased premises?
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> (ii) If so, to what extent?
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> (ii) Is the financial situation of the actual lessee relevant?
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> (iv) If so, to what extent?
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> (v) Does my award correctly state the rental to be paid for the leased premises for the period 28 May 1988 to 27 May 1991?

In paragraph 5.3 of his award he said:

> "In the event that my award is wrong as a matter of law and the financial circumstances of the lessee and/or the proprietor of the business on the leased premises are relevant to the rental assessment, I am unable to make an alternative award on that basis on the nature of the evidence put before me and I request a further arbitration hearing to establish these facts."

The essence of judgment of the Chief Justice was that the so-called subjective approach was appropriate and that the profitability or unprofitability of the tenant's business would be relevant if reasonable persons in the shoes of the parties would have taken it into account. It was for the arbitrator to determine whether or not they would have done so and, if Yes, with what effect on the agreed rent. Accordingly the Chief Justice answered the questions as follows:

> (i) The arbitrator should have approached the arbitration by determining what would be a reasonable rent for the parties to agree to in all the circumstances, taking into account all considerations existing at the review date pertinent to the demised premises and the relationship of landlord and tenant, that would have affected the minds of reasonable persons in their position had they been negotiating the rent themselves.
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> (ii) To the extent that the arbitrator considers appropriate, having regard to the answer under (i) and the evidence before him.
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> (iii) As under (i).
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> (iv) As under (ii).
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> Question (v) asked whether the Award correctly stated the rental for the review period. It is evident that the Arbitrator did not approach the fixation of the rent on the basis set out in this judgment. He first determined the rent on an open market basis, then deducted an allowance for the tenant's improvements. In the circumstances I have to answer question (v) by saying that the Award did not fix the rental on the appropriate principles. However, that is not to say that the arithmetical answer was wrong. Nor of course am I saying that it was right. The result is entirely a matter for the arbitrator, to whom I now remit the award for reconsideration.

Although the expressions "objective" and "subjective" have occasionally been used in contrasting two kinds of rent review clause (see for example *Ponsford v HMS Aerosols Ltd* [1979] AC 63, 85 per

Lord Keith; *Lear v Blizzard* [1983] 2 AII ER 662, 668 per Tudor Evans J) I think with respect that they are not truly helpful. The wider approach, whereby the arbitrator has the task of determining what reasonable parties would have agreed, itself poses an objective test of reasonableness. The real question in such cases as *Ponsford* has been whether the review clause is worded in such a way that, even if reasonable parties would have agreed on a deduction to reflect tenant's improvements, the arbitrator cannot take that into account. In *Ponsford,* the majority of the House of Lords attributed that inhibiting effect to a clause requiring an assessment of "a reasonable rent for the demised premises". They held that a reasonable rent was the market rent. The minority view is embodied in this passage in the speech of Lord Wilberforce at 75:

> "My Lords, clear words may sometimes force the courts into solutions which are unjust and in such cases the court cannot rewrite the contract. This is not such as case: in my opinion logic and justice point in the same, not opposite directions. I cannot attribute any other meaning to 'reasonable rent' in this context than one which takes into account (or disregards) what any lessor, any lessee, or any surveyor would consider it reasonable to take into account (or disregard). In this case the surveyor should disregard any effect on rent of improvements carried out (viz paid for) by the lessee."

In the present case the relevant wording of the review clause is perfectly general – ". . . such rental as is agreed upon by the Landlord and Tenant and if they cannot agree to be determined by Arbitration. . ." – and there is no basis for suggesting that, if satisfied that reasonable persons in the shoes of the parties would have taken a certain factor into account in arriving at an agreed figure, the arbitrator should nevertheless ignore that factor. Inevitably it follows, as the Chief Justice held, that the arbitrator should have taken the tenant's trading results into account if he found (the question being for him) that a reasonable landlord and a reasonable tenant would have done so in their negotiations. The arbitrator does not appear to have addressed himself to that question. Accordingly the award was rightly remitted to him for reconsideration.

It may well be that the question did not come into focus before the arbitrator because of the ways in which the parties represented their cases before him, each arguing for an extreme position. From the transcript of the arbitration hearing annexed to the case stated, it is not clear precisely what reason the tenant was putting forward for treating the trading results as relevant. The impression could have been created, perhaps unintentionally, that the tenant was claiming a deduction on a ground akin to hardship or because of some peculiarity of its own financial affairs. That would not be right. On the landord's side great weight was placed on the agreement of the valuers on a market rental, but there are passages in the transcript suggesting that the valuers had disregarded recent changes in the car industry, although it is common ground that the lease must be seen as effectively restricting the use of the premises to motor vehicle dealing. Moreover, although there is much reference in the transcript to rents in the market, it appears that no freely negotiated rentals for new leases of premises for motor vehicles dealing were available for comparison, but only figures from other rent reviews. Such reviews would be governed by the particular clauses under which they were undertaken. To mention only one hypothetical example, there might be a ratchet clause. At all events they would not necessarily be truly comparable transactions.

A clause of the kind found in the present case, under which the inquiry is as to the rent that would be agreed between reasonable parties, embodies the same idea as and is indeed a manifestation of the familiar willing vendor-willing purchaser test. The question is what figure would notionally be agreed upon by the parties, acting freely and adequately informed. Figures fixed by arbitration or rent reviews as between captive parties are not necessarily a reliable guide, since they do not represent the unfettered play of market forces, but rather the arbitrator's assessment (assuming that he has applied himself to the task correctly) of what market forces should produce. It is only a freely negotiated rent on a new letting that can confidently be taken to be truly comparable, provided of course that there are also sufficient similarities in site and otherwise.

The recorded evidence appears to contain nothing to show that the valuers were satisfied that there was enough contemporary evidence to enable a market rent for the demised premises to be assessed confidently without any regard to the trading results of the business that had in fact been carried on there. On the contrary they may have thought that they had to make do with such alleged comparable transaction evidence as there was, however inconclusive, and eschew any consideration of profitability.

So called "market" rents arrived at on a basis which put the premises beyond the economic reach of reasonable tenants would of course, not be true market rents. I am not saying that such is the case here, only that the matter requires consideration by the arbitrator. In the present economic climate the point may be of some general importance.

The instant lease does not stipulate a market rent; but, apart from the issue as to tenant's improvements, it may well be that there is no practical distinction between such a rent and that which would be agreed between reasonable parties. The arbitrator could take the view that a reasonable landlord would require and a reasonable tenant would pay a rent commensurate with the optimum use of the premises for a motor vehicle dealing business. In theory that would be a market rent. The tenant would not be entitled to a lower rent if, for instance, it had organised its business in an unprofitable way or accepted an unfavourable franchise. Still less could the tenant pray in aid any financial circumstances peculiar to itself. The question must be what rent should fairly be paid for the premises during the relevant period by a reasonable motor vehicle dealer. Presumably a reasonable motor vehicle dealer would give prominent regard to potential profitability.

It is conceivable that there is enough evidence of truly comparable transactions to enable the proper rent to be arrived at with sufficient confidence without any consideration of the tenant's accounts. If so, it would be proper for the arbitrator to find that reasonable parties would go no further. But, in the light of the evidence and the questions asked by the arbitrator of the Court, I think that the tenant is entitled to an opportunity of contending before the arbitrator that this case is not in that category.

Even where rent is expressly required to be fixed on an open market basis, evidence of the trading results that have been or can be achieved in the particular premises is relevant unless there is enough other evidence to establish the figure satisfactorily. See, for example, the cases in the English Court of Appeal, *Harewood Hotels Ltd v Harris* [1958] 1 All ER 104 and *W J Barton v Long Acre Securities Ltd* [1982] 1 All ER 465.

Mr Craddock, for the landlord, stressed the complications which will follow if the accounts of tenants and discovery of them become generally necessary in rental arbitrations. Each case must turn on its own facts and there certainly should be no general practice of requiring accounts. But in cases where there is real doubt as to whether a fair economic rent can otherwise be ascertained, such accounts are likely to be relevant. It will be for the arbitrator to decide whether or not this is one of those cases.

It should be added that, although before the Chief Justice it was accepted that on the question of a deduction for tenant's improvements the judgment of Barker J gave rise to an issue estoppel, in this Court Mr Craddock sought to re-open that issue on the authority of the decision of the House of Lords in *Arnold v National Westminster Bank Plc* (25 April 1991). The point was not even included in the appellant's points on appeal and should not be entertained at this late stage.

I record that it is accepted between the parties that the Chief Justice's order as to costs does not affect the arbitrator's award as to the costs of the arbitration down to the filing of the case stated.

For the foregoing reasons I would dismiss the appeal. In this Court the second respondent should have against the appellant an order for costs in the sum of $3000. The Court being unanimous, there will be order accordingly.

**Hardie Boys SJ:** For the reasons given in the President's judgment, I agree that this appeal should be dismissed, and that the issue determined by Barker J following the first rental review should not be reopened. I wish to add only some brief observations.

Rental review clauses were designed to protect a lessor under a long term lease against increases in the value of property or decreases in the value of money. A ratchet provision guarded against any aberration. There was an underlying assumption that the lessee would be able and willing to pay the increase needed to bring the rent up to date; or that if he were not, someone else could and would.

The economic downturn in recent years tends to negate the purpose of such clauses and focuses attention, in a way probably not previously necessary, on the factors to be taken into account on a review, lest the assumption be invalidated too. In particular, it shows that historical data is inadequate. Without modification from contemporary material, traditional material such as existing rents can lead only to artificially high rents, failed businesses and empty premises.

A number of cases decided in England in recent years have demonstrated the various drafting techniques employed in statutes as well as leases to fulfil the original purpose of rent reviews. These are of two general kinds. One calls for the assessment of a market rent, what the hypothetical willing lessee would pay to the hypothetical willing lessor for the particular premises. An example is *W J Barton Ltd v Long Acre Securities Ltd* [1982] 1 All ER 465. The other, of which the present case affords an example directs attention to what the particular parties, acting reasonably, would agree as the proper sum in the current circumstances such a case is *Thomas Bates & Son Ltd v Wyndham's Lingerie Ltd* [1981] 1 All ER 1077. Describing the former as an objective approach and the latter as subjective confuses rather than clarifies, for the second is objective too. To the extent that there is any difference between them, it is in the considerations that maybe relevant to the determination that is to be made. It may well be that there is, or ought to be, no difference in result between the two approaches. For it is clear that neither party is to be advantaged or disadvantaged by the fact that the review occurs during the term of the lease: it proceeds on the basis that a new lease is being negotiated at that time. And reasonable parties would expect to pay and receive the going rate. The difference has emerged most sharply over whether the lessee is to pay rent for improvements he has effected himself; and here at least the difference may be real rather than merely apparent. The leading case in which he has been required to do so, *Ponsford v HMS Aerosols Ltd* [1978] 2 All ER 337, turned to a large degree, however, on the fact that what was to be fixed was the reasonable rent "for the demised premises", an expression which clearly indicated the improvements. Even so, one decision has been seen as unsatisfactory, and the English Courts have adopted the reasoning in the minority judgments of Lord Wilberforce and Lord Salmon wherever the wording of the clause in question has enabled the case to be distinguished. And of course in each case it is a matter of construing the particular wording in question.

The present case does not call for a discussion of what material is relevant for the purposes of leases that require a market rent to be determined. The only issue is the relevance of the lessee's profitability where the lease is of the second kind I have noted. To adapt what Lord Salmon said *in Ponsford* at p 844, the arbitrator cannot make his assessment in blinkers or in a vacuum. The profitability of a business for which the site is suitable, and even more the profitability of a business of the only kind that is able to be carried out on the site, may well have a bearing on the value of the property and the rental to be obtained from it. The valuer or arbitrator is unlikely to be an accountant or an expert in business management, and so is likely to look to true, ie contemporary, market rentals of real comparability as a better guide than the lessee's own accounts, for they may reflect factors peculiar to the business rather than factors relevant to the rental value of the property. But in so far as they bear on the latter, they will be relevant.

The relevance of evidence as to profitability must necessarily be limited. The important distinction is between evidence that is related to the rental value of the property as between lessor and lessee on the one hand, and evidence as to the ability or the willingness or reluctance of the lessee to pay a particular rent on the other. A recent judgment of Millett J in *ARC Ltd v Schofield* [1990] 38

EG 113, is helpful in this respect. Evidence of the latter kind is generally irrelevant, for the underlying assumption to which I have referred must remain. It was subject to this distinction that evidence of the tenant's financial results was admitted in *Harewood Hotels Ltd v Harris* [1958] 1 All ER 104. I do not accept Mr Craddock's submission that the case is authority only in a situation where there is no other evidence of value, although as I have said where there is such other evidence the tenant's profitability may carry little if any weight.

However the ability of the lessee to pay may be relevant where the lease restricts the business that he may carry on in the property. That particular business may be depressed, either generally or in the particular area, so that a reasonable lessee would be unwilling to pay the rent that may have been appropriate in more prosperous times. Such a consideration must be relevant to the rent-fixing exercise. See the judgment of Robert Goff J in *Duvan Estates Ltd v Rossett Sunshine Savouries Ltd* (1982) 261 Estates Gazette 367.

Thus it cannot be said in the present case that the profitability of the lessee is necessarily irrelevant to the decision which the arbitrator was required to make. The Chief Justice was therefore right to answer the questions in the case stated in a manner that enabled the arbitrator in approaching the task set him by the terms of the lease, to have regard to the lessee's profitability to the extent that he thought appropriate.

**Gault J:** For the reasons set out in the judgment of the President, I agree that the appeal should be dismissed.

The correct interpretation of the rent review Clause 3.13 of the lease was determined by Barker J following the decision in *Thomas Bates & Son Limited v Wyndham's (Lingerie) Limited* [1981] 1 All ER 1077. That is encapsulated in the judgment of Buckley L J (p 1088).

> "In my judgment, in default of agreement between the parties, the arbitrator would have to assess what rent it would have been reasonable for these landlords and these tenants to have agreed under this lease having regard to all the circumstances relevant to any negotiations between them of a new rent from the review date."

Mr Craddock for the lessor accepted that approach before the Chief Justice and cannot now resile from it.

In my view once Mr Craddock acknowledged, as he was obliged to do in the face of such cases as *Harewood Hotels Limited v Harris* [1958] 1 All ER 104, that in certain circumstances and for limited purposes the accounts of trading of the business conducted in the premises can be relevant (as where there is no, or inadequate, evidence of truly comparable rents), he must accept that it is for the arbitrator to determine whether in this case such accounts are relevant.

It is for the arbitrator to determine also whether particular evidence of accounts is helpful. It is to be emphasised, however, that the relevance of such accounts is not to establish what the lessee can afford to pay, but to bear upon what would be a reasonable rent over the period for which the rent is to be fixed in all the circumstances and in light of the use restriction in the lease.

With the assistance of the valuers who gave evidence, the arbitrator arrived at a "market rental" for the premises and then adjusted that to take account of the lessee's improvements in accordance with the judgment of Barker J. It is unclear from the evidence what factors were, and were not, taken into account in assessing that market rental. The Chief Justice appears to have assumed that consideration had been given to relevant general commercial and economic factors. He said:

> "Thus the issue (in contention) does not concern any question of the state of the country's economy as a whole. Nor does it relate to any downturn in the motor industry in general. These considerations would necessarily be in the mind of any parties negotiating a review of rent, and would properly be taken into account in assessing the rental on an open market or objective basis. The same applies to any suggestion of a localised state of business depression. Likewise, if the tenant wished to suggest that the particular location had become less attractive, for example by reason of a street closure, or the institution of a one way traffic system. Needless to

> say evidence pointing to opposite trends in any of the respects mentioned would equally be relevant."

Passages in the evidence leave doubt as to the extent to which such matters were taken into consideration by the valuers or were reflected in comparative rentals they relied on. The doubt therefore extends to whether they arrived at a true market rental. In any event, though the result might well be no different, the arbitrator's task in this case is to fix the rental than would be reasonable for this lessor and this lessee having regard to all the circumstances.

I agree with the observations of Hardie Boys J that the approach to rental valuations such as this which has prevailed in the past with major emphasis on comparative rentals must be followed with care to ensure that the comparisons continue to be valid in changing conditions.