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IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION

Royal Courts of Justice
Strand
London WC2

Wednesday, 4th February 2004

B E F O R E:
MR JUSTICE LEWISON

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SAFEWAY STORES
APPLICANT

-v-

LEGAL & GENERAL ASSURANCE SOCIETY LTD
RESPONDENT

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(Official Shorthand Writers to the Court)

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MR J GAUNT QC (instructed by Lovells) appeared on behalf of the APPLICANT
MR J SEITLER QC (instructed by Nabarro Nathanson) appeared on behalf of the RESPONDENT

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J U D G M E N T (As approved by the Court)

(This transcript has been produced without the assistance of documents)

1.MR JUSTICE LEWISON: Safeway Stores is the tenant of a superstore at Meadow Head in Sheffield. The lease includes not only a retail store, but also a petrol filling station alongside. The lease was granted for a term of 25 years from 24th March 1997, and it provides for rent reviews at 25th March in the years 2002, 2007, 2012 and 2017.

2.The rent initially payable was split as between the retail store on the one hand and the petrol filling station on the other. When the review mechanism is operated the filling station is not separately valued, but its rent will increase in proportion to the rent for the retail store. Clause 5.2.1 of the lease requires the ascertainment of what is called the retail store open market rental. Clause 5.2.2 states:

> "The revised rent will be the rent at which the retail store might reasonably be expected to be let in the open market as a whole at the relevant review date making the assumptions and disregarding the disregards."

The assumptions are set out in clause 5.1.1 of the lease. They include, amongst others, the following, 5.1.1.4:

> "That the retail store is available to let by a willing landlord to a willing tenant by one lease as a whole without a fine or premium from either party and with vacant possession."

5.1.1.5:

> "That the lease by which the retail store will be let (the hypothetical lease) contains the same terms as this lease, except the amount of the retail store initial rent and any rent free period allowed to the tenant."

5.1.1.8:

> "That the hypothetical lease contains the following clause: not to use or suffer the retail store or any part thereof to be used otherwise [I think the word 'than' should be inserted] as a shop as defined in Class A1 of the Schedule to the Town and Country Planning Use Classes Order 1987 for the sale of food and household goods, provided always that the tenant shall be entitled to operate an off licence for the sale of alcoholic liquor, florist, pharmacy, bakery, creche, restaurant, dry cleaners and post office departments within the retail store ancillary to the use of the retail store as a shop as aforesaid with ancillary storage and ancillary accommodation."

Clause 5.1.1.11 requires certain clauses to be excised from the hypothetical lease. Those clauses relate to the petrol filling station, and in particular clause 3.18 which contains the use clause which permits part of the property to be used for that purpose.

3.The disregards include in clause 5.1.2.7:

> "Any effect on rental value attributable to the existence and carrying on of the business of the petrol filling station adjoining the retail store."

4.The rent, if not agreed, was to be determined by arbitration. Clause 5.2.4 of the lease provided that the arbitrator should act as an expert, and clause 5.2.5 said that the expert should be at least ten years qualified and have experience of valuing properties of the same type and use as the retail store.

5.Mr Graham Chase FRICS FCIArb was appointed by the President of the Royal Institution of Chartered Surveyors to determine the rent. He heard submissions from both parties, including legal submissions from the tenant. He issued his written award on 22nd August 2003. It runs to 50 closely-typed single spaced pages, plus some appendices.

6.The tenant, Safeway Stores, now seeks permission to appeal under section 69 of the Arbitration Act 1996. Five potential issues have been identified. Section 69(3) provides:

> "Leave to appeal shall be given only if the court is satisfied:
>
> (a) that the determination of the question will substantially affect the rights of one or more of the parties;
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> (b) that the question is one which the tribunal was asked to determine;
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> (c) that on the basis of the findings of fact in the award:
>
> (i) the decision of the tribunal on the question is obviously wrong; or
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> (ii) the question is one of general public importance and the decision of the tribunal is at least open to serious doubt, and
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> (d) that despite the agreement of the parties to resolve the matter by arbitration it is just and proper in all the circumstances for the court to determine the question."

7.The first point to make about section 69(3) is that in subparagraph (a) it has to be demonstrated that the determination of the question will substantially affect the rights of one or more of the parties, and not that it may do. Must each question individually have that substantial effect? In my judgment, no. It would be sufficient, if taken together, they will substantially affect the rights of one or more of the parties.

8.As to subparagraph (b), the tribunal must have been asked to determine the question, but I do not think that the question needs to have been raised with the precision of a construction summons. All that is needed, in my judgment, is that the point was fairly and squarely before the arbitrator, whether or not it was actually articulated as a question of law.

9.Subparagraph (c) makes it clear that the question must be determined on the basis of findings of fact in the award. The findings of fact in the award cannot be challenged.

10.None of the questions, as I see it, is of general public importance in the present case, and so it is (c)(i) which governs the present application, namely whether the decision of the tribunal is obviously wrong.

11.Finally, subparagraph (d) should, I think, be looked at overall and, again, not on an issue by issue basis.

12.The first issue which Mr Gaunt QC, appearing on behalf of the tenant, has identified is that the arbitrator's treatment of the petrol filling station was obviously wrong as a matter of law. The arbitrator took into account the potential for a petrol filling station. He said in paragraph 4.34 of his award:

> "Clause 5.1.2.7 of the lease confirms that to be disregarded at rent review is the effect on rental value attributable to the existence and carrying on of the business of a petrol filling station adjoining the retail store. Clause 5.1.1.11 also makes it clear that a number of clauses are to be excluded from the hypothetical lease, which include those in the preambles to the lease which identify the existence of the petrol filling station and the treatment to be adopted in assessing the rental value for the petrol filling station by way of a formula at clauses 1.1.16, 1.1.17, 1.1.22, 1.1.23, 1.1.26 and 1.1.27. From my analysis of these provisions, it is clear that all the lease is attempting to do is to ensure that there is no element of rental included in that attached to the retail store which reflects the benefit of the petrol filling station. However, in my opinion this is not to make the assumption that the store cannot have the benefit of a petrol filling station insofar as when comparing the property with a store which has no such facility and where no such facility could be provided then an adjustment should be made to reflect the fact that the store either has the ability to have a petrol filling station or does not. This is not to add any additional rent to the value of the store, but simply to reflect the benefit of such a facility being available."

He continued in paragraph 4.35:

> "Mr Holt is absolutely correct in stating that a store with a petrol filling station is able to attract more business than one which is not. It therefore stands to reason that a store which has the ability to provide such a facility is better than a store where such a facility cannot be made available. Mr Holt, however, is wrong to assess the property by comparing it to other stores which have no petrol filling station. The best approach is to compare the store which has a petrol filling station adjoining it where the petrol filling station is included in a separate demise or is valued separately. Those circumstances then replicate the precise position of the subject property."

At paragraph 4.36 he said:

> "With regard to the petrol filling station, I agree with Mr Brigdon's analysis that although the facility is to be ignored for the purpose of valuation, the planning permission does provide for the potential of a petrol filling station facility and the site is clearly of sufficient size to incorporate such a facility. I agree with Mr Brigdon that such potential would be considered by the hypothetical lessee when assessing their rental bid, although no additional value would be appropriate for the facility itself. With regard to the analysis of petrol filling station values on food superstore sites and comparables, I

> have given this further consideration later in this award when analysing the evidence of each comparable."

13.His conclusion was expressed in paragraph 5.4 of his award as follows:

> "As to issue 3, I find that the petrol filling station is to be disregarded for the purposes of assessing the open market rental value of the retail store, but when comparing this property with other evidence the fact that there is the potential for a petrol filling station should not be ignored insofar as where other food stores have the petrol filling station incorporated within a separate demise or whereby the rent is calculated by way of a formula, this represents a similar position to the subject property. When comparing the subject property to those food stores which have no filling station facility, the subject property can be regarded as being superior in this respect."

14.Mr Gaunt identifies two errors which he says the arbitrator made. The first is that he overlooked the extent of the hypothetical demise. The second is that he overlooked the restricted use covenant in the hypothetical lease. Mr Gaunt referred me to the decision of the Court of Appeal in Plinth Property Investments Ltd v Mott, Hay & Anderson [1979] 1 EGLR 17, in which the Court of Appeal held that it was impermissible to take into account the prospect of a relaxation or waiver in the covenants contained in the hypothetical lease.

15.Mr Gaunt submitted that the extent of the demise was limited to the retail store and that the use covenant to be included in the hypothetical lease did not permit use as a petrol filling station. He also submitted that the disregard of the carrying on of the business of a petrol filling station applied to the past, present and future carrying on of a petrol filling station on the adjoining site, with the consequence that the arbitrator was not entitled to take into account the potential for that use.

16.Mr Seitler QC, appearing for the respondent, sought to sidestep that submission by submitting that the demise included both the land on which the retail store was situated and also the land on which the petrol filling station was situated. He pointed out that the assumption in clause 5.1.1.11 did not require the exclusion of the definition of the demised premises in clause 1.1.1, and that the latter definition included both the retail store and the petrol filling station. He accepted that the use clause contained in clause 3.18 of the lease was to be excluded from the hypothetical lease and replaced by the lease clause in clause 5.1.1.8. The consequence however, he submitted, was that the arbitrator was required by the lease to assume the grant of a lease of the entirety of the demised premises including the petrol filling station, but on the terms of a lease under which only the use of the retail store was regulated, leaving the use of the petrol filling station unrestricted.

17.I do not agree with that submission. In my judgment, it is clear from clause 5.2.2 of the lease that the subject matter of the hypothetical lease is the retail store alone. It makes no sense, in my judgment, to exclude the terms of the actual use covenant and substitute that contained in clause 5.1.1.8 if the upshot is that a part of the overall site, which in reality has a regulated use, is in the hypothesis completely unregulated.

18.It seems to me, therefore, that the arbitrator was wrong -- and if I need to say "obviously wrong", I do so -- in concluding that the site had the capacity for a petrol filling station. It did not for the two reasons identified by Mr Gaunt: namely, first of all, the hypothetical demise did not include the filling station and, secondly, the terms of the hypothetical lease did not permit any part of the demise to be used for that purpose.

19.However, that in itself is not enough for Mr Gaunt to succeed in his application for permission to appeal. He has to demonstrate that the determination of that point will substantially affect the rights of the parties.

20.In the first place, the arbitrator did not assume that the hypothetical demise had a petrol filling station, merely that there was potential for a petrol filling station. He made some adjustments to comparable properties in the region of between 7.5 and 10 per cent, but those adjustments reflected the difference between a filling station and no filling station. Consequently, any adjustment which he made to comparables in relation to the potential for a filling station must, in my judgment, have been less than 7.5 per cent. Moreover, he came to his final conclusion on the rental level to adopt in paragraph 5.7 of his award, in which he said:

> "As to issue 6, I have identified the open market rental of the retail store at a rental rate of £16.25 per square foot, with the best comparable evidence being that from the Sainsburys store at Crystal Peaks and also the Sainsburys store at Millhouses, with the former being a rent review as at 24 June 2002 and the latter being a rent review as at 21 December 1999. However, the open market lettings at Colchester, Cambridge, Southport and Stallybridge have all been of assistance in identifying the general tone of rental levels, which range between £14 and £18.50 per square foot for stores which have some differences but which nevertheless represent modern food superstores. The appropriate rental rate to apply to the subject property is £16.25 per square foot, which produces an open market rental of £828,750 per annum."

21.Of the comparables which the arbitrator has identified as being the most helpful, the position as regards petrol filling stations is as follows: Crystal Peaks has no filling station; Sainsburys at Millhouses has a filling station but it is separately demised; Colchester has a filling station but not included in the lease; Cambridge has no filling station; Southport has a filling station; and, Stallybridge has a filling station but it had to be disregarded for rent review purposes. In addition, the comparable at Smallheath, which the arbitrator regarded as being of a higher value than the subject property, had a filling station, but again it was to be ignored for the purposes of rent review. It is therefore impossible, in my judgment, to say that the determination of this question will substantially affect the rights of the parties.

22.Mr Seitler also submitted that the arbitrator was not asked to determine this question as a question of law. However, it seems to me that the question of treatment of the petrol filling station did arise and therefore it was sufficiently raised for that particular hurdle to have been overcome, but it seems to me that the hurdle at which the tenant fails is in demonstrating that his rights will be substantially affected.

23.The second issue which Mr Gaunt identifies is the question of devaluation of premiums. The arbitrator considered evidence of 18 comparables. Three involved premiums having

been paid by the tenant. The question arose whether the premiums should be decapitalised at all. The arbitrator decided that in two cases it was appropriate to decapitalise the premium, and in the third case it was not. In paragraph 4.52 of his award he said:

> "I cannot accept that premiums should not be amortised regardless of the circumstances in which they have been paid. There will of course be clearly defined reasons for the payment of a premium which will exclude its amortisation as rent, such as payment for landlord's works. It is also clear to me that if it can be demonstrated that a premium is key money which simply reflects a particular tenant's desire to secure a trading opportunity over and above that which the market will pay, then that element of premium must also be disregarded. To amortise such a premium and add it to a rent paid is likely to reflect headline rent over and above market rent or the ability of a particular tenant to pay a rent, rather than the market ability to pay it as a whole. Conversely, if there is no identifiable purpose of the premium to reflect payment for works or other matters, then one asks oneself the question: what does the premium payment represent? There is only one answer left, which is that it is a capital payment in lieu of rent and hence stands to be devalued to a rental figure."

In paragraph 4.57 he said:

> "In analysing premiums I will therefore have regard to the specific circumstances in which the premiums have been paid, and where such premiums are clearly payments in lieu of rent and will amortise them over the term of the lease on a straight line basis but in considering the result will ensure that the total rental is not one that will exceed what might reasonably be regarded as the market rent."

In paragraph 4.58 he concluded:

> "The purpose of this clause is to identify a rent which does not have a premium attached to it. In other words, for the purposes of considering the evidence it is appropriate to devalue premiums where, in valuation terms, it is correct to do so, i.e. where the premium payment is in lieu of a rental payment for the purposes of assessing the open market rental value."

24. Mr Gaunt submits that the arbitrator asked himself the wrong question. He said that the right question for the arbitrator to ask was whether, as regards a particular comparable transaction, the particular tenant would have paid more rent if he had not paid the premium. So the question, says Mr Gaunt, is not, what does the premium represent, because it does not follow that simply because the tenant paid a premium, it is in lieu of rent. He submits that it is for the landlord to show that the capital payment made by the tenant is the equivalent to rent and that, in applying a presumption that the premium represented rent foregone, the arbitrator reversed the burden of proof and hence committed an error of law.

25. Mr Seitler submits that the arbitrator was simply drawing inferences of fact. People, as he put it, do not pay premiums for laughs, and if a tenant has paid a premium and there is no obvious explanation for that payment, it must follow that the tenant paid it because of

some perceived value in the property, and there is no reason to suppose that he would not have paid a higher rent.

26. In my judgment, the arbitrator's approach to the question of premiums does not disclose any error of law. He was evaluating the facts of each particular transaction in order to determine whether, in valuation terms, it was or was not appropriate to devalue the premium. The very fact that he devalued in two cases but not in the third demonstrated he was not applying a general rule; he was approaching the question on a case by case basis. I do not see any error of law in that approach at all.

27. The third issue was the devaluation methodology. The point here is that if the arbitrator was to devalue the premium, he devalued it in the wrong way.

28. It seems to me that this is a stronger case than the previous issue. If the question whether to devalue a premium is a question of fact or valuation, as I hold it is, then it must follow that the question how to devalue is a valuation question par excellence. It is not, in my judgment, a question of law at all.

29. The fourth issue relates to rateable value. Mr Holt, the valuer for the tenant, apparently drew some comfort from the rateable value of the subject property. Although it is not entirely clear from the award, I infer that he was comparing the rateable value of the subject property with the rateable value of some of the comparables. I would have thought intuitively that that was a very unreliable method of valuation or even a cross check. The arbitrator said this in paragraph 4.225:

> "I do not accept Mr Holt's approach to drawing comfort from the rating assessment as this is based on open market rental values and therefore follows the market and does not lead the market. Consequently, the hypothetical tenant could not have regard to the rateable value because in theory it does not exist at the time that the hypothetical letting is taking place. I do, however, acknowledge Mr Brigdon's statement as having some relevance, but if the rateable value is low then it is an advantage to the occupier of the property as this element of occupational cost is lower, improving the profitability of the store and allowing the operator to pay a higher rent. I take no comfort whatsoever from a rating assessment in this case, and in any event the hypothesis on which a rating valuation is undertaken is different to the assumptions on the subject properties rent review provisions contained in the lease."

30. There are a number of reasons which the arbitrator gives for not accepting Mr Holt's approach. First, he says that the rating assessment follows the market and does not lead the market. Second, he says that the hypothetical tenant could not have regard to the rateable value because in theory it does not exist at the time the hypothetical letting is taking place. Third, he says that in fact the point works the other way, because a low rateable value will tend to push up the rent. Fourth, he says that the hypothesis on which the rating valuation is undertaken is different to the assumptions of the subject property's rent review provisions.

31. I do think that the arbitrator was in error in saying that the hypothetical tenant could not have regard to the rateable value because it did not exist at the time of the hypothetical letting. At the time of the hypothetical letting the store was some five years old and had

been rated for many years. However, the arbitrator's other reasons for not accepting Mr Holt's approach seem to me to be adequate reasons and do not disclose any error of law. It does not seem to me, therefore, that determination of this point of law can substantially affect the rights of the parties.

32. The final issue relates to a premium which the tenant paid on the original grant of release. Mr Holt apparently argued that Safeway had overpaid when it entered into the lease originally, and that was part of his justification for arguing in favour of a nil increase in rent. The arbitrator dealt with that argument in paragraph 4.226 of his award as follows:

> "I find it difficult to find any support for Mr Holt's analysis of the original letting of the subject property with the suggestion Safeway overpaid both in terms of the rental at £13.50 per square foot and the premium of £1 million. There was clearly competition for the site at the time, and indeed there was potential for trade given that Mr Holt himself acknowledges that at the same time Tesco did pursue and successfully completed a planning application for a new store at Millhouses immediately adjoining the existing Sainsburys. It is inappropriate for Mr Holt to say that Safeway were unable to assess the position as the planning appeals on both this property and the Tesco store were running at about the same time. The planning inspector still felt that there would be room for both stores in the area, and there is nothing to suggest that Safeway regretted their decision to open this store or they had overpaid. The fact that they paid a premium to reflect their desire to beat competition only demonstrates their keenness to secure representation in this part of Sheffield. I therefore dismiss as unfounded the statements made by Mr Holt on this particular subject matter and agree with Mr Brigdon that the passing rent, together with the premium, reflected the true value of what Safeway felt the trading potential of this store represented. Undertaking the same analysis as I have in other premiums where there is no other reason for the premium to have been paid, other than payment made in lieu of rent, and amortising the £1 million over 25 years, increases the rental rate by 75p per square foot to £14.28. This does not appear to be an unreasonable figure when compared to the Sainsburys rent review transaction in December 1999 at £15.09 per square foot."

33. The submission of the tenant is that that passage in the award is wrong in law because, under clause 5.1.2.5 of the lease, the arbitrator was required to disregard any premium payable by the tenant pursuant to the lease.

34. However, the purpose for which the arbitrator was required to disregard the premium was for the purpose of arriving at the open market rent under clause 5. The arbitrator was in fact looking at the premium for quite a different reason, that is to rebut a suggestion that Safeway overpaid when it entered into the original package of terms. According to the award, which I have quoted, Mr Brigdon's submission for the landlord was that the total package, that is to say the passing rent together with the premium, reflected the true value of the store at the time. The arbitrator tested that submission by devaluing the premium and comparing it with another contemporaneous transaction. That, in my view, was not a step which the arbitrator took in fixing the open market rent on review, it was merely the rebuttal of a peripheral argument raised by Mr Holt. I do not consider that there is any error of law.

35. Consequently, it seems to me that the only real error of law is that relating to the petrol filling station, but because it cannot be demonstrated.