

A Tenant's Guide to Commercial Leasing

In the context of operating a business, leasing costs will often represent one of the biggest expenses, next to wages. Importantly, too, the lease will often be critical to the viability of a business, particularly in a retail context.

As such, before you enter into a lease, it's important to appreciate that rent is only one component of the total lease costs, as landlords will seek to pass on most other expenses to tenants. In a retail lease, these should be detailed in the Disclosure Statement and shown as outgoings.

A lease is an important document insofar as it creates binding rights and obligations for both a tenant and a landlord. As a prospective tenant, you need to ensure that you understand all of the key terms of the lease before signing any documentation.

KEY TERMS

Premises

There must be certainty in relation to what is being leased.

The premises will typically be identified in the lease by reference to the premises address, the certificate of title reference and, on occasion, a premises plan. The lease should also clearly identify whether there is any right to lease and/or licence a car space.

Depending on the circumstances, it may be prudent for a tenant to obtain or require the provision of a survey plan of the premises. This is particularly the case if the rent is calculated by reference to the size of the premises.

Your lawyer should always undertake a title search to ensure that the title to the property is in the name of the landlord, and to determine if there are any encumbrances on title which might affect the tenant's occupation of the premises (e.g. mortgages, caveats etc).

Rent

The rent is usually specified as a per annum amount. However, it will usually be payable monthly in advance.

The Lease should be clear as to whether or not the rent is inclusive or exclusive of GST. In most instances, the lease will contain a separate provision for the recovery of GST and, accordingly, the rent is usually expressed on a GST exclusive basis.

You need to ensure that the rent and the basis for rent reviews are appropriate having regard to the current or projected turnover of the business.

Term and Option

A lease must have a certain commencement date. It might commence on a specified date or the happening of a certain event (e.g. a certificate of occupancy being issued, a planning permit being obtained, or the settlement of a business sale).

Whether you are proposing to enter into a new lease, or take an assignment of an existing lease, it is critical to determine if the existing term, and any options to renew, are sufficient having regard to the value of the business and the level of proposed investment.

It would be an ambitious tenant, to say the least, who assumes that they will be able to easily negotiate a lease extension if there are few or no options remaining.

Typically, an additional term will only be offered to a tenant if a premium is paid to the landlord. This may be by way of a cash payment, or some agreement regarding the tenant paying for capital improvements.

In a retail lease, it is necessary to ensure that any payment is proportionate to the benefit which is received by the tenant. If there is no real or true consideration given for the payment of the benefit, then it will be "key money" and cannot be accepted by a landlord.

A tenant also needs to be aware that option provisions are usually strictly enforced and if exercised out of time will generally be invalid.

Rent Reviews

The rent is typically reviewed annually by reference to a fixed amount or percentage or to the Consumer Price Index (CPI).

If an option is exercised, then the rent will usually be reviewed to “market”. This means that the landlord will propose a new rent based on current market conditions.

If the parties are unable to agree on the renewed market rent, then it is usually referred to an independent valuer for determination. The parties are typically required to share the costs equally. Given this, a tenant should be wary of leases which require the rent to be reviewed to market annually as this creates uncertainty and adds to potential costs.

A tenant should also be wary of leases which have underpinning or “ratchet” clauses. These are clauses which seek to prevent the reduction of rent, or limit the extent to which the rent may be reduced. These types of clauses are prohibited under the Act.

Another trap for tenants is where they are required to exercise an option to renew a lease for a further term before they have been advised of the proposed renewed rent. If agreed with the landlord, this issue can be avoided with the insertion of an appropriate special condition.

Permitted Use

In the absence of a specific restriction in the lease, a Tenant may use the premises for any purpose permitted by law. However, this position is usually not acceptable from the landlord’s perspective and therefore it is usual for the use of the premises to be specified.

As a tenant, you need to ensure that the permitted use is sufficiently broad to enable you to conduct your business for all its intended purposes, and that it is not drafted in a manner which might unreasonably restrict your ability to deal with the lease.

Permits, Zoning and Approvals

The lease will usually contain a provision that the tenant is required to obtain and keep in force all necessary consents, approvals and licences for its occupation and use of the premises.

Your lawyer can assist with undertaking a planning search to ensure that the underlying zoning supports the use of the premises. It is also advisable to contact the local council’s building or planning department to assess if any planning or building approvals will be required.

Outgoings and Service Charges

A tenant will typically, but not always, be required to pay any outgoings (or operating expenses) in addition to the rent. This includes council and water rates, insurance, and levies payable to any authority (however, under the retail leasing legislation there are limitations on the right of the landlord to recover certain expenses from a tenant).

A prospective retail tenant should refer to the lease Disclosure Statement to better understand what outgoings are payable in connection with the premises. A tenant will also be required to pay all service charges like electricity, telephone and gas that are separately assessed on the premises.

Where there is more than one lease for a particular site, the landlord will generally apportion outgoings on the basis that the lettable area of the premises bears to the total area of the building. As such, a tenant should ensure that the outgoings or shared operating expenses are correctly apportioned in the lease and the Disclosure Statement.

Maintenance and Repairs

One of the primary obligations of a tenant is to keep the premises “in good repair and condition”.

The lease should clearly set out the obligations of the tenant and the landlord in relation to the repair and maintenance of the premises. It is a feature of most modern leases that

responsibility for maintenance and upkeep is largely left to the tenant.

However, in a retail lease in Victoria, a landlord is required to maintain the structure, the plant and equipment, and the landlord's fixtures in a condition consistent with the condition of the premises when the lease was entered into.

Nevertheless, as has been expressed by some writers in the area, if the place is a dump at the commencement date of the lease, then the landlord does not have an obligation to keep it in a better condition.

The most difficult task is often determining who owns what in the premises and who is responsible for the replacement of an item when it falls into disrepair. However, the general rule is that each party replaces their own property; although, it is all maintained by the tenant.

Security for performance

There are a number of different types of security that a landlord may require a tenant to provide in order to secure performance of the tenant's obligations under the lease: this includes a bank guarantee, cash security deposit or director's guarantees.

A bank guarantee is a promise from a bank to pay the landlord any amount (up to a specified limit) on call following a request by the landlord. Normally, the landlord does not have to inform the bank that there has been a breach by the tenant (but this would usually constitute a breach by the landlord under most leases).

A security deposit is an amount of money which a Tenant gives to the landlord to hold in trust during the term of the lease. If the Tenant breaches the lease, then the landlord will have the right to call on the security deposit. The amount is usually equivalent to between 1 – 6 months rent (inclusive of GST).

A director's guarantee is a guarantee by a director of the tenant company that the tenant will comply with its lease obligations. If the tenant does not comply, the landlord may sue the director personally for any loss suffered. Given the high risks involved, it is preferable not to provide a director's guarantee unless it is absolutely required by the landlord.

RETAIL LEASES ACT

In Victoria, retail tenants are afforded additional protections under the *Retail Leases Act (2003) (Act)*. This applies to premises used for the sale or hire of goods by retail or the retail provision of services where the occupancy costs are less than \$1 million per year. This includes:

- shops selling clothing, food and furniture
- bars, restaurants, cafes, hotels and motels
- shops hiring electrical products or gardening and carpentry tools
- medical and consulting suites
- professional service firms like lawyers, accountants, surveyors

The Act also prescribes that certain types of businesses are *not* retail premises. This includes premises where:

- tenants are in the business of wholesaling, manufacturing or storage
- the occupancy costs exceed \$1 million per year
- the tenant is a listed corporation (or a subsidiary of one)
- certain other premises as determined by the Minister

Before a retail lease is entered into or renewed, landlords must provide a Disclosure Statement to a tenant. This provides a tenant with important details of the lease, such as the proposed rent, outgoings, and various other issues which may affect the premises e.g. whether there are any redevelopment proposals.

Where there is a new lease for retail premises, the landlord must give the tenant a Disclosure

Statement and a copy of the proposed lease at least 7 days before the lease is entered into. The landlord must also provide a prospective tenant with an information brochure which is produced by the Office of the Small Business Commissioner.

In certain circumstances, where the landlord fails to provide a Disclosure Statement the tenant may withhold rent and, in certain instances, terminate the lease.

In a retail lease, a landlord is also prohibited from claiming certain costs from a tenant such as land tax, capital expenditure in relation to the structure of the premises or the landlord's fixtures, and costs in connection with the preparation of the lease (however, if the landlord incurs costs in connection with an assignment of the lease, then the tenant may be liable to pay for those expenses).

Under the Act, retail tenants are also given further protections under the unconscionable conduct provisions which protect against grossly unfair conduct by landlords such as an unwillingness to negotiate and the use of unfair tactics.

CONCLUSION

A lease is an important legal document which creates binding rights and obligations for both the tenant and the landlord. There are usually a number of commercial and legal issues which need to be carefully considered. Prospective tenants should ensure they understand all of the key provisions of the lease, and obtain advice before signing any documentation (including any heads of agreement).

A good leasing lawyer will be able to advise you regarding the terms of the lease, any unusual conditions, compliance with applicable rules and legislation, and help you to identify any relevant title and planning issues. If necessary, your lawyer will also be able to negotiate appropriate amendments on your behalf to ensure that your interests are properly protected.

Matthew Baker-Johnson Principal Avery Commercial Lawyers

Matthew is an experienced property and commercial lawyer who regularly advises business owners in relation to leasing issues. He is a member of the Law Institute (LIV) of Victorian and an associate member of the Australian Institute of Business Brokers (AIBB)

Disclaimer:

The information contained in this article is intended to provide general information only and is not legal advice or a substitute for it. You should always consult your own legal advisors to discuss your particular circumstances

