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Legal Matters

Commercial Leases – Main issues to consider

This guide describes some of the main issues that should be carefully considered when negotiating a lease for commercial premises. However, there may be other issues important to your particular business circumstances. Ensure you obtain professional advice (see Leasing Commercial Premises) before making a commitment to lease commercial premises.

Rights of the tenant generally

The lease generally determines your rights and obligations and you should ensure that if you want to be able to do certain things in the premises or adjoining areas under the control of the landlord that these requirements are set out specifically in the lease. If the right is not set out in the lease, the landlord's agreement will be required, which could be refused. Examples of some tenants' rights you should consider for inclusion in the lease are the right to:

- put up signage
- erect additional shelving or partitioning
- use any common areas
- use facilities such as toilets
- carparking for you, your staff, customers and your other visitors
- access to the premises

There are many other rights that as a tenant you could need in order for your business to be able to trade profitably and you should carefully consider your specific circumstances and needs.

Tenancy mix and competition

Take a good look around the shopping centre or local shopping precinct. What other business are nearby? Will they complement or compete with your business? Negotiate a clause in your lease to protect your business against the landlord changing the tenancy mix or leasing to tenants that have an adverse affect on sales of your business.

Seek to have included in your lease an **exclusivity of trade** clause which prohibits direct competition and gives you the sole right to conduct that type of business or sell a particular category of products in the cluster of shops controlled by the landlord.

Anchor tenants: You may be attracted to particular premises because of the presence of a significant anchor tenant such as a supermarket or department store in the building or centre. Your business may even rely on the foot traffic generated by the anchor tenant. If so, negotiate a lease provision that gives you the right to terminate the lease or receive a rent reduction if the anchor tenant leaves or there is a reduction in building or centre tenancies.

Permitted use

Leases often limit the **permitted use** of the premises to certain activities. Check the lease for which business activities the landlord will permit in the premises. Ensure the permitted use clause allows for the growth and evolution of your business, or assignment (transfer from one tenant to another) of lease to various businesses. For example, the permitted use of premises for a pizza restaurant may not allow your business to extend the menu to related dishes and will limit the number of potential businesses you can assign the lease to if you need to leave the premises before the expiry of the lease.

Fixtures and fit-out

Obtain a detailed **condition report** of the premises to be leased prior to entering into the lease. The report should document the condition of the premises at the time you take control and before you make any changes. Take date-stamped photographs and print three sets, one each for yourself and the landlord and a spare in the event a dispute arises and they are needed as evidence.

Many premises will need fixtures, fittings and services installed before you can start to operate your business.



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Who is responsible for the fit-out costs will be determined by negotiation and agreement between the tenant and the landlord.

Make sure you negotiate, as much as possible, for fit-out items that are at your cost to remain your property and that they can be removed by you when the lease comes to an end.

Fit-out can be a major cost item which should be recovered from the business. Some fit-out costs, such as the cost of moving plumbing, are often overlooked, so ensure you have an accurate fit-out budget that leaves you with sufficient funds to operate your business.

Sometimes the landlord will specify which tradespeople must be used. This requirement is to protect the quality and image of the shopping centre or premises, but can add substantially to the cost of leasing the premises.

Handover dates and fit-out period: Allow time for delays in completing the fit-out. Be aware of seasonal shortages in the availability of tradespeople (eg at Christmas time) when work on your fit-out may cease for a period of time.

Some leases allow the landlord the right to alter the date for handing over the premises to the tenant (handover date) for the tenant to undertake the tenant's fit-out. The bringing forward of the handover date could leave you unprepared and without the availability of your tradespeople. Further you could still be liable to pay rent from the fixed commencement date of the lease. Long delays in the handover of the premises could significantly affect your business and other financial commitments. Wherever possible, do not agree to lease provisions allowing the landlord to alter the handover date without the lease providing for the protection of the tenant. Protection for the tenant includes the right to be compensated and the right to terminate the lease if the handover date is changed.

Check that the lease contains an inventory of the landlord's fixtures and fittings and your **right to install and remove fixtures**. Obtain permission from the landlord, in writing, to install or remove fixtures if not already specified in the lease.

Many leases contain 'make good' clauses that require tenants to reinstate the premises to the condition at the start of the tenancy. This "make good" clause generally requires the tenant to remove their fitout at a considerable cost to the tenant. Budget enough money and time to make good the premises at the end of your lease. Where the fit-out was already in place at the time the tenant entered the lease, the tenant should attempt to remove any requirement to **"make good"** other than a general obligation to leave the premises in good repair and clean and tidy.

Term of lease and options to renew lease

Ensure that your lease term is long enough to enable you to recoup your investment and make the profit that you require.

The length of the term of the lease is a critical issue because much of the goodwill of a business could be attached to the leased premises, and once the lease comes to an end the tenant's right to remain in the leased premises is at the discretion of the landlord. If the landlord refuses to renew the lease, goodwill of the business could be significantly reduced or completely gone.

Negotiate flexibility into the term and options of the lease to suit your business circumstances. For example, if you have an established business, a long lease with several options will give you security in your location. Whereas a new business without a proven track record might require you to negotiate a lease with a short initial term and short options (e.g. 1+2+2 years).

The Commercial Tenancy (Retail Shops) Agreements Act 1985 (WA) (if applicable) entitles a tenant entering into a new lease for retail premises the right to a minimum tenancy period of up to five years. If a tenant has been given a lease including options of less than five years, the tenant may give notice to the landlord that they wish to exercise their statutory option. Notification must be given to the landlord not less than 90 days before the expiry of the current term and be on the prescribed form (Regulation 6 Form 3). available from the Department of Commerce



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Exercising your option: Providing you are not in default, an option in a lease gives you the choice to continue trading in the current location to end the lease. The landlord must extend your lease if you exercise your option on time and in the correct manner.

Usually, options are exercised in writing and often between three and six months before the end of your lease. Check the 'Options' clause of your lease for the exercise of option requirements necessary to properly renew your lease.

It is very important that you diarise when and how the options are to be exercised. If you miss the due date or don't exercise the option in the manner set out in the lease, the landlord is not obliged to renew your lease and can give you notice to leave, or change the terms of the lease, including increasing your rent.

If a **market rent review** is due at the beginning of the option term, it is a good idea to find out what the new rent will be before you exercise the option. Ask for information about the new rent in writing at least three months before the first date when you can exercise your option. An early request for a determination of the market rent will allow you time to decide whether to exercise the option or not, or to follow the process for disputing the rent.

Under the Act (where applicable), if a lease specifies a market rent review, both the tenant and the landlord can appoint a valuer to review the rent. If the two valuers do not agree then the market rent review dispute can be referred to the State Administrative Tribunal {Internal link: SBDC BizGuide "Commercial and Retail Premises – Dispute Resolution"} for resolution.

Costs

The **rent and rent reviews** are negotiated between the tenant and landlord. The Act (if applicable) does not regulate what the rent should be or the amount of the increase. However, the Act requires that the lease must specify a clearly defined single basis for calculating the rent increase for each rent review period.

Can your business sustain the current rent, rent increases and the operating expenses over the term of the lease? It is important to prepare financial forecasts that consider

the impact of increases in rent and operating expenses increases on the viability of the business over the entire lifespan of the lease. Negotiate a rent increase that does not place your business at a competitive disadvantage. If you get the rent increases wrong you may be paying more than the market rate.

Also be aware of additional rent costs (e.g. turnover or percentage rent) and the implication to disclose private business sales information to the landlord.

Operating expenses (also called variable outgoings or other occupancy costs) are the expenses of the landlord in operating, repairing, or maintaining the premises and could include council, water and sewerage rates, and repairs and cleaning of the common areas. Operating expenses are payable in addition to the rent.

Although it is common for the tenant to pay the operating expenses of the landlord it is not always the case and a lease can be negotiated so that the tenant is not obligated to pay the landlord's operating expenses.

The Act (if applicable) requires that all operating expenses for which the tenant is responsible must be individually listed in the lease and that the tenant is entitled to know how the operating expenses are determined.

Security Bonds: A bond is money that the tenant gives to the landlord, at the beginning of a lease that can be applied by the landlord to satisfy any monies owing by the tenant to the landlord resulting from the tenant not properly performing the tenant's obligations under the lease.

There are no legislative requirements for a bond under a commercial lease. However, the parties to the lease will generally reach an agreement in the lease as to the payment by the tenant of a bond and the conditions for the use, withholding and repayment of the bond.

For the tenant, it is preferable that the lease provides for the bond monies to be held in an interest bearing account. Ensure the lease specifies when the bond and interest will be returned to the tenant after vacating the premises and under what circumstances the landlord can withhold funds from the bond.



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Insurance costs: The lease often places obligations on the tenant for the cost of insurance for the building, plate glass, public liability and other cover. Resist indemnity provisions where the tenant indemnifies the landlord against claims for loss, unlawful act, or damage by the landlord. Indemnity clauses may breach your own insurance policy and should be negotiated out of the lease. Ask your insurance provider to check and approve the insurance and indemnity clauses of the lease against provisions of your (proposed) insurance policy to make sure you will not be invalidating your (proposed) insurance policy.

Legal costs: Often the tenant pays the landlord's legal fees for the preparation and negotiation of the lease documentation. However, tenants can negotiate otherwise. The tenant should, wherever they can, negotiate that each party will pay their own legal costs. At the very least there should be a limit on the amount of the landlord's legal costs for the preparation and negotiation of the lease for which the tenant is responsible.

In some cases the lease will contain a clause that obligates the tenant to pay all the landlord's legal fees if there is a dispute. This type of clause should be resisted as it could severely increase the tenant's legal costs in any dispute and would be particularly unfair in cases where the tenant was not the party at fault.

Refurbishment: Some leases require the tenant to refurbish the premises at regular intervals. Renovating your business premises can benefit your business image, but can impose a significant cost to the business. Try to limit refurbishment to every 5 or 6 years. Make sure that the lease clearly sets out the nature, extent and timing of the refurbishment.

Repairs and maintenance: Often the tenant is responsible for general repairs and maintenance. However, try to exclude structural repairs and capital items from the tenant's obligations. Be specific about which items you require the landlord to be responsible for, e.g. roof, gutters, downpipes, walls, air-conditioning and any other plant and equipment that is or becomes the property of the landlord, underground power, sewerage works, and fixtures and fittings related to services (gas, electricity, water or drainage).

Although the lease might place upon the landlord the obligation to undertake structural repairs, it is advisable to engage a builder to check that the building is structurally sound. Potential problems and costs caused by structural faults may be avoided if you are aware of them and request the fault be rectified before you make a commitment to lease commercial premises.

Default

Be aware of onerous default clauses that give the landlord the right to evict the tenant if the rent is not paid within 7 days of the due date whether or not notice of the non-payment of the rent has been given to the tenant. Negotiate for a requirement that the landlord must give the tenant at least 14 days written notice of the non-payment of rent or any other default under the lease before there are any consequences for the tenant. A typical consequence, under a lease, when a tenant defaults is for the landlord to have the right to re-enter and take back the premises and recover from the tenant all monies owing up to the end of the term of the lease together with interest on all such monies owing to the landlord by the tenant.

Assignment of lease

Ensure your lease allows you to assign the lease (transfer from one tenant to another) or sub-let the whole or part of the premises in case you decide to sell your business or can no longer operate the business.

For leases regulated by the Act, the landlord may only withhold consent to a request for assignment on reasonable grounds. Reasonable grounds may include poor credit rating of the incoming tenant or intention to use the premises for a purpose contrary to the use permitted in the lease.

For leases regulated by the Act a tenant who assigns the lease (assignor) to another person (assignee) cannot be responsible, if the assignee defaults, for the rent or any other lease obligations from the date of the assignment.

Clauses in retail leases covered under the Act that allow the landlord to withhold consent unless the tenant agrees to be liable for the incoming tenant's default are void and should be deleted to avoid future misunderstandings or confusion.



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For leases **not regulated** by the Act the assignor of the lease is **not** automatically released from the liability for the incoming tenant's default. It should be ensured that the assignment document provides that the tenant will be released from being responsible for the rent or other lease obligations from the date of the assignment if the assignee defaults.

If you sub-let the whole or part of the premises you are leasing, you are still responsible for the legal obligations of the lease (which means you still need to pay the rent even if the tenant is in default).

Be prepared to bear the costs of assignment such as checking the incoming tenant's credit rating. However, resist agreeing to pay high agent assignment fees which usually go to the agent.

Redevelopment and relocation clauses

A redevelopment clause usually entitles the landlord to terminate a lease, before the end of the lease, in order to carry out major works to renovate or redevelop the building. Without premises, your business may be forced to close or suffer a loss in sales and unforeseen expenses if required to relocate.

Generally a proposed tenant should resist the inclusion of a redevelopment clause in the lease. If you decide to agree to a redevelopment clause, it is strongly advised that the clause should provide for you to be compensated so that you are placed in the same position as if the redevelopment did not occur. Unless you can negotiate a clause which provides adequate compensation for the loss of goodwill and the hard work which you will have put into the business, it is strongly suggested that you think very seriously about the risks involved and whether those risks are worth entering into the lease.

Early termination: Other clauses may give the landlord the right to terminate the lease early. Resist such clauses and negotiate to remove them from the lease.

Caution

The above are just some of the main issues to consider when considering entering into a lease. There are many more matters that need to be considered. These suggestions do not replace the critical need for a prospective tenant to get full legal, financial, property and business advice before entering into a lease.