Small Business Development Corporation

How to negotiate your way to a better retail lease

4th edition

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Contents

Foreword................................................................................................................................. 1

Introduction ............................................................................................................................ 1
• The participants.................................................................................................................. 2

Negotiations........................................................................................................................... 3
• With whom do I negotiate? ............................................................................................... 3
• What form of communication is best?................................................................................ 3
• Disclosure............................................................................................................................ 4
• The lease............................................................................................................................... 4
• What can I negotiate?.......................................................................................................... 5

Do I have a good lease? .......................................................................................................... 5

Other conditions to be wary of ............................................................................................. 7
• Competition......................................................................................................................... 7
• Percentage rent – rent based on turnover ........................................................................ 7
• Redevelopment and relocation clauses ............................................................................ 8
• Void clauses......................................................................................................................... 8
• Strata titles.......................................................................................................................... 9
• Repairs and maintenance ............................................................................................... 9
• Suitability of use............................................................................................................... 9

Other costs associated with occupancy .............................................................................. 10

Dispute resolution................................................................................................................. 10

Summary................................................................................................................................ 11
• Need more information? ................................................................................................... 11
• Which licence?.................................................................................................................... 11
• Information and guidance on leasing retail premises..................................................... 11
Foreword

Each year the Small Business Services team at the Small Business Development Corporation (SBDC) handle several thousand leasing enquiries, most of which come from the retailing sector.

This day-to-day contact with the small business community draws attention to the high level of emotional and financial trauma associated with retail leasing, despite the introduction of legislation designed to prevent this.

Disputes between landlords and tenants are common. Sadly, much of this pain is a direct result of small business owners not understanding the significant impact a lease can have on the viability of their business. Either through reluctance or ignorance, many small business operators do not seek expert advice.

How to negotiate your way to a better retail lease has been produced to inform and advise. While it does not cover all aspects of negotiation, it does address the major causes of concern. It also illustrates many of the less obvious issues which frequently create problems for the tenant after the lease has commenced.

This publication is designed to signal warnings and to provoke serious thought by prospective tenants so that fewer business failures occur as a consequence of avoidable leasing problems.

Introduction

It is necessary to understand the interests of the participants involved when seeking to negotiate a lease. It is also important to realise that there may be a conflict between what each participant seeks to gain from the negotiations.

Negotiating a good lease is vital to the success of your business.

The golden rules for success are:
• know who you are dealing with;
• know what else is available;
• know your legal rights;
• don’t let your heart rule your head;
• establish your bottom line;
• determine the other party’s bottom line; and
• seek legal and financial advice.

If you are not entirely comfortable with the proposed lease be prepared to say no.
The participants

**Landlord/Lessor**

The owner of the property will generally seek from the tenant optimum rent, minimum expenditure, payment of expenses and a watertight lease which ensures that their rights are fully protected.

**Tenant/Lessee**

The business owner will seek leasing conditions which permit profitable operation and growth of the goodwill value of the business.

**Letting agent (who may also be the managing agent)**

The letting agent is engaged by the landlord and receives commission from the landlord once a tenant has entered into a lease.

**Managing agent (who may also be the letting agent)**

The managing agent is engaged by the landlord and carries out various duties as agreed with the landlord.

**Landlord’s solicitor**

The landlord’s solicitor is engaged by the landlord to provide appropriate leasing documentation and legal advice to the landlord.

For retail shop leases as defined under the *Commercial Tenancy (Retail Shops) Agreements Act 1985* the landlord cannot claim from the tenant legal or other expenses for:

- the negotiation, preparation or execution of the lease (or any renewal or extension of the lease);
- obtaining the consent of a mortgagee to the lease; or
- the landlord’s compliance with the Act.

**Tenant’s solicitor**

The tenant’s solicitor is engaged by the tenant to advise them on their position.

**Assignor/Assignee**

The assignor is the person selling the business. The assignor requires approval from the landlord for the assignment of the remainder of the lease to the purchaser of the business (assignee).
Negotiations

With whom do I negotiate?

It is preferable to talk to the landlord. However, for a variety of reasons this is not always possible. An agent will often be appointed to act for the landlord, particularly in shopping centres and large buildings with several premises for rent.

What form of communication is best?

Talking with the landlord or the agent is advisable for two reasons.

Firstly, you should get to know people who can have an influence on the success of your business. Every opportunity should be taken to build harmonious, friendly relationships. One day you may need a favour and you are more likely to receive a yes if you establish and maintain a good relationship from the beginning.

Secondly, it gives you the opportunity to assess the kind of people you are dealing with. First impressions are often accurate. For example:

• Does your contact say a lot but actually tell you very little?
• Are you left wondering what it is all about?
• Do you get the feeling that information is being withheld?
• Are you immediately pressured to sign on the spot? Or is it relaxed – no pressure – with time for you to properly consider things and take appropriate advice?

By knowing the people you are dealing with, and understanding what their interests are, you can better prepare to negotiate for better conditions.

Once you have reached a verbal agreement make sure it is confirmed in writing. If the landlord or the agent agree to do something for you and they don’t put it on paper, write to them confirming your understanding of what was said and ask them to acknowledge your understanding in writing.

For example, if the landlord tells you that he will allow you to add a particular product to the range of goods normally sold in your shop, which is also being sold by another shop in the building, you should get it in writing.
Disclosure

In a new retail shop lease, the landlord is required to provide the tenant with relevant information about the premises for rent. If appropriate, as in the case of a shopping centre, information about the building in which the premises are located should also be provided. This is a provision of the Commercial Tenancy (Retail Shops) Agreements Act 1985.

Information provided by the landlord should include:

- disclosure statement (to be completed by landlord);
- copy of the operating expenses budget;
- copy of the form of the lease; and
- tenant guide (attached to the lease).

This information is vital to the prospective tenant. Until it has been supplied in full and has been properly considered (advice will most certainly be needed) the tenant should not sign anything.

When you have the information, seek appropriate legal and financial advice.

Too many small business proprietors sign offers to lease before sighting the lease document only to find not negotiable conditions in the lease document about which they did not know or fully understand.

The lease

Once disclosure has been provided and you have taken advice on the lease, including the commercial implications, you should immediately list all clauses and conditions which are of concern.

If they are of great importance and must be amended then perhaps they should be headed **UNACCEPTABLE**.

Other items may be reasonably important but could be **NEGOTIABLE**.

The remainder may be only minor and therefore **DESIRABLE**.

By categorising each item, you establish a negotiating benchmark and by referring to it you are less likely to be persuaded to accept something which you know is detrimental to the business.

Against each item of concern write a preferred option. For example, if the lease calls for rent to be reviewed annually based on the market rent and you do not agree, then you might suggest that the rent be reviewed once every two years, with rent to increase by change in consumer price index (CPI).

Or, for example, if the lease requires the tenant to be responsible for all repairs and maintenance and responsibility for structural repairs is not specifically covered, then it might be appropriate to add the following:

“nothing in this section requires the lessee to be responsible for capital or structural items.”

The drafting of alternative clauses is a skill and requires specialised knowledge. It is essential for this to be done by a professional to achieve what you want and to have a legally watertight agreement with no room for misinterpretation or doubt.

When the bargaining has finished you will have the final draft. At this point it is prudent to step back and take another long, hard look at the whole project - not just the lease. If you feel confident that everything has been done properly, and you have a viable business proposition, then go ahead. If you are unsure or uneasy, then it may be sensible for you to say no.

Remember, it’s your livelihood and your lifestyle which is at stake and risks should only be taken if they have been properly considered and the implications are fully understood.
Leasing Business Premises

What can I negotiate?

In theory everything is negotiable. Usually the lease document has been prepared by the landlord’s solicitor and the conditions can be expected to be those which are acceptable to the landlord. The extent to which these conditions can be negotiated will depend on a number of issues, some of which are:

- the degree of competition between potential tenants who may be interested in the premises;
- the landlord’s financial situation;
- the benefits to be gained by the landlord’s agent;
- the intention of the landlord about the future of the building where the premises are located; and
- your knowledge and ability to negotiate.

Before going to the negotiating table you should know the maximum price you can afford to pay for the premises and the terms and conditions that you are prepared to accept.

Negotiating does not come easily to everybody. Face-to-face situations can be difficult. If you are not used to bargaining, and are not knowledgeable in the area of leasing, some outside help may be worth considering. For example, you may wish to be represented during any discussions.

The golden rule is to take nothing on trust – in the final analysis it’s your money and your future that is at stake.

Do I have a good lease?

If more people were to ask this question there would be far fewer businesses in financial difficulty.

The conditions of your lease are critical to the success of your business. It is worth spending the necessary time and effort to get it right from the beginning.

Assuming your market research (part of your business planning) has indicated that you have chosen premises in the right location, then the conditions of the lease must provide the following:

- Security of tenure for the desired time.
- An affordable rent for the duration of the lease.
- Conditions which will not interfere with either the day to day running of the business or impose additional financial burdens on the business.
- Protection from competition, especially important if the business is located in a shopping centre or a group of shops owned by the same landlord.
- The ability to conduct a profitable business.

Let us now look at each of the above points in more detail:

1) Security of tenure

There is nothing more unsettling for a family than not knowing how long they are going to have a roof over their heads. In business, it is equally important to know that your lease will provide that security. The term of the lease should be negotiated to provide the following:

- Sufficient time for the proprietor to achieve their operational objectives.
- A lease attractive to a potential buyer.

Depending on the business in question (a new venture, a run-down business in need of rebuilding, or a thriving business) the amount of time needed to achieve the proprietor’s objectives will vary. If, for example, the business plan indicates that a 10 year period is necessary then the lease must provide for this 10 year term.

It is possible to negotiate a lease which is made up of a combination of an initial term and an option, or options, for further periods. For example, you could consider a two year term with an option to renew the lease for a further three years, and then for a further five years, giving an overall total of 10 years.
In this way, business proprietors, who may not be entirely certain of the future success of their enterprise, can hedge their bets a little. If at the end of the term the business is not doing well, or if for any other reason it is decided not to continue with the business, then the options need not be exercised.

The disadvantage of this arrangement is that the landlord may wish to impose additional costs, or conditions, for each option period which might not apply in a ‘term only’ lease which has no options. Generally, however, any renewal of lease pursuant to an option granted in a lease is, and should be, on the same terms and conditions as the original terms of the lease.

In a shopping centre where a fixed five year term with no further option period is proposed, the tenant must determine whether this will unduly affect the saleability of the business. In a couple of year’s time a prospective buyer will have a relatively short time to recoup any goodwill paid for the business, and may also run the risk of a new shop fit-out being requested by the landlord at the end of three years.

2) Rent

Most leases provide for the regular review of rents – usually annually. There is no statutory ceiling on the amount of the increase. However, it is required that a clearly defined formula by which the increase is to be calculated be set out in the agreement. For example, that formula could be:

- 5% per annum;
- Consumer Price Index (CPI); or
- market.

If the formula is not included, then no variation is possible unless all parties agree.

It is essential that the prospective tenant properly considers the impact that any increase will have on the viability of the business and on the sale of the business. For example, a starting rent of $12,000 per annum with a five per cent annual rent increase will become $16,885 per annum after seven years.

Market rent

There are a number of ways used to determine how the rent is to be reviewed. A common way is market rent, which in retail shop leases is defined as follows:

“The rent obtainable at the time of that review in a free and open market as if, all the relevant factors, matters or variables used in proper land valuation practice having been taken into account, that retail shop were vacant and to let on similar terms as are contained in the current retail shop lease.”

Very often tenants have a rude awakening at the first rent review when they find that the market rent is considerably higher than they are currently paying. This occurs when the landlord has offered a ‘subsidised’ rent, or gives a rent free period to an uninformed tenant. As an example, market rent may be $250 per square metre, but because the premises are empty, the landlord may offer a lease at say $150 per square metre for the first year. It is therefore wise to find out what the actual market rent is before signing the offer to lease.

3) Operating freedom

Apart from the basic conditions of the lease (for example, the amount of rent to be paid and the term of the lease), the leasing document usually contains many other clauses imposing conditions and responsibilities on the tenant. Some of these clauses could adversely affect the viability of the business and we address a number of them in the next section of this publication.

4) Protection from competition

If the lease you are considering permits the landlord to offer leases or licences to other tenants to start up business of a competing nature, then the possible effects must be considered carefully.

Where such a clause exists, and the landlord is unwilling to remove it or to agree to compensate for loss of income caused through the introduction of a competing business, then the potential for financial loss, and perhaps inability to sell the business, should not be underestimated. In these circumstances, it may be advisable to look elsewhere.

5) Profitable business

It is important that all the occupancy costs (including rent, operating expenses and insurance) are calculated and increases over the term of the lease, and any renewal of the lease, estimated. It is critical to determine if the business will be profitable at these levels of occupancy costs.
Other conditions to be wary of

Competition

Responsible landlords try to ensure that the mix of tenants in a centre is well balanced. The mix should offer a wide range of products and services to the community it serves, while enabling individual businesses to prosper without undue interference or constraint.

One clause which frequently appears in shopping centre leases is: “The landlord may issue a lease or a licence to any other person wishing to trade in goods or services similar to those permitted by this lease.”

This means you could be the only butcher, baker or candlestick maker now, but a few months after signing the agreement you could have competition that greatly affects the profitability of your business.

In the end you have either an acceptable or an unacceptable contract. Judge it as a business proposition not an emotional one. If the numbers do not stack up then walk away and live to negotiate another day.

Percentage rent – rent based on turnover

Some agreements call for the tenant to pay all, or part of, the rent calculated as a percentage of the turnover of the business.

What this usually means is that a base rent is paid and once a certain level of turnover has been reached, further rent, calculated as a percentage of additional turnover, is paid to the landlord.

This is how it works:

| Base rent | $30,000 |
| Percentage rent | 5% |
| **Total business turnover – say** | **$630,000** |
| $30,000 = | $600,000 |
| .05 | (point at which % rent becomes due) |

The difference between actual turnover of $630,000 and the formula figure of $600,000 (ie. $30,000) is the amount on which the additional five per cent will be paid as calculated below:

| Base rent | $30,000 |
| Additional Percentage rent $30,000 x 5% | $1,500 |
| **Total Payable** | **$31,500** |

In the above example, both the landlord and the tenant benefit. The tenant benefits because a fair and reasonable rent has been offered, and the landlord benefits because an opportunity to share in the prosperity of the business has been created.

Often the percentage to be paid is very low (one per cent or even less) so that the unsuspecting tenant is lulled into a false sense of security believing one per cent will not amount to very much. However, this is only one side of the coin. Let us now look at a business with the following details:

| Actual turnover | $500,000 per annum |
| Base rent | $25,000 per annum |
| Percentage rent at one per cent |

Using the same method to calculate the amount at which percentage rent will commence:

$25,000 = $2.5 million
.01

We can see that unless a miracle occurs, and turnover increases five-fold, there is no likelihood that any percentage rent will be due, so why should the tenant worry?

In any lease agreement where a turnover/percentage rent clause applies, every month the tenant is obliged to provide the landlord with the details of the turnover of the business. This is forbidden in a lease where no such clause exists.

This information could then be used by the landlord or agent to determine how much rent they believe the tenant can afford. It may also be used if the tenant decides to sell the business and the buyer talks to the landlord or agent.

What to do

- Make sure that the base rent is fair and reasonable, as in the first example.
- If this cannot be achieved, try to delete this clause altogether.
- Find another basis for negotiation (your adviser will help) which is acceptable.
- If the landlord will not negotiate then you may need to reconsider your interest in the premises.
Void clauses

What is a void clause?
A void clause is one which contravenes a particular law or statute and, therefore, cannot be legally enforced.

Void clauses regularly appear in leases. By taking proper advice before entering into a lease, the tenant can avoid the confusion and uncertainty which can arise when a disagreement occurs with a landlord over void clauses.

Why do leases contain void clauses?
There are a number of possible reasons why leases contain void clauses. These are:
• poor drafting of the lease document;
• a genuine oversight;
• a strategy designed to create an advantage; or
• a difference in legal opinion as to the validity of the particular clause in question.

What do I do if I find a void clause?
There are two possible ways of dealing with this problem.
Firstly, you can draw it to the attention of the landlord and request it be removed from the lease. This way, there is no possibility of a disagreement concerning the clause. If the landlord refuses, at least it is known that you are well informed and there is less likelihood of an attempt to bluff you into doing something, or paying something, that the void clause may indicate is your responsibility.

Secondly, ignore it knowing that if it comes to the crunch it can not be enforced.

The particular circumstances and the nature of the people you are dealing with will indicate the most appropriate course of action. If in doubt – seek advice.

Redevelopment and relocation clauses

A redevelopment and/or relocation clause usually entitles the landlord to terminate a lease before the end of the agreed lease term in order to carry out major works to renovate or redevelop the building in which the premises are located.

These types of clauses can include the relocation of the tenant to alternative premises. There could be numerous reasons why a landlord would want to relocate tenants and likewise numerous reasons why a tenant would not want to be relocated. Forced relocation can be disruptive to a business and costly and stressful for the tenant.

For retail shops, as defined under the Commercial Tenancy (Retail Shops) Agreements Act 1985, certain requirements apply to redevelopment/relocation clauses. It is important to know these requirements and your rights. Information on these requirements and your rights is available from the SBDC’s specialist Commercial Tenancy service.

In certain circumstances a redevelopment/relocation clause, to be included in the lease and be enforceable by the landlord, requires State Administrative Tribunal (SAT) approval. It should be noted there is no obligation for the tenant to agree to the landlord’s request to approve the landlord’s application to the SAT for the inclusion of the redevelopment/relocation clause.

For leases not covered by the Act most redevelopment/relocation clauses do not provide for compensation to the tenant upon termination of the lease. Unless you can negotiate a clause which provides 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 before signing the lease.

You should obtain as much information as you can from the landlord about their future plans. Remember that shopping centres are often sold for their redevelopment potential. If your centre is one which may be attractive to a developer the possibility of the redevelopment clause being enforced may be higher. Older buildings and shopping centres are more likely to be redeveloped than newer ones.

If you decide to agree to a redevelopment/relocation clause, it is strongly advised that the clause provides for you to be compensated and to be put in the same position you would have been in had the redevelopment not occurred.
Strata titles

The Strata Titles Act 1985 empowers strata companies to levy individual owners for a variety of purposes.

Leases for strata title property invariably require the tenant to pay the levies even though they may not be directly related to the operation, repair or maintenance of the property or premises.

This can be of concern if during the term of the lease the ownership of several shops located in a building changes from one owner to several owners. In this situation new levies not previously charged can arise. If the lease provides for levies to be paid by the tenant, substantial additional costs can be incurred by the business.

The payment of strata levies has complications and specific advice should be sought in relation to their payment.

Repairs and maintenance

Disputes over who is responsible for repairs and maintenance are common and are usually caused by the non specific way in which the lease has been drafted.

Often there is an expectation on the part of the tenant that the landlord should be responsible. After all, it is the landlord’s building for which rent is being paid so why should the tenant have to pay for repairs and maintenance?

Perhaps a reasonable approach would be to request the landlord be responsible for the structure of the building (i.e. roof, walls, and anything relating to the exterior of the building including gutters, down pipes etc), and the tenant to be responsible for the internal surfaces, doors and windows, plus any equipment or fittings provided by the landlord for the use of the tenant.

Equipment such as air conditioners and fire sprinklers should perhaps be replaced by the landlord when their useful life span has been reached, but the day-to-day maintenance ought to be fairly placed upon the tenant.

Similarly, the lease could provide for the internal paintwork and wall paper maintenance to be the responsibility of the tenant, with the requirement to re-paint or re-paper at predetermined intervals related to need rather than want. For example, if the premises are subject to much use and need to be painted annually in order to maintain their appearance, then the tenant should be responsible. On the other hand, if the premises are not subject to a great deal of wear and tear it may not be necessary to repaint as regularly.

Before entering into the lease ensure that the premises are independently inspected. A report on the premises and all plant and equipment should be accepted by both tenant and landlord. An inventory and photographs can be useful appendices to the report.

The report can be used if there is a dispute when the lease ends about the condition of the premises or equipment, and whether or not that condition has been occasioned by fair wear and tear or some other cause.

Suitability of use

Generally, the landlord will make no warranties as to suitability of the premises, and unless the lease provides otherwise, you will take the premises as you find them.

The following are some of the issues you need to consider in relation to the suitability of the premises:

- health and fire safety regulations, council and state planning requirements;
- any structural repairs required to the premises;
- any prohibitions and restrictions in relation to the use of the premises;
- any licences and approvals required;
- security in relation to the premises;
- access to the premises;
- provision of services such as electricity, waste disposal, insulation and air conditioning; and
- room for expansion at a later date.
Other costs associated with occupancy

In addition to rent, you can be asked to pay a number of other charges associated with your use of the premises.

In addition to your own operating costs (e.g. electricity, telephone and advertising) you will probably be required to pay some, or all, of the following charges:

- building insurance
- common area charges (applicable in shopping centres)
- council rates
- gardening
- land tax
- landscaping
- legal fees
- marketing levy
- merchant association levy
- repair and maintenance
- public liability insurance
- water and sewerage rates

All of these costs can considerably increase your overheads. Therefore, it is essential that you understand how much you will have to pay in total. Negotiate wherever you can and make sure you find out how these charges have increased in previous years. For example, if costs have increased by six per cent per annum over the last few years, then assume that a similar increase will continue. Factor this into your budget so that you can more accurately estimate what your occupancy costs will be for each year of the lease.

Do not forget, if your costs increase by 10 per cent per annum, then by year seven of the lease you will be paying double. Will the business be able to generate the additional income needed without eroding profit? If the answer is no, or possibly not, then either the base rent needs to be reduced and/or the amount by which the rent can increase needs to be renegotiated.

Dispute resolution

The lease should outline procedures to deal with disputes between the landlord and the tenant.

Ideally, a landlord and tenant and/or their representatives should discuss any areas of disagreement and find a workable solution that is satisfactory to both parties. Many disputes can be resolved with goodwill between the landlord and tenant. Therefore it is very important to maintain a good relationship wherever possible.

The Commercial Tenancy (Retail Shops) Agreements Act 1985 contains a prompt low cost dispute resolution procedure for leases regulated by the Act. The dispute resolution procedure in the Act cannot be contracted out of or access to it refused by the landlord in any way.

In most cases, a retail tenancy dispute will be considered first by the Small Business Commissioner. If the matter cannot be resolved through the Small Business Commissioner, the matter may be referred to the State Administrative Tribunal (SAT) for determination.

For other commercial leases, referral to a mediator, including through the Small Business Commissioner could be less costly than the court system.

The Small Business Commissioner provides a range of services to help the parties resolve their dispute. This includes providing information, advice and guidance together with bringing the parties together for the purpose of resolving the dispute informally, and more formal impartial alternative dispute resolution.

Negotiating a lease that is suitable for your business circumstances and protects your interests as a small business owner and tenant will greatly assist in reducing the likelihood of disputes with your landlord.
Summary

From the information in this publication it should be clear that a lease is critical to the success of a business. To enter into a lease without all the facts, and without taking proper advice, will almost certainly prove more costly than you were expecting.

If you have a leasing query and are not sure what your next step should be, please contact the Small Business Development Corporation. Other sources of advice include:

- solicitors
- industry associations
- accountants

Remember, the key to successful negotiating is knowing the bottom line, that is, the point beyond which you are not prepared to go.

Need more information?

The SBDC is the first place you should contact to get your business successfully under way. There you can find expert advice on how to buy, start or improve your business. You can also research your industry using the comprehensive range of reference material.

All of our publications, plus more information on a huge range of small business topics, are also available from our website at smallbusiness.wa.gov.au

Which licence?

The SBDC’s Business Licence Finder is a one stop source of information on business licence requirements.

Visit smallbusiness.wa.gov.au for more information.

Information and guidance on leasing retail premises

Our specialist Commercial Tenancy service offers tenants and landlords information and guidance on the Commercial Tenancy (Retail Shops) Agreements Act 1985.

There is no charge for the service which includes all aspects of lease negotiations and operations.

In addition to this book, SBDC publishes four other publications which may help

- Leasing business premises: a commercial and practical guide
- Common questions about the Commercial Tenancy Act for leases entered into on or after 1 January 2013
- Common questions about the Commercial Tenancy Act for leases entered into on or after 1 July 1999 but before 1 January 2013
- Common questions about the Commercial Tenancy Act for leases entered into before 1 July 1999

Any other questions on leasing retail premises?

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