

COMMERCIAL LEASES - some fundamental principles to consider

All the terms in a commercial lease are negotiable and, therefore, flexible. However, the extent to which any terms are negotiable depends on various factors: the background of competition, market forces, the particular circumstances each landlord and tenant and the financial standing of the tenant. Ultimately, just as in any other market sector, it is supply and demand that determines the scope for negotiation and flexibility. The following points should be borne in mind in any negotiations:-

Generally

Tenants should be aware that the letting agent, when negotiating the terms of a proposed new lease, is acting solely for the landlord, and trying to get the best deal for the landlord. Unless the tenant has plenty of experience of leases and their potential problems, therefore, he or she would be well advised to appoint a suitable adviser (either a suitably-experienced lawyer or a suitably-experienced surveyor) to negotiate and advise on the proposed lease terms. It is expensive and frustrating to try to renegotiate the fundamental lease terms once the draft lease has been submitted on the basis of terms that the landlord thought had already been agreed

Repairing obligations

A tenant's repairing obligations should reflect the condition of the property at the start of the lease and the length of the lease term: someone taking on dilapidated premises for a one year term should not be expected to carry out the same repairs as someone taking on a brand new building for a 50 year lease. The "standard" repairing obligation would require the tenant to put the property into a good state of repair, even if it was not in that state at the outset. If a tenant wants to limit liability to maintaining the original condition of the property, a "schedule of condition" setting out the state of the property, will need to be agreed between landlord and tenant

Initial rent

In a falling market, where supply exceeds demand, a tenant can negotiate good terms. In a rising market, where a landlord can afford to wait for the first rent review, confident that the reviewed rent will be a substantial increase, it may be worth the tenant's while to agree a slightly higher initial rent than would otherwise be payable if by doing so the rent can be fixed for a longer period than normal

Alterations and improvements

Most commercial leases prohibit completely any structural or external alterations, and require the tenant to obtain the landlord's consent (at the tenant's expense) before carrying out any internal, non-structural changes.

As this can be an expensive and lengthy process, it is worth combining it with negotiations for the new lease itself (if the tenant knows at that stage that alterations will be required); approval tends to be given more quickly if it is a precondition to the completion of the lease itself

It is important to ensure that, if alterations are carried out by the tenant (or at the tenant's expense), they should be ignored when it comes to a rent review: the tenant should not be expected to pay the capital cost of the alterations *and* to pay an increased rent because the alterations have improved the property

Permitted use

It is vital to ensure that the proposed use of the property is permitted under the terms of the lease and not in breach of planning control: both the landlord and the local council must be content with the proposed use. Just because the landlord agrees to the proposed use, it does not follow that the council will, and it is the tenant's (not the landlord's) responsibility to check this: the tenant would still be obliged to pay the full rent under the lease, even if the council prevented the proposed use of the property

Also, the use of the property can have an impact on rent reviews: if the use is restricted, this will depress the rental value, but some landlords seek the best of both worlds, by restricting the permitted use but expecting the rent review to be on the basis of a more open use. This should be resisted

Insurance

Under most commercial leases, the landlord arranges the buildings insurance cover but the tenant is obliged to pay the premium. This would include insurance against loss of rent if the property is unusable as a result of an insured risk, in which case the rent payable by the tenant would be suspended. The tenant should arrange insurance for contents, loss of profit, etc, as these aspects would not normally be covered under the landlord's insurance

Service charges

In addition to paying the rent (and the insurance premium), the tenant may have to contribute towards (or pay the whole of) the costs of repairing and maintaining the structure and exterior of any buildings, and any facilities (service conduits, accessways, etc) shared with other occupiers. This can be a significant cost, so any survey report should cover these items as well as the property that is actually to be let

VAT

Even where a lease does not specifically say so, a landlord can (and sometimes must) charge VAT on the rent payable under the lease. If the tenant is not VAT registered, this can result in a significant increase in the tenant's overheads

Legal and other expenses

Liability for each party's legal expenses in connection with the grant of the new lease is a matter for negotiation. In the absence of any specific arrangement, each side is liable for their own legal expenses, and this is the arrangement I prefer. However, landlords often expect tenants to pay both sets of legal expenses - as though by granting the lease the landlord was doing the tenant a favour! If the lease is of benefit to both parties, I see no reason why the tenant should take on the extra expense of the landlord's legal costs. If it is unavoidable, then it is important to get an early indication of the likely level of those costs, so that the expense can be budgeted for

Rent reviews

The rent is likely to be reviewed during the lease term.

This review, if to market rent, may be "upwards only" or "upwards or downwards". With an "upwards only" rent review, the rent will not drop if rents generally drop - good for the landlord, but bad for the tenant. Rents can also be increased in line with RPI increases, linked to turnover, etc.

Length of the lease term

From the tenant's point of view, where a full rent is to be paid, there is little merit in insisting on a long lease; this would simply mean that the tenant's liability will last for longer. It is better to take a short lease and renew it when it expires (this also minimizes the amount of Stamp Duty Land Tax that will be due). This does, however, depend on the tenant having security of tenure (see below)

Break clauses

An alternative is to take a longer lease but with the right to "break" the term after (say) 5 years. This can be particularly useful if the break clauses coincide with the rent reviews, so that the tenant can escape from the lease if the rent is reviewed to too high a figure. However, sometimes a landlord will insist on a break clause being "two way", so that the landlord can terminate the lease as well

Security of tenure

Under the Landlord and Tenant Act 1954, a business tenant has the right to call for a new lease when the current lease expires. The landlord could only successfully resist in specified circumstances (briefly, where the tenant has not complied with the lease obligations, or the landlord needs the property for its own business or to carry out repairs or redevelopment). If, however, the relevant provisions of the Act are specifically excluded, the tenant would *not* have the benefit of them, strengthening the landlord's bargaining position on renewal.

Assignment and sub-letting

Most commercial leases will contain provisions restricting the tenant's ability to deal with the lease or the property: any transfer of the lease will need the landlord's consent - which cannot normally be unreasonably withheld, though the landlord might insist on the outgoing tenant guaranteeing performance of the incoming tenant's obligations; subletting might be completely prohibited, or subject to the landlord's unrestricted approval

Repossession

The lease will normally include a right for the landlord to "repossess" (take back) the property if the rent is paid late or if any of the tenant's other obligations is not fulfilled. If the landlord seeks to use this right, both landlord and tenant should seek immediate professional advice, as the law relating to these provisions is both detailed and complex. Tenants should note that repossession will not "wipe the slate clean": they will still be liable to pay any money that is due, including (usually) the cost of any "dilapidations": repairs needed to bring the property up to the standard required under the lease

Stamp Duty Land Tax

In addition to the Tenant paying SDLT when the lease is granted, SDLT returns may be needed, and further SDLT may be due, if the lease is varied or extended, if there is a rent review within the first 5 years of the lease term or (sometimes) if you remain in occupation of the property after the lease expires. Speak to us if any changes occur, so that we can advise you in detail.

Guarantors

The guarantor (or surety) is responsible for compensating the landlord if the tenant defaults under the lease. Guarantors should try to negotiate a provision that they will be automatically be released from liability if the particular tenant whose obligations they are guaranteeing assigns the lease.

A guarantor's obligations can be heavy, and should not be taken on without full consideration. It is often appropriate for guarantors to receive advice independently of the tenant whose obligations they plan to guarantee

An alternative form of security for the landlord is to insist on a rent deposit; the terms of the deposit should be explicit and recorded in writing at the same time as the lease wording is agreed

Other legal obligations

As well as complying with the tenant's obligations to the landlord under the lease, the tenant will also be responsible for complying with legal obligations imposed on the occupier of business premises, such as compliance with health and safety at work legislation, disability discrimination legislations, the Asbestos at Work Regulations, etc. Even if such compliance requires improvements to the property that will ultimately benefit the landlord – such as installing a ramp for disabled access – the cost is down to the tenant. In addition, the landlord's consent will be needed, at the tenant's expense.

Further, most commercial leases include a covenant by the tenant in favour of the landlord to comply with all such legislation, so the landlord can force the tenant to improve the property at the tenant's cost, even if no outside agency does.

The remedy: Make sure the property already complies with all relevant legislation before you take it over.

Completion expenses

On completion of a new lease, the landlord will expect to collect (and so the tenant should expect to pay) -

- the rent for the period from the start date to the next rent day
- the insurance premium from the start date to the next insurance renewal date
- the service or maintenance charge (if applicable) from the start date to the next service charge payment date
- any agreed rent deposit (together with an amount equivalent to the VAT on it, though no invoice will be issued at this stage)
- any agreed contribution towards the landlord's legal costs

Continuing relationship

The relationship between the landlord and tenant will continue after the lease has been signed. It is therefore sensible to pursue negotiations constructively and fairly, so as not generate bad feeling for the future

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