Coles Miller Solicitors LLP

Commercial Property

Considering a commercial lease? A basic guide

Why is it important to understand your lease?

A lease is essentially a contract that gives the tenant the exclusive right to occupy and use the landlord's property for a period of time. As with any other contract, the terms of the lease reflect the circumstances and the parties' needs when the lease is granted. Before entering in to a lease, it is essential to understand these key terms and to take advice at the outset so that your position, as either landlord or tenant, is protected as far as possible.

Key terms to consider are:

The Term (the length of the lease)

The lease is granted for a period of time, referred to as the "term". Generally, a business lease is granted for a "fixed term", that is, a defined period starting and ending on fixed dates and, in most cases, for a period of years between 2 and 10. Bear in mind that as a tenant, if you enter in to a lease, then potentially you are committing to paying the rent and observing the lease obligations for the whole term. You may not want a lease that is too long, particularly if you are starting up a new business.

Alternatively, you may want to negotiate a longer term but with a break option (see below). N.B Stamp Duty Land Tax (SDLT) is sometimes payable on a new lease. SDLT is calculated by reference to the amount of rent and the term of the lease. In basic terms, the longer the lease and the higher the rent, the more SDLT that will be payable. Once the annual rent is agreed, we can provide you with a calculation showing the amount of SDLT (if any) that would be payable. For example, we could show you the amount of SDLT payable on a 3 year lease, compared to the amount payable on a 6 year lease. This may also influence your decision on the length of the lease term.

It is important to be aware of when the fixed term will end, and whether it can be terminated earlier by either party.

Break Clause

The right to bring the lease to an end early is usually contained in a "break clause". A break clause can be in favour of the tenant only, the landlord only or both parties. You need to consider whether you would want the right to end the lease and/or whether you would want the other party to be able to do so.

As a tenant, you will want to avoid operation of the break clause being subject to compliance with various conditions in the lease (other than the payment of rent) which could make it very difficult to be able to exercise the break.

It is imperative that all the requirements of a break clause are followed precisely (e.g. payment of rent, repairs and decoration, timing and service of notice). Failure to do so could result in a break clause becoming ineffective meaning the lease will continue for its full term.

Rent and rent review

The rent payable will normally be the biggest point of consideration/negotiation for both parties. You may wish to take advice from a surveyor on whether the rent is a fair rent for the property in the current market. We cannot advise you on the level of rent itself.

The rent will generally be expressed to be an annual sum that has to be paid in four instalments in advance. It is common for the lease to require the rent to be paid on the "usual quarter days", which are 25 March, 24 June, 29 September and 25 December, or in the alternative paid monthly or on any other dates agreed by the parties.

The rent may increase during the term of the lease in a number of ways:

- There may be set dates for the rent to be reviewed. The rent may be reviewed by reference to the open market valuation, or by reference to an index, typically the Retail Price Index (RPI). In the majority of leases where the rent is reviewed, the rent will never decrease. It will either stay the same or increase.
- The lease may provide for the rent to be increased by pre-agreed increments, or "steps" each year.
- The lease may have a set figure for rent and then require the tenant to pay an additional amount of rent linked to the tenant's business profits ("turnover rent"). This is quite unusual.

In addition to the rent, the tenant generally will also have to pay:

- VAT on the rent (if applicable).
- Outgoings (such as business rates, insurance premiums and utility bills).
- Service charges.

Service charges

If the lease is of the whole of a building, the tenant is likely to be responsible for all the outgoings and maintenance costs associated with the building. Where the lease is of a part of a building, it is generally easier for the landlord to pay the outgoings and carry out the repairs and maintenance and then bill the tenant for the tenant's share of those (the service charge).

It is important that the tenant knows what costs the landlord can include in the service charge. The landlord will want to pass the total cost of running the property to its tenants, so the service charge will usually include all costs including repairs, maintenance, any improvements and alterations, utility bills, insurance premiums and the cost of employing staff (such as groundsmen, receptionists, cleaners and its management company's fees).

The landlord may also want to collect a sum to put towards a major expense in the future (a "sinking fund" contribution).

The landlord will usually provide an estimate of the charges to be incurred for the coming year.The tenant is then usually required to pay this estimate in quarterly instalments (often at the same time as the rent). At the end of the service charge year, the landlord should provide a full account which will compare the estimate against the sums actually spent. Any deficit will be payable by the tenant on demand, any credit should be credited against the tenant's service charges for the following year.

Insurance

Generally the landlord will insure the property and will recover the cost from the tenant as an additional rental payment.

Points that we will assist you with and will be looking for when we review a draft lease are:

- Are the risks covered appropriate for the property and the tenant's use of it? What are the excluded risks? Typically, this might be damage caused by terrorism, but may also be subsidence and flooding.
- Will the tenant be liable to pay any excess on a claim?
- What are the terms of the insurance policy? If the tenant does not comply with these, the insurance policy might be invalidated and the landlord could have a claim against the tenant for breach of an obligation in the lease.
- Typically, the tenant will have to disclose certain information about itself, its business and what is kept at the property.
- What happens if the property is damaged so that it cannot be occupied? Is the rent suspended and, if so, for how long?
- What will happen if the landlord cannot rebuild the property? Typically, there will be a period during which the tenant will not have to pay rent. This period should be the same as the period that the landlord insures for loss of rent and there should usually be a right to terminate the lease at the end of that period if the property is still not fit for occupation and use.
- What other insurance cover does the tenant need? For example occupiers liability cover, contents cover for furniture, equipment and stock and business interruption insurance

Repairs

Usually, there will be repairing obligations on the tenant. There may also be repairing obligations on the landlord, depending on the situation. It is essential to consider the extent of the repairing obligations from the outset, as failure to comply with such obligations throughout the lease term could be very costly for a tenant.

If the tenant is required to put and keep the property in repair, it must put the property into a good state of repair, even if it was not in a good state of repair at the date of the grant of the lease. This is commonly known as a full repairing lease.

It is therefore essential that tenants inspect the state and condition of the property, or instruct a surveyor to do so before taking on a lease, so that any issues of disrepair can either be addressed by the Landlord or the outgoing tenant if there is one. If issues are not addressed the new tenant takes on full responsibility whether or not they caused the disrepair.

An alternative to having a full repairing obligation, is an obligation to keep the property in the same state and condition that it is in when the lease starts. A photographic schedule would usually be prepared to record this.

Dilapidations

At the end of the term, however this occurs (e.g. exercise of a break clause, landlord repossession for rent arrears, or expiry of the term) the landlord may ask its surveyor to prepare a list of every want of repair and decoration called a schedule of dilapidations. The surveyor will look at the tenant's repairing obligations in the lease and identify where the tenant hasn't complied with those obligations. As mentioned above, it is therefore essential that the repairing obligations are considered very carefully before the lease starts.

This schedule of dilapidations is then served upon the tenant and usually a negotiation occurs between the surveyor acting for the landlord and the surveyor acting for the tenant and a sum is agreed to be paid by the tenant to the landlord. The surveyors will carefully read the lease clauses detailing the description of the premises, the repairing obligations and any schedule of condition prepared at the commencement of the term.

To avoid a large claim for dilapidations a tenant ought to have a programme of works during the term and if possible invite the landlord to inspect in the last few months and agree any essential works because the tenant may be able to carry out the works itself at a lower cost and certainly not have to compensate the landlord for the time taken to carry out the works when the premises cannot be re-let.

The landlord cannot claim dilapidations if it proposes to demolish or carry out a major redevelopment, nor if, even in the present state of repair, the premises could be re-let at the market rent. Any claim is limited to the difference between what the capital value of the premises would be if let in full repair and the current state of repair.

Alterations and improvements

The lease may impose restrictions on what alterations and improvements the tenant can make. This is to protect the landlord from alterations that might damage the landlord's investment interest in the property. There will usually be a requirement to reinstate the property to its original configuration before the end of the term.

The restrictions should be appropriate to the type of property and length of the term.

- If the lease is of the whole property and for a long term, there may be few restrictions.

- If the lease is of only part of a larger property or for a short term, the lease may prohibit absolutely structural alterations, but may allow internal alterations, either with or without the landlord's consent

- Putting up or moving internal partitioning will generally be treated as an internal alteration unless the lease provides otherwise.

It is important to consider whether you may wish to make any alterations to a property at the start of a transaction, so that the landlord's written consent can be obtained prior to the start of any works, to avoid a breach of the lease covenants.

In some leases, the landlord's consent or approval of any signage is also required.

Assignment and underletting

If the tenant wants to transfer its interest in the lease to someone else, the transfer is referred to as an "assignment". If the tenant wants to keep its interest in the lease, but allow someone else to use the property or part of it, the tenant could grant an underlease (also called a sublease).

The tenant should look out for the following points:

- There are likely to be a number of restrictions associated with assignment and underletting (also known as "alienation") and these should be considered carefully.

- The landlord will usually require the tenant to guarantee that the new tenant (the assignee) pays the rent and complies with the lease obligations until the end of the term. The tenant will still be on the hook to the landlord as a guarantor and in the worst case scenario, could be obliged to retake a lease of the premises. This is why it is important to give careful consideration to the length of the lease in the first place, as being able to transfer the lease to someone else doesn't necessarily mean that your obligations come to an end at that point. In most cases, you will still be liable to the landlord, in the role of guarantor, until the end of the term.

- Failure to obtain landlord's consent to a transfer or underletting will put the tenant in breach of its lease and may lead to forfeiture proceedings by the landlord or a claim for damages. The tenant should also be aware that if no consent is obtained where required, the assignment is said to be "unauthorised", which means that the tenant will not be released from liability under the lease as from the date of the assignment.

The Landlord and Tenant Act 1954 (the 1954 Act)

The purpose of the 1954 Act is to try and safeguard and protect the goodwill in a tenant's business that builds up during occupation under a lease and to balance this against the landlord's rights as the owner of the property.

Essentially, a business lease is a lease where the tenant occupies the premises for the purposes of its business. Where the lease has the protection of the 1954 Act, it will continue until the lease has been properly terminated under the 1954 Act or renewed and, until then, the tenant will have the right to remain in the property after the contractual lease has expired. The tenant has certain rights to renew the lease at the end of the contractual term. The tenant can serve notice of its intentions upon the landlord or the landlord can serve notice upon the tenant and the recipient of the notice has to respond within set time limits.

If the tenant does have the right to apply to a landlord for a new lease under the 1954 Act it will be on similar terms to the existing lease, subject to agreeing a new rent figure. There are certain notice requirements in order to take advantage of these

rights but, subject to timely service of the correctnotices, the landlord only has very limited grounds on which to refuse. One of those grounds is if the landlord needs the property back because they have a genuine intention to redevelop the property or the building, or they have a genuine need to occupy the property themselves.

Contracting out of the 1954 Act

The landlord may serve notice prior to the grant of the lease requesting that the tenant agrees to forego these rights. The tenant must sign a declaration (usually a sworn statutory declaration) confirming that it is aware that it is giving up the right to stay on in the premises and request a new lease at the end of the term. All of this is then effectively authorised and recorded in the lease.

If the lease contains a clause confirming that the lease has been excluded from the 1954 Act the lease is said to be "outside" the 1954 Act. The lease is for a fixed term only and so the tenant will have no right to renew the lease when it finishes at the end of the term and the property must be vacated.

This is an important point to consider for tenants who want to protect the goodwill of their business and for landlords who want to retain the greatest flexibility to deal with the building as they wish at the end of the term.

Rent Deposit

Where the landlord considers that a tenant or an assignee is a risk, maybe because it has no (or weak) references, it may ask for a rent deposit of say 6 months rent to be held in a separate bank account as security for the rent. The deposit can be drawn upon by the landlord if the tenant is ever in default and the tenant must make up any monies drawn. At the end of the term, the landlord is entitled to deduct from the deposit any costs required to remedy any breaches of the lease, before returning the balance to the tenant.

Guarantor

Where the landlord considers that a company tenant or an assignee is a risk, maybe because it is a new company with no previous trading accounts, it may ask for a director of the company to stand as guarantor. The guarantor will be personally liable for compliance with all the lease terms where the tenant is in default.

Disability Discrimination Act 1995

This act affects all premises occupied by a service provider, who should not permit their premises to discriminate against a disabled person and thus will have to make reasonable adjustments to it. This is an extremely complicated area of law and the official line is that anyone who has the public coming to their premises should undertake a Disability Audit to gain an idea as to whether their premises comply or not.

Control of Asbestos Regulations 2012

It became illegal to use asbestos materials under Building Regulations for any works carried out after 1999.

The Control of Asbestos Regulations affects all non-domestic premises and imposes various duties on people who have control over non-domestic premises. Under Regulation 4, the duty holder (usually being the person legally responsible for the structural repair of the premises) must carry out an assessment of his premises to determine whether asbestos is present and to enable him to manage the risk from asbestos. The assessment requires a specialist survey from a suitably qualified surveyor who will have undertaken specific training. The potential liability for non-compliance is extremely serious and constitutes a criminal offence.

The regulations require a proportionate approach to be taken and only require a full assessment where the potential risk warrants one, or where premises are complex and/or works are being proposed that could potentially disturb asbestos materials.

The landlord will be asked to provide a copy of the asbestos report as part of the searches and enquiries made in agreeing a lease.

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Fire risk assessments

The Regulatory Reform (Fire Safety) Order 2005 replaces the system of fire certificates with a new system of risk assessments. In workplaces and other non-domestic places caught by the order, the person with control of the premises has a duty to take such general fire precautions as will ensure that the premises are safe.

The approach is a proportionate one and the standard is 'a suitable and sufficient' assessment by reference to the size and type of premises. In the case of straightforward premises, it may be possible for the fire risk assessment to be carried out by someone within the organisation, for example, if the responsible person has relevant experience or has received some formal training. More complex premises may need to be assessed by an external consultant who has comprehensive training or specialist experience in fire risk assessment.

In the event of a fire, the lack of an assessment could result in severe criminal penalties for the tenant occupier and might also potentially invalidate buildings insurance.

Energy Performance Certificate

The Landlord should provide a tenant with an energy performance certificate and the tenant is entitled to insist that an EPC be provided. From 1st April 2018, a landlord may not let a property where the energy performance of the property is below the minimum required standard (currently Band E).

Costs and Indemnity

Generally all leases will include a provision that the landlord can recover its costs if it is:

- asked to give consent (e.g. to alterations or an assignment of the lease)
- or needs to take steps to enforce provisions in the lease because the tenant is in breach of the lease
- or if the landlord needs to serve a schedule of dilapidations due to repairs to the property

Most leases will also contain an indemnity for the landlord's cost if it suffers damage due to a breach of the tenant's obligation in the lease.

Conclusion

Entering into a lease is a substantial financial commitment. It is imperative to seek advice at the outset, so that the best terms can be negotiated and the documentation can be carefully reviewed to protect your interests.

"Get smart legal advice for your lease queries"

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