Commercial lease reform in the UK: can we learn anything from Australia about the awareness of small business tenants?

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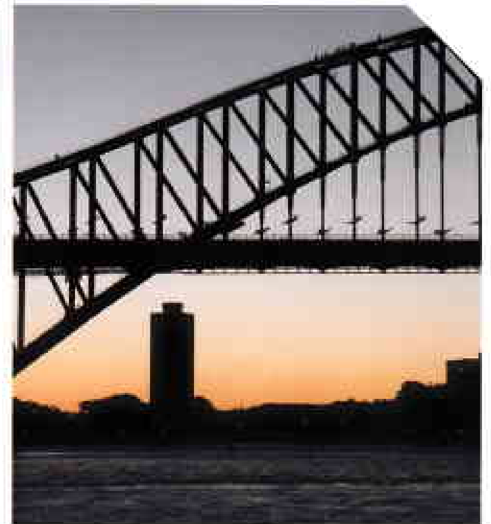
Sixty second summary

The way in which the commercial leasing system in the United Kingdom has treated small business tenants has been a cause of some concern to both business groupings and government. Initially the areas of most concern were upwards-only rent reviews, confidentiality clauses and dispute resolution. Since then the response in the UK has been to use voluntary codes of practice to address these and other emerging issues. In response to the same issue, other countries have gone down a legislative route, and this research by Professor Neil Crosby at the University of Reading Business School in the UK investigated how the Australians have attempted to solve their small business tenant problems. Many of the policy objectives of the Australian State Governments are similar to the UK and their response has been to ignore voluntary solutions and implement legislation or mandatory codes, which create an enforceable framework for both negotiations and the lease document.

Their particular small business tenant issue relates to retail although there is no reason why small commercial and industrial tenants should be treated differently when it comes to attempting to better inform tenants all the way through the letting process.

The Australian legislation has provisions for extensive information to be passed by landlord to tenant at the commencement of negotiations and this includes a copy of the proposed lease and a Government information brochure. They also have to provide tenants with full disclosure of all financial and other details of the lease at least seven days before the lease is signed. Failure to comply can lead to fines and possible termination rights for tenants. The research found that this gave Australian tenants more information than UK tenants and was thought to drive them to take professional advice earlier in the process. Previous research undertaken by Professor Crosby has found that the UK's voluntary lease code is not fully effective and he concludes that the mandatory provision of information and disclosure could be used in the UK to better inform prospective small business tenants.

Other aspects of the Australian legislation include first, the use of compulsory low cost dispute resolution, often using mediation, prior to any dispute being entered into court; and second, the use of Government funded lease registrars or commissioners to undertake the investigation of non-compliance under the Acts, run the mediation service and attempt to educate small business in the implications and pitfalls of signing leases without due consideration. These two aspects of the Australian legislation received praise from property professionals interviewed for the research in Australia.



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Introduction

Commercial lease reform has been on the UK Government agenda since 1992 following the commercial property crash of 1990. In the aftermath of the crash some business tenants found themselves locked into long leases with upwards only rent review provisions at a time when business activity and market rents had fallen. In 1990, 90% of the lettings by value within the Investment Property Databank were on 20-25 year leases and the upwards-only provision was virtually universal. The Government postbag was allegedly full of letters from disgruntled tenants and in a 1992 consultation paper the Government isolated upwards-only reviews, confidentiality clauses and dispute resolution as its major targets for legislation. The property industry persuaded Government not to legislate but to operate within the framework of voluntary codes of practice and since then there have been two codes in 1995 and 2002 (RICS, 1995; 2002) and a third is in course of preparation at the time of writing in August 2006.

In two University of Reading monitoring reports for the UK Government (Crosby, et al, 2000; 2005), the awareness of small business tenants has been raised as a policy issue and in its last response to these reports the UK Government highlighted it as one of three continuing concerns; the other two being subletting and upwards-only reviews.

While the UK has gone down a voluntary route to obtain commercial lease reform, other jurisdictions have resorted to legislation. In Australia, the catalyst for Government interest in commercial leases occurred much earlier than in the UK. In the 1970s the growth of retailing within major shopping centres centralised retail property ownership within a few major developer/investors and small business tenants operating shops in these centres began to complain of a misuse of power by these owners. There was no statutory right to a new lease and the shopping centre managers were charged with aggressive treatment of tenants at renewal negotiations and also failure to disclose charges which were subsequently included after the lease was signed. Small shopkeepers were obliged to pay for inappropriate items in service charges, complete refits at renewal, design fees for the fit out and, where major anchor stores refused to pay for certain items in service charges, these were spread around the remaining tenants.

Responsibility for tenancy matters in Australia lies with the eight States or Territories of the Commonwealth (Federation) of Australia. Calls for intervention were answered in a number of States by retail tenancy legislation, commencing in Queensland in 1984, Western Australia in 1985 and Victoria in 1986. Now all States and Territories have legislation or a mandatory code. Despite continuing calls for a national uniform tenancy code, the Federal Government has so far declined on the grounds that tenancies are a State matter and they have no jurisdiction. Table 1 sets out the current legislation in each State.

The legislation across the States has many similar features and this research aimed to investigate this legislation to see if there were any findings which could have implications for the UK policy debate on commercial leases.

Table 1: Australian State/Territory current legislation

State	Name of Act	Date of Commencement	Last Amended
Australian Capital Territory (ACT)	Leases (Commercial and Retail) Act 2001	01/07/2002	04/03/2003
New South Wales (NSW)	Retail Leases Act 1994	01/08/1994	01/01/2006
Northern Territory (NT)	Business Tenancies (Fair Dealings) Act 2003	01/07/2004	
Queensland (QLD)	Retail Shop Leases Act 1994	28/10/1994	03/04/2006
South Australia (SA)	Retail and Commercial Leases Act 1995	30/06/1995	06/12/2001
Tasmania (TAS)	Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998	01/09/1998	
Victoria (VIC)	Retail Leases Act 2003	01/05/2003	23/11/2005
Western Australia (WA)	Commercial Tenancy (Retail Shops) Agreements Act 1985 incorporating the Commercial Tenancy (Retail Shops) Agreements Amendment Act 1998	01/09/1985 01/07/1999	28/06/2001 Presently under further review

Sources: Compiled by the author primarily from Philips Fox (2004), Clayton Utz (2005) and Minter Ellison (2006)

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The Australian Legislation

Voluntary codes or Government intervention

Given the reliance of the UK on a voluntary solution, it is interesting to note that all States have resorted to legislation to solve their small retail business tenant issue. Virtually all States ignored the voluntary solution although New South Wales (NSW) first attempted to produce a mandatory code. This was not agreed so a voluntary code was put in place with the support of all sides of the industry, with the hope that it would become agreed as a mandatory code in time. In the event, individual landlords and tenants did not comply with it and it was decided that a voluntary code would not work and the parties would not agree to it becoming mandatory. Having decided that voluntary codes were ineffective, the NSW Government legislated in 1994.

Most interviewees in the research expressed surprise that the UK had persevered with a voluntary solution and thought that these were not adhered to by individuals. They seemed comfortable with Government intervention in the process and the debates in Australia concern the detail of the legislation rather than its existence. Of course, this may be because of the fact that it has been around for so long. There did seem to be a universal feeling that the 1980s shopping centre landlords had behaved badly and they still have a reputation for being aggressive in their current dealings with tenants. However, the existence of legislation may play its part in this process. As it exists, landlords may feel that, as long as they comply with it, any aggressive behaviour within the legislation is perfectly fair, given the protection that tenants now have. The research did not investigate the motivations or behaviour of landlords but it remains an interesting potential area of study. However, whatever the motivation, the Australians have rejected the voluntary route as a vehicle for protecting small business tenants, in this case retail.

The scope of the legislation

As the catalyst for intervention was the behaviour of shopping centre managers, the Australian focus is on retail, but there are a number of interviewees who feel that all commercial tenants should now be included in the legislation. Defining the scope of the legislation has been a major problem and in many States it is purely small premises legislation, as any retail unit under 1,000 square metres is included. In two States they use a rent criteria; in South Australia it is Aus$250,000 pa but in Victoria it is Aus$1,000,000 pa. The Victorian limit is so high it includes most shops in most centres. Victoria also has a criteria related to the tenant, whether the company is listed on the stock exchange. As the rent limit is so high, the listing criteria basically controls which tenants are included.

Although the basic indicators used by most Governments for classifying small businesses are number of employees and business turnover, no State utilises this for its retail tenancy legislation, relying on floorspace, listing and/or rent limits to identify tenancies within the Act. In some States the definition of retail is drawn quite wide so retail service occupiers are included and in one State commercial premises of less than 300 square metres are also included.

The scope of the legislation therefore varies between States and some companies are included in the Act in some States and not in others. In addition the definition of retail is not always consistent. The concentration on indicators that relate to the premises rather than the tenants suggests that in many States the legislation is in fact a smaller retail premises Act rather than a small business tenant Act, with some small commercial premises included in some States.

Issues covered by legislation

Table 2 sets out the issues that are covered in the various Acts across Australia. Not all issues are covered in all Acts but in addition to defining who or what is included, the Acts generally cover issues of information and disclosure prior to leases being signed, what can and cannot be written into individual lease clauses, a dispute resolution mechanism prior to court proceedings and the incorporation of Australian fair trading legislation into the Acts. The legislation is substantial. In Victoria, the current Retail Leases Act is 138 pages and two previous Acts remain in force for leases signed prior to 2003. Most States have founded some form of lease registrar or commissioner and in Victoria it is the Small Business Commissioner (SBC). He estimates that 70% of his workload comes from retail tenancy matters. His role is education, investigation and dispute resolution under the Act.

The detail of the legislation is set out in the main report for this research which includes as an appendix a compendium of the legislation in the different States by Minter Ellison, lawyers, which can also be accessed from **www.minterellison.com.au**

Table 2: Major issues covered by the retail leases legislation

Major Category or Issue	Issues within Category
Premises or tenants within the Acts	Definition of premises / Definition of tenants / Definition of who or what are not included
Provision of information during and after negotiations	Provision of draft leases and other information Disclosure statements by landlords and tenants Termination rights from failures to deliver information and disclosure statements / Notification/registration of leases
Terms of the lease	Implied terms / Regulation of actual terms such as rent review, outgoings, sinking funds, assignment, subletting, minimum term, refurbishment, renewal rights where they exist, etc.
Dispute resolution	Role of Courts / Mediation systems / Role of registrars and small business commissioners / Valuations / Confidentiality of proceedings and evidence
Unconscionable conduct	Incorporation of unconscionable conduct into Retail Leases Lists of behaviour that might be construed unconscionable.
Other issues	Key money, compensation to tenants, trading hours, security deposits, personal guarantees, land and sales tax provisions, payment of rent during fit out, management fees, advertising and promotion.

Information and disclosure

Perhaps the most relevant part of the legislation for the UK policy debate are the provisions concerning information to tenants at the commencement of negotiations and a detailed disclosure statement just before the lease is signed.

The information required in Victoria at the commencement of negotiations is a draft copy of the lease plus the provision of an information brochure published by the SBC. Penalties for non-compliance range from a fine (Aus$5000 in Victoria) to the opportunity to terminate the lease. Interviewees for the research were convinced that small business tenants would either read the information and be more informed or, more likely, seriously worried by it and seek professional advice earlier than they would in the absence of the information. In the UK, the Government monitoring report (Crosby, et al, 2005) found that very small business tenants were often entering a lease for the first time, did not take professional advice at the commercial negotiation stage of the process and sometimes not even legal advice after heads of terms had been agreed, were more likely to take the first lease offered and generally did not get the best deal that could be on offer. They also found that the vast majority of tenants did not have knowledge of the code of practice and were not given it by anybody in the negotiation process.

The issues are the same in both countries with the objective of making small business tenants more aware of the implications of signing a lease. Getting advice late in the negotiation is not ideal and Australian interviewees suggested that advice late in the process to a small business tenant not to sign a lease, when they have spent weeks, and maybe months, setting up a small business and are about to go into occupation, is often refused.

The second element of information is disclosure and again there are rights to terminate leases and fines as penalties for non-compliance. In Victoria, the disclosure statement must be given to the tenant by the landlord at least seven days before the lease is signed. The disclosure statement includes all financial items including service charges and also prospective issues that might disrupt the tenant during the lease, for example, planned refurbishment of a shopping centre. In NSW and Queensland the form runs to six pages of questions/issues. In some States the tenant must also give a disclosure statement but often this is purely a declaration that they have received the landlord's statement and have read it.

The application to the UK is obvious. Given the major problem with the education of small business tenants and the lack of penetration of the two Codes of Practice at the negotiation stage, the mandatory regime is perceived in Australia to improve the awareness of tenants and at very least persuade them to take advice earlier. The lease registrars or commissioners have the power to investigate breaches of the legislation and impose fines and the tenant may in some cases be able to withhold rent and/or terminate the lease. If the voluntary education and dissemination programme does not show significant improvement in the UK, the study of the Australian legislation has provided a model for using regulation to achieve the policy objective of informing small business tenants early in the process of the implications of the lease.

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Terms of the lease

The legislation in all States has detailed provisions prescribing terms of the lease. These provisions have a large number of similarities in that the same types of issue are addressed across all States, even if the detail sometimes differs. Total costs of occupation figure prominently in the legislation due to their role as one of the most controversial aspects of the relationship in the 1980s. These costs can be categorised within rent determination, rent review and other costs of occupation such as outgoings. All of the legislation, except for the code in Tasmania, defines outgoings and they normally include annual maintenance and repair of the building as well as rates, taxes, levies and premiums. The legislation also addresses liability and apportionment and outgoing information exchange. It also usually addresses issues of liability for letting fees and management costs, land tax and promotion and advertising fees. Because of the concentration on retail in shopping centres, the legislation also focuses on key money, turnover rent and rent determination at review and renewal. The Minter Ellison (2006) compendium lists 60 different issues present in the legislation but only the main issues are discussed here.

The legislation in virtually all States prescribes a minimum term of five years although in some States, such as Victoria, this can be contracted out of (in the case of Victoria with a certificate from the SBC). Analysis of lease terms in Australia indicates that in shopping centres all but the anchor tenants get the minimum term with no right to renew. One major regional shopping centre in Victoria had 7 leases out of 250 with terms of around 20 years but these were for the major and more minor anchor stores. The standard or speciality shop units all had 5, 6 or 7 year leases or leases of less than 5 years, presumably under the contracting out provisions. Reviews are often annual with fixed increases or increases based on the consumer price index (CPI), sometimes with a rate above the CPI. Rents on renewal are controversial; with research elsewhere in the world (for example, Fisher and Lentz, 1990) suggesting that, where there is no right to renew, tenants' renewal rents are significantly higher than new letting rents. This implies that tenants are paying some of their business value over to landlords to secure the location.

The lack of a statutory right to renew is part of this controversy. Interviewees with a landlord bias suggested that the right to renew takes away the landlord's right to manage dynamically while interviewees with a tenant bias suggested that retailers were quite capable of adapting to changing retail phases and formats and needed the right to renew to stop landlords abusing their market power at lease expiry. In two States there are preferential rights awarded to tenants; i.e. the right of first refusal, but there are grounds by which landlords can refuse. It would appear from Victorian Government discussion papers concerning their legislation that, while accepting that there are occasions where tenants are treated badly at lease expiry, they do not feel it appropriate to constrain the landlord's right to manage. It would appear that the majority of other State Governments agree judging by the lack of renewal rights in their legislation.

Rent reviews also attract detailed consideration. In many States the basis of review must be specified and reviews cannot be more frequent than every 12 months. The allowable bases of the review are usually specified and in many States no more than one basis can be adopted (for example, a clause suggesting the higher of two bases is void). All States have effectively banned an upwards-only rent review or a review where the fall is capped. They have all defined market rent and the rent determination process to obtain market rent and that normally requires a specialist retail valuer to be appointed, that appointment being made independently if the parties cannot agree. In some States this appointment is by the retail or business commissioners, and in others it is by the Australian Property Institute, the largest valuation professional body in Australia.

The interviewees suggested that before the lease legislation was enacted, market reviews with upwards-only provisions were common. As a result of the legislation, which banned upwards-only reviews, the landlords moved swiftly to indexation and fixed increases. Even within the context of UK longer leases, a ban on upwards-only reviews by the UK government, similar to the ban imposed by Australian lease legislation, may give some impetus to the use of these alternative forms of review; so far little used in the UK.

Assignment and subletting is also controlled in all of the legislation. An absolute right to refuse a subletting appears to be allowed in most States, but not an absolute right to refuse an assignment. The assignment process is controlled through the legislation in all of the States and usually landlords must give consent unless certain grounds for refusal are met, usually based around a non-permitted use or the proposed assignee being not of a sufficient financial standing. Disclosure statements from landlords, assigners and assignees are an issue at assignment as well as at the granting of new leases in some States.

Before the 2003 Act in Victoria, subletting was similar to assignment in that an absolute right to refuse was not allowed but landlords were given the right to refuse in the 2003 Act for, it appears, no other reason than to align with some other States. It is slightly ironic that, at precisely the time that flexibility in subletting rose to the top of the UK commercial lease reform agenda, Australian legislation aimed at small tenants significantly reduced tenants' rights to sublet.

Repairs and outgoings are defined and regulated under the Acts. In all States, leases must specify how the amounts are to be calculated, how they are to be shared out between different tenants and when they are to be recovered. All States have a list of prohibited items and the kinds of item which appear regularly in those lists include depreciation (sinking funds) and any item which is not specifically related to the tenant's unit.

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Dispute resolution and the role of lease registrars /commissioners

Unlike the UK, where alternative dispute resolution is available voluntarily through the RICS dispute resolution service, the legislation in Australia requires that parties go through a process of mediation before the case will be heard by the court. The success rate at, or before, mediation is around 75% in Victoria; with some cases decided before formal mediation by informal discussion. The service is run by the Victorian Small Business Commissioner and is subsidised heavily so that the parties pay their own costs and they are charged only Aus$95 (around £40) each for the mediation. Mediators are paid Aus$590 and an average mediation takes 3-4 hours.

There was virtually universal praise from interviewees concerning mediation as an initial attempt to resolve disputes before court hearing and for the role of the SBC in Victoria, which includes dispute resolution.

The annual report of the SBC (2005) sets out the activities of the office of the SBC including a number of illustrative cases relating to its three major roles of education, investigation of non-compliances with the Act and dispute resolution. The enforcement procedures have been used lightly by the SBC as, in most cases, the non-compliance has been out of ignorance rather than attempts to mislead or circumvent the Acts. One of the more powerful and influential tools concerning the compliance issue is unconscionable conduct incorporated from Fair Trading legislation. Landlords are nervous about being found guilty of acting unconscionably in negotiations with tenants as they feel it affects their reputation far more adversely than being found to have made a mistake in complying with the legislation. Unconscionable conduct is where one party has taken advantage of its superior market power in negotiations, although case precedent suggests it is difficult to successfully bring an action. It is still an interesting concept not fully investigated in this research but worthy of further consideration in a wider context than just commercial leases.

Policy implications for the UK

If the UK government were to consider partial legislation for small business tenants, nothing in the policy and application of the Australian legislation should change the current emphasis from all small business tenants to retail tenants only. But the study of Australia identifies the difficulties of implementing legislation across part of the market; defining the scope of the Act has caused numerous difficulties over the past 20 years and there is nothing to think that it would be any easier to implement in the UK if partial legislation were considered.

The information and disclosure provisions are perceived to have improved the awareness of small business tenants; at the very least it has persuaded them to take professional advice early. It would appear that mandatory information could be the key to achieving UK Government objectives concerning the awareness of small business tenants and it could be made mandatory for landlords and their agents to provide all prospective tenants with a copy of the Code and the proposed lease, with fines and termination rights for non-compliance. Disclosure statements also have a role to play in increasing the ability of small business tenants to get a fair lease.

Overall, it is plain that some of the themes of lease legislation in Australia address the same issues of small tenant awareness that exist in the UK. The most obvious ones are the information and disclosure provisions and the use of lease registrars or commissioners to administer education, compliance and dispute resolution. Given the failure of the property industry in the UK to voluntarily ensure proper dissemination of the two Lease Codes, the success of mandatory information provisions and easier dispute resolution processes could be considered as a solution to the UK small business tenant policy issue.

About the research

The research was carried out by Professor Neil Crosby of the University of Reading Business School, with a travel grant provided by the RICS Education Trust and the Investment Property Forum Educational Trust.

The aim of the research was to examine perceptions of the effectiveness of small business tenant legislation in Australia and to provide a preliminary evaluation of its potential use in UK. The research was undertaken during the first half of 2006 and consisted of a major review of the literature concerning the development of lease legislation in Australia since the 1980s. As the legislation is State and not Commonwealth based, a case study approach of Victoria was used supplemented by a brief overview of legislation in the other States. During March and April of 2006, the issues identified in the literature were developed within a set of semi-structured interviews with a combination of Government officials, property professionals and representatives of landlords and tenants. In total 28 individual interviews were carried out in March and early April of 2006 with 36 interviewees. The majority took place in the case study area of Melbourne but a number of interviewees acting nationally were interviewed in Sydney.

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The full report can be obtained free from the University of Reading Website
main report – **www.rdg.ac.uk/rep/ausleaserpt.pdf**
appendices – **www.rdg.ac.uk/rep/ausleaseapp.pdf**

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