



# fact sheet

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## Leasing opportunities in a changing environment *Downsizing? Moving? Sharing? Surrendering?*

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Increasingly, Commonwealth tenants are dealing with the accommodation impacts of operating in a dynamic and changing environment. Whether it is operational change, a merger, separation of functions, the cessation of an activity or just a desire to explore more efficient and cost-effective accommodation options, successfully managing changing accommodation involves:

- assessing the impact of the actual operational need on existing and future accommodation, including the size, type and location of premises
- investigating market options including whether there is oversupply or undersupply of the particular type of premises in the local market and what opportunities this provides for divestment of existing tenancies and, if necessary, acquiring new accommodation that provides better overall value
- considering applicable Commonwealth guidelines and policies around accommodation
- identifying and developing a clear understanding of the opportunities available under an existing lease
- identifying the risks associated with a potential divestment / acquisition strategy
- developing a well-considered change management plan for the accommodation needs that addresses:
  - operational needs
  - market opportunities and risks
  - legal opportunities and risks under existing and potential lease arrangements
  - financial impacts on a whole-of-project basis (ensuring that assessment includes not only up-front costs such as rent but also associated costs such as reinstatement and refit costs, changes in outgoings structures, surrender price and ongoing risk and liability associated with the divestment or procurement model selected).

This fact sheet explores some key considerations in managing accommodation change in the context of a leasing framework.

### **Understanding the need**

The accommodation management plan should identify the accommodation need that arises from the changed circumstances. For example, in terms of space, the actual operational need might support a consolidation exercise within existing premises coupled with a divestment exercise for spare space. At the other end of the spectrum there may no longer be a need for the premises at all and what is needed is an exit and divestment strategy. This could be the case where there is a complete cessation of function or where it is feasible to co-locate with another agency in existing premises.

The need may also arise from financial considerations. The Commonwealth tenant may be looking to optimise value from its lease accommodation by exploring more efficient and cost-effective accommodation options.

Other considerations relevant to assessing the need include any special use considerations and compatibility opportunities or constraints for shared premises. Examples include particular security needs, technology requirements, the degree of public access and associated amenities needed to facilitate the operational charter, the need to be in particular locations and the degree to which particular operations may impinge on any co-location (such as identifying compatible uses that may benefit co-located entities or discordant uses that constrain co-location).

Once the need is identified it provides the context for the assessment of various options and for determining the preferred strategy.

### **Understanding the lease concepts**

The development of the accommodation management plan involves identifying and optimising opportunities under the relevant lease frameworks. The opportunities and risks will be heavily impacted on by the terms of the actual lease documents. A good starting point is to consider some fundamental property law concepts that underpin opportunities under leases. Some of the basic concepts are briefly discussed below.

#### ***Basic nature of a lease***

A lease grants a tenant a proprietary interest in the described 'premises'. A key element of a lease is that it grants the tenant exclusive possession. Since leases are legally binding agreements, they are entered into between parties that are legal entities and that have the requisite legal capacity to enter into the lease. In the Commonwealth sphere, the tenant may typically be the 'Commonwealth of Australia' or, where the relevant legislation permits, it may be a Commonwealth authority, statutory body or corporate Commonwealth entity.

#### ***Duration of a lease***

A lease will stipulate a 'term' of occupation, it may contain option rights and it will usually provide for an overholding right at lease end (typically, but not always, from month to month).

Unless the lease contains express rights allowing a party to voluntarily end the lease before the expiry date, a party is not entitled to unilaterally end the lease. A commercial negotiation could be commenced to secure mutual agreement to end a lease early (this is commonly referred to as a 'surrender'), but there is no compunction on a party to agree to an early surrender. Where agreement is reached, it is usually subject to some type of surrender fee and possibly other conditions.

#### ***Dealing with a lease***

At common law a tenant has broad rights to deal with a lease, including rights of sub-letting, licensing and assignment. However, lease documents invariably modify the broad common law rights and place varying degrees of constraint around dealing with the lease. The constraints can range from absolute prohibitions, permitted dealings with consent, permitting dealings without consent but with notification or permitted dealings without consent or notification.

#### ***Permitted Use***

A lease will specify the particular use for which the tenant can occupy and use the premises. This is usually referred to as the 'Permitted Use'. The Permitted Use can be couched in very broad terms (such as 'office accommodation') or it can be quite specific (such as 'office accommodation for ABC Pty Ltd'). Even if the lease allows dealings with the lease without consent, a tenant cannot grant another occupant any rights that are broader than or inconsistent with the Permitted Use.

## **Some typical options for divesting leased space or acquiring shared or divested space**

### ***Sub-lease***

A sub-lease occurs when a tenant under a lease grants a lease of its interest to another party. The lease granted by the tenant in this way is known as a sub-lease (also called an 'underlease') and the original lease is then known as a head lease.

A sub-lease can be for the whole or part of the premises.

Generally, a sub-lease needs to be for a term that is less than the duration of the head lease. If it is granted for a term equal to the head lease then it constitutes an assignment and does not operate as a sub-lease.

### ***Some considerations for sub-leasing***

#### **Does the Permitted Use allow the activity to be undertaken by the proposed sub-tenant?**

- If the Permitted Use does not support the activity to be undertaken by the proposed sub-tenant, a commercial negotiation will be needed to secure the landlord's agreement to vary the Permitted Use. The landlord is not compelled to agree and may impose conditions on any agreement. These conditions may or may not impact on the viability of the proposed sub-lease arrangement.

#### **Is the proposed term of the sub-lease less than the term of the head lease?**

- The sub-lease negotiations will need to factor in the length of tenure under the head lease to ensure an effective sub-lease can come into existence.

#### **Does the lease contain an absolute prohibition of sub-leasing?**

- If it does, a commercial negotiation with the landlord will need to be entered into and there is no obligation on the landlord to agree to sub-leasing. The landlord may seek to attach commercial or other conditions to its consent and the impact of these on the overall viability of the proposal need to be addressed.

#### **Does the lease permit or otherwise contemplate sub-leasing?**

- If the lease does not contain an absolute prohibition on sub-leasing, does it require the landlord's prior consent?
- If the lease does require the landlord's consent, what are conditions around that (is there any obligation on the landlord not to unreasonably withhold consent; is there an obligation on the tenant to pay the landlord's costs; are there any controls around the extent of those costs (for example, does the lease provide for 'reasonable' costs or a capped amount); what information does the lease require the tenant to give the landlord as a prerequisite to consent?
- If the lease does not require the landlord's prior consent, does it require notification or impose other conditions?

#### **If the Commonwealth tenant is granting the sub-lease does it remain liable under the head lease?**

Given the nature of a sub-lease, the Commonwealth tenant does remain liable under the head lease. It should therefore:

- undertake due diligence to ensure it satisfied that the sub-tenant is financially viable and is likely to act in a manner that will not result in the Commonwealth tenant being in breach of the head lease

- ensure that the form of the sub-lease offers the necessary level of protection to the Commonwealth tenant (including, by way of example, suitable indemnities in favour of the Commonwealth tenant; maintenance, repair and yielding-up obligations consistent with the Commonwealth tenant's own obligations under the head lease; restrictions on further dealings with the sub-lease; and covenants to not act in a way which could expose the Commonwealth tenant to liability or breach under the head lease)
- require any guarantees or other security that are reasonable and appropriate in the circumstances
- ensure it has secured the necessary approvals for any potential risks and liabilities arising from the grant of the sub-lease.

**If the Commonwealth tenant is taking the sub-lease what additional considerations apply?**

The Commonwealth tenant should ensure that:

- the sub-landlord is legally entitled to grant the type and term of tenure needed
- the terms of the head lease are legally assessed before entering into any binding arrangement for a sub-lease
- the sub-lease is in a form suitable for the Commonwealth tenant (including avoiding incorporating head lease terms that are by their nature inapplicable to Commonwealth tenants and ensuring that legal and regulatory considerations relevant to the Commonwealth tenant are addressed by the sub-lease).

**Assignment**

Assignment of a lease occurs when a tenant (known as the assignor) transfers the whole of its interest in the premises to another person (known as the assignee). By virtue of the assignment, the original tenant's interest in the premises passes to the new tenant. The assignee takes the place of the assignor, pays rent directly to the landlord and is bound by the lease terms running with the land.

*Some considerations for assignment*

**Does the Permitted Use allow the activity to be undertaken by the proposed assignee?**

- If the Permitted Use does not support the activity to be undertaken by the proposed assignee, a commercial negotiation will be needed to secure the landlord's agreement to vary the Permitted Use. The landlord is not compelled to agree and may impose conditions on any agreement. These conditions may or may not impact on the viability of the proposed assignment.

**Does the lease contain an absolute prohibition of assignment?**

- If it does, a commercial negotiation with the landlord will need to be entered into and there is no obligation on the landlord to agree to assignment. The landlord may seek to attach commercial or other conditions to its consent and the impact of these on the overall viability of the proposal need to be addressed.

**Does the lease permit or otherwise contemplate assignment?**

- If the lease does not contain an absolute prohibition on assignment, does it require the landlord's prior consent?
- If the lease does require the landlord's consent, what are conditions around that? By way of example, is there any obligation on the landlord not to unreasonably withhold consent, is there an obligation on the tenant to pay the landlord's costs, are there any controls around the extent of those costs (for example, does the lease provide for 'reasonable' costs or a capped amount), what information does the lease require the tenant to give the landlord as a pre-request to consent?
- If the lease does not require the landlord's prior consent, does it require notification or impose other conditions?

**If the Commonwealth tenant is the assignor, does it remain liable under the head lease?**

At common law the assignor remains liable for the remainder of the term of the lease despite the assignment. In some circumstances, local legislation will affect this general principle. Landlords will usually require an indemnity from the assignor to cover breach by the assignee or other loss caused by the assignee. At times the original lease may contain favourable clauses releasing the Commonwealth tenant where there is an assignment or this may be agreed as part of the assignment process (though it is rare for a commercial landlord to make this concession if the lease does not already provide for it). Prudent steps for the assigning Commonwealth tenant include:

- undertaking due diligence to ensure it satisfied that the assignee is financially viable and is likely to act in a manner which will not result in the Commonwealth tenant being held liable
- ensuring the that form of assignment document offers the necessary level of protection to the Commonwealth assignor (including, by way of example, suitable indemnities in favour of the Commonwealth tenant and a back-to-back indemnity with any indemnity that the Commonwealth needs to give the landlord)
- requiring any guarantees or other security reasonable and appropriate in the circumstances
- ensuring it has secured the necessary approvals for any potential risks and liabilities arising from the assignment.

**If the Commonwealth tenant is the assignee what additional considerations apply?**

The Commonwealth tenant should ensure that:

- the assignor is legally entitled to grant the type and term of tenure needed
- the terms of the lease being assigned are legally assessed before entering into any binding arrangement for assignment
- any necessary risk assessment is undertaken and relevant approvals are secured, bearing in mind that an assignment of a lease from a private entity is more likely to contain terms that may not be consistent with Commonwealth requirements
- an assignment document in a form suitable for the Commonwealth tenant is agreed (including, if necessary and feasible, varying terms in the lease that are by their nature inapplicable to Commonwealth tenants and incorporating into the assigned lease legal and regulatory considerations relevant to the Commonwealth tenant).

**Surrender**

***What is a surrender of a lease?***

A surrender of lease operates to end the lease between a landlord and a tenant before the expiry date. It is a voluntary process.

***What right does a party have to surrender a lease?***

Unless a lease contains an express provision allowing 1 or both parties to end it before the end of the term, a party cannot elect to unilaterally end a lease before its expiry date. Where a party desires an early surrender, it will be necessary to engage with the other party and agree the terms of that surrender.

Some Commonwealth tenants do secure early surrender rights in their leases, but this is relatively rare. Commercial landlords are unlikely to look favourably on early surrender rights, as it creates uncertainty around their revenue stream and if such a right is required then the trade-off may be a premium rent or other conditions.

***What is the effect of a surrender?***

Once a surrender becomes effective, the tenant's obligations to pay rent and observe its obligations under the lease cease. Unless the surrender document contains a release from prior obligations, the parties are still able to sue for breaches of the lease occurring before the surrender and to recover damages.

***What are some of the common considerations when a Commonwealth tenant wishes to surrender a lease?***

Once it has been determined that the premises are surplus to need and surrender is being considered as a divestment option, the following considerations need to be taken into account.

*Timing*

Consider the timing for the surrender and ensure there is sufficient lead time to allow the exit strategy to be implemented and, if a relocation is to occur, that the new accommodation is ready by the time the surrender takes effect.

*Permitted surrender*

Assess the lease provisions and the activities required including the following:

- Are there any provisions in the lease allowing early surrender?
- If the lease allows early surrender, what conditions does the lease place around that process – for example, when can the rights be exercised, form of notice, financial conditions, exit requirements?

Care should be taken to ensure compliance with a process specified in the lease to make sure that the benefit of the relevant clauses is not compromised.

*Agreed surrender*

Where the lease does not provide for early surrender, a strategy for embarking on the negotiation process is needed. Considerations include:

- assessing the full cost of the surrender – this includes not only calculation of the direct cost but also a legal assessment of the lease to address particular obligations and risk. Some examples include the extent of removal, make-good or reinstatement obligations, ownership of fittings (including removal and resale or reuse rights), special conditions around incentives contemplating a full term and amortisation arrangements
- assessing the impact on the landlord of the request to surrender – for example, whether the market is such that there is a high demand for the premises and the landlord will have little difficulty re-letting or whether the landlord is likely to find it difficult to secure a new tenant
- factoring into framing of the initial offer a recognition of the landlord's position and considering an offer that is cognisant of the commercial impact on and likely risk for the landlord.

The negotiation process is likely to see the landlord focusing on commercial considerations and limiting its risk. Issues that are likely to arise include:

- the surrender fee – this could extend from something quite reasonable, such as an amount equivalent to rent and outgoings up to the surrender date, through to quite generous amounts determined by the landlord
- reimbursement of part of any incentive
- payment of remaining amortisation contributions for the full term
- more extensive yielding-up obligations than contemplated by the lease
- payment of legal and other expenses (including possibly an amount attributable to re-letting fees)
- payment in lieu of reinstatement.

### *Some considerations for the surrender agreement*

Some of the key matters on which a clear agreement should be reached include:

- the date of surrender
- the fees payable in consideration of surrender (including any payment in lieu of fulfilling yielding-up obligations)
- any particular obligations agreed to be performed (such as removal, make-good or reinstatement beyond that contemplated by the lease)
- the extent of release from the lease (whether it is a full mutual release with effect from the surrender date with all remedies for prior breach being extinguished or whether remedies attributable to pre-surrender breaches are preserved)
- costs.

### **Some particular Commonwealth considerations in shared or divested accommodation**

Transactions between different Commonwealth emanations raise a range of additional considerations, particularly where sharing or divesting of existing accommodation is concerned.

#### ***Is there a legal need to assign or sub-lease?***

This fact sheet has highlighted options such as sub-leasing and assignment, which in varying degrees could be used to meet the accommodation needs of Commonwealth tenants in a changing environment.

As well as considering the scope of the sub-leasing and assignment clauses in a particular lease, there is sometimes an initial threshold consideration, namely: will in fact a formal assignment or sub-lease occur?

#### ***Commonwealth-to-Commonwealth arrangements***

Where the legal entity that is a party to a lease is the Commonwealth of Australia and the incoming occupant is also the Commonwealth, a formal sub-lease or assignment is not possible because the party (being a legal entity) to the lease remains the same. Therefore, in general terms the sharing of space with, or divestment to, the incoming Commonwealth occupant can occur without taking the formal legal steps for a sub-lease or assignment.

However, this general right may be constrained by the terms of the lease. For example, if the Permitted Use is expressed to be 'office accommodation for the Department of X' and the incoming occupant is the Department of Y then there is an impediment to the incoming tenant taking over all or part of the premises, as that will result in a breach of the Permitted Use provision under the lease. There may be other clauses in the lease that may also act as barriers to another non-corporate Commonwealth entity taking up space even though it is still the same legal entity. Examples include clauses that may place limitations around the degree of public access to the premises, the type of fit-out allowed and the type and hours of use.

Despite that fact that a formal sub-lease or assignment may not be required, it is still common for non-corporate Commonwealth entities that are legally both 'the Commonwealth' but have distinct administrative arrangements to document any shared accommodation or divestment arrangements in a memorandum of understanding. The memorandum of understanding does not constitute a legal contract or pass proprietary interests, but it documents the administrative agreement and arrangements between the particular Commonwealth entities.

#### ***Commonwealth-to-Commonwealth authority, statutory body or corporation***

In the case where one of the parties to a proposed sharing or divestment activity is in fact a separate legal entity to the Commonwealth (for example, a statutory authority created under legislation or a

corporate Commonwealth entity) then it is necessary to proceed with the legal formalities in order to validly grant the relevant party the necessary tenure rights. In this case, typically a sub-lease or assignment would be pursued.

Regard should be had to the dealings with lease provisions, as typically many Commonwealth leases will expressly contemplate sub-leasing or assignment to other Commonwealth entities. The more favourable leases will contain broad assignment and sub-leasing rights without the landlord's consent to other Commonwealth authorities or statutory bodies, and at times also to corporations. However, there will also be leases that have very limited rights and consent may still be needed. Ultimately the extent of the rights will need to be ascertained by reference to the provisions addressing dealings with the lease, the permitted use and any other particular lease provisions impacting on use.

### Other considerations

The discussion in this fact sheet is general in nature and should not be relied on as an exhaustive guide. The law underpinning this subject matter is complex, different types of tenancies can attract the operation of different laws and local laws and practice can impact on some of the issues discussed. Licences also attract different considerations. It is important that legal advice be obtained as early as possible in the planning process to ensure that relevant considerations are taken into account and that good planning and project management measures can be put in place to optimise a successful outcome.

### More information please contact

For further information about leasing opportunities in a changing environment, please contact one of AGS's specialist legal advisers:

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