

Commercial notes

Number 21 | 14 December 2006

Procurement of construction services

Finance Circular No. 2005/12 – Construction Services, released by the Department of Finance and Administration (Finance), provides further guidance on the definition of a procurement of construction services.

The Finance Circular confirms that a procurement of construction services is a 'covered procurement' and subject to the mandatory procurement procedures (MPPs) when the value of the procurement exceeds the \$6m financial threshold and the procurement is not otherwise exempt from the operation of the MPPs.

Application of the MPPs to construction contracts

AGS Commercial Notes No. 16 (10 June 2005) discussed the application of the MPPs (Division 2 of the Commonwealth Procurement Guidelines (CPGs)) to construction contracts (see article 'The Implications of the Commonwealth Procurement Guidelines for Real Property and Infrastructure Related Activities').

That article noted that the MPPs would apply to construction contracts if their value exceeded the relevant financial threshold in the CPGs. The application of the MPPs could extend to some precommitment leasing and private financing transactions and related agreements such as management and consultancy contracts. However, real property leases and the sale and purchase of real property would not be covered by the MPPs although they would still be subject to other aspects of the CPGs (i.e. Divisions 1 and 3 of the CPGs).

Definition of procurement of construction services

Appendix E of the CPGs defines procurement of construction services as procurement 'related to the construction of buildings and all procurements covered by the *Public Works Committee Act 1969* (PWC Act)'.

Finance Circular No. 2005/12 provides that, for the purposes of that definition, 'building' is used according to its normal dictionary definition. In relation to the second part of the definition, 'construction services' includes all activities meeting the definition of 'work' as stated in the PWC Act.

For ease of reference, the Finance Circular sets out the definition of 'work' from the PWC Act. This definition makes clear that construction services will include, for example, the alteration, repair, refurbishment or fitting out of buildings and other structures, and the installation, alteration or repair of plant and equipment designed to be used in relation to the buildings and other structures.

The Finance Circular notes that 'work' also includes a temporary building or structure and a demountable building or structure. Accordingly, these are also included as part of the definition of construction services for the CPGs.



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Valuing a construction procurement

In relation to valuing a construction procurement, the Finance Circular confirms that a procurement must not be divided into separate parts for the purpose of avoiding the procurement threshold. This means that, in considering the application of the MPPs, a construction project conducted through a single procurement process cannot be divided into its various component parts, but rather all the contracts that might be let in the course of the procurement process must be taken together for the purposes of valuing the total procurement.

If the project is to be conducted through several separate procurement processes (for reasons other than avoiding the application of the MPPs), the threshold could be applied to each of those processes separately.

For example, the construction of a building in a single design and construct process may involve the letting of contracts for project management, architecture, construction, fitout, cost planning etc. The value of all these procurements must be considered together for the purposes of valuing the procurement. If when taken together these exceed the \$6m threshold, then the letting of each of those contracts individually must comply with the MPPs.

However, while an initial procurement of construction services may include provision for maintenance services for a period after completion of the building, the procurement of further maintenance services after that period becomes subject to the CPG requirements for the procurement of general property and services (i.e. the \$80,000 threshold applies rather than the construction threshold).

A procurement must not be divided into separate parts for the purpose of avoiding the procurement threshold.

Precommitment leasing or PFI arrangements

Appendix B to the CPGs provides that the MPPs do not apply to the leasing or purchase of real property or accommodation. The Finance Circular notes that the exemption for leasing accommodation applies only to leases for accommodation from 'the commercial property market'.

The exemption does not apply where leasing is being applied as a method of financing a construction services project as may be the case in some precommitment leasing or PFI (private financing initiative) arrangements. In such a case, these procurements would be considered to be procurements of construction services for the CPGs.

AGS *Commercial Notes* No. 16 discusses precommitment leases and PFI projects in more detail.

While the Finance Circular does not provide any guidance on which types of precommitment leasing or PFI arrangements will be caught by the MPPs, or perhaps more importantly on which precommitment leases will not be caught by the MPPs, it would seem that where a developer designs and constructs a building to an agency's particular requirements and the conditions of lease are agreed at the conception of the project with the agency, the project may be considered to be a procurement of a construction service rather than the leasing of accommodation for the purposes of the CPGs.

Many agencies will conduct a tender process for accommodation that may result in a precommitment leasing arrangement. In that case, where the agency is prepared to consider a number of possible locations, it will usually not be difficult for the acquisition strategy to comply with the MPPs.

However, if agencies require that premises be built on a particular parcel of land (not owned by the agency), the procurement strategy will require careful consideration very early in the planning for the acquisition strategy. There are a number of potential approaches that may be available depending on the circumstances:

- Where the agency is merely taking the lease of an existing property this would be exempted from the MPPs. This exemption would probably apply even if some refurbishment or fitting out were to be done by the lessor.
- The agency may be able to rely on the direct sourcing exemption under clause 8.65.d of the MPPs to enter into design, construct and lease arrangements with the owner on the grounds that the property can only be obtained from a particular business and there is no reasonable alternative due to technical reasons (e.g. the importance of that particular location).
- Where a competitive process is required by the MPPs or considered necessary by the agency, notwithstanding that the MPPs may allow direct sourcing, there are a number of options including:
 - negotiating an option to purchase the land with the right to assign that option to a third party. (This approach permits the agency to run a competitive process for design, construct and lease by including in the conditions of tender a provision that the agency will assign the option to purchase to the successful tenderer.)
 - purchasing the site and providing in the conditions of tender for the transfer of ownership to the successful tenderer, who then designs, constructs and leases to the agency.

The procurement strategy will require careful consideration very early in the planning for the acquisition strategy.

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Market rent review provisions

Today almost all commercial leases contain provisions under which the rent payable by the tenant is to be reviewed at certain points during the term of the lease. There are rent review provisions which provide for fixed increases: for example, a percentage or CPI increase. These are generally self-executing provisions, which means they operate without the parties having to activate them.

On the other hand, there are those provisions which the parties must activate before they operate and which contain machinery for a rent review. An example of a provision of this type is a current market rent review clause.

This note examines the operation of a current market rent review clause and how a clause of this type, if properly drafted, will ensure an objective market rent review. This note also considers some of the legal, valuation and drafting issues involved in the determination of a current market rent; in particular:

- who may initiate the process of review
- timing provisions in rent review clauses
- some of the relevant criteria that a valuer must take into account in making a determination
- the meaning of the expression 'speaking valuation', and what opportunities exist to challenge a determination
- some process issues for property managers.

Initiating the process of review

It is important to provide in a market review clause that either the landlord or tenant may initiate the review process.

Landlords will generally resist giving tenants the right to initiate the review process. Landlords will be looking to protect themselves and their lenders so that in the case of a falling market they may choose not to review the rent.

It is very important that the tenant obtain the right to initiate the review process. This right of the tenant becomes most important in circumstances where the landlord does not want a review to be carried out: for example, in a falling market.

The question whether the rent review process at any rent review date may only be triggered by either the landlord or the tenant, or can be triggered by both parties, can only be answered by construing the relevant provisions of the lease. This question has been subject to much litigation in cases generally where the tenant has not had a clear right to activate a review in a falling market. The following cases help to illustrate the point.

Landlord bound to instigate review

A rent review clause provided that the rent 'shall' be reviewed every 18 months. However, it also said that the 'lessor may at any time' issue the notice which would instigate the rent review. It was held that the landlord was bound to instigate a rent review every 18 months. The **landlord had a discretion as to when to issue their notice, but not whether to issue it.** (*Myers & Ors v Pioneer Concrete (Vic) Pty Ltd* [1997] ANZ ConvR 331; Federal Court of Australia, 6 December 1996)



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No right to initiate review

A landlord demanded \$211,000 rent for the beginning of the option term. The tenant was paying only \$132,000 at the time and had a valuation which said that the market rent was \$95,000. The tenant served a notice, allegedly under the lease, which required that the rent be fixed by a valuer. However, the Court held that the tenant had no right to serve the notice.

On a proper construction of the lease, the tenant had no independent entitlement to a rent review. The tenant could not serve a notice requiring a valuation unless the landlord had first given a notice setting out its assessment of the market rent. The landlord had not given such a notice and was not obliged to do so under the lease. (*Highpoint Homemaker Centre (Vic) Pty Ltd v Sanstar Pty Ltd*, Supreme Court of Victoria, 20 June 1997)

Reviews discretionary despite letter

A letter recording an agreement to lease said that rent reviews 'will' occur at certain times during the term of the lease. However, the lease gave the landlord the sole discretion whether to initiate reviews on the relevant dates. The lease provided that the letter was to prevail over the lease if there was any inconsistency between the two.

The tenant argued that the reviews were mandatory, but the argument was rejected. There was no inconsistency between the letter and the lease. The letter simply defined specific dates for reviews, and did not make the reviews mandatory on those dates. (*Commonwealth of Australia v GIO Compulsory Third Party Insurance Ltd*, Supreme Court of Western Australia, 22 July 1997)

Review not instigated – rent stays the same

A lease provided for three-yearly rent reviews. Under the lease, the landlord would activate a review by serving the tenant with a notice setting out the landlord's opinion of the current market rent. The figure contained in the landlord's notice would become the new rent if the tenant did not dispute it. If the tenant did dispute the notice, the new rent would be determined by a valuer.

The lease contained a ratchet clause, which said that 'the rent payable by the Lessee following the review date shall not ... be less than the rent payable at the commencement of the Lease'. At the first review date, the rent was increased from the initial \$300,342.60 to \$639,618.50.

At the second review date there was no review. The landlord also did not activate the review procedure at the third review date and the tenant commenced proceedings to argue that in a falling market the rent should be reduced to the initial rent of \$300,342.60.

The tenant's argument was rejected. It was held that the lease only provided for a rent review at the landlord's discretion. This meant it was possible for there to be no review on a particular review date. The court said that if the rent was not reviewed, clear words were required if the rent was nevertheless to be varied. It found no such clear words in the lease in question. It held that, without a fresh review instigated by the landlord, the rent remained at \$639,618.50. (*New Zealand Post Ltd v ASB Bank Ltd*, [1998] ANZ ConvR 393, Court of Appeal of New Zealand, 15 May 1996)

Accordingly, it follows that to avoid the need to argue the point in litigation (generally without success) and to protect the tenant in a falling market, it is recommended that the rent review clause allows either party to trigger the review process and that the lease does not contain a ratchet clause which prevents the rent being decreased on review.

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Time limits

Under most market rent review clauses the landlord is required to take steps within a prescribed time to activate the rent review process.

Where a landlord fails to initiate the process within the prescribed time, it becomes open for the tenant to claim that by reason of such failure, the landlord has lost the right to review the rent.

The courts have now provided a clear statement of the law on this point. The position now is that a landlord who has failed to observe the time limits specified in the rent review clause will lose their right to raise the rent only if such time limits are of the essence of the contract and that, in the absence of any indication in the lease to the contrary, the presumption is that the time limits prescribed by such a clause are not of the essence of the contract: *United Scientific Holdings Ltd v Burnley Borough Council* [1978] AC 904.

In *United Scientific Holdings*, the House of Lords allowed a review by the landlord out of time. Lord Diplock observed:

It is not disputed that the parties to a lease may provide expressly that time is or time is not of the essence of the contract in respect of all or any of the steps required to be taken by the landlord to obtain the determination of an increased rent, and that if they do so the court will give effect to their expressed intention.

...

... the best way of eliminating all uncertainty in future rent review clauses is to state expressly whether or not stipulations as to the time by which any step provided for by the clause is to be taken shall be treated as being of the essence.

The importance of making time provisions of the essence is well illustrated by other judicial decisions where time was not made of the essence, and the court held the landlord was entitled to a review of the rent out of time, and in some cases, even though the fixed term of the lease had expired.

A well drafted lease will make time of the essence, so a landlord in a rising market will lose their right to activate the review process three months after the review date.

Criteria to be taken into account on review

It is strongly recommended that rent review clauses should contain valuation criteria for the review, including assumptions which should be made by the valuer, matters which must be taken into account, and matters which should be disregarded.

As valuers have a very wide discretion in applying valuation principles it is important, to ensure an objective review process, that they are made to take into account certain criteria. This can be achieved by giving certain directions and by specifying such criteria in the rent review clause and requiring the valuer to follow those directions and apply that criteria in determining the rent.

Current market rent

The valuer should first be directed as to the type of rent to be determined, and so the lease must refer to the type of rent to be determined, for example, current market rent.

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The term 'current market rent' has been expressed in various ways, such as 'open market rental value', 'current annual market rent' and 'current annual open market rent'. These terms are effectively identical in their meaning. The preferred term is current market rent, which is well established in valuation practice and poses no legal or valuation difficulties or ambiguity: *Burns Philp Hardware Ltd v Howard Chia Pty Ltd* (1987) 8 NSWLR 642.

The expressions 'reasonable rent', 'fair rent' or 'fair market rent' are generally considered to be different from 'current market rent' and take into account what is reasonable between the actual parties to the lease. That introduces subjective considerations into the rent review process: *Wickham Properties Pty Ltd v Astor Motel Pty Ltd* (1991) ANZ ConvR 440; *Ricciardello v Caltex Oil (Australia) Pty Ltd* (1991) ANZ ConvR 445. This is considered undesirable and presents difficulties for valuers.

Another expression, 'best rent', requires a rent at the top of the rent range and on the basis of the highest and best use of the premises, which may not be its actual use by the tenant. This distorts the valuation task unfairly against the tenant, which is unjustified and should be resisted by the tenant when the lease is being finalised.

A well drafted lease will adopt the expression 'open market rental value' which has been held to be the equivalent of 'current market rent'.

The distinction between 'market rent' and 'open market rent' was the subject of consideration by Harman J in *Sterling Land Office Developments Ltd v Lloyds Bank plc* [1984] 2 EGLR 135 at 137:

I do not believe there is any difference between an 'open market rent' and a 'market rent'. I am convinced that the words 'market rent' are not by themselves apt to refer to a rent within a closed or circumscribed market to which only certain bidders are admitted.

Accordingly it is important to correctly describe the type of rent to be determined. From a tenant's point of view this will ideally be the 'current market rent' or 'open market rental value'.

Assumption of vacant possession

The expression 'vacant possession' was the subject of consideration by Donaldson J in *FR Evans (Leeds) Ltd v English Electric Ltd* (1977) 36 P&CR 185. The valuer was instructed by the rent review clause in that case to ascertain the rent at which the premises were 'worth to be let with vacant possession on the open market ... disregarding ... any effect on rent of the fact that the lessee or its tenant has been in occupation of the demised premises'. His Honour said at 189:

It is implicit in this instruction, and is expressed in [the rent review clause] that the tenants are to be deemed to have moved out or never to have occupied the premises.

This assumption ensures valuers do not determine (as they may otherwise be inclined to do) that tenants would pay more than market rent for premises they occupies which they may otherwise do to avoid the cost of relocating.

Accordingly, the rent review clause should direct the valuer that vacant possession must be assumed in assessing market rental value and a clear expression of that requirement should be set out in the rent review clause.

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Lease incentives

During periods of economic downturn when commercial premises are more difficult to lease, landlords frequently grant lease incentives to tenants, and sometimes very substantial incentives usually in the form of a rent-free period or a contribution to the cost of the tenant's fitout.

In many commercial leases it is provided that lease incentives, in respect of the particular lease and other premises, should be disregarded. This should be strongly resisted by the tenant as it will result in a review of 'face rent' (rent shown in a lease which is artificially higher than market because of incentives provided and allowed for in the rent shown in the lease) and a comparison of other 'face rents', again ignoring that they are inflated because of the incentives provided under the other leases used as comparisons.

A well drafted lease will require incentives to be taken into account by the valuer which will result in an objective review of 'effective rents' rather than 'face rentals'.

Willing landlord and willing tenant

The assumption of a willing seller and a willing buyer is central to valuation principles for the valuation of the freehold. There should be an assumption of a willing landlord and a willing tenant for the purpose of the rent review. The assumption involves a landlord who is not forced to lease the premises, but could not afford to wait until the rental market improved, and a tenant who is actively seeking premises such as those under the lease but is not under pressure to lease those premises: *FR Evans (Leeds) Ltd v English Electric Co Ltd* (1977) 245 EG 657.

The nature of this assumption was discussed in *Alcal Australia Ltd v Scarcella & Ors* [2001] NSWCA 401. The principle issue was whether the valuer should or can have regard to the market when determining a market rent, even where there was no potential market for the hypothetical lease, or there was no other likely bidder to lease the premises. Stein JA said that the 'valuer must envisage a hypothetical willing lessor and willing lessee and determine the rental at which they would reach agreement'. His Honour held that the trial judge was correct in making his orders and declarations, and that to make the assumption that a market for the hypothetical lease did not exist, as the tenant contended, would be inappropriate and have the capacity to lead to a subjective determination.

The most important factor is that the valuer addresses the matters required by the lease. If that is not done then the valuation is liable to be set aside by the courts on the ground that it does not comply with the lease.

Challenging the determination

Although there have been many attempts to challenge the validity of rent review determinations in the courts, few have succeeded.

It is generally only 'speaking valuations' that may be open to challenge, and although a challenge may not be made for mistake, it may be made where the valuer does not follow the process required under the lease (that is, the valuer has regard to some matters and disregards other matters in a way that is inconsistent with the direction given in the lease).

A well drafted lease will require the valuer to produce a 'speaking valuation', and accordingly that valuation should be examined to see that it follows the process the lease requires. If the valuation does not do this it may be open to challenge.

With a 'speaking valuation' the method of arriving at a valuation and reasons should be stated. Detailed reasons and conclusions are not essential. It is not necessary that the reasons given be as detailed or as comprehensive as

judgments of courts or awards by arbitrators. The test is whether they are sufficient for the parties to understand that the terms of the engagement have been satisfied and how the valuation was arrived at.

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Process

The procedure to implement a rent review involves correspondence (and communications), including:

- the rent review notice
- correspondence between the parties
- correspondence relating to the appointment of the valuer.

In general terms care should be taken to ensure that the rent review notice and other correspondence is:

- in the correct form
- addressed to the correct person or persons
- served on such person or persons in accordance with the terms of the lease.

Judicial decisions indicate that the parties need to exercise certain precautions. First, if each party appoints a valuer who acts independently, the appointment should be advised to the other party before that valuer commences to act or completes the task: *Gollin & Co Ltd v Karenlee Nominees Pty Ltd* (1983) 57 ALJR 711.

Secondly, some care needs to be taken in communications between the parties (or their representatives) and the valuer. Representations can only be made to the valuer, if the rent review clause authorises it. This allows written submissions to be made, and also rent valuations submitted (by valuers employed by each party).

If each party appoints a valuer who acts independently, the appointment should be advised to the other party before that valuer commences to act or completes the task.

Conclusion

It is important for agencies to be aware of the process of a market rent review, who may initiate the review, and the importance of timing provisions, proper directions and criteria to be included in the rent review clause to ensure the valuer is required to make, from the tenant's point of view, a fair and objective determination.

There are limited grounds for challenging a determination and few challenges have been successful. Therefore it is suggested that particular care be taken in agreeing to the provisions in the first place.

From an agency's point of view it is essential to get the market rent review provisions right, at the time the lease is negotiated.

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Current leasing issues for Commonwealth property managers

This note examines three current leasing issues for agency property managers:

- providing for and managing building outgoings in the context of a net rent lease
- warranties of fitness given by the landlord, and remedies for breach
- options for the tenant in dealing with make-good obligations at the end of a lease.

Providing for and managing building outgoings in the context of a net rent lease

A net rent lease differs from a gross rent lease in that, in addition to the rent, the tenant pays the whole or a proportion of:

- statutory or building outgoings (or both), or
- increases in statutory or building outgoings (or both) over a base period.

The challenge for the parties is to comprehensively define outgoings in the lease. Although this task is difficult, if it is approached by specifying both the outgoings included and those excluded, a better outcome is likely to be achieved. Effective management of the tenant's outgoings obligations assumes a comprehensive outgoings definition in the lease.

Statutory outgoings

The following issues are relevant in defining statutory outgoings:

- Municipal rates which are recurrent impositions and usually form part of statutory outgoings should be confined to the land on which the leased premises are located.
- If taxes are included, they should be specified, confined to those which relate only to the leased premises, and defined to exclude future taxes and taxes which require a one-off capital payment.
- Outgoings should be calculated on the discounted amount for early payment, exclude fines and penalties for late payment, and be assessed as if the land is the only land owned by the landlord.

Building outgoings

In defining building outgoings, the following issues should be considered:

- determination of items to be included or excluded
- whether the outgoings are relevant to, and of benefit to, the leased premises
- whether any outgoings should be subject to a limit in each accounting period (for example, it might be possible to cap management fees and repairs and maintenance).

Expenditure of a capital nature, contributions to a sinking fund, the cost of replacement, refurbishment or redecoration not reasonably attributable to fair wear and tear, the cost of effecting works of a structural nature, costs recoverable under a policy of insurance, interest charges, fines and penalties, charges on amounts owed by the landlord and amortisation of capital costs should be excluded.



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Effective management of the tenant's outgoings obligations assumes a comprehensive outgoings definition in the lease.

Structuring the tenant's liability for outgoings

In negotiating how best to structure the tenant's liability for outgoings, the tenant may be required to accept the landlord's approach to outgoings in other leases within the building.

The tenant's liability may be structured so that they pay the whole or a proportion of outgoings or increases in outgoings over a base period. Matters which are relevant in structuring the liability of the tenant include:

- When the tenant pays a proportion of outgoings or a proportion of increases in outgoings over a base period, that proportion should equate to the proportion that the net lettable area of the leased premises bears to the net lettable area of the building.
- When the net lettable area of the building changes, the landlord should provide a surveyor's certificate which identifies the new net lettable area of the building and the date of effect of that change.
- When the tenant's liability is based on increases in building outgoings over a base period:
 - the lease should assume that for the whole of the base period the building was completed, fully occupied and operational, the landlord received no benefit from guarantees or warranties and that all contracts for servicing and maintenance were in place and operational
 - the base period and the frequency of updating that base period during the term of the lease need to be established or alternatively, the parties could agree that, to simplify the process, outgoings will be deemed to increase by a fixed percentage at the commencement of each accounting period under the lease.

Determining how tenants might discharge their liability

When determining how tenants might discharge their liability for outgoings, and how that liability might be confined, property managers should be alert to the following:

- Consider if the tenant could pay annual or monthly instalments in advance based on the landlord's estimate, with an adjustment at the end of the outgoings period having regard to an audited statement, or in arrears based on an audited statement of outgoings for the accounting period.
- Do not deem statements provided by the landlord in relation to outgoings as conclusive. The tenant should have a right to dispute amounts and to require the landlord to provide relevant assessments, invoices and receipts for payment to permit the tenant to determine whether expenses have been properly incurred.

In the event of the parties being unable to agree, the dispute could be settled in accordance with the dispute resolution provisions of the lease or a dispute resolution provision which applies only to outgoings.

- Base all calculations on the assumption that the only land owned by the landlord is the land on which the leased premises are located
- Consider whether it is preferable to update the base accounting period or provide for outgoings for the base accounting period to increase by a fixed percentage in each subsequent accounting period.
- Ensure that outgoings exclude amounts payable by other tenants or occupiers of the land or building.

The statements provided by the landlord in relation to outgoings should not be deemed to be conclusive.

A net rent lease provides little incentive for the landlord to rein in outgoings and therefore potential for dispute is always present.

- Consider whether outgoings should exclude amounts payable by the landlord to perform certain obligations under the lease. (For example, if the landlord incurs expenditure of a capital nature because of the need to replace one of the building services, that expenditure should be excluded from the outgoings.)
- Ensure that if their outgoings liability is overpaid, the tenant has a right to set off that overpayment against future outgoings liabilities or rent.
- Include only those outgoings which benefit the tenant's premises. For example, if the tenant occupies ground floor premises, it is reasonable that outgoings exclude the cost of servicing and maintaining the lifts.

Assuming liability under a net rent lease

The following issues need to be considered by a tenant in assuming liability under a net rent lease:

- Landlords generally prefer net rent leases, however, that preference sometimes assumes that outgoings are defined by example rather than by a comprehensive schedule of inclusions and exclusions.
- Each party may incur significant management and administrative costs over the term of the lease in resolving whether expenditure is an outgoing or whether that expenditure has been incurred, was necessary, and is reasonable in quantum.
- The tenant risks paying for costs included in the rent payable by third parties or for the landlord's capital improvements in the event that outgoings are not properly defined.
- A net rent lease provides little incentive for the landlord to rein in outgoings and therefore potential for dispute is always present.

The lease should provide the tenant with practical remedies if the landlord breaches a warranty of fitness or a related covenant.

Warranties of fitness given by the landlord and remedies for breach

The law implies no warranty that premises to be leased are fit for the purpose for which they are let. It follows that in the absence of an express warranty by the landlord, the tenant has no remedy if the premises are not physically or legally fit for the use permitted by the lease.

It is common for the lease to provide that the landlord does not warrant the suitability of the premises for any purpose.

If the tenant wishes to secure warranties in relation to fitness and in particular, the standard and performance of the building services, those warranties must be expressed in the lease.

A prudent tenant will seek to secure warranties by the landlord that at all times during the term of the lease, the leased premises:

- are fit for use and occupation for the use permitted by the lease
- comply with standards specified in the lease or alternatively, all relevant Australian Standards and industry standards at the commencement of the lease term
- comply with all laws
- do not contain hazardous substances.

To give effect to the landlord's warranties the tenant should consider whether the lease might provide for the landlord to comply with related obligations to:

- keep and maintain the building services and structure in good repair and condition and, subject to the tenant's obligations, keep and maintain all other parts of the leased premises and the building in good repair and condition
- effect service contracts for the maintenance and repair of specified building services and provide evidence of those contracts when required by the tenant
- provide certificates, including certificates by the maintenance contractors, that the performance of certain building services complies with the standards required by the lease and that those building services have been maintained in accordance with the service contracts the landlord must effect in accordance with the lease
- ensure that the landlord is responsible for structural faults and defects and the removal of hazardous substances
- comply with all laws.

Remedies for breach of warranty of fitness

The lease should provide the tenant with practical remedies if the landlord breaches a warranty of fitness or a related covenant. In addition to specific performance and termination, remedies could include:

- abatement of rent, or a rent holiday, if the landlord fails to rectify a breach within a specified time following notice from the tenant of that breach
- a right to rectify the failure at the landlord's cost if the breach is not rectified within a specified period and to set off that cost against rent
- a right to liquidated damages which may be set off against rent.

Ideally, the lease should provide the tenant with remedies which do not require the tenant to seek the intervention of the courts or to terminate the lease, as those remedies are generally costly, delay rectification, and provide no guarantee of success.

For these reasons, it is important for tenants to have rights to abate rent and to rectify a breach of warranty or a related covenant at the landlord's cost. To avoid the need for the tenant to recover its costs through the courts, the lease should permit the tenant a right to set off those costs against rent.

Options for the tenant in dealing with make-good obligations at the end of the lease

An obligation on the tenant to remove its fittings, make good and restore the leased premises on or before the expiry or termination of the lease or any holding over is, like rent and outgoings, a valid consideration in determining value for money. Due to the make-good obligation being deferred, the cost to the tenant is difficult to assess and therefore the tenant should consider the alternatives. Initially, the tenant could seek to avoid a make-good obligation and insist on an arrangement as follows:

- the tenant has a right, but not an obligation, to remove its fittings during or after the term
- the tenant rectifies damage caused by that removal
- ownership of fittings not removed vests in the landlord.

It may be preferable to vest ownership of the tenant's fittings in the landlord in order to reduce the tenant's make-good obligation.

Where the tenant is unable to avoid a make-good obligation

If the tenant is unable to avoid a make-good obligation, matters to be considered in settling that obligation include the following:

- Whether the removal and make-good should be confined to the term of the lease and any holding over, or extend to a period after that time, and if so, at what cost. For example, does the tenant remain liable for rent if the removal and make-good take place after the expiration of the term?
- When determining the extent of the make-good, the level of make-good should be no higher than the standard existing at the commencement date of the term, after making due allowance for fair wear and tear during the term.

As it will be difficult for the parties to achieve consensus in relation to the level of make-good (having regard to fair wear and tear during the term), it may be preferable to agree that the tenant's obligation will be satisfied if the tenant makes a payment to the landlord of a specified sum, or a sum which is agreed, and failing agreement, determined in accordance with the dispute resolution provisions of the lease.

The lease may need to provide some guidance on those matters which will be taken into account in determining the amount to be agreed.

- It may be preferable to vest ownership of the tenant's fittings in the landlord in order to reduce the tenant's make-good obligation. The tenant's fittings may have value only while in place, and if the cost of removing those fittings is likely to exceed that value, the tenant might decide that ownership of those fittings should vest in the landlord on installation.

The landlord may accept ownership if it is entitled to depreciation benefits or if those fittings add value to the building. In those circumstances, the tenant will not be responsible for fair wear and tear or the risk of damage to, or replacement of, those fittings.

However, if the lease provides for rent to be reviewed to market, the tenant should attempt to exclude the value of those fittings in determining that market rent.

It may be helpful to include in the lease a condition report of the premises at the commencement date of the term.

Robert Claybourn practises in the areas of property, leasing, construction and procurement law. He specialises in project delivery advice and documentation.

Tips for clients

Tenants should consider the following matters in determining their make-good position:

- Physical make-good will be difficult to satisfy and provides potential for dispute. Accordingly, it may be preferable to provide for make-good to be satisfied by a payment taking into account the standard of the premises at the commencement date, and the impact of fair wear and tear over the term.
- It may be helpful to include in the lease a condition report of the premises at the commencement date of the term if that condition is relevant to the make-good obligation.
- If the tenant is unable to avoid a make-good obligation, it might be possible to negotiate that the make-good obligation does not apply if the tenant exercises the option to renew the lease.
- If ownership of the tenant's fitout vests in the landlord on installation, consideration could be given to a payment by the landlord to the tenant if for any reason the lease does not run its full term.
- Care should be taken to address liability for rent or for use and occupation if the tenant is permitted to satisfy its make-good obligation within a specified time following the expiration or earlier termination of the lease.

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ISSN 1433-9549
Approved Postage PP 255003/05310