

FRI leases: an overview

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The purpose of this article is to provide a simple overview of the main terms and conditions of a standard full repairing and insuring lease (FRI lease) of a retail unit from a tenant's perspective.

Many professionals and business people occupy the premises from which they trade under a long term FRI lease. These leases are typically for a term of 20 to 25 years and contain a host of covenants and obligations often running to 60 pages or more.

Once the main terms such as rent, length of lease and fit-out have been negotiated with the landlord or the letting agent, the landlord will instruct his solicitor to draft the lease. The tenant's solicitor will investigate the title to the premises and the planning position much in the same way as if the tenant was purchasing the premises; after all the tenant is essentially purchasing a 20 to 25 year interest in the premises which can later be sold on. The tenant's solicitor will then go through the draft lease and make any necessary amendments in order to protect the rights of the tenant. Generally this process of drafting and re-drafting will continue until both sides have agreed the main terms.

The contents of the lease will vary depending on whether the premises are a stand-alone unit or a unit in part of a larger building with shared services. Leases of units in shopping centres for example, tend to include a number of quite specific provisions such as minimum trading hours, non-permittable uses and regulations concerning window display and so on.

The lease itself

One of the most important things to check is that the premises set out in the lease ("the demised premises") corresponds exactly with the physical premises the tenant proposes to trade from. For example, if there is a storage area behind the shop, is this area included in the lease or does the tenant simply have a licence to store products there?

In the lease of a unit which is part of a larger building such as a shopping centre, a detailed description of the demised premises should be set out in a schedule to the lease and will normally include only the internal surfaces of the walls, ceiling and floor but not any structural part of the building. This is important as all of the tenant's covenants in the lease, including the covenant to repair, relate specifically to the demised premises as defined.

Where the building is still in the course of construction, or the tenant proposes substantial fit out works, an agreement for lease will usually be entered into. An agreement for lease is essentially a contract where the parties agree to execute a lease in an agreed form, on the completion of the works.

The term

FRI leases are generally for a term of 20 years but may be longer or shorter depending on the circumstances. It is sometimes possible for a tenant to negotiate a break clause where he can terminate the lease early in a specified year. Generally in order to exercise a break option a tenant will be required to pay a financial penalty to

the landlord and will have to give up to six months advance notice. Legally a business tenant has a statutory right to a new lease after five years continuous occupation.

Rent reviews

The amount of rent payable by the tenant will obviously be set out in the lease and this amount is generally payable quarterly in advance. Standard FRI leases provide for rent reviews every five years which are "upwards only". In other words the rent on review can never fall below the rent payable during the immediately preceding five year period. If the parties are unable to agree on a revised rent at rent review then the matter is usually referred to an independent surveyor who will either act as an "expert" or as an "arbitrator", depending on the specific lease terms. The current Law Society standard rent review clause provides an expert or arbitrator to be appointed by the president of the IAVI, Law Society or the Society of Chartered Surveyors at the discretion of the applicant. Rent review clauses are quite technical and can have long term financial implications for the tenant. For this reason, it is important to ensure that both legal and valuation advice is taken in relation to their specific contents.

The basis of rent review is to ascertain the market rent which the landlord might reasonably expect to achieve for the premises on the open market at the date of rent review. Certain matters are disregarded on rent review such as the goodwill which is attached to the premises by reason of the tenant's business and any works carried out to the premises by or at the expense of the tenant (other

than those works required by the lease). It is important that the tenant ensures that the rent review clause reflects the terms of the lease and does not introduce artificial assumptions and disregards designed to increase the rent payable (for example, disregarding a restrictive use or a restrictive assignment clause in the lease).

Use of the property

The lease will only permit certain specified uses and the tenant should ensure that the permitted use is wide enough to cover its entire business. For example, if the permitted use is described as "pharmacy" this might be amended to read "pharmacy including the sale of cosmetics and use for film processing". Also certain uses may require additional planning permission. For example, if the tenant proposes to use the premises as a convenience store with an ancillary off licence use, this will not be covered by simple "retail shop" planning. A separate application will need to be made for off licence use and this should be set out in the agreement for lease and the heads of terms.

Some leases, especially in shopping centres, have a very restricted user clause and although the permitted use may be sufficient for the tenant, the restrictions may make it more difficult for the tenant to assign or sub-let the lease to a third party in the future.

A landlord is not entitled to unreasonably withhold its consent to a change of use. However, the onus of proving what is unreasonable falls on the tenant and it is often difficult to show that the landlord is unreasonably withholding its consent to a change of use where the refusal is based on "good estate management." This is especially true in shopping centre leases where a broad mix of uses is essential to the success of the centre.

Responsibility for repairs

One of the most onerous of the tenant's covenants is the covenant to repair. The word "repair" goes much further than mere maintenance. An obligation to repair usually gives rise to an implied obligation to put the property into a good state of repair, if it is in a poor state of repair at the start of the lease. For this reason, it is important for a tenant to carry out a detailed survey in advance of signing the lease.

The extent of the tenant's repair obligation will generally depend on whether it is taking a lease of the entire building or just part of the building:

A tenant occupying an entire building is usually responsible for all of the repairs, maintenance and decoration of the building including the repair of the main structural elements such as the roof, walls

and foundation. Where the building is new (or has been constructed in the past twelve years) the tenant should insist on a structural defects indemnity from the main contractor and collateral warranties from members of the design team.

A tenant occupying part of a larger building on the other hand will only be responsible for the internal parts of the property (including equipment and internal fittings) but not any structural parts of the building or anything outside the property. In this latter case, the landlord will be responsible for the repair and maintenance of the main structure and common parts of the building. The individual tenants within the building will then contribute an appropriate proportion of those total costs via the service charge provisions in their leases (see *service charges*).

What is alienation?

Alienation is the legal term given for an assignment (transfer) or sub-letting by the tenant of the lease to a third party. The standard FRI lease contains a covenant preventing the tenant from assigning or sub-letting without the consent of the landlord, which consent cannot be unreasonably withheld. Again what is "unreasonable" depends on the circumstances. For example, it would be reasonable for a landlord to withhold its consent where the incoming tenant is not of adequate financial standing to pay the rent and comply with the covenants in the lease. There will normally be a total prohibition on assigning or sub-letting only part of the property. In a lease, sub-lease or assignment to a limited liability company, the landlord will generally require a personal guarantee from one or more of the company's directors.

Alterations

Most leases distinguish between structural and non-structural alterations and exterior and interior alterations. Generally, tenants are not permitted to make alterations or major works, which would result in the demised premises losing "its original identity". Internal, non-structural alterations, alterations to any shop fascia and alterations to signage are usually permitted subject to landlord's consent, which consent should not be unreasonably withheld. The extent of the alterations permitted will usually depend on the nature of the demised premises.

Even if the landlord does consent to the proposed alterations, the tenant may also require other consents such as planning permission and/or a fire safety certificate. The lease will contain a separate covenant that the tenant must comply with all planning laws, building regulations and other statutory requirements.

The landlord may also have to approve the plans before the tenant applies for planning permission. If the demised premises are part of a protected structure it may be difficult to get planning permission for any external alterations or signage.

Service charges

Where the tenant is taking a lease of a unit within a larger building then the tenant will be contributing towards the repair, maintenance, insurance and cleaning of the common areas through a service charge levied by the landlord or management company. Service charges are usually payable quarterly in advance based on estimates previously provided by the landlord's managing agents.

At the end of each financial year the managing agents prepare a final service charge statement detailing the amounts actually incurred. If the tenant has made an overpayment during the course of that year, it is usually credited against the next service charge year and if there has been any underpayment then the tenant will have to settle that underpayment usually within seven to 14 days of demand.

Sometimes leases can contain conditions for a "sinking fund" to enable the landlord to build up a certain sum of money to meet future substantial capital costs, for example, for the replacement of a lift. The services provided by the landlord or the management company and paid for by the tenants are usually set out in the lease.

It is important for the tenant's adviser to check how the service charge is calculated in the lease. The most equitable way is generally for the percentage to be based on the ratio the floor area of the demised premises bears to the floor area of all lettable units in the building.

Stamp duty and VAT

A tenant is liable to pay stamp duty on commercial leases not exceeding 35 years at a rate of 1% of the annual rent plus €12.50 if there is a rent review clause and a further €12.50 on the counterpart lease. If the tenant is also paying a premium for the lease then this will also be liable to stamp duty.

The rate payable depends on the amount of the premium. For example, for lease premiums over €150,000 the rate is currently 9%. The creation of a lease can also give rise to a VAT liability. Note that the rules for VAT on commercial leases are complicated and a new VAT on property regime came into force on 1 July 2008. ■