

The changing nature of commercial lease negotiation in Christchurch

Anderson Lloyd Lawyers Partner Mike Kerr provides some insight into the challenge of negotiating new commercial leases as the central Christchurch rebuild gains momentum.

The Christchurch earthquakes have thrown up a lot of issues for commercial landlords and tenants and highlighted some deficiencies with the lease agreements commonly used for commercial property.

As Christchurch moves into the rebuild phase, developers and landlords are beginning to negotiate new lease arrangements with prospective tenants to enable the building of new commercial premises, while landlords of the remaining buildings look to re-tenant vacant premises.

There are always competing interests between landlord and tenant when it comes to thrashing out the key terms of commercial leases and a sensible approach is needed to find a fair balance which meets the needs of both parties and allows development to occur.

The earthquakes brought about issues such as inaccessible premises, the ability of parties to cancel leases due to building damage, costs of earthquake strengthening and insurance, to name a few.

Court decisions since the earthquake have clarified (somewhat) the rules of the game and a new standard form lease released this month attempts to establish new rules for the post-earthquake environment.

Lessons learned in Christchurch are being applied throughout the country to enable clarity and faster decisions on lease matters after natural disasters. Being able to predict legal outcomes after unpredictable events is good for both sides of any business transaction and reduces the potential for costly disputes.

The standard lease produced by the Auckland District Law Society Incorporated (ADLS) has been used for many years throughout New Zealand and is the most common form of commercial lease. The intent is that a standard form lease avoids a lot of wasted time and cost negotiating individual terms between landlord and tenant, although some negotiating is inevitable.

In the months following February 22, 2011, lack of access to premises within the CBD cordon (whether the premises were damaged or not) was a major issue.

The previous version of ADLS lease provided for the lease to end if the premises were damaged and 'untenantable', but both of these elements were required.

For undamaged buildings within the CBD cordon or where the extent of damage was not known the leases continued and in some cases the tenant had no right to withhold any rent.

There was also significant debate, and subsequent litigation, between those representing landlords and tenants as to what 'untenantable' really meant.

This uncertainty creates difficulties for both landlord and tenant. The landlord may be trying to negotiate their insurance position while maintaining the lease continues, while tenants are wondering whether they should sign new leases when their current lease may continue. The prospect of paying double rent is not one to savour.

The new ADLS lease allows for cancellation rights where access is prevented, which will help alleviate this problem, but the period of exclusion required before cancellation still requires discussion.

Costs associated with earthquake strengthening (for those buildings still standing) remain at the forefront of issues surrounding new leases.

Previously, where the landlord was required to carry out work (for example strengthening work required by Christchurch City Council, CERA or otherwise) landlords were able to on-charge a percentage of the cost of that work to tenants as extra rent (known as improvements rent).

These provisions were rarely exercised in the past, but given the significant costs involved in seismic strengthening, tenants (particularly on shorter-term leases) have recently tended to resist helping to pay for these upgrades.

The new ADLS lease removes the improvement rent clauses.

Landlords still have an ability to cancel leases if the works required will be unreasonably expensive, but may only do so if the works are required to be carried out during the term.

Earthquake-prone building policies of councils throughout New Zealand allow for seismic strengthening over long periods of time depending on the category of building and notices issued to upgrade buildings may not allow the landlord to cancel.

Rent and rent review negotiations in a CBD market which is almost literally starting from a blank canvas will be interesting.

Typically, commercial rents are 'ratcheted' so that the rent when reviewed periodically does not drop below the starting rent.

This is an important protection for landlords against varying market conditions and allows them and their banks to invest with peace of mind of a minimum return on investment.

Ratcheted rents will remain important if developers are to invest in the CBD as the return on this investment must remain favourable when compared with investment elsewhere.

However, new CBD rents will be significantly higher than tenants were used to and the laws of supply and demand may give tenants pause when fixing a base rent at commencement levels.

The effect of gradually increasing supply over time may cause rents to 'correct' over the coming years.

It must, however, be recognised that rent is not only reflective of market conditions, but must also show a reasonable return on investment for landlords.

Insurance complications are never far from most property issues these days and commercial leases are no different.

Recovery of excesses from tenants (which are usually nominal) is an issue for landlords to consider, as is the availability of insurance which can no longer be taken for granted.

We are now seeing resolution of some of these insurance issues clear the way for development, but parties to commercial leases must take care when considering insurance obligations.

In order for the rebuild of commercial premises to gain momentum, landlords and tenants need to work together to negotiate leases which meet the needs of both parties.

The leasing landscape has changed and parties need to adjust. This requires recognition by both parties that in some important respects the game has changed.

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