IN THE TENANCY TRIBUNAL)

AT CANBERRA IN THE) TT 276 OF 1998

AUSTRALIAN CAPITAL TERRITORY)

BETWEEN:
LY HOOK & CO PTY
APPLICANT

AND:
COTRELL PTY LTD
RESPONDENT

DECISION OF PRESIDENT BURNS DELIVERED ON THE 18th DAY OF DECEMBER 1998

The applicant is the lessee of premises known as shop 12 Kaleen Village Center, Kaleen in the Australian Capital Territory. The respondent is the lessor of those premises. By lease number RN 829437 dated 17 November 1992, the applicant leased the subject premises for a term of 6 years terminating on 28 September 1998. This lease ("the original lease") contains an option for a further term of 6 years commencing on 29 September 1998. The original lease incorporated into its terms the provisions of a Memorandum of Provisions filed in the office of the Registrar of Titles ("the Memorandum of Provisions").

It is common ground between the parties that the tenant has exercised its option for the further term of lease and the landlord has acknowledged the exercise of that option. The applicant is therefore entitled to a new lease (" the new lease").

The present dispute between the parties centers on the question of what is the rent applicable at the commencement date of the new lease. The applicant asserts it is entitled to a market review of rent. The respondent disputes this and submits that the commencement rent for the new lease has been set as the rent payable at the expiration of the original lease. The facts in the dispute are not in contention. The parties provided written submissions and the Tribunal has been asked to decide the matter on the basis of the admitted fact and documents.

In order to understand the issues it is necessary to briefly summarise the submissions of the parties.

Submissions of the Parties

The applicants case is that the new lease, by virtue of the provisions of clauses 5.4 of the original lease and clause 3.23 of the Memorandum of Provisions contains a "ratchet clause". Clause 3 of the original lease, incorporating the provisions of the Memorandum of Provisions, provides, in so far as it is relevant:

> "3.2. If the Landlord wants to increase the Rent to apply from and including a Market Review date, then the Landlord may give the Tenant a Market Review Notice at any time before or after that Market Review Date.
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> 3.23. Despite the other provisions of this clause 3 if the Rent decided on under this clause 3 to apply from and including a Market Review Date is less that the rent applicable immediately before that Market Review Date, then the Rent from and including that Market Review Date remains unchanged."

Clause 5.4 of the original lease provides in part:

> " 5.4 The new lease is to be identical with this lease except that:
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> a) the commencement date of the new lease is to be the day after the Expiry Date; and
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> b) the term of the new lease is to be the period of the first term specified in item 12 of the Reference Schedule; and
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> c) the expiry date of the new lease is to be the last day of the term of the new lease; and
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> d) the rent applicable at the commencement date of the new lease is to be the rent determined under clause 3 of the memorandum of provisions incorporated in this lease as if the commencement date of the new lease were a market review date;
> ".

The applicant submits that by virtue of clause 44 of the Code the "ratchet clause" provision in the new lease is void, and cannot be used to determine the rent at the outset of the new lease. Clause 44 of the Code provides:

> "44. A provision of a lease relating to a rent review which is a multiple rent review clause or a ratchet clause is void."

Clause 45 of the Code then provides:

> "45. If a lease contravenes clauses 43 or 44 the rent is to be set or reviewed by reference to market rent unless the parties agree on an alternative basis for setting or reviewing the rent, provided the agreement does not contravene clauses 43 or 44."

As a fall back position, the applicant submits that in the event that the operation of clauses 3.2 and 3.23 of the original lease in determining the rent to be paid at the outset of the new lease is not invalidated under the provisions of the Code then it would be harsh and oppressive on the part of the respondent to seek to rely on what is in effect, a "ratchet clause" and prohibited under the Code.

In reply the respondent submits firstly that the respondent has already validly activated the mechanism for setting the new rent in such a way as to not offend the provision of the Code.

Alternatively the respondent submits that the rent at the commencement of the new lease is determined by the operation of clauses 3.2 and 3.23 of the original contract acting as terms of that contract. As the original lease was not a lease that was subject to the Code the respondent submits that the rent setting mechanism is likewise not subject to the provisions of the Code.

Additionally the respondent denies that its conduct towards the applicant is harsh and oppressive.

I recognise that this summary of the parties submissions hardly does justice to the lengthy and well researched submissions provided by the parties to the Tribunal, but I believe it is adequate for present purposes.

What is the nature of the Option?

The option contained in clause 5 of the original lease is an option to obtain a new lease. As Russell J expressed it in Rider v Ford (1923) 1 Ch 541 at 547:

> " But the right to renew is a right to call for a fresh lease. The new lease is the result of a fresh demise. Even if all the provisions of the fresh lease were the same as in the old lease it would none the less be a fresh demise, and a fresh term with fresh covenants."

The same principal was expressed by Isaacs J in Gerraty v Mcgavin (1914) 18 CLR 152 at p 163:

> "Now, what is the position of a lease obtained by the exercise of an option to renew? Clearly it is a new lease, a new demise. An option given for valueable consideration is merely an irrevocable offer, but beyond that there is no contract for a further term, unless and until the offer is clearly accepted, by exercising the option."

What is the effect of exercising the option?

When the irrevocable offer to grant a new lease contained within the original lease is accepted by the lessee giving the appropriate notice a contract comes into existence, one of the terms of which is the granting of a fresh demise over the subject premises.

The fact that the exercise of the option results in the grant of a new estate is of less significance in recent years than it was at one time. As Young J stated in Polgara Pty Ltd. v Vision Wise Holdings Pty Ltd (1996) NSW ConR 55-781 at p. 55, 985:

> "However, for the last five years or so decisions of the High Court of Australia in The Progressive Mailing House Pty Ltd v Tabali Pty Ltd (1985) 157 CLR 17 and the Court of Appeal in Wood Factory Pty Ltd v Kiritos Pty Ltd (1985) 2 NSWLR 105 make one look at leases in the same way as one looks at contracts under the general law. This has meant that when looking at leases which grant options to renew one looks at the contractual regime which the parties have set up to cover their relations. Even though there is the grant of a new lease, except insofar as the deed of regrant merges within it terms of the existing contract , the original contract continues to govern. Thus when one is looking to see the contractual agreement that the parties have made one looks to see the contractual regime which was set up by the original contractual document and pays less attention... to the actual fact that according to the law of estates there is a regrant of an interest."

The decision of Young J in Polgara (above) is not authority for the proposition that the granting of a new estate by exercise of an option is of no significance whatsoever. The ultimate result of that case depended upon the interpretation of the option clause in that case, which is cast in significantly different terms to the option clause in the present case. The clause considered by Young J provided that the rent at the outset of the renewed lease was to be "determined in the manner" provided in a rent review clause in the original lease. His Honour held that the words "in the manner" denoted the method or general procedure to be adopted and did not comprehend the result that would be achieved by the rigid application of the rent review clause in question. It is significant, however, that his Honour stated that had the clause provided that the new rent was to be "determined in accordance with" the operation of the rent review clause in the original lease, his

decision would have been different. Nor is Young J's decision authority for the proposition that in setting the initial rent for a renewed lease the parties are acting in satisfaction of a contractual obligation imposed by the original lease. The decision in Polgara merely means that in order to understand the new agreement one must have regard to the contractual regime set up by the original lease.

The acceptance of the offer in the original lease to obtain a new lease results in a contract for a further term ie. a lease. The provision for determining the rent applicable at the outset of the new lease is a term of that contract. It cannot, in any meaningful way, be suggested that it operates as a term of the original lease.

The fact that the parties envisaged that a further written lease would eventuate in which the new rental would be stated, but the mechanism for determining that new rental would not, is no barrier to the finding that the parties had reached an agreement, one of the terms of which was the operation of the mechanism to determine the new rental. In Master v Cameron (1954) 91 CLR 353 Dixon CJ, McTiernen and Kitto JJ said, at p 360:

> "Where parties who have been in negotiation reach agreement upon terms of a contractual nature and also agree that the matter of their negotiation shall be dealt with by way of a formal contract, the case may belong to any of three classes. It may be one in which the parties have reached finality in arranging all the terms of their bargain and intend to be immediately bound to the performance of those terms, but at the same time propose to have the terms restated in a form which will be fuller or more precise but not different in effect. Or, secondly, it may be a case in which the parties have completely agreed upon all the terms of their bargain and intend no departure from or addition to that which their agreed terms express or imply, but nevertheless have made performance of or more of the terms conditional upon the execution of a formal document. Or, thirdly, the case may be one in which the intention of the parties is not to make a concluded bargain at all, unless and until they execute a formal contract.
>
> In each of the first two cases there is a binding contract: in the first case a contract binding the parties at once to perform the agreed terms whether the contemplated formal document comes into existence or not, and to join (if they have so agreed) in settling and executing the formal document; and in the second case a contract binding the parties to join in bringing the formal contract into existence and then to carry it into execution. Of these two cases the first in the more common"

And in Booker Industries Pty Ltd v Wilson Parking (Qld) Pty Ltd (1982) 149 CLR 600 Gibbs CJ, Murphy and Wilson JJ stated, at p 606:

> "If a lessor agrees to renew a lease at a rent to be fixed by a third party, and agrees (expressly or impliedly) to do all that is reasonably necessary to ensure that the rent is so fixed, it is not right to say that there is no concluded contract until the rent is so fixed. There is a contract that immediately binds the lessor to perform his obligation to do all that is reasonably necessary to ensure that the rent is fixed although the performance of the further obligation to renew the lease is conditional on the rent being fixed."

The High Court recognised in Booker (above) that the two obligations referred to (to do all that is reasonably necessary to ensure that the rent is fixed as per the agreed mechanism and to renew the lease) are both obligations under the one agreement. That is the agreement created by the acceptance of the offer to renew found in the original lease. In the instant case the agreement which comes into existence upon the acceptance of the offer to grant an option in the original lease is an agreement one of the terms of which is that the rent at the outset of the new lease is to be determined by operation of an agreed mechanism, which happens to be identified by reference to the terms of the original lease. However in operating that mechanism the rent is not determined by operation of the original lease. The agreement created by acceptance of the option in the original lease is complete and operative within itself, albeit that in understanding the contractual arrangement created in the new lease it is permissible to have regard to the contractual regime set up by the original lease.

In my opinion the difference in drafting between the provisions considered by Young J in Polgara and clause 5.4 of the original lease presently under consideration leads to the conclusion that all of clause 3 of the original lease including the clauses pertaining to rent review in clause 3 of the Memorandum of Provisions becomes part of the contract created by the lessees acceptance of the offer to renew contained in the original lease, including the ratchet clause. Clause 5.4 refers not simply to clause 3 of the original lease as providing the "manner" of setting the new rent, it refers to rent as "determined" under that clause. Thus the rent is set as the rent determined by application of the formula found in clause 3 of the original lease including the relevant clauses of the Memorandum of Provisions, including clause 3.23.

Application of the Act and Code

Clause 5 of the Code provides:

> "5. Subject to clauses 6,7 and 8 this Code applies to

(a) a lease entered into;
(b) a lease renewed or extended under an option; or
(c) a variation to a lease made;

on or after the commencement of the Code."

Clauses 6,7 and 8 of the Code have no present application. The Code commenced on 1 January 1995. The offer to renew the lease was accepted in 1998.

Section 5 of the Act provides so far as is relevant:

"5. (1) Subject to section 8, this Act applies to a lease for premises, situated in the Territory, of any of the following kinds:

(a) retail premises, or premises located in a shopping center, other than premises with a lettable area greater than 1000 meters^2 that are leased to a corporation that is not eligible to be incorporated as a proprietary limited company under the Corporations Law:

(b) small commercial premises that are not located in a shopping center;

(c) premises, or a class of premises, prescribed by the Code."

Section 8 of the Act has no present application. I understand there to be no dispute that the premise in question come within those specified in paragraph 5(1)(a) of the Act.

The term "lease" is defined in identical terms in the Act (section 3) and the Code (clause 2):

"'lease' means an agreement, whether in writing or not, that provides for the occupation of premises exclusively or otherwise, whether for a fixed term, periodically or at will, and includes a sublease but does not include-

(a) an agreement relating to the common area of a shopping center by reason only that it provides for a person to use a portion of that area; or

(b) a lease granted under, or to be taken to be granted under, the *Land (Planning and Environment) Act 1991;"*

The agreement that came into existence upon the lessees acceptance of the offer of renewal in the original lease is indisputably an agreement "that provides for the occupation of premises" and as such is a lease for the purposes of the Act and the Code. The two exceptions in the definition of "lease" in the Act and Code do not presently apply. The provision of the Act and Code apply to the agreement created by the acceptance of the offer to renew in the original lease.

Does Clause 3.23 When Setting Initial Rent Operate as a "Ratchet Clause"?

The term "ratchet clause" is defined in identical terms in the Act (section 3) and the Code (clause 2):

> ""ratchet clause', in relation to a provision in a lease for determining rent variations in such a way that rent might decrease, means a provision in that lease that has the effect of preventing, or giving a lessor the power to prevent, that decrease."

It is obvious from this definition that a " ratchet clause", for the purpose of the operation of the Act and the Code is a clause relating to rent variations. The Code itself draws a distinction between "rent setting" and "rent reviews" - see Division 6, generally. In particular 43 of the Code makes void certain provisions of a lease dealing with the setting of rent:

> "43. A provision of a lease setting the initial rent is void to the extent that it -
>
> (a) has the effect of reserving to a party a discretion as to which of 2 or more methods of calculating the rent is to apply; or
>
> (b) provides for the rent to be in accordance with whichever or (sic) 2 or more methods of calculating the rent would result in the higher rent"

Unlike clause 44 of the Code, which deals with rent reviews, clause 43 makes no reference to the term " ratchet clause" as used in the Code and the Act. The term "ratchet clause" as used in the Act and Code therefore does not include a term in an agreement which provides a mechanism for the setting of an initial rent. Whilst clause 45 of the code provides that where a lease contravenes clauses 43 or 44, the rent is to be "set or reviewed" by agreement or reference to market rent, it is clear that the word "set" in clause 45 refers to a contravention of clause 43, and the word "reviewed" similarly refers to a contravention of clause 44.

For these reasons I am satisfied that clause 3.23 of the Memorandum of Provisions to the original lease does not operate as a "ratchet clause" for the purpose of the Act or the Code when setting the initial rent of the new lease.

Operation of the Rent Setting Mechanism

For the reasons I have given I am satisfied that the agreement between the parties was that the rental at the outset of the new lease was to be determined by use of the formula in clause 3 of the Memorandum of Provisions to the original lease, on the basis that the commencement date of the new lease is treated as a "Market Review Date" for the purpose of that clause.

Schedule 2 to the Memorandum of Provisions contains the agreed procedures for obtaining a market review of rent under the original lease where the lessor and lessee cannot agree on the rent to be payable on a rent review. The provision of Schedule 2 to the Memorandum of Provisions are a continuation of clause 3 of the Memorandum of Provisions.

Briefly described, the mechanism for rent variation under the original lease is as follows:

> a) if the lessor wishes to raise the rent from a market review date (which is defined in Schedule 4 of the Memorandum of Provisions) then the lessor is to provide to the lessee a "market review notice" setting out the lessor's rent assessment for the premise (clause 3.2 and Schedule 4 of the Memorandum of Provisions);
>
> b) if the lessee does not give a "dispute notice" to the lessor within 21 days after receiving the "market review notice" then the lessors assessment of the rent in the "market review notice" becomes the new rent applicable from the market review date (clause 3.3 Memorandum of Provisions);
>
> c) if the lessee objects to the lessors assessment in the "market review notice" by providing a "dispute notice" to the lessee, a market valuation of the premises is undertaken in accordance with the procedure set out in Schedule 2 of the Memorandum of Provisions, the terms of which it is unnecessary to consider any further.

It will be remembered that clause 3.2 of the Memorandum of Provisions provides:

> "3.2 if the Landlord wants to increase the Rent to apply from and including a Market Review Date, then the Landlord may give the Tenant a Market Review Notice at any time before or after that Market Review Date."

By letter dated 7 July 1998 to the solicitor for the applicant tenant, the respondents agent stated:

> "Following the receipt of advice, our client believes that Clause 3.2 of the Memorandum of Provisions which provides that "if the Landlord wants to increase the rent to apply from and including a Market Review Date, then the Landlord may give the Tenant a Market Review Notice at any time before or after that Market Review Date" forms part of the existing lease which was entered into in 1992 and is therefore not voided by the Tenancy Tribunal Act. Furthermore, the clause will not apply in any new lease which will comply with the provisions of the Code and Tenancy Act.
>
> Our client does not propose to seek an increase and therefore maintains that the initial rental payable under the new lease should remain at the current level."

The lessor thus argues that the mechanism which is set in train by the lessor delivering a "Market Review Notice" under clause 3.2 of the Memorandum of Provisions is avoided , and the rent is set at the rent payable at the expiration of the original lease.

I am unable to accept that proposition. If the lessors interpretation is accepted, one would be entitled to ask: what rent is it that the landlord could seek to "increase" under clause 3.2 at the time of setting the rent for the new lease? This is one example of why it is important to recollect that the exercise being undertaken is the setting of rent under a fresh demise. Simply put, there is no "rent" for the purpose of the fresh demise until the mechanism in clause 3 of the Memorandum of Provisions is put in train. It is apparent, therefore, that the parties intended that the mechanism in clause 3 of the Memorandum of Provisions would be put in train and a rent accordingly determined. The lessor has no entitlement to avoid that procedure in the way in which it purported to in the letter of 7 July 1998.

Putting into effect the mechanism in clause 3 of the Memorandum of Provisions would result in a requirement that the lessor nominate a proposed rent. If the lessee disputes the proposed rent a market rental valuation must take place. However irrespective of the outcome of the valuation process clause 3.23 of the Memorandum of Provision, if given effect, would result in rent being fixed at that payable immediately before the valuation.

Is there some good reason why clause 3.23 of the Memorandum of Provision should not be given effect? In my opinion there are two reasons. Firstly, the same reasoning applicable to my decision that the lessor could not avoid the operation of the rent setting mechanism applies equally to the question of whether clause 3.23 was intended by the parties to have application in the setting of the

rent for the new lease. There is no "rent applicable" under the agreement created by the acceptance of the offer to renew in the original lease immediately before the setting of the new rent. It is meaningless to refer to the rent as "remaining unchanged."

Secondly, even if I am wrong about the intention of the parties as to the application of clause 3.23 to the rent setting process, the inclusion of that clause in that process offends clause 43 of the Code. If clause 3.23 is given effect in the rent setting process the effective result is that the rent is set at either the market rental or the rent applicable at the expiration of the original lease, whichever is the higher. This is a clause "providing for the rent to be in accordance with whichever of 2 or more methods of calculating the rent would result in the higher or highest rent" and as such contrary to the provisions of clause 43(b) of the Code. Pursuant to clause 45 the rent is therefore to be set either by agreement of the parties or by market rent valuation.

Conclusion

Irrespective of which reason operates to preclude clause 3.23 from having effect, the result is the same. The lessee, in the absence of an agreement with the lessor as to the rent payable at the outset of the new lease, is entitled to have the rent set by reference to a market rental, to be undertaken in accordance with the procedures specified in Schedule 2 of the Memorandum of Provisions. However the procedure to be adopted in undertaking the market rent valuation will differ depending upon the reason why clause 3.23 is ineffective. As my preferred position is that clause 3.23 is ineffective because the parties have evinced an intention that it not apply to the rent setting procedure, I believe it is appropriate to give effect to the procedures agreed by the parties to determine the new rent. The appropriate order for the Tribunal to make is a declaration that the rent applicable at the commencement of the new lease is to be a market rental determined in accordance with the procedures specified in Schedule 2 of the Memorandum of Provisions to the lease dated 17 November 1992 between the parties.