

Commercial Leases and COVID-19 – Mandatory Industry Code



The Prime Minister announced on Tuesday, 7 April 2020 that the Commonwealth, the State and Territory governments have agreed on a [“mandatory” industry code of conduct governing commercial, industrial and retail leases](#) impacted by the COVID-19 pandemic. The Code does not cover residential leases. It will be for the States and Territories to address residential leases separately, although the principle of a 6 month moratorium on evictions still applies to them.

The Code sets out the principles that will guide the structuring of rent relief for eligible tenants, with a view to enabling them to survive the COVID-19 pandemic and recover their businesses afterwards. Legislation will be required in each State and Territory to give the principles the force of law. The principles are expressed in broad and generalised language, and it is anticipated that more detail will be contained in the legislation, which is eagerly awaited.

We have summarised the key principles below, and commented on a number of implications and practical issues that will need to be fleshed out, either in the legislation or in negotiated agreements between the parties to each lease.

The fundamental approach that underpins the Code, is that the financial burden of the impact of the pandemic should be shared equitably between the landlord and the tenant, having

regard to the circumstances of each of those parties, and the nature and extent of the impact in relation to each lease. Each situation will be different, and the Code envisages that a bespoke agreement will be negotiated between the parties, in good faith, against the background of the principles set out in the Code.

In essence, the parties to each lease must reach an agreement on rental relief which is consistent with the principles in the Code, in addition to dealing with other commercial issues relevant to their particular lease. Importantly, the Code anticipates that a binding form of mediation will apply, where the parties cannot agree. In these difficult and uncertain times, with many landlords and tenants under extreme financial, not to mention emotional, stress, it seems realistic to expect that this fall back resolution process will be heavily used. The procedure, detailed terms of reference and resourcing for this process will be crucial in resolving these issues over the next 6-12 months, or more.

Application

The Code will apply where the tenant has a turnover of less than \$50m and qualifies for the JobKeeper programme.

For retail corporates the test is applied at a “group” level and not by individual premises.

- To qualify for the JobKeeper programme a tenant must satisfy the ATO that as a result of the pandemic, its turnover has fallen, or will likely fall, by 30% or more, by reference to its trading in the corresponding period in 2019, as reported in its Business Activity Statements.
- Legislation establishing the JobKeeper programme has now passed both houses of parliament. It will be known as the Coronavirus Economic Response Package (Payments and Benefits) Act 2020, and will be administered by the Commissioner of Taxation. Under the new Act the federal Treasurer is given the power to make rules in relation to the programme, including in relation to eligibility criteria, conditions of entitlement, record keeping and other matters. Until these rules are issued, there may be uncertainty as to whether or not the Code will apply to some leases.
- The ATO's assessment of a tenant's application under the JobKeeper programme will determine whether or not the Code will apply to each particular lease. At this point it is unclear whether a landlord will have any right to seek a review of the ATO's determination.
- There are potentially a number of circumstances where a tenant that initially qualified for the JobKeeper programme, ceases to qualify before the end of the 6 month programme period. For example, if its turnover increases to the point where it ceases to meet the threshold, or its entitlement is re-assessed following a review, or possibly for non-compliance with the programme rules. Until the detailed programme rules are released, it will not be clear how these events may impact on a tenant's eligibility under the programme - and therefore the continued application of the Code - or what the timing impacts might be. A negotiated agreement may need to address these possible scenarios.
- The "grouping" of larger retail chains may have an unfair impact on some landlords – for example if a particular site continues to trade profitably while the overall group suffers a significant impact, that landlord may be required to grant concessions which in effect subsidise other landlords.

Duration of relief

Relief is to apply for the duration of the COVID-19 pandemic (which is defined by reference to the period the JobKeeper programme operates – currently 6 months commencing on 30 March) and for a reasonable recovery period thereafter. At this stage no one knows whether the 6 month period will be too short, or possibly too long. It could be wound back if early restrictions are effective, or it could conceivably be extended, using existing or modified criteria. Any negotiated agreement would need to be sufficiently flexible to deal with these scenarios.

- Determining what is a "reasonable recovery period" could be very difficult. It may vary from one tenant/business to another, and be affected by a range of other as yet unknown circumstances. It's also possible that recovery could be set back if restrictions are re-imposed.

Proportionality

The financial risk and cashflow impacts are intended to be shared between the landlord and the tenant on a proportional basis.

- The basic approach here is that the relief should be in proportion to the reduction in turnover. For example, a 40% reduction in turnover would result in a 40% rent reduction.
- However the principles also suggest that in assessing the impact to the tenant, regard must also be had to its revenue, expenses and profitability. Other government concessions and assistance (e.g. JobKeeper payments, payroll tax relief etc) should be taken into account in this assessment. This approach could result in a rent reduction being a lower percentage than the reduction in overall turnover. Consideration needs to be given to how these assessments can be undertaken in a cooperative and confidential manner.
- The financial position of the tenant will change as the effects of the pandemic abate, and a negotiated agreement may need to require ongoing financial reporting by the tenant, and possibly allow for an independent review process, with necessary adjustments, to ensure that the burden continues to be apportioned on an equitable basis.

Form of relief

The rental reduction is to take the form of a rental waiver or a combination of rental waiver and rental deferral. However the rental waiver component must be at least half of that package.

Any deferred rent is to be repaid over the remaining term of the lease (but not less than 2 years) commencing after the "recovery period".

- The waiver means that landlords will be required to write off at least 50% of the rental reduction amount. Where landlords have debt facilities, unless banks agree to write off debt (unlikely), landlords will suffer a loss and may need to restructure (increase) debt facilities.
- In relation to the component of the rental reduction that is to be deferred (rather than waived), if repayment of that deferred amount is likely to compromise the tenant's future ability to pay amounts due under the lease, then the principles say that rent should be waived rather than deferred. In many cases this will be extremely difficult to determine, especially in the early days of the pandemic. Even if the parties agree initially to defer a certain amount, it may be that when those payments become due, they cannot be enforced, having regard to this principle.

Negotiated agreements may need to set out more definitive financial criteria and possibly provide for some form of independent financial assessment.

Subject to more clarity and detail that may emerge in the legislation, this principle will create considerable financial uncertainty for landlords and could result in landlords being required to waive up to 100% of the rent reduction amount for the COVID-19 period and the recovery period.

Freeze on default action

Landlords may not terminate leases, or access security (e.g. bank guarantees) during the COVID-19 period and the post-COVID-19 recovery period.

- Although not clear from the wording, it may be that this restriction also applies with respect to pre-COVID-19 defaults, as the emphasis seems to be on not evicting tenants during the COVID-19 period, and not the date of the default.
- It will be important to clarify and fix the recovery period for each lease, otherwise there will be uncertainty as to when enforcement action can be taken.

Freeze on rent review

Rent reviews will not be undertaken during the COVID-19 period or the "reasonable recovery period".

- Presumably these reviews will, unless otherwise agreed, occur immediately after the end of the recovery period.
- It's not clear whether subsequent reviews are also postponed by a similar period, or just those that would have occurred during the COVID-19 period and recovery period.
- It's difficult to predict what market rents will look like post COVID-19. In the case of retail leases covered by the Retail Leases Act 2003, where "ratchet" provisions do not apply, market rents may potentially reduce significantly. For leases not covered by the Act, a ratchet provision may provide some benefit for landlords.

Extension of lease terms

Tenants may require lease terms to be extended by a period equivalent to the COVID-19 period and the recovery period.

- This appears to be optional for tenants, but not for landlords. If landlords require an extended commitment from the tenant, given the relief granted during the COVID-19 period and recovery, it will be necessary to include this in the negotiated agreement.

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Good faith negotiations

Landlords and tenants are required to enter into good faith negotiations with a view to agreeing on a relief package, consistent with the principles.

- The Code emphasises the need for landlords and tenants to enter these negotiations in good faith, to be open and honest and to provide sufficient and accurate information, with a view to agreeing appropriate arrangements on a case by case basis.
- The parties should genuinely initiate these negotiations as soon as practical. However until the detailed legislation has been passed it is difficult to know what the legal restrictions and commercial drivers will be for those negotiations.
- Where the parties are unable to agree on terms, either party will be able to initiate mediation, and the intention appears to be that the mediation process will result in an outcome that is binding on both parties. Many parties will not be able to reach agreement and will fall back to the mediation process for a resolution. The terms of reference and operation of the mediation process will be an essential part of this scheme.

Please contact our Property Group if you have questions in relation to the Code or need assistance with negotiations in relation to your lease.