COVID-19: (AUSTRALIA) NATIONAL CODE OF CONDUCT – COMMERCIAL TENANCIES

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Australia Real Estate Alert

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**This information is accurate as of 11.00 am Tuesday 14 April 2020 and is subject to change as this situation evolves.*

On 7 April 2020, a National Code of Conduct (the Code) applicable to certain commercial tenancies that have been impacted by COVID-19 was issued.

You can read more about the Code in our previous summary which can be found here. The Code will be given effect through relevant State and Territory legislation or regulation as appropriate.

Although the Code provides welcome guidance to those many landlords and tenants which are seeking to achieve certainty as to their position under commercial leases, it has quickly become apparent that there are several uncertainties in relation to the Code and its implementation.

It is hoped that these uncertainties will reduce with the passage of enabling legislation. In the interim, we have given consideration to some of the key questions for landlords and tenants.

WHO DOES THE CODE APPLY TO?

The Code applies to all commercial leases (including retail, office and industrial leases) where the tenant:

(a) is suffering financial stress or hardship as a result of the COVID-19 pandemic (as defined by their eligibility for the Commonwealth Government's JobKeeper programme); and (b) has an annual turnover of up to A$50 million, (referred to in the Code as an "SME tenant").

WHAT IF A TENANT DOES NOT QUALIFY UNDER THE CODE?

The National Cabinet has indicated that during the COVID-19 pandemic period, the principles of the Code should "nevertheless apply in spirit to all leasing arrangements for affected businesses, having fair regard to the size and financial structure of those businesses".

Landlords and tenants who are not subject to the Code may still use its principles as a framework for negotiating rent relief arrangements, but it is not currently the intention that this be mandatory. It will be interesting to see whether any dispute resolution mechanisms (such as the binding mediation contemplated by the Code) may be made available to resolve rent relief negotiations which are not subject to the Code and which otherwise reach a stalemate.

WHEN DOES THE CODE COMMENCE?

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The commencement date of the Code will be determined by each State and Territory, with the Code to apply from a date after 3 April 2020 for the period during which the JobKeeper programme is operational. Landlords and tenants are also expected to take into account "a reasonable recovery period". The JobKeeper programme is currently in place for 6 months from 30 March 2020.

DOES THE CODE APPLY TO NEW LEASES ENTERED INTO DURING THE COVID-19 PANDEMIC?

The Code provides that these principles will apply in good faith to existing leasing arrangements, which we expect to be arrangements which were entered into before the commencement of the Code.

It appears that the Code will therefore only apply to leases that are "on foot" as of such commencement.

What does this mean for existing agreements for lease which trigger the commencement of leases during the crisis period? This will turn on the provisions of any enabling legislation, however we expect there may be a reasonable argument that an existing agreement for lease is an "existing leasing relationship".

For parties negotiating new leases (including the renewal of existing leases) which are to commence during the crisis period, it would be prudent to record whether the rent includes an allowance for rent relief on account of COVID-19 implications.

WHAT EVIDENCE DOES A TENANT HAVE TO PROVIDE TO SUPPORT FINANCIAL STRESS OR HARDSHIP AND HOW DO THEY DEMONSTRATE IT IS A DIRECT RESULT OF THE COVID-19 PANDEMIC?

The Code defines financial stress and hardship as "an individual, business or company's inability to generate sufficient revenue as a direct result of the COVID-19 pandemic (including government-mandated trading restrictions) that causes the tenant to be unable to meet its financial and/or contractual (including retail leasing) commitments".

SME tenants which are eligible for the JobKeeper programme are deemed to be in financial distress under the Code. It is unclear whether other tenants may also satisfy this definition.

Landlords and tenants are expected to provide "sufficient and accurate information" within negotiations, which is defined to include information generated from an accounting system and information provided to or received from a financial institution. We are already seeing a degree of tension between landlords and tenants as to the scope of information which is appropriate for such purposes.

HOW IS TURNOVER DETERMINED?

"Turnover" is defined by reference to assessments undertaken for eligibility for the Commonwealth's JobKeeper programme.

It appears that "turnover" must therefore be determined by reference to the activities of the tenant and not the relevant premises. Where an eligible tenant has several premises, potentially with different turnover impacts (or, potentially, with some trading and some not), this means that all landlords of such premises will be required to offer the same minimum rent reduction proportionate to turnover impacts.

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It will also mean that where a tenant experiences a significant "bricks and mortar" trading impact, but potentially stable or even increased online turnover, the online turnover must be allowed for in the application of the Code.

HOW DO TURNOVER TESTS APPLY TO TENANTS THAT ARE PART OF CORPORATE GROUP OR A FRANCHISE STRUCTURE?

This is a key question which gives rise to considerable uncertainty. It is complicated further by current questions of eligibility for "economic groups" under the JobKeeper Scheme.

For example, what happens if a tenant under the lease is a franchisor but the business at the premises is that of the franchisee? What if their eligibility for the JobKeeper Scheme differs?

WHAT IF THE GROUP BUSINESS OF A TENANT IS UNDERTAKEN THROUGH VARIOUS ENTITIES?

In circumstances where the Code applies to the relationship between "landlords and tenants", it is likely that this issue will give rise to disputes. While the provisions of the enabling legislation will be key, it appears that tenants may not necessarily be able to insist that rent relief take account of the impacts of COVID-19 upon other entities in its corporate structure.

ARE TENANTS ENTITLED TO A REDUCTION IN RENT DUE TO COVID-19? FOR HOW LONG?

Yes, if the tenant is an eligible tenant under the Code (as discussed above).

If a tenant is eligible, then the Code will apply to negotiations between the landlord and the tenant with the landlord being required to offer a rent reduction that is proportionate to the amount of the reduction in the tenant's turnover during the COVID-19 crisis period and subsequent recovery phase. The proportion is also to be consistent with the assessment criteria used when determining whether a tenant is eligible under the JobKeeper Scheme.

While the tenant is entitled to pay a reduced rent during the relevant period, part of this may be deferred for payment after the end of such period. The amount of the deferment may be up to 50% of the total value of the reduction. The balance, being at least 50%, must constitute a waiver.

Any deferred rent must be amortised over the balance of the lease term, or 24 months, whichever is the greater, unless otherwise agreed between the landlord and the eligible tenant. No repayment should commence until the earlier of the COVID-19 pandemic ending (as defined by the Government) or the existing lease expiring, and taking into account a reasonable subsequent recovery period.

The parties may have recourse to binding mediation where they are unable to agree the proportion of reduced rent which is to be waived and that which is to be deferred.

What does this mean if a lease expires before the pandemic ends? How does the landlord retain the contractual right to recover rent? This is not addressed in the Code. The provisions of enabling legislation will be key, however it will be prudent for landlords which agree any deferral arrangements to document the obligation to pay deferred rent and the ability to have recourse to security where deferred rent obligations are not met.

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There is a prohibition on a landlord charging interest on deferred amounts. Curiously, the Code does not appear to prohibit the charging of interest on unpaid rent which has not been waived / deferred in accordance with the Code.

WHAT HAPPENS TO RENT REVIEWS DURING THE CRISIS PERIOD?

Principle 13 of the Code imposes a freeze on rent increases for the duration of the COVID-19 pandemic and a reasonable subsequent period.

We expect that the right to the increase rent will be carried forward and be able to be implemented with effect from the end of the relevant period, although again this is not clear.

An interesting and potentially problematic issue arises in respect of market rent reviews during the crisis period and subsequent recovery phase, particularly where reviews are to occur on a "rise and fall" basis (and not subject to a "ratchet"). In these circumstances, a tenant may potentially crystalise a significantly depressed rent with the landlord unable to restore rent to a recovered level until the next market review date (potentially years into the future).

WHAT ABOUT OUTGOINGS?

Landlords will be required to pass on any reductions in statutory charges (eg rates, land tax), as well as the benefit of any deferral of loan repayments on a proportionate basis that has occurred as a result of COVID-19. The Code is not clear as to how this proportionality will operate.

The landlord will also be required to waive the recovery of outgoings or other expenses under a lease during the period that the tenant is unable to trade from the premises. The Code does not clarify whether "outgoings" relate only to base building outgoings or also tenant specific outgoings. This will need to be reviewed once the relevant legislation has been passed.

Principle 8 of the Code states that landlords reserve the right to reduce services as required.

WHAT ABOUT LANDLORDS WHO ARE FACING FINANCIAL HARDSHIP DUE TO COVID-19?

Principle 4 of the Code states that regard must also be had to the landlord's financial ability to provide rent waivers. This gives rise to an obvious inconsistency given that landlord must provide waivers of at least 50% of the mandated rent reduction. In these circumstances, the landlord's financial position would appear to only be relevant to negotiations for waivers in excess of 50% of the relevant amount.

WHAT ABOUT SHOPPING CENTRES? DO LANDLORDS NEED TO OFFER THE SAME DEAL FOR ALL TENANTS WITHIN THE SAME SHOPPING CENTRE OR BUILDING?

No, landlords are expected to agree to "tailored, bespoke and appropriate temporary arrangements" for each SME tenant on a case-by-case basis.

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IF ONLY A FEW TENANTS ARE LEFT TRADING IN A SHOPPING CENTRE OR BUILDING, CAN THE LANDLORD CLOSE THE BUILDING OR SHOPPING CENTRE TO REDUCE COSTS WITHOUT INCURRING COMPENSATION CLAIMS FROM THE REMAINING TENANTS?

Unless the Government issues a direction requiring closure, then the likely answer is that the landlord may be exposed to claims in the event of closure.

IS THERE A RIGHT FOR TENANTS TO TERMINATE THE LEASE AGREEMENT DUE TO COVID-19?

In the absence of a right of termination under a lease, no. Subject to any applicable rent deferrals and waivers and trading hours concessions, the Code requires that an eligible tenant otherwise comply with the terms of the lease. Principle 2 of the Code states that if tenants do not comply with the lease, they will lose the protections afforded by the Code.

CAN A LANDLORD CALL ON SECURITY DURING COVID-19?

Principle 11 of the Code states that landlords must not draw on a bank guarantee, security deposit or a personal guarantee during the COVID-19 period and/or a reasonable recovery period.

CAN A LANDLORD TERMINATE A LEASE DURING COVID-19?

Landlords must not terminate leases due to non-payment of rent during the COVID-19 pandemic period (or reasonable recovery period). However, it is not clear whether Landlord's can terminate a lease during this period where there has been a persistent non-payment of rent prior to the COVID-19 period.

Presumably, Landlords can terminate leases if the tenant is in breach of another provision in the lease, other than non-payment of rent or requirement to trade obligations.

Principle 14 of the Code provides that landlords may not apply any prohibition or levy any penalties if tenants reduce opening hours or cease to trade due to the COVID-19 pandemic. This means that if a tenant chooses to close their store - even absent a Government direction to do so - the landlord has no recourse against the tenant for breach of the requirement to trade clause in the lease.

Any termination would be subject to the right of the tenant to seek relief against forfeiture, which is a remedy that is generally readily available even without the extenuating circumstances of COVID-19.

WHAT HAPPENS IF THE PARTIES CAN'T AGREE?

Where landlords and tenants cannot reach agreement on leasing arrangements (as a direct result of the COVID-19 pandemic), the matter may be referred (by either party) to applicable state or territory retail/commercial leasing dispute resolution processes for binding mediation.

Landlords and tenants must not use mediation processes to prolong or frustrate the facilitation of amicable resolution outcomes.

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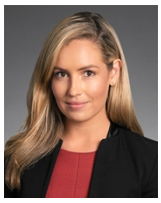
There are significant questions about the practicality of this dispute resolution process particularly in circumstances as the relevant dispute resolution forums are currently closed for public meetings or hearings. Even where mediations will be held via videoconferencing or teleconferencing, the sheer volume of matters that may be referred is likely to result in significant delays. It is entirely possible that rent relief arrangements to apply during the crisis period will still be unresolved well after the end of the pandemic.

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