

Mandatory Code of Conduct – Commentary: Potential Issues

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On 7 April 2020, the Federal Government through the National Cabinet announced a mandatory code of conduct for commercial tenancies which have been impacted by COVID-19 (**Code**). The Code is a set of good faith leasing principles that will apply when parties are negotiating amendments to existing leasing arrangements as a result of the commercial impact of COVID-19 and the subsequent Government restrictions.

The Code is to be enacted by each State and Territory Government through legislation or regulation. It will be applied to commercial tenancies where the tenant is suffering financial stress or hardship and is thus eligible for the Jobkeeper programme, and they have a turnover of up to \$50 million. The turnover threshold will apply to retail corporate groups at the group level and not individual retail outlet level.

Western Australia

The WA State Government has introduced the *Commercial Tenancies (COVID-19 Response) Bill 2020* and the Bill is currently being processed in Parliament. The Code, which is to be prescribed by regulation, may take another month to finalise following stakeholder consultation and therefore is not as yet proclaimed law in Western Australia. Without knowing exactly how and when WA will apply the Code - despite it being drawn from and reflecting the National Cabinet mandatory code of conduct - we consider that there are some potential issues that may arise in the implementation and application of the Code.

In this commentary, we discuss some of the impacts, practical issues, and concerns that may arise for landlords and tenants.

The Code

Under the Code, there are a number of principles that impose certain obligations on the landlord and the tenant when negotiating amendments to an existing leasing arrangement. We consider that some of these obligations will give rise to a number of issues.

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1. *The Landlord must not terminate a lease due to non-payment of rent during the COVID-19 pandemic and a reasonable subsequent recovery period.*

It is understood that the WA Government intends to introduce a 6-month moratorium on evictions due to non-payment of rent. We consider that there are a number of issues with this requirement:

- a) Will this requirement be limited to terminations resulting from rent that falls due and is payable only during the period of the COVID-19 pandemic and reasonable subsequent recovery period, or will it encompass rent owing but not paid prior to those periods. For example, is a landlord able to terminate a lease where a tenant was in arrears prior to the COVID-19 pandemic.
 - b) A reasonable recovery period will differ between tenants, industry sector, location, and business type. How are parties to determine such a recovery period and what is reasonable in the circumstances? Unless this is defined in the legislation to provide certainty, this will be a clear trigger for dispute between parties that may result in a tsunami of mediation requests.
 - c) It is also possible that some businesses, e.g., travel agencies, will either take a very long time to recover or never return to performance levels pre the COVID-19 pandemic. Landlords will need to ensure they have a continued right to obtain financial performance information during the recovery period.
 - d) It is assumed that a landlord will be able to terminate the lease for other serious non-monetary defaults arising under the lease, including those arising from insolvency. Otherwise, this would leave landlords with very limited options in the event that a tenant defaults under the lease for reasons other than non-payment of rent.
2. *Tenants must remain committed to the terms of their lease, subject to any amendments to their rental agreement negotiated under this Code. Material failure to abide by substantive terms of their lease will forfeit any protections provided to the tenant under this Code.*

Unless clarified in the legislation, the issue that may arise is whether any defaults by the tenant that occurred prior to the COVID-19 pandemic would be considered a failure to abide by the substantive terms of their lease. For example, would the tenant forfeit the protections under the Code if they had unilaterally stopped paying rent under the lease prior to the Code coming into effect.

3. *The Landlord must offer tenants a proportionate reduction in rent payable in the form of a waiver and/or deferral of up to 100% of the amount ordinarily payable under the lease. This is to be based on the reduction in the tenant's trade during the COVID-19 pandemic and a reasonable subsequent recovery period.*

It is important to note that under the Code, a waiver must constitute at least 50% of the total reduction in rent payable, and should constitute a greater proportion if failure to do so will result in the tenant being unable to fulfil their ongoing obligations under the lease. Any amount of reduction provided by a waiver may not be recouped by the landlord over the term of the lease or recovered at a later date.

This will provide much needed respite to many commercial tenants. However, this will have a significant impact on smaller landlords, such as retirees who are relying on the rental income

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in retirement. It will mean that unless the tenant waives the requirement for a minimum of 50%, those smaller landlords may lose as a minimum, half their income.

4. *Payment of rental deferrals by the tenant must be amortised over the balance of the lease term and for a period of no less than 24 months, whichever is the greater, unless otherwise agreed by the parties.*

Repayment of any other negotiated deferrals should occur over an extended period and should not commence until either the COVID-19 pandemic ends (as defined by the Federal Government) or the existing lease expires, taking into account a reasonable subsequent recovery period, whichever is earlier.

The issue here is that the payment of rental deferrals and any other negotiated deferrals by the tenant will be significantly delayed, potentially until after the expiry of the lease term and any security held by the landlord. As such, it will be imperative that landlords document rent and all other deferrals carefully and ensure that they have the necessary additional security to provide comfort that they will eventually receive payment.

5. *The Landlord must pass on any reduction in statutory charges or insurance in the appropriate proportion applicable under the lease.*

For landlords, the obligation reflects an equitable sharing of benefits received and the principle that tenants should only pay outgoings reasonably and properly incurred.

In QLD and NSW, the State Governments will provide a 25% discount on land tax for the 2020 calendar year as long as the savings are passed on to the tenant in a proportionate manner. There are currently industry calls in WA for the rebate of land tax, rates, car park levies etc., to assist landlords generally. However, no such changes have been made to the land tax regime as yet.

6. *The Landlord should proportionally share with the tenant any benefits it receives due to the deferral of loan repayments provided by a financial institution, or any other case-by-case deferral of loan repayments offered to other Landlords, with the tenant in a proportionate manner.*

The Australian Banking Association and banks have co-operated to provide COVID-19 business loan relief packages. This will include:

- a) a deferral of principal and interest repayments for all standard business loans of less than \$10m held by a business customer for a period of 6 months (interest will be capitalised);
- b) up to 30 September 2020 or for the period of the loan deferral, whichever is later, participating Banks agree not to enforce business loans for non-monetary defaults, other than certain excluded non-monetary defaults.

This means that the participating banks may either:

- a) extend the term of the loan repayment to account for interest incurred during the deferral period and keep the level of repayments the same; or
- b) increase the level of loan repayments to account for the interest incurred during the deferral period and keep the term of the loan repayment the same.

The relief package states that participating banks will not apply or require a payment of the capitalised interest in a lump sum at the end of the deferral period.

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Clearly interest, just like rust, never sleeps. Just how this 'benefit' is shared in a proportionate manner with a tenant is not clear. Proportionality refers to a balance between competing considerations, it denotes the concept of fairness. Is a complex mathematical model required to ensure arrangements are both proportionate and sustainable for both parties?

7. *The Landlord should, where appropriate, waive recovery of any other expenses (or outgoings payable) from the tenant during the period the tenant is unable to trade. Importantly, the landlord retains the right to reduce services as required in such circumstances.*

There appears to be a differentiation between rent and outgoings. A landlord whilst required to waive and defer rent is only required to waive outgoings where appropriate, leaving it open to landlords to recover some of the holding costs it incurs for a property.

8. *As to a tenant's inability to trade, how will that be established, solely on specific government restrictions or based on the judgment of the tenant? The Landlord must not apply any fees, interest or other charges in respect of rent waived.*

As previously noted, any amount of reduction in rent provided by a waiver may not be recouped by the landlord over the term of the lease or recovered at a later date. A landlord must not seek to compensate for the loss of rental income through the application of any type of charge. This will have a significant effect on smaller landlords who rely on this rental income.

9. *The Landlord must not apply any fees, punitive interest or other charges in respect of rent deferred.*

It would appear that a reasonable commercial interest rate could be charged by a landlord on deferred rent amounts as opposed to 'punitive interest'. This is consistent with the proportionality principle. As no guidance is provided on how or when non-punitive interest may be charged, how it will be calculated and applied remains to be seen.

10. *The Landlord must not draw on the tenant's security (including cash bond, bank guarantee or personal guarantee) for non-payment of rent during the COVID-19 pandemic and a reasonable subsequent recovery period.*

It should be noted that non-recovery under a security is limited to non-payment of rent. This leaves open the option to recover for a breach of other obligations under a lease, for instance non-payment of outgoings. We have also previously noted the issue of recovering rent owing but not paid prior to the COVID-19 pandemic, and whether that will be precluded by the non-draw down on a tenant's security.

Landlords will need to monitor the securities they hold for existing tenants to ensure they do not end or are required to be handed back at lease end when any deferred rent is still required to be repaid by a tenant.

11. *The Landlord should provide the tenant an opportunity to extend its lease for an equivalent period of the rent waiver and/or deferral period on existing lease terms during the subsequent recovery period after the COVID-19 pandemic.*

This would appear to be a sensible option, particularly where there are on-going deferred rent payment obligations or, indeed, to give the landlord an improved lease covenant from existing tenants to whom rent relief has been granted. Particular care should be taken in respect of retail shop leases that the requirements under the *Commercial Tenancy (Retail Shops) Agreements Act 1985* (WA) for the granting of new leases are complied with.

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12. *The Landlord must agree to freeze any rent increases (except for retail leases based on turnover rent) for the duration of the COVID-19 pandemic and a reasonable subsequent recovery period, regardless of any arrangement between the landlord and tenant.*

This would appear to be an absolute requirement. However, it is not clear what happens at the end of the COVID-19 pandemic and a reasonable subsequent recovery period. Can a frozen rent review be applied after the thaw?

13. *The Landlord may not apply any prohibition or levy any penalties if the tenant reduces opening hours or ceases to trade during the COVID-19 pandemic.*

This is consistent with the overall intent of the mandatory code of conduct for commercial tenancies, despite some tenant's having unilaterally stopped trading and the payment of rent. Landlords will of course be familiar with section 12C of *Commercial Tenancy (Retail Shops) Agreements Act 1985* (WA).

Binding Mediation

The code provides that in the circumstances where the landlord and tenant are unable to agree on a temporary leasing arrangement, the matter is to be referred to the appropriate retail/commercial leasing dispute resolution process in that State or Territory for binding mediation. Landlords and tenants must not use mediation to prolong or frustrate the process.

In Western Australia (subject to any changes, by regulation or otherwise, being made to the *Commercial Tenancy (Retail Shops) Agreements Act 1985* by way of the *Commercial Tenancies (COVID-19 Response) Bill 2020*), the appropriate body to conduct the binding mediation in respect of retail leases, would be the Small Business Commissioner through the Small Business Development Corporation (WA) and then the State Administrative Tribunal by referral.

Under the Code, either party may refer the matter for mediation. In relation to other commercial leases, such as industrial or office leases, it is unclear at this stage what body the governing legislation will provide for the conduct binding mediation.

There is a real risk however that any mediation service will be inundated by referrals where parties cannot (or for strategic reasons, will not) agree and thus result in the service requiring extra funding and resources for trained mediators who also understand commercial property. The high number of referrals will potentially push out the final resolution of disputes over COVID-19-impacted tenancies possibly well past the end of the COVID-19 pandemic and the subsequent recovery period. How this will be addressed in practical sense will significantly impact how and if tenancies recover, and whether the existing lease agreement is able to continue after the COVID-19 pandemic. For parties to continue a business relationship post the COVID-19 pandemic, resolution of any dispute will need to be speedy, fair and balanced.

Conclusion

The Code has put much of the responsibility of helping tenants onto landlords and the potential impact that this will have on smaller landlords will be significant.

Nevertheless, in order for landlords and tenants to reach a fair and sustainable agreement that will see the lease through the COVID-19 pandemic and beyond, parties should observe the following:

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- Under the Code, parties will need to enter into good faith communications regarding rental relief. Those communications should be clearly stated to be made without prejudice and confidential as between the parties;
- Parties will need to address rental arrears existing prior to the COVID-19 pandemic;
- Landlords will need to consider the benefits or otherwise of extending the term of a lease to cover the period rent relief is given;
- Landlords may request from a tenant sufficient and accurate information as specified in the Code, and these should include information generated from an accounting system and information provided to and/or received from a financial institution. Tenant's should immediately start preparing this information and confirming eligibility for the Jobkeeper programme;
- In assessing eligibility for rent relief that is proportionate, the landlord will need to review the tenant's turnover and compare it with the comparable period in the preceding financial year;
- Landlords will need to restrict the period of rental relief provided to the tenant with an agreement to revisit or renew arrangements thereafter as required;
- Landlords will need to consider the effect of rent relief on rent reviews under the lease, including the exclusion of any rental relief received from consideration in a subsequent market rent review;
- Landlords will need to consider whether interest will be charged on deferred rent and if so, how and when this will be charged;
- All financial and trading information will need to be kept confidential as between the parties;
- All rental relief arrangements should be properly documented by way of a deed of variation or similar; and
- Once the new legislation is enacted, parties will need to consider any retrospective application under the *Commercial Tenancies (COVID-19 Response) Bill 2020*.

Finally, it will be important that both landlords and tenants work together, that both parties consider their relative financial position and what arrangement will be balanced and sustainable for both parties during the COVID-19 pandemic and for a reasonable period afterwards.