

National Cabinet Mandatory Code of Conduct - SME Commercial Leasing Principles During COVID-19

The National Cabinet released its National Code of Conduct (Code) on 7 April 2020 to govern commercial, industrial and retail tenancies affected by the COVID-19 pandemic. The stated objective of the Code is to proportionately share the financial risk and cash-flow impact during the COVID-19 period, whilst balancing the interests of tenants and landlords.



What is the National Code of Conduct and who does it affect?

The Code imposes a set of “good faith” principles for application to commercial tenancies (including retail, office and industrial) between owners/operators/landlords and tenants which apply to negotiating amendments to existing leasing arrangements during the COVID-19 pandemic period.

The Code applies to all tenants that are suffering financial stress or hardship that:

1. have an annual turnover of up to \$50 million; and
2. are an eligible business for the purpose of the Commonwealth Government's JobKeeper program. For these tenants, assuming they are not charities, this means that the business has lost 30% or more of their revenue compared to a comparable period a year ago.

The \$50 million annual turnover threshold will be applied in respect of franchises at the franchisee level, and in respect of retail corporate groups at the group level (rather than at the individual retail outlet level).

Despite this cap on the eligibility of tenants, the Code stipulates that the principles should nevertheless “apply in spirit” to all leasing arrangements for affected businesses.



When will the Code come into effect and how long will it apply?

The Code states that it will come into effect on a date defined by each State or Territory after 3 April 2020 and apply for “*the period during which the Commonwealth JobKeeper program remains operational*”.

In fact, the effects of the Code, to the extent they result in binding variations to existing leases or ancillary agreements or deeds documenting deferral and repayment arrangements which extend beyond this period, will likely last significantly longer than the specified period.



Principles of the Code

The Code stipulates 11 overarching principles which apply in guiding arrangements between landlords and tenants, and include that landlords and tenants must:

1. negotiate in good faith;
2. work towards achieving mutually satisfactory outcomes;

3. behave honestly and transparently;
4. in the context of negotiations, each provide “sufficient and accurate information”; and
5. make arrangements which are appropriate for the particular lease and are proportionate to the impact on the tenant.



Leasing Principles

The Code sets out 14 leasing principles, which are to be applied on a case-by-case basis.

Where landlords and tenants cannot reach an agreement, they will be subject to referral by either party to applicable State and Territory dispute resolution processes for binding mediation.



What does this mean for tenants and landlords?

Tenants

A number of the leasing principles will affect tenants as follows:

1. tenants will not be evicted due to non-payment of rent during the pandemic period (or reasonable subsequent period);
2. tenants will have the benefit of:
 - a. proportionate reductions in rent payable in the form of waivers (being rent abatement) and deferrals of rent of up to 100% of the rent payable, based on the reduction in the tenant's trade;
 - b. rental waivers (rent abatement) must constitute a minimum of 50% of the total reduction in rent payable over the pandemic period and should constitute a greater proportion of the total reduction in rent payable where failure to do so would compromise the tenant's capacity to fulfil their ongoing obligations under the lease;
3. if rent is deferred, payment of the deferred rent must be amortised over the balance of the lease term or a period of no less than 24 months, whichever is greater (unless otherwise agreed). Repayment of deferred amounts cannot commence until the earlier of the pandemic end date (as determined by the Australian Government) or the existing lease expiring. Repayments should occur over an extended period to avoid placing undue pressure on tenants;
4. no fees, interest or other charges may be applied in respect of rent waived, nor any fees, charges or punitive interest may be charged on deferrals;
5. for retail tenants, landlords may not apply any prohibition or levy penalties if the tenant reduces opening hours or ceases to trade during the COVID-19 pandemic; and
6. where appropriate, waiver of an expense or outgoing payable for the period the tenant is unable to trade.

Tenants must otherwise comply with their lease terms, subject to amendments to the rent as negotiated pursuant to the Code. A material failure to comply with the substantive terms of a lease means that a tenant forfeits any protections under the Code.

Landlords

Landlords will be impacted in a number of ways, including the following:

1. landlords must not terminate leases due to non-payment of rent during the pandemic period (or reasonable subsequent recovery period). However, this restriction on termination relates only to non-payment of rent. Presumably, for breaches of other covenants by tenants, the term of the lease and the relevant legislation will govern a landlord's right to terminate. From a retail lease perspective, our view is that it is likely that landlords will also be precluded from terminating for breach of trade or keep open covenants consistent with other statements in the Code, although this is not expressly stated;
2. if there is a reduction in statutory charges such as land tax and council rates, or insurance, that reduction must be passed onto the tenant in the appropriate proportion;
3. landlords must freeze any rent increases until the pandemic is over (excluding retail tenancies where rental is calculated pursuant to turnover rent);
4. landlords should seek to share any benefits received due to the deferral of loan payments provided by a financial institution as part of the Australian Banker's Association's COVID-19 response. It is noted that banks are generally offering repayment holidays, but interest on any loan continues to accrue and is payable over the remaining tenure of the loan (ie, it is not a waiver of interest amounts accruing on loans during the COVID-19 period), so how this principle is required to be implemented is unclear;
5. landlords should, where appropriate, seek to waive recovery of any other expense (or outgoing payable) by a tenant during the period the tenant is not able to trade;
6. landlords must not draw on tenants' security for the non-payment of rent during the pandemic period and/or a reasonable subsequent recovery period. Presumably, landlords will still be able to call upon a tenant's security for other breaches under the lease (for example, a failure to make good); and
7. landlords should provide tenants with the opportunity to extend leases for an equivalent period of the rent waiver and/or deferral period to provide tenants additional time to trade during the recovery period on existing lease terms.



Are there any shortcomings to the Code?

The Code deals with some of the practical issues which will arise as landlords and tenants work to resolve arrangements pursuant to it.

There is a lack of certainty as to its extent and application - given current circumstances and the speed with which the Code has been developed.

These may be addressed in relevant legislation however some issues that require further clarity include:

- a lack of certainty around key terms such as the "COVID-19 pandemic period" and "a reasonable subsequent recovery period";
- how mediation processes and/or penalties for non-compliance might operate;
- addressing issues in relation to Agreements for Lease and existing incentive (eg rent incentives and fitout contributions) and specifically whether the Code requirements will be in addition to any existing and operational incentive arrangements;
- if the Lease expires prior to when the 24 month period ends, what document will be required to deal with the tenant's repayment covenant and how the landlord's security position can be protected, particularly where bank guarantees might expire;
- it is not clear whether interest can be charged on deferred rent - the wording of the Code suggests this is possible where interest is not punitive in nature; and

- Whether the Code will prohibit landlord actions (eg termination or recourse to security) in respect of historic arrears incurred prior to the COVID-19 pandemic period (or whether this moratorium only relates to rent unpaid during the COVID-19 pandemic period or subsequent reasonable recovery period).



Where to from here?

While the Code sets out the relevant leasing principles, the application of those principles will ultimately depend on the relevant legislation and/or regulations to be passed by the States and Territories, and how quickly they act. We will continue to monitor the implementation of the Code by the States and Territories closely and provide a further update in due course.



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