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# AUSTRALIAN RETAIL LEASE MANAGEMENT

PO BOX 295, Mosman, NSW 2088 ☎ 02 9904 4875 📠 02 9904 4876 📧 info@retaillease.com.au

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## RECOVERY v INSOLVENCY FOR SMALL TO MEDIUM RETAIL BUSINESSES

### A PRACTICAL WAY FORWARD FOR COVID-19 IMPACTED RETAIL AND COMMERCIAL TENANCIES

#### **COVID-19 Pandemic and Retail**

COVID-19 is an infectious disease caused by a recently discovered coronavirus, unknown before an outbreak in Wuhan, China in December 2019. COVID-19 became a modern global pandemic, affecting many countries including Australia. Millions around the world have been infected or become severely ill. Hundreds of thousands have died. The damage upon our modern community and business life, especially Small and Medium Enterprises (SMEs) is unprecedented. Apart from the human tragedy, the crises could not have come at a worse time for many Australian retailers. It has been well reported that some retail sectors were distressed prior to the COVID-19 pandemic. Some commentators called 2017-2019 a 'retail apocalypse', citing stagnant sales growth, the imposition of online shopping, changing consumer sentiment and unsustainable occupancy costs.

#### **Public Health and Economic Crises**

In response to the COVID-19 public health risk, on 15 March 2020 the Australian Government convened a National Cabinet comprising of Premiers of the States and Territories. At State level, public health authorities quickly introduced emergency measures to contain coronavirus spread within local populations. Laws were passed to confine the community to their homes and severely restrict social gathering and movement, commonly known as 'lockdown' or social and business hibernation. Reasonable excuses to be outside a place of residence were limited; obtain food, exercise, medical reasons, essential services etc. With schools closed and many people working from home, cities and towns became almost deserted. The economic costs quickly became clear, resulting in mass layoffs as businesses shut down, many with a liquidity crisis to pay overheads and staff during this period.

#### **"COVID-19 Safe Harbour" and changes to bankruptcy and insolvency laws**

On 24 March 2020, Federal Parliament passed emergency laws for the crisis, amending s588G(2) *Corporations Act 2001* by relaxing harsh insolvent trading rules. That amendment increased the debt levels triggering bankruptcy and liquidation proceedings to \$20,000 if a business could not pay a



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debt as and when it fell due. It extended the response time for bankruptcy and liquidation demands to 6 months in the hope that doors of business can be kept open as long as possible. The temporary changes gave business breathing space in circumstances where a company director must not permit a company incur debts at a time it is insolvent, or will become insolvent, an action which carries a civil and offence penalty if the failure to prevent the debt is dishonest. Critically, directors can be personally liable for all debts whilst trading insolvent and upon liquidation. The rationale was that these emergency amendments assisted directors and not be panicked into hasty decisions for otherwise viable businesses.

While colloquially termed 'COVID-19 Safe Harbour', the amendments simply suspend the operation of s588G(2) so long as the debts being incurred are "in the ordinary course of the company's business". They do not affect the s588GA "safe harbour" defence to "insolvent trading" previously introduced into the Act in 2017. This is still developing as a body of law, creating a defence to protect a director, suspecting insolvency, who then embarks on developing one or more courses of action 'reasonably likely to lead to a better outcome' for creditors than administration or liquidation, but incurs debts in that process. German to its legal application is all taxation lodgements be up to date, all employee entitlements be met (as failure to pay remains a civil penalty) and critically, **the director bears the evidential burden of proof.**

Currently, the COVID-19 safe harbour might be cold comfort to directors whose business is fundamentally altered by COVID-19 from matters outside of their control. It all might just be "kicking the can down the road". With a need to be mindful of just 6 months protection (unless extended), SME's must plan now for what happens next. For retailers, this means **dealing with landlords**. A retail business paying \$160,000 per annum occupancy can easily slip over the \$20,000 threshold. Even though a Court is likely to consider the state of the economy in any future proceedings, the May to September 2020 period is expected to be crunch time, when the 2017 s588GA "safe harbour" defence becomes critical to those retailers with a business capable of being saved.

## Unprecedented Economic Stimulus

In early April 2020, the Federal Government announced a series of temporary economic stimulus packages **JobSeeker** and **JobKeeper** for some wage earners and businesses, pumping billions of dollars into the Australian economy to improve the liquidity crises from the public health orders. These measures included Government backed business loans and State tax assistance and small grants to assist cash flow.



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## Commercial Rents Arrangements for COVID-19

On 7 April 2020, in recognition of the vulnerability of SMEs, the Australian Prime Minister announced the National Cabinet Mandatory Code of Conduct ("SME") Commercial Leasing Principles During Covid-19 ("the Code"). The intention of the Code was a minimum set of standards to **address potential lessor and lessee power imbalances** and preserve affected SMEs and the vast community they employ. The key principles of the Code are an SME business hibernation protocol; protective, proportionality, rental assistance for COVID-19 affected lessees and recovery period. It mandated case-by-case, good faith negotiations between lessors and lessees.

## What the Code means for SMEs

The Code is strongly tied to the national JobKeeper program. Protections given under the Code apply to SMEs suffering financial stress or hardship. The JobKeeper program requires reduced revenue of at least 30% as a result of the COVID-19 pandemic. However, if a tenant does not meet that threshold and is still affected, the Code and other State regulations enforceable under the Code might apply such as *Conveyancing (General) Regulation 2020* in NSW.

## Rent negotiations under the Code, the Recovery Period and State law

Landlords and tenants are required to negotiate in **good faith**. Good faith is not defined. The Australian High Court is yet to rule on a precise interpretation, however the NSW Court of Appeal has considered the term which compels 'reasonableness', 'fair dealing', 'co-operation' and 'acting honestly with fidelity' to the negotiation having regard to the interests of both parties. Landlords and tenants must agree to a **proportional share** of rent reductions for the pandemic and recovery period or agree to new arrangements. The nexus between available sales and fulfilling the lease contract, once quite separate concepts, is thus enshrined in law. For example, if the business has lost 60% trade, a start point would be 60% rent reduction. Best practise would dictate signing and registering documents to record the final agreement. Leases, fit-out agreements and property law are complex and parties need to customise their particular circumstances, arranging and tailoring rent and lease terms to suit. This may mean temporary deals to "get by", a completely new arrangement or perhaps a mutual lease termination.

Under the Code, landlords have limited actions available under their leases. Lessors are required to reduce lease rental payments in proportion to a reduction in a lessee's business; lessors cannot unilaterally terminate, draw on security such as bonds, bank or personal guarantees or increase rents. Waivers (not deferrals) are to be a minimum of half of the reduction in the lessee's business and deferrals, (suspended payments due later) must be amortised no less than 24 months and a



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lease extended accordingly. If a final agreement is not reached, there must be a formal mediation. Agreements must not jeopardise future legal rights and obligations. Landlords cannot use the Code at the expense of other secured or unsecured creditors or try to squeeze preferential payments ahead of other creditors. The Code states: -

*“The Parties will take into account the fact that the risk of default on commercial leases is ultimately (and already) borne by the landlord. The landlord must not seek to permanently mitigate this risk in negotiating temporary arrangements envisaged under this Code.”*

The COVID-19 situation might change, negotiations might fail and mediations, Tribunals and Courts might settle the dispute. In the negotiation, parties might provide:-

*“Sufficient and accurate information: this includes information generated from an accounting system, and information provided to and / or received from a financial institution, that impacts the timeliness of the Parties making decisions with regard to the financial stress caused as a direct result of the COVID-19 event.”*

and

*“...all parties recognise the intended application, legal constraints and spirit of the Competition and Consumer Act 2010.”*

The *Competition and Consumer Act 2010* was amended by the *Small Business and Unfair Contract Terms Act 2015* and various State laws have covered retail leases for many years. Lessees should familiarise themselves with these protections in coming negotiations.

## **The Lease – Financial and Legal Position**

The lease still governs the parties. It would be irrational and irresponsible not to know the true legal and financial position before entering into negotiations that will affect a lessee’s survival or failure. If the business struggled with high rent before COVID-19, its likelihood of survival to full recovery will be impossible or greatly reduced. Unless you know where your money is coming from and going to, what your debts are and to whom, you won’t know if your lessee company (or you personally if you are the lessee) will be viable post COVID-19. You won’t know if you or your company is, or will become insolvent. In any event, you might be lucky enough have a force majeure (superior clause) to rely upon. Unfortunately, not many modern leases contain such a clause which: -



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*“...excludes a party from liability for failure to perform that contract where that failure was due to forces, either natural or human, beyond the party’s control.”*

Common examples might be earthquake, sabotage, natural disaster etc. Without such a clause in the lease, it won’t apply. Anything else? Even though traditionally there has been a high bar to its use, in such extreme circumstances as COVID19, there may be an argument for the doctrine of “frustration” applying to SME leases:-

*...where a contractual obligation has, without the default of either party, become incapable of being performed...when performance is impossible, rendered pointless, becomes illegal, or the outbreak of war.”*

If a retailer is of a class and occupies business premises and is forced to close such as a nail salon, beauty salons or is legally restricted in its services by size and customer throughput or by actions of the shopping centre, a Court might be persuaded that the doctrine of frustration would apply in these unprecedented times.

## Tenants – Long Road to Recovery from COVID-19

Tenants often feel vulnerable in stressful and uncertain times. In this emergency, it has quickly become apparent some parties will utilise a perceived power imbalance and not comply with the Code’s spirit and intent. Some tenants are asked to sign **one-way** confidentiality agreements as a pre-condition to even start lease negotiations. Boiled down, the 3 steps lessees need to take are: -

- Assess the financial and legal position for the COVID-19 period **and** recovery period;
- Negotiate all leases or mediate if no initial agreement reached;
- Plan to re-open, inform the lessor or initiate insolvency procedures to protect assets if no agreement seems possible.

## Recovery period – What’s that?

Recovery is unlikely to be a ‘V’ shape. It will probably arrive in fits and starts or within a second wave, with some sectors never returning to pre COVID-19 levels. Moving the financial goal posts might be OK for now, but it’s possible there will be tsunami of business collapses and bankruptcies when the Government stimulus stops just before the Christmas peak retail period. Unless there’s some certainty. it’s not likely SME’s will want to carry more debt and take on loans that might be impossible to pay back, however cheap those loans are.



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## Lease Negotiations

Some landlords and agents offer “take it or leave it” deals. These might be commercially acceptable dealing with quite simple issues like rent relief mandated by the Code, but what about rent the recovery period? What can a retailer commercially achieve for the recovery period? What about its short-and long-term impact on the ability to pay rent due from reduced mall or local traffic?

Importantly, what’s the real result impacting sales and margin and your ability to pay rent and any deferrals? **Any deal put on the table might easily take you into insolvency later down the track.**

Any deal where an agent pressures you to sign could easily lead to the loss of your assets including your home. If you are being pressured by an agent to sign under duress, you need to think about the future legal implications. There are laws that prevent unfair and unconscionable conduct with compensation available. These laws are envisaged for the COVID-19 **‘everything-at-stake’**-situations

## Financial Modelling

Retailers need to take control of their future. For COVID-19 and the reasonable recovery period, you will need to clarify the sales reduction comparison and estimate future sales and increases in operating costs to offset the mitigation of loss through labour and variable costs reductions. Each retailer and location will be different. For example, many businesses are parasitic upon transport hubs or local office complexes for sales which may not return to pre COVID-19 levels. The business may be viable only with reduced hours. With social distancing, it might not be viable at all. If your business targets tourists, you will need to think carefully about new and old markets and if there’s sustainability longer term. It is doubtful international tourists will return soon. Foodservice will be impacted by minimum standards and table arrangements for personal protections, social distancing and sit down with extra costs for cutlery, deep cleaning, kitchen size restraints, take away packaging and delivery costs. Other businesses, such as apparel may be required to steam clean ‘try-on’ items after every touch point or be limited in service due to proximity constraints on customers.

Anyone asked to forecast the how’s and why’s of Covid-19 impacted retailers over the next 12 months should give the most honest and good faith answer: "it's anyone guess". How do you forecast for a post pandemic where no historic precedent exists? However, without a forecast and properly prepared financial modelling, it’s impossible to even start thinking about any rent deals.

The financial modelling needs to adjust cashflow for Government assistance packages, potential sales reductions and increased expenses and deferred lease payments under Code. Multiple locations often need multiple lessors to co-operate with you discussing your situation many times. That is because if one lessor refuses to co-operate within the confines of what the business can offer



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and pay in good faith, a **single refusal can affect the viability of the business as a whole** and bring the entire chain down. In this event, your financial modelling will form part of your evidence if you are facing future bankruptcy proceedings by creditors, including a creditor claim from your landlord.

## Be Prepared to Tough It Out to Survive

Lessors and many of their agents use primitive forms of psychology in rent negotiations. Agents rarely having the final say. Various Government inquiries such as “The Fair-Trading Inquiry” and the “Productivity Report into the Market for Retail Leasing” over the years have shown a common tactic is a **bully boy approach, notably in the large shopping centre industry** compared to the high street. Sometimes an over the top letter from a landlord’s lawyer helps subdue and scare some easy to deal with retailers not savvy with landlords trained in these tactics. Landlords call this “plucking the low hanging fruit”. After a while, that tactic gets tiresome and they move on to what retailers can really afford.

One technique in negotiating is called **anchoring**. It is often the reason why landlords try to get you to make the first offer. However, making a rental offer in an era of COVID-19, where there’s plenty of uncertainty and no one has any experience, few retailers can confidently forecast the next 12 -18 months. Landlords can’t even do that forecasting for their own business at present. However, your financial modelling becomes your anchor. It’s your reference point for negotiations and all discussions should revolve around that. Should a dispute ever end up in Court, your financial modelling would provide the best evidence to show your good faith and the lessor’s possible bad faith, potentially grounding a strong legal defence and damages and compensation claim against your landlord and their agents.

## Getting to YES

1. The first issue to consider are the losses sustained on closure in response to public health orders, staff retrenchments, lack of customers or staff to safely serve them (even if customers were around). Detail other important matters like landlords closing off areas, preventing access and social distancing measures;
2. The second issue is landlord and SME assistance and how that affects your cash flows and profitability;
3. The third issue is the costs to get back on your feet and the business up and running, with the likely sales you will make.



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Calculate the rent you can pay to survive, store by store. Be realistic.

## The Negotiations – Your rights under the code

Prepare for landlord objections. You know you will get these types of objections.

Landlord: We have a legal right to collect outstanding rent and will litigate.

Reply: The Code sets out the principles of rights and obligations. You may have the right to litigate, so go ahead, but the Code links sales with occupancy. When the lease was agreed pre COVID-19, things were different; it's not your fault, not mine. Who is responsible for my store traffic, my customer safety and currently traffic and sales drops from last year and your rent?

Landlord: Your projections are too pessimistic.

Reply: We cannot operate this lease on the conditions you propose. The financial modelling has been completed by accountants and retail experts and based upon the best available facts. If you think they are wrong, specifically point out what you say is not correct and why.

Landlord: You must pay the rent under the Code, it's your risk for the recovery period, the future has nothing to do with me.

Reply: The Code includes a reasonable recovery period. What sales do you project I make during the recovery period? My financial models are my best endeavours.

Landlord: You must pay the rent or I will sue you personally.

Reply: That's your choice, but if I cannot honour an agreement to pay rent according to my financial modelling given in good faith, it would be better to close the store now to not incur more debt or appoint an administrator.

Landlord: You have personally guaranteed the lease. I will bankrupt you and can seize your home.



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Reply: That's your choice, but if I cannot honour an agreement to pay rent according to my financial modelling, it would be better for me to close the store and seek advice from a bankruptcy trustee to ensure a fair distribution and you do not obtain an priority at the expense of anyone else.

## Ways forward

Whilst there are normally several objections, you must be prepared to deal with your landlord, your forecast, and the losses you will incur if the parties do not arrive at a sensible commercial solution. You could pay a % of sales based on comparative last year's occupancy costs. This is fair to both parties because as traffic levels rise, so does the rent. This is why **financial modelling anchors your good faith offer**. Get ready for a tough negotiation and preparation is the key. Know what the legal consequences are for you and the landlord if you cannot strike a fair deal. Be prepared to walk away from a bad deal and exit the premises. Whilst some landlords are different, many will use multiple negotiation techniques and many are trained in these tactics. Get help if you need it, and remember you are probably negotiating for your very survival. Landlords in Covid-19 times need retailers to survive, and being professional means sitting down to sort through how both parties can last the next 12-18 months. Then the deal needs to be documented properly as a Deed and possibly registered as a Variation.

## Final Thoughts

In the recession of 1990's, retail businesses and landlords were dropping like flies as consumer sentiment and spending halted with 18% interest rates. Many early lease deals came back to haunt the Courts when rent payments became impossible. With many retail collapses just prior to COVID-19, the novel virus may have simply pressed the fast forward button. In other words, unless retailers want history to repeat with a cautious or unemployed consumer, and with pockets not deep and business not profitable enough to endure rent deferrals, great care should be taken with a landlord hungry to get your signature before signing any deal ostensibly under the Code.

This is general information only. This is not legal or accounting advice. Each landlord and tenant have different needs, motives and solutions to their own individual circumstances. Anyone contemplating anything contained in this article should seek their own independent and expert advice.

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