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Insolvency Law Reform 'The Road Ahead'

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Current state of play

Since late March the Government has had a range of 'temporary' measures in place to assist business weather the economic impact of the coronavirus epidemic.

These measures include:

- Various support / assistance packages the centrepiece of which was the Jobkeeper subsidy – extended with tightened criteria until March 2021;

- Temporary increase in statutory demand and bankruptcy to $20,000 and temporary increase in the time for compliance to six months – extended to 31 December 2020;

- A six month temporary suspension of the prohibition against insolvent trading – extended to 31 December 2020;

- The mandatory code of conduct for landlords and tenants – extended until 31 December 2020;

- Financiers have been encouraged to offer temporary hardship relief by way of temporary deferral of interest payments – banking relief extended until 31 March 2021 subject to bank review;

- In addition the ATO has reduced its enforcement activities.

<u>Temporary Relief Measures</u>

The Coronavirus Economic Package Omnibus Act 2020 (Cth) took effect on 25 March 2020.

It makes temporary amendments to Australian Insolvency and Corporations Law that were intended to provide a safety net to otherwise profitable and viable businesses which face financial distress as a result of the economic impact of coronavirus and health measures to prevent its spread.

Corporations- Statutory Demands

Issue	Current Law	New Law
The statutory minimum for a creditor to issue a statutory demand	$2,000	Temporarily increased to $20,000 (for a period of 9 months)
The period within which a debtor must respond to a statutory demand	21 days	Temporarily increased to 6 months

Points to note

- The legislation takes effect from 25 March 2020. For statutory demands issued 24 March 2020 and prior, the normal law applies i.e. $2000 and 21 days.

- Accordingly as the law does not have retrospective effect, those companies subject to outstanding unsatisfied statutory demands which had been served were not provided with a six month period of grace, being demands already in the system.
- The temporary changes apply to winding up in insolvency grounded on an unsatisfied statutory demand.
- It does not apply to winding up on other grounds e.g. the just and equitable ground.
- Presumably, a winding up application grounded upon demonstrated evidence of insolvency is similarly not subject to the new restrictions.
- The legislation was self repealing - it covers the period 25 March 2020 to 24 September 2020 – its effect has been extended to 31 December 2020.
- Methods of enforcement through the Courts such as writs of possession, writs of execution and garnishee notices are unaffected by the legislation. The issue here is of course the respective courts, respective responses to the coronavirus crisis.

Individuals- Bankruptcy

Issue	**Current Law**	**New Law**
Minimum Debt	$5,000	Temporarily increased to $20,000
Timeframe in which a debtor must comply with a bankruptcy notice	21 days	Temporarily increased to 6 months
Timeframe where a debtor is protected from enforcement action following presentation of a declaration of intention to present a debtors petition	21 days	Temporarily increased to 6 months

Points to note

- Similar to Corporations, as the law does not have retrospective effect bankruptcy notices already in the system were subject to the normal rules.
- Therefore a subsisting bankruptcy notice needs to be complied within 21 days and failure to do so would ground an act of bankruptcy enabling the creditor to issue a sequestration order, i.e. bankruptcy.
- Similarly the legislation covers a period of 6 months from 25 March to 24 September 2020 – extended to 31 December 2020.

Relief from Insolvent Trading

- Directors will be temporarily released of their duty to prevent insolvent trading with respect to any debts incurred in the ordinary course of the company's business. Accordingly, the potential of personal liability for insolvent trading is lifted for the 9 month duration of the legislation.
- To secure the relief, debts must be incurred in the ordinary course of the company's business i.e. that is necessary to facilitate the continuation of the business.
- There is no relief from fraudulent or intentional insolvent trading.
- Debts incurred in this period are still due and payable by the company in accordance with the applicable payment terms.

- This amendment has been characterised as a “temporary second safe harbor “for directors
- However , directors should be conscious it is not a panacea to the potential for personal liability as a result of their company’s activities
- Directors fiduciary duties at common law and under statute continue in place. In particular, as a company is approaching the threshold of insolvency its directors owe a fiduciary duty to consider the interests of creditors.
- The failure to pay employee entitlements remain a civil penalty for which directors can be personally liable.
- The lock down liability for failing to lodge returns with the ATO will continue to apply.
- It is understood however the ATO will act judiciously during this period including temporary reductions or deferrals, withholding enforcement action including director penalty notices and wind ups.
- The recently introduced anti-phoenix provisions in the Corporations Act will continue to apply.

General Comments

- There has been quite a lot of commentary lauding these measures as freeing up directors to provide them the flexibility to focus on the task of navigating the challenges brought by the corona virus;
- It is quite clear however that the measures are not a “get out of jail free card” and that directors will need to continue to be cognisant of the interests of creditors particularly if the threshold of insolvency approaches.
- There is an argument that temporary relief from insolvent trading was an unusual measure to be introduced at such a relatively early stage of the response to the economic impact of the corona virus.
- An insolvent trading claim is only available in liquidation. The new measures presuppose that any attempt to resurrect the company would have failed and has the effect of protecting a director’s personal assets from the implications of the rescue attempt. In such circumstances, who bears the costs of the failed rescue attempt - it would be the company’s creditors, employees and counterparties.
- **There is a school of thought, that a correct reading of the legislation entails that unless the company is placed into voluntary administration or liquidation before the expiry of the legislation, the benefit of the protection will not be available to directors.**

Total corporate insolvencies nationally were 10627 in the 2018 calendar year and 11225 in 2019 calendar year.

Insolvencies for the current year total 5274 for the year to date and since the introduction of the relief measures have been down between 40-50% on equivalent periods last year.

The means in some ways the relief measures have been too effective as some businesses would have been insolvent but for the advent of Covid19 and the introduction of the related relief measures.

<u>Current Restructuring and Insolvency Framework</u>

Workouts

If action is taken early, an informal workout may be able to be effected, without the stigma of a formal appointment, which could reduce the value of the assets of a company or the loss of confidence of investors and/or customers.

Furthermore, generally a formal appointment will involve additional costs, adverse publicity and result in an independent practitioner controlling the company's business, property and affairs.

The advantages of a workout are as follows: -

- Reduction in costs;
- Directors retain control of the business;
- The company's reputation is preserved;
- Directors can avoid insolvent trading and other voidable transaction recoveries;
- It is not a creditor driven process

The disadvantages of a workout are as follows: -

- Directors may be found during the process to have breached their directors duties;
- Any standstill and workout agreement requires the agreement of all creditors, i.e. without such agreement the non-consenting creditors are free to pursue their normal legal remedies and this can jeopardise the objectives of the workout. This is contrasted with a VA, wherein the decision of the creditors present, and voting at the Section 439A meeting, binds the entire body of creditors. Hence, formal administration provides for more certainty than an informal workout;
- Financiers can potentially fall foul of the Corporations Act provisions with respect to insolvent trading by 'shadow' directors;
- Directors may be held liable for insolvent trading.

Informal workouts could include use of the 'safe harbour' provisions in the Corporations Act.

Safe Harbour

Pursuant to Section 588G(1) of the Corporations Act – Director's duty to prevent insolvent trading by company, a director of a company can be held personally liable if : -

> *(a) a person is a director of a company at the time when the company incurs a debt; and*
> *(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and*
> *(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become so, as the case may be; and*

The risk of being held personally liable (and also criminal liability) can be seen as a trigger for director's to place the company into Voluntary Administration prematurely rather than working towards a restructure outside of a formal appointment in a distressed situation.

The Government considered that the introduction of a safe harbour to the insolvent trading provisions will *facilitate the restructure of businesses, striking a better balance between encouraging entrepreneurship and protecting creditors.* Subsequently, on 28 March 2017 the Minister for Revenue and Financial Services released draft legislation, the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill* 2017 ("the Bill") with respect to these reforms. The Bill amends the *Corporations Act 2001* (Cth) and the *Payment Systems Netting Act 1998* (Cth).

Directors are provided with a 'carve out', against liability for insolvent trading as opposed to a defence to insolvent trading where they "start taking a course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors" than an external administration. This shifts the evidential burden away from the director, to the party alleging the safe harbour does not apply. This is said to be line with the policy objectives of facilitating honest and genuine business turnaround attempts.

It should be noted that, such protection only extends to debts "incurred in connection with that course of action."

This model looks to protect directors against insolvent trading claims where a director has been acting in the best interests of the company and its creditors as a whole with a safe harbour within which they may attempt to return the company to solvency.

The legislation provides the following:

Carve out

- If the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and
- The person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole; and
- Incurring the debt does not materially increase the risk of serious loss to creditors.

This approach places the onus of proof on any subsequent liquidator to prove that the director had breached any of the three exceptions above. It would be a matter for the Court to consider what is reasonable in relation to steps taken and period of time.

End of Protection

(i) the action ends;
(ii) the course of action stops being reasonably likely to result in a better outcome for the company and its creditors; or
(iii) the company enters external administration.

Exclusions

- a person who is disqualified from managing a corporation at the time the debt was accrued;
- Australian Securities & Investments Commission ("ASIC") has determined the person was ineligible as a result of prior conduct;
- There has been a substantial failure to meet its taxation law reporting requirements or is one of two or more such failures by the company during the 12 month period prior to the debt being incurred; and
- there has been a substantial failure to pay employee entitlements, including superannuation contributions.

The better “outcome” test is an objective test, dependant on the circumstances of each case.

Factors to be considered

- the steps taken to prevent misconduct by officers and employees of the company;
- the steps taken to ensure the company maintains appropriate financial records;
- obtaining appropriate advice from an appropriately qualified entity;
- the director keeping themselves informed about the company’s financial position;
- developing and implementing a restructuring plan to improve the company’s financial position.

“Obtaining appropriate advice from an appropriately qualified entity” is a consideration when determining if a course of action was reasonably likely to lead to a better outcome.

The broad wording ‘appropriately qualified entity’ has received mixed views. Some commentators have called for a minimum qualification requirement (such as being a registered liquidator), while others preferred the broad view, recognising that different companies face unique circumstances and what is appropriate for one company, may not be necessarily appropriate for another.

It is expected that the pre-insolvency advisory sphere will open to a wider range of advisors.

Privileged Communications

Communications with lawyers are subject to legal professional privilege i.e. such communications cannot ordinarily be obtained under compulsion of law and used in evidence in any proceedings brought against the director

This is relevant to any early communications with a non-lawyer advisor which evidence the directors state of awareness or the period of the company’s insolvency, which could be used against directors in insolvent trading claims where the safe harbour is not available and/or before the safe harbour period commences.

It is arguable that this is a structural flaw of the legislation which necessitates the involvement of lawyers, where they might either not otherwise be necessary or cost prohibitive and that that some limited qualified privilege should have been extended to communications with nonlawyer advisors.

Duty of Care

The legislation raises the possibility that professional advisers could be held liable for breach of duty of care for failure to advise of the availability of the safe harbour.

That is directors who are ultimately found liable for insolvent trading could seek to ‘share the loss’ in circumstances where their professional advisors such as accountants and lawyers failed to advise them of the availability of the safe harbour protections.

Like all duty of care cases the availability of such a claim would be a matter of degree – a professional advisor would be unlikely to owe such a duty for an hour consultation.

It would be more likely to be triggered where there is an extended retainer to advise with respect to solvency issues

Public Companies – ASX Listing Rules

ASX Guidance note 8 makes it clear that entities in financial difficulties are subject to the same disclosure obligations as other entities.

Listing Rule 5.10 was amended in March 2018 to reflect the availability of the safe harbour.

The fact that an entity's directors are relying on the insolvent trading safe harbour provisions to develop a course of action that may lead to a better outcome for the entity, is not something that ASX would generally require an entity to disclose under Listing Rule 3.1.

ASX is of the view that investors would expect directors of an entity in financial difficulty to be considering whether there is a better alternative for the entity and its shareholders than an insolvent administration. The fact they are doing so is not likely to require disclosure unless it ceases to be confidential or a definite course of action has been determined.

ASX takes the view the appropriate course when an entity is attempting a financial restructure or reorganisation, is to approach ASX with respect to a voluntary listing suspension to manage its disclosure obligations.

Safe Harbour in Practice

The two year anniversary of the safe harbour reforms fell due in September 2019 and the legislation provided for a review process at that time.

When reviewing the effectiveness of the provisions it should be borne in mind that there is no statutory record of companies adopting the safe harbour, and much of the negotiation is likely to be conducted in confidential circumstances.

Therefore we are largely left with anecdotal evidence of the utilisation of the safe harbour, which suggests that it has not been embraced as widely as anticipated to date.

Observations provided by McGrath Nicol[1] suggest that safe harbour advice is more likely to be utilised by public companies and large proprietary companies rather than small business.

This stands to reason for a number of reasons:

- Such companies are more likely to satisfy the safe harbour qualification criteria;
- Such companies have the resources to pay for safe harbour advice and implementation of restructure plans;
- Directors of smaller companies are likely to already be personally exposed by way of personal guarantees.

Having said that safe harbour may be appropriate in the following circumstances:

- **Where a company is asset rich** – cash flow poor – the safe harbour could be utilised to execute a strategy of selling illiquid assets with a supportive creditor base;

[1] Australian Restructuring Insolvency and Turnaround Association Journal Volume 31 #2 2019 at page 31.

- **Pre-positioned sales –** the safe harbour may be useful to provide directors sufficient comfort to pursue a pre appointment sale if it is the best interests of creditors;

- **White Knight Transactions** - If a company is relying on a last ditch sale process to generate liquidity to save the business, it is sensible for the directors to form the view that this represents a better outcome for the company in accordance with safe harbour provisions.

- **Refinance Negotiations** - The safe harbour could provide directors protection, in respect of refinance negotiations conducted in distressed conditions should those negotiations ultimately prove to be unsuccessful.

There is an argument that the law already provides for a 'safe harbour' by way of the voluntary administration provisions which also includes formal protections for creditors. Statistics show that a relatively small number of companies are effectively rehabilitated through the voluntary administration/deed of company arrangement process.

It is the suspicion that the concept of the 'safe harbour' outside formal administration would in reality apply to a relatively small proportion of distressed companies and that as in the case of informal workouts, the blowtorch of scrutiny will apply to failed 'safe harbour' turnarounds.

Voluntary Administration / Deed of Company Arrangement

The objectives of the voluntary administration are stated in Section 435A of the Corporations Act, as follows: -

> *"the object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:*
>
> *(a) Maximises the chances of the company, or as much as possible of its business, continuing in existence; or*
> *(b) If it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would results from an immediate winding up of the company."*

The voluntary administration provisions allows for a short moratorium, which allows a company and its directors the opportunity to formulate a proposal to creditors, which will deal with the debts incurred prior to the voluntary administration and continue to trade in the future.

The advantages of a voluntary administration are as follows: -

- An independent insolvency practitioner is appointed who controls the company's assets and reports to creditors on the financial performance of the company and its prospects for the future;
- Administrator has the advantage of seven day rent free period in respect of property owned by others;
- Directors have the opportunity to put forward a proposal to ensure the business and the company continues in existence;
- The appointment of an Administrator can avoid personal liability in respect of unpaid tax liabilities;
- The process is relatively short, a standard administration lasts approximately 5 weeks;
- It is a creditor driven process and they have the power to decide the future of the company;

- Any dividends payable occur faster than if the company was placed into Liquidation;
- Creditors and other stakeholders benefit from the company continuing in existence;
- In the event a proposal is accepted by creditors, voidable transaction and preferences are not pursued;
- Creditors are unable to pursue personal guarantees during the administration process;

The disadvantages of a voluntary administration are as follows: -

- It is a creditor driven process and they may reject the proposal being put forward and place the company into Liquidation;
- The appointment is advertised;
- The directors conduct and personal financial positions are reported to creditors;
- During the administration, directors are no longer in control of the company's business, property and affairs.

In order to determine which appointment is in the best interests of the directors and the company as a whole, advice needs to be sought.

Again, it is imperative that early advice be sought so that the options available increase. In the event early advice is not sought, directors may find that the only option available is a formal appointment and one that results in an orderly winding up of the company.

Liquidation

The advantages of Liquidation are as follows: -

- An independent insolvency practitioner is appointed who controls the company's assets;
- The appointment of a Liquidator avoids personal liability in respect of unpaid tax liabilities;
- Avoids the expense of a Voluntary Administration;

The disadvantages of Liquidation are as follows: -

- Directors do not have the opportunity to put forward a proposal to ensure the business and the Company continues in existence
- The appointment is advertised;
- Any dividends payable occur slower than if the company was placed into Administration;
- The Company is being wound up with no prospect of a turnaround;
- Fire Sale conditions may occur;
- Creditors and other stakeholders lose out as the Company will not be continuing in existence;
- Insolvent Trading and Voidable Transactions provisions are available and the director and other related parties can be exposed.

Legitimate Pre Pack

There is a mechanism by which directors can legally buy back the business and assets of their company and begin again. The process is often described as a pre-pack:

- A pre-appointment review of the insolvent company is undertaken to determine if this option is viable and if it is a liquidator is appointed;

- The director or a related party, within the first few days of the appointment, executes a conditional sale agreement to buy the assets and enter into a license agreement to continue to trade the business for the next few weeks;

- The sale price is estimated between the going concern value and auction value of the company and is paid upon execution of the conditional sale agreement, however this figure is not finalised until a registered valuer has valued the assets and a public sale campaign has been conducted;

- If during the sale campaign conducted by the Liquidator, inviting offers from the public to purchase the business and assets as a going concern, a better offer has been received, the directors/related party will have the opportunity to outbid the better offer; if this is possible the conditional contract becomes binding; if this is not possible the business and assets will be sold to an alternative purchaser and the funds paid by the director/related party are refunded;

This process ensures that market value for the company's business and assets is obtained. Furthermore, with a Liquidator controlling the process, a director cannot be accused of being involved in an illegal phoenix sale.

Receiverships

A Receiver or Receiver and Manager may be appointed by the court or by a secured creditor. A secured creditor has the capacity to appoint a receiver and manager by virtue of a security interest or mortgage over the assets of the company. The security interest can be fixed and floating over specific assets or floating over all the assets of the company.

The advantages of Receivership are as follows:-

- Avoid the expense of an Administration;
- Receiver does not need to report to all the other creditors of the company, only their appointer;
- Receiver has advantage of seven day rent free period in respect of property owned by others;

The disadvantages of Receivership are as follows:-

- The moratorium provided for in a Voluntary Administration is not available to a Receiver and thus unsecured creditors are free to continue with recovery/enforcement action;
- During the receivership the director is no longer in control of the company's business property and affairs;
- Unsecured creditors do not get to control the process;
- After discharge of the secured creditor debt the company is returned to the director and the company may be vulnerable to some other form of insolvency administration.

Small business Reforms

The budget announcements provide clear signals to the business community that the temporary relief packages in particular Jobkeeper will be wound back and a more permanent framework will be put in place to assist business deal with the economic fallout of Covid19 and plot a path to recovery.

The government is fast tracking reforms specifically tailored to small business to be introduced by 1 January 2021 to assist with the economic impacts of COVID 19 and to replace the temporary relief measures

Much of the detail is yet to be released but the reforms contemplate two new models / concepts

- Small Business restructuring:
- Simplified liquidation

Small Business Restructuring "(VA Lite)"

Nature of Model:

- Contemplates a debtor in possession model, coupled with a moratorium on creditors claims whilst the company in conjunction with a small business restructuring practitioner formulate a debt restructuring plan;.
- It incorporates a number of the characteristics of the Voluntary Administration regime but it is intended to be appropriate to small business as VA"s are seen to be cost prohibitive to small business.

Eligibility Criteria:

- A company must be insolvent or likely to be insolvent.
- Total liabilities have to be lower than the amount prescribed by the regulations which is currently foreshadowed to be $1 Million.
- A company is not eligible to use the debt restructuring process if a director has previously used the process or the simplified liquidation process.
- The draft explanatory material suggest that the regulations could require the business to ensure that payments to employees that are due and payable are paid up and tax lodgements are up to date before a plan could be put to creditors.
- The intention here is to ensure the creditor profile and priority is simplified before undertaking the process.

Time frame:

- The company has a 20 business day period to develop a plan to restructure the business's debts.
- Creditors have 15 business days to vote on the plan.
- A restructuring plan will need to provide sufficient information so creditors can decide whether to accept or reject the plan.

Creditor rights:

- Court proceedings and enforcement proceedings are stayed and cannot be begun or proceeded with during the debt restructuring process.
- The rights of secured creditors, owners of property and lessors of property are consistent with those applying under the VA process.

Voting:

- More than 50% of creditors in value
- Related party creditors are excluded from voting.

Fees

This appears to be left to the regulations, which have yet to be released.

The Treasury Fact Sheet released when the reforms were announced suggests the following:

- A flat fee for developing the restructuring plan;
- Remuneration to cover management of the plan will operate as a percentage fee of disbursements under the plan.

Small Business Practitioner

The material released to date indicates that at this stage registered liquidators will be able to complete the new form of administration.

However it remains open for the regulations to define more limited criteria to qualify as a small business restructuring practitioner.

Transitional Arrangements

The Treasury Fact Sheet foreshadows transitional arrangements to enable directors and practitioners to familiarise themselves with the new process.

The existing temporary relief measures with respect to statutory demands and protection from insolvent trading will be available to eligible business if they declare an intention to access the simplified restructuring process to its creditors, i.e. through ASIC website.

This transitional measure would only be available until 31 March 2021.

For those businesses which do not declare an intention or actually make an appointment the standard position with respect to statutory demands and insolvent trading will be restored.

Other key features

- As debtor in possession companies/their directors can only deal with company property in ordinary course of business;
- There are no physical meetings of creditors. Proposals are voted on electronically or other means of technology e.g. circulating resolution
- Entry into a debt restructuring process constitutes an act of insolvency.
- If the restructuring plan is not accepted, or terminated - the Company can utilise one of the more traditional forms of Administration such as VA or CVL and creditors are also free to pursue their rights
- If there is an inconsistency between the Legislation and the Regulations, the Regulations are to prevail. This is said to be necessary to allow the executive to be responsive to the needs of small business in a rapidly evolving environment

Simplified liquidation:

The proposed simplified liquidation process is intended to reduce the costs of liquidation for eligible small business, with a view to increasing potential returns to creditors.

It appears to be essentially a CVL without.

- The investigations associated with a Section 533 report .
- Meetings of creditors.
- Committees of Inspection
- ASIC and creditors cannot appoint a reviewing liquidator;
- The regulations may include some restrictions on the recovery of preference payments

Eligibility Criteria:

- The company is insolvent
- Liabilities do not exceed an amount to be prescribed in the regulations foreshadowed to be $1 million
- No director has been a director of a company that has previously used the simplified liquidation process or a debt restructuring process.
- The company's tax lodgements are up to date.

Time for adoption

- A liquidator cannot adopt the simplified liquidation process if more than 20 business days have passed since the appointment.
- A liquidator must give creditors at least 10 business days notice before adopting the simplified process.
- The liquidator cannot adopt the simplified process if more than 25% in value of creditors request the liquidator not to follow the simplified liquidation process

Mandatory Code of Conduct – Retail and Commercial Tenancies

A recent decision of the NSW Supreme Court in **Sneakerboy v Georges Properties Pty Ltd (No.5) [2020] NSWSC 1141** has provided some clarity to the application of the regulations of the Mandatory Code of Conduct for retail and commercial tenancies.

The code was announced on 7 April 2020.

The objective of the code was to share in a proportionate measured manner, the financial risk and cash flow impact during the Covid-19 period whilst seeking to appropriately balance the interests of tenants and landlords.

It was intended that parties were to negotiate and agree to bespoke arrangements for each tenancy taking the tenants particular circumstances into account.

Parties were expected to negotiate in good faith and provide each other with sufficient information in order to negotiate outcomes consistent with the code.

Each jurisdiction introduced draft regulations to implement the code, which are generally consistent.

In NSW, the **Retail and other Commercial Leases Covid-19 Regulation 2020 NSW** commenced on 24 April 2020.

Coverage

The regulation applies to the enforcement or exercise of rights under a lease in relation to circumstances during the period from its introduction 24 April 2020 to 31 December 2020 (i.e. this has been extended from 24 October 2020).

Application

The regulation applies to leases that existed before the commencement of the prescribed period i.e. 24 April 2020 and any subsequent renewal or extension of an existing lease.

- A 'retail shop lease' under the Retail Leases Act (1994) NSW which extends to licence agreements and other informal retail tenancy agreements covered by the Act; and

- A 'commercial lease' which relates to leasing of premises or land for a commercial purpose – it does not include agricultural leases.

The regulations do not apply to new leases entered into after 24 April 2020 unless it is a renewal or extension of an existing lease.

Parties to these leases are free to negotiate terms outside the scope of the code.

Criteria

The Regulation applies to small to medium enterprise (SME) tenants who meet both of the following criteria:

- Qualify for the Commonwealth Jobkeeper program which generally requires:
  - the lessee operated a business since 1 March 2020;
  - the business has suffered (or likely to suffer) a decline in turnover by 30% or more;
  - the lessee is not in liquidation or under bankruptcy; and
  - the lessee is not an excluded entity (being major banks, government or local government entities or sovereign entities).
- Annual turnover in the 2018/2019 financial year was less than $50 million:

(NB the criteria for Jobkeeper have been tightened from the September quarter).

The National Cabinet did suggest that the principles underlying the code should apply “in spirit” to all leasing arrangements although the consequences of non compliance have never been made clear where the eligibility criteria are not met

How is Turnover calculated

- for franchisees – the turnover of the business conducted at the premises or land concerned;
- for members of a corporate group – the turnover of the group (which includes a subsidiary tenant or related party tenant); and
- in any other case – the turnover of the business conducted by the lessee.

Turnover of a business includes any turnover derived from internet sales.

Impacted lessees can choose to contract out of the protections.

Restrictions on Enforcement

Landlords are prohibited from taking prescribed action against an impacted lessee during the prescribed period under the terms of the lease, or seeking orders from a court or tribunal for breaches because of:

- A failure to pay rent;
- A failure to pay outgoings;
- A failure to open for business during the hours specified in the lease; or
- Breaches of the lease in order to comply with Commonwealth or NSW State Government COVID-19 legislation (public health orders etc).

Prescribed action generally includes:
- Termination of the lease, evicting the tenant, and exercising a right of re-entry to the premises;
- Call on a bank guarantee or rental bond or pursuing a guarantor;
- Charging interest or fees on unpaid rent;
- Recovering damages; and
- Any other remedies available.

Tenants must comply with all their other (non COVID-19 related) obligations under the lease.

Leasing principles

Either party can request to renegotiate the rent payable and any other terms of the lease.

During the COVID period, a landlord cannot take any prescribed action unless they have complied with a request and participated in good faith negotiations.

The following principles apply when negotiating temporary lease arrangements:

1. landlords won't have the right to terminate leases for non-payment of rent during the COVID-19 pandemic period (or a reasonable subsequent recovery period);

2. tenants will need to continue to comply with the terms of their lease, subject to any negotiated amendments with their landlord;

3. rent reductions should be proportionate, payable in the form of waivers and deferrals of up to 100% of the amount of rent that would normally be paid. The amount of reduction should be assessed on a case-by-case basis, based on the reduction in the tenant's trade;

4. at least 50% of the total rent reduction should be in the form of a rent waiver (unless the tenant waives such a requirement);

5. tenants must be allowed to amortise the deferred rent over the greater of either the balance of the lease term or over no less than 24 months, unless the tenant and landlord agree otherwise;

6. if the landlord receives any reduction in statutory charges, such as land tax or council rates, or insurance, this reduction is to be passed on to the tenant in the appropriate proportion applicable under the lease;

7. any benefits received by landlords due to deferral of loan payments should be shared with the tenant in a proportionate manner;

8. landlords should seek to waive the recovery of any other expense (or outgoing payable) by a tenant, under lease terms, during the period the tenant is not able to trade;

9. all repayments should occur over an extended period and no repayment should commence until the earlier of the COVID-19 pandemic ending (as defined by the Australian Government) or the existing lease expiring, taking into account a reasonable subsequent recovery period;

10. no fees, interest or other charges should be applied to rent waived and no fees, charges or interest may be charged on rent deferrals;

11. landlords won't have the right to draw on a tenant’s security (such as bond, bank guarantee or personal guarantee) for the non-payment of rent during the period of the COVID-19 pandemic and/or a reasonable subsequent recovery period;

12. the tenant should be provided with an opportunity to extend the lease for an equivalent period of the rent waiver and/or rent deferral period. This is intended to provide the tenant additional time to trade, on existing lease terms, during the recovery period after the COVID-19 pandemic concludes;

13. landlords agree to freeze rent increases during the COVID-19 pandemic period and a reasonable subsequent recovery period, except for retail leases based on turnover rent; and

14. landlords won't have the right to apply any prohibition or levy any penalties if tenants reduce opening hours or cease to trade due to the COVID-19 pandemic.

Mediation

Where attempts to renegotiate in good faith with an impacted lessee have failed, the Regulation provides for mandatory mediation before action can be taken in a tribunal/court.

This will be by way of reference to applicable state or territory retail or commercial leasing dispute resolution processes for binding mediation.

In NSW, both retail and commercial leases must refer to the NSW Small Business Commissioner (with some exceptions) and the Commissioner needs to certify the mediation failed before proceedings can be initiated in a court or tribunal.

The Regulation requires a court or tribunal to have regard to the Leasing Principles of the Code when considering a decision or order enforcement action.

The Regulation does not prevent enforcement action on grounds not related to the economic impacts of the COVID-19 Pandemic.

The existing rules of equity and common law continue. For example, tenant’s seeking relief against forfeiture (which gives the tribunal/court broad discretion to prevent a landlord from terminating a lease on grounds of equity and fairness) is unaffected.

Sneakerboy

The Sneakerboy case provides some useful guidance as to the application of the Covid-19 leasing regime.

Facts

Sneakerboy operated a sneaker business out of five premises in three states as well as an online presence.

The company experienced a sudden decline in revenue in February 2020 which it attributed to the Covid-19 pandemic and ceased paying rent i.e. they had a history of paying late.

On 20 March 2020, the Government placed mandatory restrictions upon non-essential indoor gatherings which included the lessee's store and on or about 23 March 2020 the lessee ceased trading from the premises and redirected stock to focus an online sales.

On 25 March 2020 the lessor re-entered possession of the relevant Sydney CBD premises on the basis the rent was late and the lessee had abandoned the premises.

NB – this took place before the introduction of the Mandatory Code of Conduct.

Issue

The landlord called upon the bank guarantee in the amount of $253,668.90 which was paid by the bank on 15 June 2020.

This had the effect of paying the outstanding rent.

In **Sneakerboy v Georges Properties Pty Ltd [020] NSWSC 996 "(Sneakerboy No.1)"** the tenant sought relief against forfeiture.

i.e. this is an order that it be permitted to re-enter the premises and continue to occupy the premises under the lease.

Decision

Ultimately the relief was granted as the landlord had secured repayment of the unpaid rent by calling in the bank guarantee.

The restoration of the lease had the effect of bringing it under the umbrella of the leasing regulation.

Sneakerboy Retail Pty Ltd trading as Sneakerboy v Georges Properties Pty Ltd (No.2) [2020] NSWSC 1141 (Sneakerboy No.2) clarified a number of issues with respect to the Leasing Regulation.

Application of Covid-19 Regime

The court held that the Covid-19 Leasing Regime had retrospective effect from 1 April 2020 (i.e. in line with the period the Jobkeeper program is operational, notwithstanding the regulation was not passed until 24 April 2020).

Tenants Trade

Leasing principle 3 of the Code of Conduct provides:

"rent reductions should be proportionate…… the amount of reduction should be assessed on a case by case basis based on the reduction in the tenants trade".

The court held:

- That consideration should be given to a particular tenants turnover from all locations where the tenant conducts rental business including online sales.

- If tenants costs are down e.g. due to the effect of government subsidies, then that should reflected in the calculation of an appropriate reduction.

- Businesses with regular trade should compare revenue with an equivalent period in the previous year. Whereas seasonal businesses would need to compare Covid-19 effected turnover with a longer pre-Covid-19 period.

Recovery Period

The Code of Conduct provides its protections to a subsequent reasonable recovery period after the Covid-19 pandemic period.

In Sneakerboy the court accepted a reasonable recovery period would be six months from the end of the leasing regime providing Sneakerboy at least until 30 April 2021 before the landlord could raise the rent and recover possession.

However the court foreshadowed that in relevant circumstances the court might be open to longer periods of recovery. As the code is intended to apply on a case by case basis, it is a possibility that the recovery period could be less in relevant circumstances being where normal trading conditions are restored quicker.

Implications

- Eligible tenants need to negotiate rent relief during the period the regulation is in place. This is to take advantage of the codes protection including the entitlement to a reasonable recovery period. This is currently due to expire on 31 December 2020. If negotiations are not concluded before that time, the protections will not be available. (subject of course to further extensions).

- The courts appear to be reasonably lenient to 'Covid-19' effected tenants. Accordingly, landlords should exercise some caution with respect to lease termination.

- Landlords will have to factor the availability of subsequent reasonable recovery period into their negotiations. The effect of the protections offered by the code in respect of reduced rent and prohibition of terminations, could last at least six months and potentially beyond that after the codes expiry, before the standard lease terms resume.

The anecdotal evidence suggests the code enabling regulations have had some difficulties in their practical application:

- There have been some reports of both tenants and landlords not engaging with the process, this is particularly the case with respect to overseas based landlords.

- Landlords have requested an unreasonable level of financial information in the rent review process.

- Both landlords and tenants have behaved opportunistically with respect to the process. There have been instances of landlords seeking new leases at the existing rental as a condition of providing Covid-19 relief.

- The respective state leasing dispute resolution process were under resourced for the level of mediation services required, when the regulations were introduced. In NSW an additional $10 million was allocated to the NSW Small Business Commission in September.