The Market for Retail Tenancy Leases in Australia

Submission in response to Productivity Commission Draft Report

1. I provide this further submission to the Productivity Commission in response to the Commission's five draft recommendations contained in pages 205-217 of the Commission's draft report.

2. In my view, the greatest injustice occurs with respects to tenancies of less than 1,000 square meters (being the threshold for the provisions of the *Retail Leases Act*) and specifically with respect to shopping centres, similarly using the definition contained in the *Retail Leases Act* namely "a cluster of five or more stores" obviously including large and regional shopping centres). The *Act* is correct to focus its operation on the protection of these tenants. Similarly this submission will focus on tenants in shopping centres with premises of less than 1,000 square metres located in shopping centres. As is noted in the Report, larger tenancies do have greater bargaining power and the writer readily sees this in day to day legal practice, where the "mini major" tenant has considerably greater bargaining power as against the small tenant.

3. The most succinct way of illustrating the issues is to do so with reference to examples. The first example is based broadly on a specialty retail tenant in a regional shopping centre where the premises are approximately 100 square meters and the second example is based on a shopping centre that has been re launched and the Centre as whole (as well as the tenant) is experiencing a decrease in its sales.

Example 1:

(a) Fit out costs: $180,000

(b) Rent:

Centre leases to competitor

Year	**Rent**	**% rent increase**	**% sales increase**	**Sales**
1	$120,000			$750,000
2	$127,200	6%	9%	$817,500
3	$134,832	6%	-20%	$654,000
4	$142,922	6%	6%	$693,240
5	$151,497	6%	4%	$734,834

(c) Centre offers new lease at:

Rent	% rent increase	% sales increase	Sales
$209,067	38%	-2%	$734,834

(d) Landlord requires refurbishment of shop : $100,000 (estimated cost)

(e) If tenant leaves – costs of defit - $18,000

(i) The very significant obstacle which could be experienced by the Commission in properly evaluating the market of retail leasing in Australia, is that much depends upon what is quantifiable or reportable. Those who operate and have involvement with retail leasing would have, from day-to-day practice, very definite views as to the significant problems and unfairness experienced by retailers in shopping centres. Some of the critical

issues may not be quantifiable – for example, as Example 1 illustrates, the tenant is required to fit out the premises, in this example at a cost of $180,000. There would be no record of the costs of fit out. This is a further expense of the tenant in addition to the rent and outgoings. In this particular example the tenant is required to spend $180,000 much of which is borrowed funds before commencing trade. Unlike commercial tenancies (I will also raise concerns with respect to the Draft Report's comparison of retail tenancies with commercial tenancies later), the tenant only receives a shell. The tenant is required to spend all funds in fitting out the premises including relocating sprinkler heads, connecting to air conditioning and some of these expenses require the tenant to either use the landlord's contractor who sometimes is a related entity to the landlord or the landlord's preferred contractor. The tenant is required to comply with onerous obligations including the attainment of the landlord's Architect's approval and in many cases it is required to pay the landlord the costs of such consultants providing their approval. It is common practice in certain regional centres for the tenant to be obliged to even pay costs such as a survey of the premises. It is precisely because there is insufficient competition that the centre can charge all such costs to the tenant. This can be contrasted with strip centres and particularly prior to the introduction of shopping centres where all of the fit out costs would not be that of the tenant. Thus in this example the tenant is required to spend $180,000 setting up the premises.

(ii) In this particular lease the rent increases by CPI plus 1.5%. This in itself is unfair. The annual reviews should be CPI. Further as nearly every regional shopping centre shifts 100% of the outgoing costs to the tenant, the actual yearly increase in occupancy costs can far exceed CPI plus 1.5% - for example when there is an increase in land tax this is passed onto the tenant. In this example we assume that the total gross rent increase each year amounts to 6%. You will note that by the end of the term in fact the increase, because the 6% is compounded, amounts to a 26% increase in the 5 year term.

(iii) One of the great injustices in the tenant having to disclose its turnover is that it is typical for the shopping centre, once it sees that the per square meter sales is greater than the average in its other centres or sees that tenant's sales are increasing, the centre then attracts/entices a competitor to the tenant into the shopping centre. What is most disappointing in practice is that whilst the leasing agent may not specifically disclose the turnover of the existing tenants in a certain category, it is common for the leasing agent to give an estimate of the sales being achieved by existing tenants. I appreciate that this is prohibited under the *Act* however in practice tenants who are being enticed into centres experience this. Whether or not the leasing agent actually discloses the current turnover, the shopping centre entices competitors. Now whilst the lease protects the centre in that the rent is going up 6% each year, in this example in year 3 when a competitor was introduced into the centre, the tenant's sales dropped by 20%.

(iv) Unfortunately, the tenant has the lease secured by a personal guarantee which exposes the tenant's personal assets yet the landlord on the other hand is a multibillion dollar entity that is protected by the lease entitling it to the minimum increase regardless of the sales achieved by the tenant and regardless of whether the landlord by its own conduct in introducing a

competitor, damages the tenant's business. Further, the landlord has put very little cost into the tenancy itself as the tenant has been required to fit out the premises and all costs are shifted to the tenant. The difficulty experienced by the tenant is – where else is the tenant to go? It is not like in the days of strip shopping where there were alternate landlords. There is only one landlord usually in each regional centre.

(v) In this particular example, at the end of the lease term the rent had increased to $151,497 which amounts to a 26% increase because of the fixed increases each year and then the centre requires a 38% increase if the tenant is to accept a new lease. In this particular example this is $209 067. Because the landlord introduced a competitor the tenant's sales have in fact dropped by 2% and are now $734,834, that is the landlord will in the commencement of the 6th year have achieved a 64% increase in rent whilst the tenant has experienced a 2% drop in sales. Now the tenant is facing a significant dilemma. The tenant has worked hard over the last 5 years to establish goodwill and to build this business. The tenant invested $180,000 at the commencement. The tenant has spent $676,451 in rent over this period and now the tenant is faced with a further 38% increase in rent which would mean that the ratio of rent to sales is 28% which is not sustainable and would make the business profitable. If the tenant walks away (and I note that the Report makes comment that the tenant is not forced to sign the lease) then the tenant foregoes its fit out costs and foregoes the goodwill that it has established in building the business. Further, the tenant may after repaying its initial investment of $180,000 and the costs of defit which in this example we estimate to be $18,000 have lost money after being in the centre. One thing is certain, if the tenant leaves most the tenant's goodwill is lost. The tenant is in a vulnerable and unfair position. Many tenants in this situation proceed and agree to the demands of the landlord notwithstanding their best endeavors to negotiate and end up having to work longer hours themselves or with other non paid family members in order to survive. But at the same time the landlord requires the tenant to refurbish the store. In this example we estimate the cost of refurbishment to be approximately $100,000. What is further disappointing is that the centre's Architects can be most unreasonable in their demands as to the type of finishes and refurbishment, some of which have no impact on the tenant's sales, yet the tenant has nowhere to seek redress against such demands. To provide an actual example, in a recent lease transaction, the tenant wished to refurbish existing fittings by completely refurbishing their exterior such that the fixtures would appear brand new. The Disclosure Statement (issued by two of the largest shopping centres landlords in Australia) actually stated the words that they required"brand new fixtures and fittings". We wrote to the solicitors for the landlord saying we consider this position to be environmentally irresponsible. They responded to us by saying that whilst their clients consider themselves "good corporate citizens" but they would not accede to our request. This particular transaction in the end had very dire consequences resulting in the tenant losing her home and notwithstanding 25 years of trade, becoming destitute in her retirement.

(vi) The tenant in this example is at some point doomed to fail. Whilst the multibillion dollar shopping centre landlord has the protection of trustee limitation clauses in the lease and has very limited exposure to the tenant, the tenant on the other hand is required to give personal guarantees such that the tenant's personal assets (usually including the family home) are

exposed. The tenant cannot sell the business because the profitability of the has been greatly reduced or in fact the tenant is losing money and the response of the landlord ultimately will be that when the tenant fails they will sue for the shortfall in rent until they find a new tenant and then the whole process starts all over again.

(vii) In contrast, if rather than there being one landlord there were hundreds of landlords as there were in the days that strip shopping was the only alternative, this harsh environment would not exist, and landlords would be competing to obtain the business of tenants. In this regard respectfully I cannot agree with the sentence in paragraph 11.1 of the Commission's Draft Report where it is said "generally there is competition amongst landlords for tenants". In my view it is unequivocal that the opposite is in fact the case.

(viii) The response might be that the tenant should go and lease on a shopping strip. The problem is that the market concentration of shopping centres has significantly damaged shopping strips. If we take an example of Parramatta, you have a very significant concentration of stores attracting customers with appropriate car parking facilities at the regional shopping centre and it unfortunately has the effect of turning the strip into almost a "ghost town." Continuing to use Parramatta as an example, if there were to have been a second shopping centre which I understand was a proposal at the other end of Parramatta, near the Riverside Theatre near where David Jones used to be, that would have kept the strip alive and there would have been competition and also there would have been competition not just because there would be two shopping centres but because the thoroughfare between the two – the strip shops would also survive. A positive example in this regard is Victoria Road at Chatswood where there are two shopping centres and there is a strip between.

(ix) If one practices in this area, one knows that this example is not an anomaly but is common. One must come to the conclusion that the monopolistic power of having only one landlord in a region means that there is insufficient competition resulting in significant hardship to the tenant. In the long run this will cause great distress, personal suffering and financial disaster for many tenants and will mean that only certain businesses will be able to survive in shopping centres. Further the shopping centre can keep turning over tenants so that this scenario gets repeated. In larger chains, the only reason why the tenant will renew the lease in such circumstances is the economies of scale can be such that even a very small contribution to profit of say $10 000 may still justify keeping the store open bearing in mind also that there will be costs in closing the store, that is defit obligations.

(x) Later in this submission I will put forward some further ideas with respect to overcoming the gross injustice of this system however I acknowledge that it is not easy to work out how to solve it. In many ways the horse has already bolted in that there are existing shopping centres and where the land would have been purchased at much cheaper prices than today's prices and those centres would have the major draw cards already there. I commend the Commission for noting the obstacles of planning legislation which do not assist in overcoming this injustice with respect to competition. That being said I consider that the Commission has an ideal opportunity to commence looking at these issues. The key point is that we cannot overlook

the fact that in this example the landlord receives a 64% increase in rent and the tenant obtains a 2% drop in sales and all of the costs have been shifted to the tenant. The only way in the long run that this can be overcome is to make the market more competitive. Exactly how this is to be achieved is a difficult question to answer.

Example 2 – Centre which is not performing:

(a) Fit out costs: $180,000

(b) Rent:

Year	Rent	% rent increase	% sales increase	Sales
1	$90,000			$562,500
2	$95,400	6%	-10%	$506,250
3	$101,124	6%	-8%	$465,750
4	$107,191	6%	-8%	$428,490
5	$113,622	6%	-7%	$398,496

(c) Defit cost - $18,000

(i) It is often assumed that always sales increase in a particular centre - that is not always the case particularly where a centre closes down to refurbish and then struggles to regain its market share. This example shows the plight of the tenant who has provided a personal guarantee so that their personal assets including their house are exposes to the obligations of the lease yet the landlord is protected because each year the rent still increases by 6% notwithstanding that the sales fall. Again similar to the last example, the tenant is required to fit out the premises at a cost of $180,000. Trade commences and the tenant achieves insufficient sales to make the store profitable. Sales continue to decline over the 5 year term. The tenant is faced with a dilemma. The tenant is obliged to pay rent for the next 5 years notwithstanding that the centre itself is not performing. In this sense the lease protects the landlord and guarantees the landlord a certain return whether or not the landlord delivers by making the centre successful and like in the previous example all costs are shifted to the tenant. If the tenant was to vacate, it would get sued for the balance of the lease term or until the landlord was able to mitigate its loss and it would also be required to defit the premises the cost of $18,000. This is a further example of the harsh realities experienced by the tenant in situations where a centre does not perform. Please note that often in these situations the landlord will not give frank disclosure of its sales or they might argue that sales are increasing because they are leasing more lettable area and sometimes these can be to discount $2 shops or temporary tenancies. The landlord may not acknowledge the failure of the centre and unfortunately are under no obligation to do so. On the other hand the tenant is required to disclose all of its sales. There is a great imbalance in the information held by both tenant and landlord.

(ii) This example is a disaster for the tenant and in the end will create great injustice to the tenant because the centre is performing so poorly the tenant will be unable to also sell its business.

Registration of Leases

4. The report makes reference to one of the submissions which said that there is transparency in relation to rentals and that for a cost of $18 any tenant can find the rentals of any particular tenancy in a shopping centre. I wish to make the following comments in relation to this remark:

    (i) It is true that leases that are registered can be searched for a nominal fee and further there are services available where you can have access for a period of 12 months to rentals for shopping centres throughout Australia and we frequently recommend that our clients obtain this information. I wish however to draw the Commission to the following very significant caveats in this regard.

    (ii) I can only recall one lease in the last several years which had the lease incentive recorded in the lease itself. Invariably the landlords require any lease incentive to be contained in the Agreement for Lease (which of course is not registered) or in a side letter. In fact we sometimes have difficulty with solicitors acting for the landlord who are instructed that there is to be no reference whatsoever in registered documentation to the lease incentive and we argue that one of the boiler plate clauses then requires amendment, namely that the lease contains all the terms of the agreement between the parties because technically the landlord could rely upon that clause to exclude the fit out contribution/ lease incentive. Whilst usually it takes some time, we are usually successful in convincing the solicitors for the landlord to make reference to the letter or the Agreement for Lease. It is a false assumption that the lease discloses leasing incentives or fit out contribution.

    (iii) It must be understood that the only reason why the landlord would not register a lease promptly is so that the information is not available to the market. From a legal point of view it is in the interest of both parties that the lease be registered to protect indefeasibility of title under the Torrens system. There can be no "legitimate" reason for delaying the registration of the lease.

    (iv) To cite an actual example from our practice, a 7 month rent free period was provided to a tenant in a regional shopping centre and 4 years later the lease had not been registered (this was discovered when the tenant tried to sell the business.) In summary it is important to be cautious of comments stating that there is transparency through registration. There may be transparency generally in relation to the base rent, agreed, but certainly not in relation to incentives.

5. I trust that by the two examples cited above that I have highlighted two typical scenarios which emphasise the lack of competition in relation to shopping centre tenancies and the great injustice and hardship which is experienced by the tenant. I make the following comments in relation to some of the draft recommendations of the Commission.

6. I consider that the real issue is not lowering of compliance costs. That is of minimal significance. The real issue is taking steps to make the market more competitive for tenants in shopping centres. In day-to-day practice in this area, it is our view that one cannot come to any other conclusion that the monopolistic position of the shopping centre creates an unjust outcome for the tenant and the market is not really operating because there is, in effect, really only one landlord. That is the issue. Maybe it is difficult

for the real damage to be quantified- how many bankruptcies have occurred, how many tenants have lost their homes, how many tenants are financially struggling because of this? As our examples show, whilst statistics may show the rental, they do not take into account all the other expenses of the tenant, particularly the fit out and as the examples show all expenses are payable by the tenant. Those who practice in this area see the day-to-day hardship caused to the tenant and where as say an employee has a union to defend him/her; there is no avenue of redress for a tenant in these circumstances – that is, where there has not been a breach of the *Retail Leases Act* – but simply use of monopolistic power. It is a complete contrast to when there were strip shops and there were hundreds of alternative landlords. This needs to be the Commission's focus. It is not an easy question to solve. With respect, the idea of minimising compliance costs in my view falls into insignificance in comparison to this issue. I do sympathise with the Commission in that it may be difficult to have empirical data to clearly identify this but a measure could be for example: a comparison of rent over the last 20 years as against profit for small retailers over the last 20 years. That alone will speak volumes. Again of course one needs to be aware that it is not showing all of the other costs required to be paid by the tenant and again I emphasise all costs are shifted to the tenant from the landlord.

7. It is positive to see the number of responses from tenants and landlords and tenant and landlord groups to the Commission however I wish to add the following feedback and suggestions as to why more retailers have not been forthcoming telling their story:

   (i) Firstly because of the system which the two examples illustrate most retailers are simply struggling to survive. They have insufficient time and some insufficient expertise to make a submission.

   (ii) Tenants have a fear that by speaking out, they will be somehow penalized in lease negotiations.

   (iii) Unfortunately there is a great skepticism and disappointment amongst retailers in relation to government's role in assisting them. After what occurred at Orange Grove, many tenants have lost confidence in the role of government to act appropriately in this area. Having said that, many proactive steps have been taken by the New South Wales Department of State and Regional Development – Retail Tenancy Unit, to educate and assist both landlords and tenants. More needs to be done to restore the confidence of tenants in the role of Government in this area.

   (iv) Confidential Submission: [See confidential submission]

   (v) I consider one method of starting to overcome and deal with some of these issues would be for the Government to fund a tenant's organization being the tenant's equivalent of the Shopping Centre Council of Australia. The Commission could give consideration into what powers this entity would have. It could be funded by the difference in the interest rate earnt by government by the investment of the bond money as against the rate paid to tenants. This body could have some link with the ACCC itself. It is imperative that such body be properly funded for it is only in very rare circumstances I deem it appropriate to submit a retail lease dispute to the ACCC as I have in a recent dispute and are impressed by the interest of the offices however I appreciate that they are under resource constraints.

8. I consider it is a positive step to consider a voluntary Code and I note that I made such suggestion in my previous submission also however it must be done on the basis that there be a warning to those in the industry that if the Code does not work then stringent legislative response will be made. This way one is giving opportunity for the industry itself to rectify some of its problems but if it fails to then government will step in. I also think that if there was a body for the tenants that this body could have dialogue with the Shopping Centre Council of Australia such that the parties could better understand each other's needs. Maybe also the tenant's body could list certain conduct on its website to deter shopping centre landlord for engaging in very hard negotiating tactics.

9. I note the recommendation to bring certain conduct within the *Trade Practices Act*. I wish to make the following comments in relation to this:

   (i) It is imperative to understand that in relation to dispute resolution, the current system is excellent because it provides for compulsory mediation and if mediation fails it allows the parties to proceed to the Administrative Decisions Tribunal which is a low cost jurisdiction and except in special circumstances costs are not awarded against the losing party. In contrast, if retail leasing matters are to be determined by the *Trade Practices Act* this would require parties proceeding to court. As our examples have shown the tenant is already overly burdened by expenses to then have to mount court proceedings with the prospect that if the tenant loses that order against them would be prohibitive. I am very concerned that this proposal would undermine all of the good that the current system is delivering. In our view there are very little problems with the current system with respect to dispute resolution. As I have pointed out above the problem lies with the monopolistic power of the shopping centre. To focus on dispute resolution again in our view would be a missed opportunity to deal with the primary issue.

   (ii) Whilst it is admirable to in the long run try to create harmony between the various state legislations, I strongly submit that this should be done provided it does not in any way weaken the rights that the tenant already has and in this regard great care must be taken so that any step forward would be assisting the tenants and not removing any such rights. I have a similar caution in relation to the suggestions with respect to minimising the compliance costs. In our view that is of minimal significance relative to the real issues and problems in this area. I highlight that mediation has an 81% success rate at the Retail Tenancy Unit and that such a success rate should be embraced and enhanced and only with great caution should it be amended or changed.

   (iii) If there were any further amendments to the *Trade Practices Act* I would strongly recommend that there be compulsory mediation like there is under the Franchising Code of Conduct and further that there be an equivalent body to the ADT, rather than the necessity for instituting court proceedings. Having said that the answer simply is leaving as it is because that is the current scenario under the *Retail Leases Act* and the ADT.

   (iv) I submit that it is inappropriate to view retail leases similarly to that of commercial leases as I note this is one of the recommendations in the Report. I make the following comments:

i. With commercial tenants, their location has minimal impact on their ability to attract business. This comment is not entirely true, for example: a tenant may wish to have a harbour view premises to create a certain image so they would be attracted to more premium locations – but on the whole it is a reasonable generalisation. Most commercial tenancies could be located anywhere, particularly with all the use of technology and internet access and the whole telecommunication revolution and many businesses for example now operate from home but the customer does not really notice an appreciable difference. Retail is entirely different. Retail relies upon passing trade. Retail relies upon being located near other retailers particularly the larger retailers which attract customers. Further, retailers are aware that customers do not wish to go to multiple locations but would rather be able to park in one location and then be serviced by a number of retailers from that one location. Position is everything in retail. Good service is everything in relation to commercial tenancies. For this and the fact that where the primary large tenants and draw card tenants are is in shopping centres and that there are limited number of shopping centres and that the whole centre is owned by the one landlord is the reason that retail tenancies have to be treated differently and further some of these reasons have been highlighted by the examples set out earlier. If commercial premises were monopolies then yes, maybe there could be a similar treatment however that is not the case. The issues faced by retail tenants particularly because location is essential to their business are entirely different to that faced by commercial tenants. Respectfully, I submit that there is no merit in proceeding on the basis that retail tenancies should be similar to the law in relation to commercial tenants generally. As commercial tenants do not have access to the protections put in place under the *Retail Leases Act*. The *Act* has been updated and improved over the last 14 years. To detract this would be most disappointing.

ii. Commercial tenancies are not subject to generally the hardships that retail tenants are subject to. For example: a commercial tenant usually does not have to supply their own ceiling, whereas a retail tenant does. The commercial tenant does not have to put in its own "shop front" that is usually there. Often the landlord will supply or contribute towards the fit out. Again, because this market is more competitive and not subject to the monopolistic constraints of the regional shopping centre in the retail leases market. Thirdly the commercial tenant is not required to disclose its sales and fourthly if at the end of the lease the parties cannot agree, the commercial tenant can change location and with only minimal damages to its goodwill because the success of a commercial tenant is not linked to the location.

In summary I submit that the Commission's recommendations should focus on dealing with and overcoming the fundamental problems and injustices in the current system which are market based and predominantly are because shopping centres by their nature have becomes monopolies and this creates an injustice in any negotiation with the tenant. The real issue is not unconscionable conduct or breaches of the *Retail Lease Act* – the current framework deals with these, the real issue is the bigger picture as to how to create competition so that rather than being dictated to by one landlord, the tenant has a range of options before it or there are safeguards put in place such that this market monopoly is controlled.

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