

SECURITY OF TENURE

A lease is an agreement by the owner of a property (lessor) and a tenant (lessee) for the use of the property for an agreed purpose, on agreed conditions, for an agreed term, at an agreed price. Like any other contract, a lease has a finite life and imparts no continuing right of occupancy when the lease ends.

The law of property in Australia dates back centuries and provides the critical framework for a stable economy and society. Fundamental to property law is the different forms of land ownership – freehold, leasehold, strata, company title and so on – each distinguished by the rights that accrue to that title. While governments have sometimes legislated to marginally alter these rights and principles, they have been very wary of in any way undermining the stability and certainty of property laws and titles because of their importance to the effective functioning of society as a whole.

Freehold title provides a property owner with much greater rights over the use and disposal of their property than does a leasehold title. For this reason, freehold title comes at a greater cost and with greater responsibilities than a leasehold title. Providing retail tenants with an automatic or preferential right to renew their lease undermines these principles. On one hand, it would erode the owner's freehold right to use their property as they wish; on the other, it would provide leaseholders with a freehold right to continued occupancy when the lease ends.

Retail tenancy legislation in Australia has generally recognised that principle. This has been a matter which has been considered during the introduction of retail tenancy legislation around Australia in the 1980s and 1990s and during the many reviews of this legislation that have occurred over the last 20 years. In every case the Government of the State or Territory has declined to impose a continued right of occupancy when the lease has expired. (Preferential rights of renewal of retail leases in South Australia and the ACT were imposed by Opposition and minor parties in the Parliaments of that state and territory against the express wishes of the Government of the day.)

Any proposal that may restrict a lessors' freedom to deal with their own property as they wish after the lease has ended, either by imposing a 'right' or 'preference' to the tenant to renew the lease or through the imposition of 'third party' rent-setting for a renewed lease, raise a number of fundamental concerns. The main concerns are that these restrictions:

- would provide tenants with the benefits of freehold title but without the cost and risk of freehold title, which is fundamentally unfair and undermines long accepted principles of property ownership;
- are based on the misconception that it is always the tenant who is in a disadvantageous bargaining position at the end of the lease;
- seriously impede a shopping centre manager's ability to successfully manage the centre, to the detriment of the owner/investor and the tenants;
- limits competition by restricting the entry of new retail tenants to the market which will inevitably discriminate against small retail tenants;
- reduces the value of property assets and therefore of property investments.

The benefits of leasehold for retailers

It is important to understand the benefits that leasehold brings to retailers and the reason why retailers prefer to rent shops rather than purchasing their own properties. This is because leasehold, unlike freehold, removes the property risk from retailers' business plans; means they have a smaller capital outlay (or a lower debt); and greater flexibility in locating their businesses.

Intuitively a retailer would prefer to hold freehold rather than leasehold over their shop. Retailers who purchase their own shop do not have to worry about whether their lease will be renewed or worry about what level of rent they will have to pay in the renewed lease. What they do have to worry about is the capital (or debt) required to acquire the shop and pay for the fit out, in addition to their business start-up costs. A tenant retailer, on the other hand, while still having to find the capital to launch the business (or purchase the business) and fit out the shop, does not have to find the significant additional capital (or go further into debt and pay the ongoing interest on that debt) in order to purchase the shop. The tenant retailer, therefore, obviously has a much smaller capital outlay and much less capital at risk than an owner retailer.

The relative advantages of freehold and leasehold are demonstrated in the **Table 1** below, which compares the position of the owner retailer and the tenant retailer (both in a shopping strip and a shopping centre).

Table 1. Owner Retailers v. Tenant Retailers

	Capital outlay required	Risk being carried	Advantages	Disadvantages
Owner retailer	<ul style="list-style-type: none"> • purchase of shop, including financing costs • fit out of shop • business set up costs 	<ul style="list-style-type: none"> • property risk • retailing risk 	<ul style="list-style-type: none"> • security of tenure • no rent 	<ul style="list-style-type: none"> • greater capital outlay • more capital at risk • unable to easily change locations (less mobility) • generally subject to mortgage
Tenant retailer (shopping strip)	<ul style="list-style-type: none"> • fit out of shop • business set up costs 	<ul style="list-style-type: none"> • retailing risk 	<ul style="list-style-type: none"> • less capital outlay • less capital at risk • greater mobility • lower rent (than a shopping centre) 	<ul style="list-style-type: none"> • no security of tenure beyond term of lease • lower turnover • less control over location of competitors
Tenant retailer (shopping centre)	<ul style="list-style-type: none"> • fit out of shop • business set up costs 	<ul style="list-style-type: none"> • retailing risk 	<ul style="list-style-type: none"> • less capital outlay • less capital at risk • greater mobility • higher turnover and sales productivity • greater control over location of competitors 	<ul style="list-style-type: none"> • no security of tenure beyond term of lease • higher rents (than a shopping strip)

By definition, security of tenure under a leasehold agreement is only provided for the term of the lease. However, leasehold is inherently more flexible than freehold as a tenant is not anchored to their current premises for any longer than the period of the lease. This is particularly important if the location turns out to be a poor one for their retail offer. It means that they can relocate to another centre or to another retail location at greater convenience at the end of the lease.

By purchasing a shop the owner retailer is anchored to that location. If they want to move from that location, they are exposed to the risk that any attempt to sell the shop will be (during poor trading periods) difficult and protracted. They have to find a buyer for the retail business (not an easy task if it is in a poor retail location) or, if they can't sell the business as a going concern, they have to find a buyer for the shop (which also might not be easy if it is a poor location for retail). Even if they find a buyer for the business, or just the shop, it is unlikely that they will be able to recoup the money they spent in fixtures and fittings setting up the retail business.

Leasehold removes the property risk from retailers

Although owner retailers and tenant retailers both carry the risk that their business plans will not be successful, a tenant retailer carries no property risk. As such, if a tenant retailer's business fails, that is the extent of their loss. They do not also carry the risk that property values will decline. That risk is being carried entirely by the owner of the shop or by the owners of the shopping centre.

Property risk is a very real risk. In the late 1980s and early 1990s, for example, shopping centre values were savagely slashed by the market and investment returns plummeted. Many owners went broke and shopping centres were sold off in a fire sale. The retailers in those shopping centres, however, generally survived. They did so largely because they were not carrying the property risk and did not have to service the debt on heavily mortgaged property that had declined substantially in value.

Property values fell again in the wake of the global financial crisis in 2008 and 2009 and many investors in shopping centres suffered significant losses. While retailers have struggled following the cycling of the financial and monetary stimulus, generally speaking most have survived the downturn. Once again they have not had to service debt on mortgaged property that had declined in value.

For the owner of the shop or shopping centre to accept the property risk they have to anticipate that they will get a reasonable return on their invested capital. One person's rent is another person's income. So often in the consideration of public policy issues in the retailing industry the interests of the owner of the rented shop or the investor in the shopping centre are completely overlooked. This means that public policy overlooks the interests of the members of the superannuation funds, life insurance funds, real estate investment trusts, property syndicates and other property investment vehicles which invest in property, including shopping centres. If the return to these investors is not compelling, they will take their money elsewhere.

End-of-lease restrictions are fundamentally unfair

The imposition of restrictions on the freedom of lessors to deal with their own property, at the end of the lease, by the inclusion of a 'right' or 'preference' to the tenant to renew the lease, are fundamentally unfair. The argument for 'security of tenure' is essentially an argument for having it both ways: gaining the relative security that comes from property ownership without taking on the cost or risks of property ownership. Such measures also increase the property risk for the owner because they can diminish the return to the owner for carrying the property risk or they increase the risk of having to retain under-performing retailers.

Such measures also place retail property at an unfair disadvantage compared to other property classes. Why should a small retailer (not to mention the large businesses, including listed retailers, which also have the protection of the retail lease legislation) gain the advantage of security of tenure beyond the period of the lease when this advantage is not available to other small businesses, such as an accountant or solicitor in sole practice in an office building?

End-of lease restrictions are unnecessary

Measures designed to increase a retail tenant's security of tenure are also unnecessary because the vast majority of tenants who have observed the terms and conditions of their lease and whose retail offer is still relevant to the customer base of that centre, do gain a new lease. Further, in circumstances where a lease is not renewed, in the vast majority of cases they are not renewed at the instigation of the tenant.

This was a clear 'finding' of the Productivity Commission's inquiry into the *Market for Retail Tenancy Leases in Australia*. Making particular reference to the renewal of leases in shopping centres, the Commission found that "the majority of retailers in centres are offered subsequent leases". This highlights the absolute lack of evidence of a market failure that needs to be resolved through further regulation because, as the Commission states, the majority of retailers are offered a renewed lease.

At the heart of arguments for measures such as first right of refusal for sitting tenants is the idea that landlords capriciously refuse to renew leases. This is nonsense. It would be an irrational act for a landlord to drive out of his shopping centre a well-performing tenant whose retail offer is still relevant and attractive to customers and who has observed his obligations under the lease. This is because there is always a real risk that that retail space cannot be re-leased or be re-leased quickly. Automatic rights of renewal and similar measures become, almost by definition, protections for poorly performing or poorly managed tenants.

End-of-lease restrictions threaten viability

Measures designed to prolong a retail tenant's security of tenure beyond the term of their lease cannot be imposed without a cost to the shop or centre owner. They would be destructive to the vitality of shopping centres and are therefore harmful to the ongoing viability of those centres.

While, as noted above, the majority of leases are renewed, it is vital that landlords retain the discretion and flexibility not to renew leases. Shopping centres are vibrant and complex places. They must remain relevant to the constantly changing tastes of their customers. They must have broad cross-sectional appeal for all customers from young people to mature aged persons. They also have to constantly adapt to demographic changes in their catchment areas.

If a shopping centre doesn't maintain an appeal to all of its customers (i.e. have the right 'tenancy mix') it will lose customers and stagnate. That will be to the detriment of its tenants as much as its owners. Occasional changes to the tenancy mix of shopping centres, as well as fairly regular redevelopments, are therefore a very necessary fact of life in a shopping centre.

Management of the tenancy mix is a constant and evolving process designed to maximise the customer pulling power of the centre for the benefit of all retailers. An automatic or preferential right of refusal undermines the capacity of centre management to undertake this necessary fine-tuning of a shopping centre. Retailers who choose to locate in a shopping centre because of its attractiveness to customers must accept this fact.

There is no consistent position from retailers

Good retailers and good retailer associations distance themselves from calls for end-of-lease restrictions. They know that the retention of poorly-performing tenants drives down the overall quality of a shopping centre causing it to lose drawing power among its customers. This will directly affect their own sales performance and could do so even more directly if customer traffic flow to their part of the centre is reduced.

When prompted by the Presiding Commissioner during a public hearing in 2008 to inform its inquiry into the market for retail tenancy leases, the retail tenancy consultant representing the National Retail Association, Malcolm Macrae, stated: *'I think it may be going a step too far. I think the automatic right of lease - no, I don't support that at all. That perpetuates privilege and perhaps reduces capacity to change.'*

End-of-lease restrictions discriminate against small retailers

Such measures also, in the longer term, discriminate against small tenants. Security of tenure measures are likely to mean a greater propensity for owners to "play safe" and give preference to established or proven retailers or state or national retail chains when seeking new tenants. Faced with a choice between an established retailer and someone seeking to set up in business for the first time, the lessor will be less likely to take a risk on the small retailer or would-be retailer.

Because these measures increase the property risk for owners they would then have to compensate by seeking to lower their overall risk when they take on a new tenant. They do this by seeking a higher rent at the outset and/or greater requirements for bank guarantees or personal guarantees from tenants. It is the small retailer, or would-be retailer, who ultimately suffers from the adoption of so-called 'security of tenure' measures. This perverse outcome is frequently the consequence of regulatory approaches seeking to reduce risks faced by one party. This is because those risks are not eliminated by the regulation; they are simply shifted elsewhere.

End-of-lease restrictions are anti-competitive

National competition policy requires that legislation not restrict competition unless the public benefits outweigh the costs. There is no doubt that security of tenure measures are anti-competitive because they restrict the entry of new retailers into the market. In terms of the costs and benefits of security of tenure proposals, any benefits would obviously only accrue to those retail tenants who would not otherwise be offered a new lease by their shopping centre. The costs however, would be imposed on centre owners and managers, potential new retail tenants and, most importantly, shopping centre customers.

The costs imposed on centre managers and owners are significant. Essentially they are the restrictions on the owner/manager's ability to successfully manage a centre and the reduction in the value of the property as a result of the limitations on its use. The costs are particularly high for potential new entrants to the retail market. If existing tenants are, effectively, given a lease in perpetuity, opportunities for new entrants to the industry are severely restricted. Competition is therefore diminished.

Shopping centre customers would also bear the cost because competition between retailers would be reduced. For example, there may be a potential new retail tenant who would be able to offer the same goods as an existing retailer in a centre but at a reduced price. However, the customer would not be able to take advantage of this lower price unless the existing tenant decided to terminate the lease and leave the centre, allowing a lease to be granted to the new tenant.

Protections provided in state retail tenancy legislation

It should be noted that state retail tenancy legislation does provide protections to sitting tenants even where there isn't a preferential right of renewal. As an example, s. 44 of the NSW *Retail Leases Act* already provides that not less than 6 months and not more than 12 months before the expiry of a lease the landlord must by written notice to the tenant either:

(a) offer the tenant a renewal or extension of lease on terms specified in the notice; or

(b) inform the tenant that it does not propose to offer a renewal or extension.

An offer of renewal or extension is not capable of revocation for 1 month after it is made.

Whilst the landlord cannot revoke the offer for 1 month, if the tenant accepts the offer, the tenant may then delay negotiating, finalising and executing the new lease. If the tenant delays in executing the new lease and then decides not to execute and vacate, the landlord is disadvantaged as the landlord has not been in the market place seeking a replacement tenant because it had thought it had an "agreement" for a new lease with the tenant.