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LAWYERS

13th August 2007

Our ref: JDS

Your ref:

The Commissioner
Australian Government Productivity Commission
PO Box 80
BELCONNEN ACT 2616

Dear Sir

Re: Enquiry into the Market for Retail Tenancy Leases in Australia

I refer to the above matter and make submission hereto.

This firm operates as a Legal Practice as set out in the Legal Profession Act (NSW) 2004 and in the course of our business, acts for lessees of Retail Shops in NSW. Indeed this firm also operates from premises which are leased as so.

In the course of the last two years, we have actively marketed to persons and entities engaged in the retail and retail franchise spheres of business. To that end this firm and it's principal have acted in that time for about 20 businesses that operate under a Retail Lease within the meaning given by the Retail Leases Act (NSW) 1994 ("the RLA"). Of those 20 matters, about one half have involved issues of dispute with the lessor further to the lease. Comprised within those matters have also been matters where the dispute was as between a franchisor and a franchisee and the discourse to resolution has taken place further to provisions of the Trade Practices (Industry Codes - Franchising) Regulation (Cth) 1998, which is better known simply as the Franchising Code of Conduct. That is notwithstanding that in many such cases, the dispute has ultimately arisen as a result of the retail lease under which the franchise operates.

I make the following observations as to the RLA as observed at this practice:



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BACKGROUND

Clearly, where a lessor engages in the process of seeking to lease property as a retail shop for consideration of rent, they do so, simply to maximise the return on their investment in the property, as is the nature of business.

Similarly where a Lessee enters into a lease of retail premises, they predominantly do so to operate a business from those premises and to generate an income by way of profit.

The essential nexus between the lessee and lessor is that the more rent the lessee pays to the lessor, the less profit then that can be generated by the lessee's business. However, if the lessee has a vibrant and thriving business by virtue of the lease of property from the lessor, then by rights the lessor will seek to ensure that the rent they are receiving is commensurate with the value of the property to the lessee, in light of the income and profit they are able to generate by operating a business at the lessor's property.

There is a key distinction by virtue of Part 7 of the RLA as to shopping centres comprised of multiple shops, as distinct from other retail shops which whilst covered by the RLA are not necessarily a part of some broader operation. Examples of shopping centres are those comprised of sometimes hundreds of shops in one structure, and which exist broadly in most Australian cities. In the larger cities it is not uncommon to find one large shopping centre for every 5 to 10 suburbs. This submission is broadly directed as to the issues peculiar to shopping centres.

THE PROBLEMS

It is our experience that the vast majority of retail lease problems arise when the rent payable by the lessee to the lessor is not a sustainable one. There are many reasons why a rent may be or become unsustainable, including:

1. Lack of consumer traffic ("people traffic") past the shop, leading to low sales;
2. Failure to effectively market and promote, leading to low sales and comprised of two factors:
 - a. Failure of the shop owner/lessor to promote the shop location such as to generate sufficient people traffic and in particular where the shop exists in a shopping centre, where the operation of the shop is dependent upon consumers physically passing the shop.
 - b. Failure of the business owner/lessee to properly market and promote their business.

3. Lack of business acumen by the business owner/lessee leading to inability to generate sufficient income to pay the rent as and when it is due.
4. Factors involving the economic cycle leading to a downturn in business. Generally this is not an issue that can be addressed at any level other than State or Federal government by way of economic policy, but the impact of such factors can be addressed.
5. Changes to the number of shops of a given type being operated at a shopping centre which can lead to a contraction in the available market for a given type of shop. This mixture of shop types is commonly known as the retail mix.

DISCUSSION

These five points raised above as are now discussed below at some length.

PEOPLE TRAFFIC - CUSTOMERS ARE EVERYTHING

As to point (1.) above, this is perhaps the most difficult area to address legislatively. When a lessee enters into a retail lease, in particular at a shopping centre, they duly expect that in opening a business at that shop, there will be people traffic past the shop sufficient to make the business viable. It happens in our experience from time to time that there is not sufficient people traffic past a given shop to enable that business to be viable. We have observed a number of apparent reasons for this

- a. Alterations to the physical layout of shopping centre which change the path along which people traffic is otherwise directed, or flows.
- b. Failure by the shopping centre to adequately maintain or effectively promote the shopping centre, generally in an otherwise competitive market, such as where a competitor shopping centre begins trading nearby.
- c. Construction of a shopping centre, adjacent to an area where another shopping centre or centres exist. This has the following effects:
 - i. The shops in the incumbent shopping centre which existed already, become less viable by virtue of increased competition from the new shopping centre.
 - ii. The shops in the new shopping centre exist in a 'start-up' environment where the market for the shops and the shopping centre has not been established, and thus the shops and the shopping centre must generate a market from a zero base.

Generally in each of the above examples, the lessee is nevertheless bound by the terms of their lease and rent continues to be payable at the rate prescribed by the lease, and with rental increases similarly prescribed, notwithstanding that in such a market situation sales from the shop are bound to be falling. Thus profitability decreases, generally sharply and of course, for the remaining term of the lease.

SHOPPING CENTRE OPERATIONS & MARKETTING

As to point (2.) above, the operation of shopping centres in Australia, is conducted naturally enough, for profit. The writer is unaware of any shopping centres not operated in that way. The operation of any business amounts to a balance between income received and expenses disbursed. The remainder in that event comprises profit.

Like any business, a shopping centre has a number of key expense components, but two major one would appear to be:

- a. Operational and maintenance costs.
- b. Marketing, advertising and promotional costs.

A lessee of a shop in a shopping centre is essentially at the mercy of the shopping centre operator, in that if the shopping centre operator fails to properly maintain the premises or effectively market and promote same, then the flow of people traffic through the shopping centre will fall, having a consequent effect on the sales and profitability of shops in the shopping centre.

Whilst Part 7 of the RLA seeks to make transparent certain aspects of shopping centre operation which go to the factors discussed above, the writer is unaware of any specific provisions which mandate that the shopping centre operator must maintain or market appropriately.

Of course to fail to do those things noted above would amount to negligence by the shopping centre operator, and if not negligence then an argument as to unconscionable conduct in respect of such matters would exist further to Part 7A of the RLA, or in the alternative s.52, s.53 or Part IVA of the Trades Practices Act (Cth) 1974.

The question though needs to be asked, just exactly which aggrieved lessee has the financial resources to engage in protracted litigation on such matters, where the outcome is uncertain and the costs of same may well run into the many hundreds of thousands of dollars.

Without doubt there are such lessee's in retail leases in NSW, but this firm has only had occasion to deal with single, sole operators. For such people and entities, there is little or no prospect of funding the huge costs involved in seeking legal redress.

PROVISION OF COMPETENT LEGAL ADVICE

As to point (3.) above, there is and can never realistically be any limitations placed on whether the operator of a retail shop need possess sufficient business acumen to operate the business, at least in terms of general retail operations.

There will in our view always be operators who fall short of the mark, lose money and cease operating their business. That is the unavoidable reality of business.

However, there is scope in the writer's view to ensure that the lessee of a retail shop is properly and sufficiently informed prior to entry into the lease, such as to mitigate losses arising from the lack of understanding of lease obligations. Such as can lead to losses.

For this reason, it is our view that prior to the entry into of a retail lease by a lessee, they ought to be required to obtain competent legal advice from a solicitor, in the same way that generally one must be legally advised prior to entering into a residential mortgage.

The Law Society of NSW through the NSW Solicitors Rules at rule 45 thereof mandates a particular course of events which must be followed in the provision of such advice.

Such advice would no doubt include advising as to the matters at hand in the lease. However, of greater importance, would be the legal advisers opportunity to acquire evidence of any representations made to the proposed lessee and record those in the lessee's disclosure statement¹.

One might respond to such a suggestion with the remark "*Lawyers feathering their own nests again*", as to costs that by necessity would flow to the legal profession from such a requirement. However were such a position put, I would reply as follows:

- a. Changes to the RLA in late 2005 mean the lessee is not liable for the lease preparation costs of the lessor where formerly they were. This has amounted to a large saving to the lessee.
- b. The relatively small cost of legal advice pales compared to the huge losses a lessee can face if the tenancy turns sour.

It is unfortunate in our view that a significant number of business operators under a retail lease whom fail, appear to us do so because they did not

¹ The Lessee's Disclosure Statement is in NSW a document which (further to s.11A) of the RLA, amongst other things, provides the opportunity to a lessee to record any representations made to them by the lessor.

understand the full costs and implications of the lease. The requirement for competent legal advice would assist in minimising risk arising from such matters and ensure that all representations were more properly recorded.

THE RETAIL SHOPPING CENTRE LEASE AS A PARTNERSHIP

As to point (4.) above, all persons and entities engaged in business within the economy are subject to the effects of fluctuations in the economic cycle, be that within Australia or as a consequences of changes to the nature of the world economy.

It is the nature of the economic cycle that there are fluctuations, good times and bad times.

However, it is the general nature of a lease that the lease is driven by rent. That is to say payment of rent is a fundamental term of the lease. Rent similarly, in the vast majority of retail leases is a certain and known amount which does not change, but for annual reviews which will generally increase the rent.

The law of leasing extends back many hundreds, if not thousands of years and generally this is how things have always been.

In this day and age though, and given all those other matters raised herein, why is that if there is an economic downturn and businesses in a retail shopping centre suffer a similar downturn in sales, that the rent nevertheless continues to fall due at the same rate, or in the event of a rent review, an even higher rate?

Surely there must be scope for rent to be driven primarily by turnover of the shop ("Turnover Rent").

After all, without it's tenants, a retail shopping centre will fail just as surely as the tenants would have no shop to trade from without the shopping centre.

Turnover Rent has the benefit for the lessee that if turnover falls for some reasons beyond the lessee's control, such as economic downturn or failure of the shopping centre to properly promote, then the rent also falls as a dollar amount, but in a such a way that the proportion of turnover paid on rent remains the same. That will not assure a business' viability, but it does add a layer of protection.

Similarly, turnover rent encourages the shopping centre owner to ensure the following takes place as best they can:

- a. To ensure the shopping centre is adequately advertised and promoted.

- b. To ensure the shopping centre is adequately up kept.
- c. To ensure that a proper mix of retail shops is maintained.

One might argue against this that shop lessee's would under-report their turnover so as to seek a lower rent. However the following arguments are made against this:

1. Most shopping centres already collect turnover figures from tenants as a requirement under the lease.
2. Technology already exists which can easily uplink and report sales turnover to a given location for all shops, thus removing the human component.

RETAIL MIX

To maintain viability of operations, it is necessary for a shopping centre to ensure that the number and placement of particular shop types is adequate to ensure that consumers will attend the shopping centre to make purchases. This concept is known as the retail mix.

Whilst seeking to limit the control over retail mix by a shopping centre has potential to have an adverse effect on the shopping centre as a whole, individual lessee's in the shopping centre have in the view of the writer the right to be informed prior to entering into a new lease, or the renewal of an option, just exactly what competition they will face during the term of their lease.

Clearly it is not realistically possible to totally predict what shop operators may seek to operate a given shop in a given shopping centre. Similarly it is not possible to totally predict consumer sentiment and taste and thus determine which types of shops will be in demand. However it is quite clearly possible to make reasoned estimates of such matters and in fact (to our best knowledge) shopping centre operators do this day in and day out.

It is totally plausible that a shopping centre operator can advise a prospective tenant of the proposed retail mix for a given portion of the shopping centre prior to entry into a lease and in fact the shopping centre operator should in our view be forced to disclose such matters prior to entry into the lease.

After all, a business is only operated knowing with some certainty what the level of competition will be. No business operator possessed of good business acumen would commence a business in a market where the level of known competition could lead to a failure of the business.

It has been our experience that in some retail shopping centres, a lessee may sign a lease and then shortly thereafter find they face competition which they

could not have known they were going to face, yet which the shopping centre operator must have known at the time of commencement of the lease was likely to arise by the shopping centre's placement of a particular competitor into a particular shop.

RECOMENDATIONS

We consider that the Enquiry should give serious consideration to recommending that the following changes to the law as to Retail Leasing in Australia take place:

1. That a federal system of retail leasing laws be introduced so as to ensure consistency of retail leasing legislation across the entire nation. This should otherwise preserve the NSW legislation and its inexpensive dispute resolution procedures.
2. That prior to the entry into a retail lease, the proposed lessee be required to obtain independent legal advice as to the transaction, and specifically that all and any representations made to the lessee by the lessor be recorded on the disclosure statement as a component of that advice.
3. That a system of Turnover Rent be mandated in all shopping centre leases. That is that rent may only be levied on a percentage of turnover basis
4. That there be a requirement upon shopping centres to disclose to a proposed lessee in advance of entry into a lease, the Retail Mix which is foreshadowed for the immediate area around the shop proposed to be leased.

CLOSING

I commend this submission for your consideration. I do hope that the recommendations made herein are adopted.

Please call Mr James Soothill on 0402694216 or 95446443 should you wish to discuss the matter further.

Yours Faithfully
Soothill & Associates

James D. Soothill