Article Information

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Lease incentives: When is a claw back considered unenforceable?

In the context of commercial leasing, consideration should be given to what would constitute a penalty versus a genuine pre-estimate of damage for the purposes of enabling a landlord to lawfully claw back a proportion of an incentive where a tenant is in breach of its leasing obligations.

Incentives are becoming more prominent in office leasing transactions with demand for office space continuing to soften following the pandemic which has pushed businesses to rapidly adopt new behaviours with respect to remote work. This has, in some jurisdictions in Australia, precipitated lower effective rents (and higher lease incentives for tenants in the form of rent reductions or fit-out contributions).

When negotiating incentives, it will be prudent for landlords to carefully consider the effectiveness of claw back provisions which requires consideration to be had to the bargain struck and the monies the landlord would be entitled to, assuming the lease runs its course. It will also be prudent to consider whether there are other commercial arrangements (such as a secured loan) capable of being implemented to improve the prospects of a recovery of monies invested by a landlord towards a tenancy's fit-out to mitigate the risk associated with a claw back mechanism not being enforceable where the effect of the claw back mechanism is to overcompensate the landlord by enabling the landlord to recover monies to which it would never had been entitled had the lease run its course.

In the recent case of Alamdo Holdings Pty Ltd v Croc's Franchising Pty Ltd (No 2) [2023] NSWSC 60, it was decided by his Honour Justice Stevenson, that the contractually agreed claw back right specific to a fit-out contribution was unenforceable because the claw back right went further than was necessary to protect the interests of the landlord and was, therefore, considered to be a penalty.

Background of the case

The landlord, Alamdo Holdings Pty Ltd (**Alamdo**), was the owner of a property in Hudson Avenue, Castle Hill (**Premises**). Alamdo leased the Premises to Croc's Franchising Pty Ltd (**Croc's**) and on 16 November 2017, the parties entered into a suite of transaction documents comprising:

1. an Agreement for Lease;
2. a Lease (**Lease**); and
3. an Incentive Deed (pursuant to which Alamdo agreed to pay Croc's $250,000 towards Croc's fit-out of the Premises) (**Incentive Deed**).

Croc's failed to pay part of the rent due under the Lease for the period from March 2020 until December 2020. As a result of Croc's default under the Lease, Alamdo terminated the Lease on 3 December 2020.

Alamdo retained the ownership and benefit of the fit-out. Pursuant to the Incentive Deed and Lease, Alamdo became entitled, upon termination of the Lease, to repayment of a proportion of the incentive payment calculated on a pro rata basis by reference to the balance of the initial term of the Lease. This form of claw back mechanism is extremely common in incentive arrangements in leasing transactions across most asset classes.

Considerations and arguments

Alamdo sought to recover a refund of a proportion of the incentive contribution it made towards Croc's fit-out relying upon the claw back mechanism contained in the Lease and the Incentive Deed.

Croc's primary contention was that the provisions of the Lease and Incentive Deed giving effect to the partial repayment of the incentive were unenforceable as a penalty.

His Honour[1], having regard to established general law principles espoused in *GWC Property Group Pty Ltd v Higginson* [2014] QSC 264, posed the following two questions to determine whether the pro-rata reimbursement of the incentive should be considered a penalty in the circumstances:

1. *Can the relevant clauses be characterised as a threat against Croc's failing to comply with its obligations under the Lease or as a punishment for permitting that circumstance to arise?*
2. *Do the relevant clauses serve to guard the legitimate interests of Alamdo, are not out of all proportion to such interests, and reflect a genuine pre-estimate of Alamdo's damage?*

Alamdo contended that:

1. in calculating the incentive, regard was had to the rent payable by Croc's under the Lease, the length of the term of the Lease and the expectation that Croc's would remain a tenant for at least during the initial term of the Lease;
2. it was conscious when negotiating the transaction documents that it was exposed to a commercial risk if it paid lease incentives but the Lease did not continue for the entire initial ten year term – in this circumstance, Alamdo was conscious that it would need to pay a new lease incentive to secure a new tenant;
3. in light of Alamdo's expectation as to the need to pay a new incentive repayment during the term of the Lease if it was terminated, Alamdo estimated its loss would be the pro rata amount of the lease incentive payment it had paid Croc's as a tenant calculated by reference to the balance; and
4. Alamdo included a claw back mechanism which it indicated reflected its estimate of loss that would be suffered by Alamdo in circumstances where the Lease was terminated prior to the end of the initial term.

His Honour held that if Alamdo were able to recover a proportion of the incentive payment, which had gone towards payment of Croc's fit-out costs (which Alamdo was retaining ownership of), Alamdo would be better off than had the Lease run its course without incident. As such, his Honour found that the clauses in the Incentive Deed and the Lease went further than was necessary to protect Alamdo's legitimate interests and should be characterised as, in effect, a punishment to Croc's. Accordingly, his Honour held that Alamdo was not entitled to enforce the relevant provisions of the Incentive Deed and, therefore, recoup a proportion of the incentive.

Conclusion

This case demonstrates the difficulties associated with enforcing claw back mechanisms on the basis that:

1. the benefits given to tenants by way of fit-out contribution and abatement have been considered by the courts as reflecting prevailing market conditions – in essence, the incentives reflect the financial concessions made or incurred by the landlord to secure the lease which would not be recoverable from the tenant had the lease run its course; and
2. in circumstances where the lease terminates on account of the tenant's breach, the landlord is entitled to damages for breach of that lease and if the landlord has difficulty in reletting the premises then this fact will be adequately reflected in contractual damages (which has regard to the rent, outgoings and other payments that the landlord would have been entitled to under the lease had the tenant continued with its lease until the expiry date).

Landlords predicate incentives assuming compliance with lease until lease expiry. Landlords should consider the risk of default (having regard to the financial standing of the tenant) when negotiating incentives and considering the structure of the incentive. The terms of the bargain struck require proper analysis in making any assessment as to whether repayment clause will have strong prospects of enforceability. This case demonstrates the need for incentive arrangements to be more nuanced and provides impetus for landlords to consider:

1. more creative ways to structure incentives including through secured financing arrangements which provide the landlord with broader enforcement rights to recover any fit-out contribution against a tenant (and any guarantor) in circumstances where a lease terminates on account of a tenant default (which may be treated as a cross default); and
2. structuring incentives as abatements across the term of the lease to mitigate the risk associated with the unenforceability of repayment clauses.

[1] Alamdo Holdings Pty Ltd v Croc's Franchising Pty Ltd (No 2) [2023] NSWSC 60, at paragraph 289