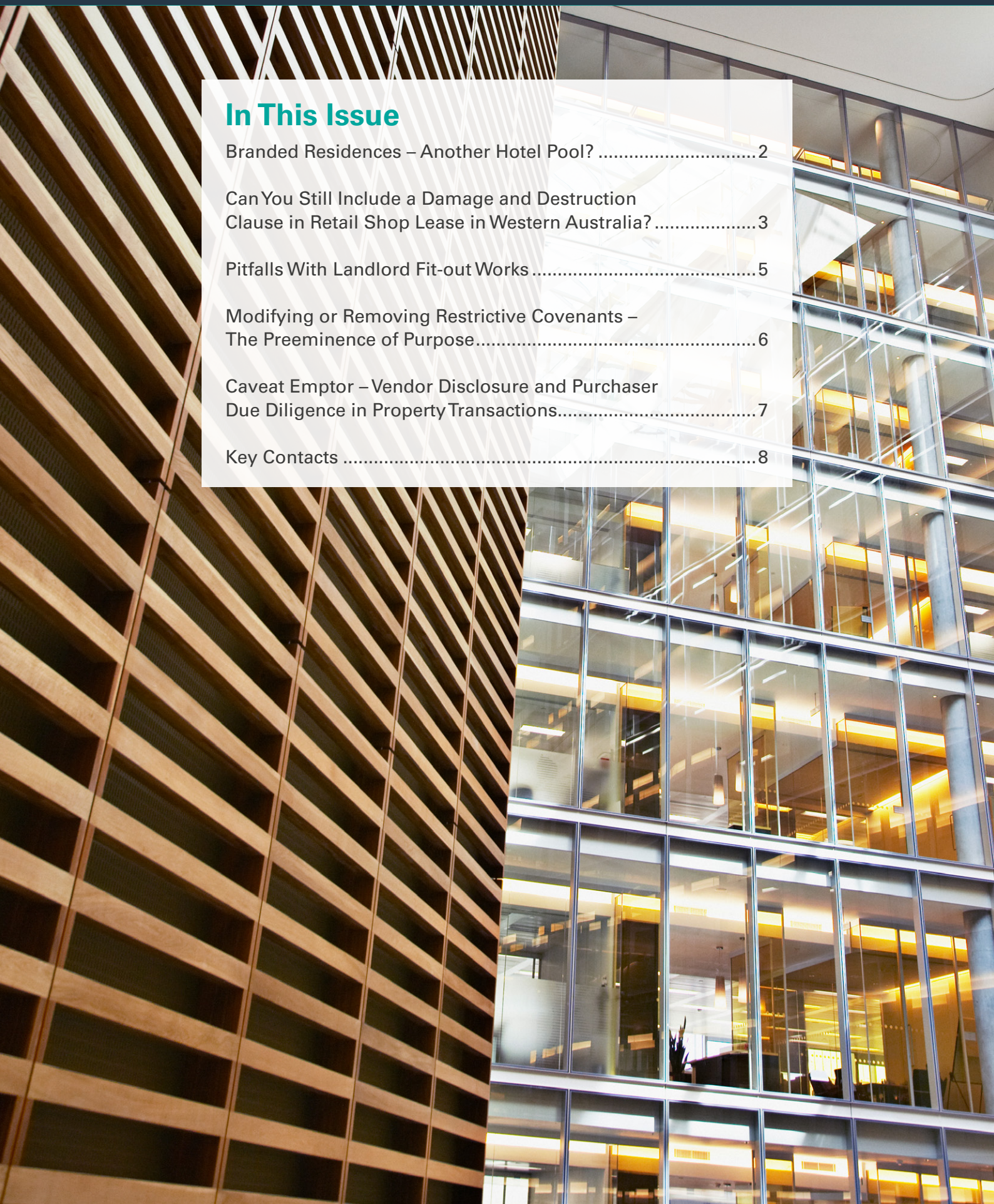
SQUIRE PATTON BOGGS

Real Estate Roundup

February 2024



In This Issue

Branded Residences – Another Hotel Pool?

In the hospitality and property development industries, "branded residences" are becoming increasingly popular, allowing developers to make early (and potentially improved) capital returns, and providing another revenue source for hotel brand companies. However, developers and hoteliers alike need to be aware of the various legal implications of branded residential schemes – including those triggered by the rental schemes that those residences participate in. Here are a few headline notes:

What Are Branded Residences?

- Branded residences are premium residential units, villas or rooms that are affiliated with a hotel brand. Generally, they form part of a broader hotel-and-residences project and, therefore, benefit from brand and hotel affiliation, amenities and services.
- Selling branded residences can provide an opportunity for hotel developers to achieve earlier return on capital and additional funding avenues. Generally, brand-name affiliation increases the value of the residences as compared with nonbranded alternatives (and the hotel brand, consequently, applies a fee for that affiliation). Branded residences are usually sold to third-party purchasers to live in or, alternatively, for rental back to the associate hotel (to form part of room inventory for hotel guests) (i.e. via branded residence rental schemes – see below).

What Are Branded Residence Rental Schemes?

Developers can offer optional or mandatory participation in a rental scheme, on a pooled (i.e. rental pool) or individualised (i.e. nonpooled, or rental programme) basis, summarised as:

- **Mandatory or optional** – An optional model allows greater flexibility for residence owners to live in their residence; however, a mandatory model may be more attractive to ensure a certain room inventory (and future returns) for the hotel.
- **Rental Programme** – The residence owner receives a proportion of the returns earned from their residence (based on their particular room being booked by hotel guests).
- **Rental Pool** – Returns for all scheme residences are "pooled" together and then shared between the participants (on a predetermined basis). A rental pool generally equates to a rental scheme with shared risk (since individual residence owners benefit equitably, rather than on the returns from their respective unit only).
  However …

Another Pool?

- Rental schemes (and particularly mandatory pools) can be treated as regulated financial instruments in certain jurisdictions where they are deemed to have the characteristics of a managed or collective investment product, for example.
- Developers should carefully consider their rental scheme model (and the extent of their branded residence offering) to avoid attracting adverse regulatory requirements on their real estate offerings.

Our team is experienced in global hospitality, branded residence and mixed-use developments – contact us to discuss your next project.

Can You Still Include a Damage and Destruction Clause in Retail Shop Lease in Western Australia?

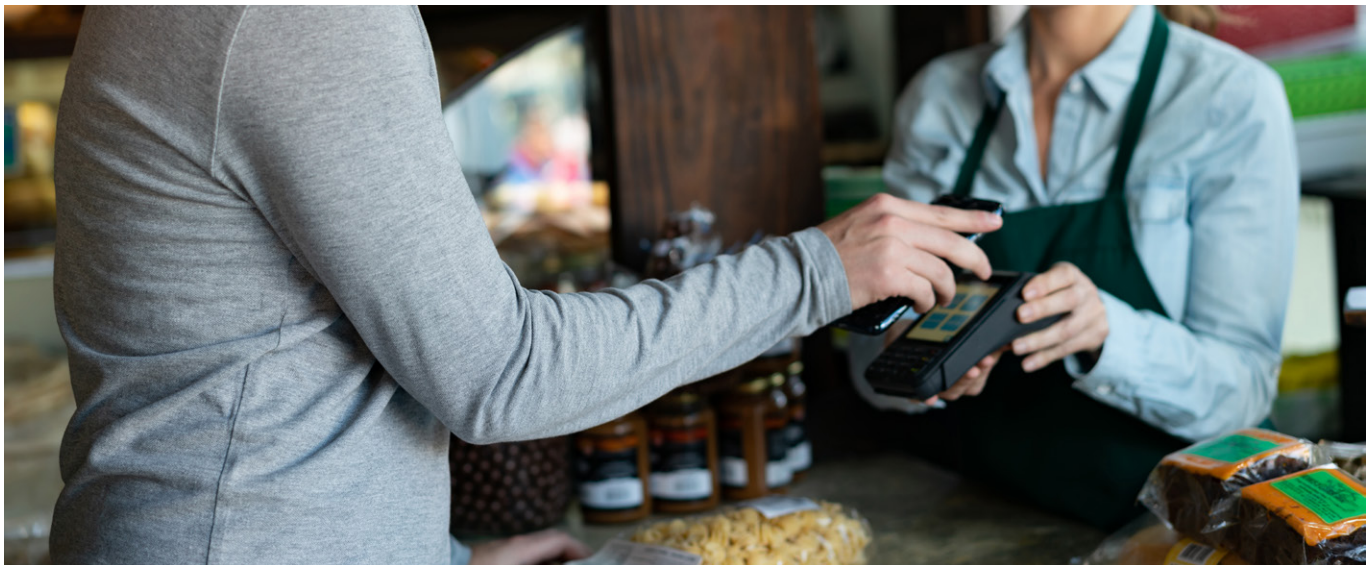
The statutory five-year minimum term afforded to tenants of retail shop leases[1] is intended to protect small businesses, and the same could be said about damage and destruction clauses, which provide a mechanism under which a tenant (or a landlord) can elect to terminate a lease where, within the five-year minimum term, premises are damaged or destroyed such that access to the premises is impossible or severely restricted and rebuilding is impractical.

Landlords have traditionally sought, and received, approval from the WA State Administrative Tribunal (SAT) under section 13(7) of the *RTA* to include damage and destruction clauses permitting termination within the five-year minimum term in retail leases. However, since the SAT's decision of *Synicast Pty Ltd and Showroom X Pty Ltd* [2023] WASAT 47 (*Synicast*), the SAT has refused to preapprove the inclusion of such clauses because, at the time of the application, special circumstances are said to not "exist". This decision has cast doubt over the enforceability of damage and destruction clauses in retail shop leases and raises the question of what is to happen if a retail shop is damaged or destroyed during the first five years of a retail lease.

The facts of *Synicast* are as follows:

- Synicast Pty Ltd (Landlord) and Showroom X Pty Ltd (Tenant) entered into a five-year lease. At the time of entering the lease, the Tenant was aware the Landlord intended to redevelop the land and agreed to vacate after a minimum term of 18 months.
- The Landlord applied under section 13(7) of the *RTA* for the SAT's approval of two clauses that permitted the Landlord (and the Tenant) to terminate the lease before the expiry of the statutory five-year minimum term. Approval was sought for Special Condition 5, which permitted the Landlord or Tenant to terminate the lease for the intended redevelopment, and Clause 33, which permitted the Landlord or Tenant to terminate in the event that the premises was damaged or destroyed and could not be rebuilt in a timely manner.
- Initially, the SAT approved Clause 33 (this decision was not later challenged) and determined that it had no power to consider the redevelopment clause under a Section 13(7) application, as approval for a redevelopment and relocation clause falls exclusively within Section 14A of the *RTA*.
- The Landlord successfully appealed the decision, and on appeal, President Pritchard determined that based on prior authority (which is discussed in detail in *Synicast*), where there is a proposed redevelopment and the early termination clause did not provide for relocation, Section 13(7) (and not Section 14A(3)) was the appropriate provision for the application.

In considering the approval of the redevelopment clause, President Pritchard explained that Section 13(7) requires the SAT to be satisfied that special circumstances "exist at the time of the application to the Tribunal", meaning that the circumstances must "be real or actual or part of objective reality".[2] The SAT ultimately concluded that "the special circumstances must have actually come into existence, or there must be an 'objective intention' that the special circumstances will arise during the term of the lease"[3] at the time of a landlord's application to the SAT under Section 13(7) of the *RTA* for it to be approved. It was also found that the "assessment of whether that intention exists requires the existence of objective and provable facts."[4]



1 Section 13(1), *Commercial Tenancy (Retail Shops) Agreements Act 1985* (WA) (*RTA*).
2 *Synicast*, [30].
3 *Synicast*, [30].
4 *Synicast*, [30].

After analysing prior case law on what constitutes "special circumstances", President Pritchard ordered that special circumstances existed in this case, as the evidence before the SAT showed the Landlord intended to pursue the development during the lease term and this fact existed at the time of the application. While it was not the question to be determined by the SAT, President Pritchard also noted that in the case of preapproval for a damage and destruction clause, it was "not clear" whether special circumstances "existed" when the application for approval was sought.

Since the *Synicast* decision, the SAT has refused to preapprove the inclusion of any damage and destruction clauses in retail shop leases because, at the time of the application, the damage or destruction does not yet "exist", nor is there an objective intention for it to arise. Member Dr. De Villiers has indicated that it is insufficient to seek approval "in anticipation of potential damage or destruction".[5]

This then raises questions over the enforceability of damage and destruction clauses and creates a great deal of uncertainty around what landlords and tenants should do if a retail shop is damaged and/or destroyed in the first five years of a retail lease. President Pritchard indicated in *Synicast* that if "an unforeseen special circumstance" arises during the term, the parties could agree a variation for which the landlord could then seek approval.

Takeaways

1. Based on *Synicast* and subsequent decisions of the SAT, there appears to be no point in landlords applying to the SAT for preapproval of damage and destruction clauses. Landlords and tenants will have to accept uncertainty that such provisions are void until SAT approval is sought to agreed provisions once such an event has occurred.
2. As President Pritchard noted in *Synicast*, there is very little guidance on what circumstances warrant approval for early termination clauses, and it would be highly desirable for this deficiency to be addressed by the state government. Further clarification on the test or further examples of when early termination clauses should be permitted should be prescribed to clear up these uncertainties.

5 See, for example, *GPT Re Limited and Lam* [2023] WASAT 52 and *Vicinity Manager Pty Ltd and Om Ji Om Pty Ltd* [2023] WASAT 54.

Pitfalls With Landlord Fit-out Works

It is common in commercial leasing transactions for a landlord to agree to carry out fit-out works to premises to accommodate the requirements of a tenant. These works can be carried out prior to the tenant commencing its own fit-out works or in conjunction with these works as an integrated fit-out. Usually, the tenant's obligation to pay rent and outgoings under a lease is deferred until the landlord has completed its fit-out works.

The recent case of *A Lloyd Babb Pty Ltd v Bexgrove Pty Ltd [2023] NSWSC 1167* highlights some of the pitfalls for a tenant if a lease does not properly protect a tenant in circumstances where the landlord's fit-out works are delayed.

The facts in *Lloyd Babb v Bexgrove* were as follows:

- The landlord (Bexgrove) agreed to subdivide a commercial strata unit to create a separate first-floor area, which was to be the premises under the lease.
- The lease was for a term of five years, with an option to renew for a further five years, and contained an option to purchase, exercisable within the first three years of the term.
- The lease commenced on 1 October 2021, from which date the tenant (ALB) agreed to pay rent (at a discounted rate), despite the fact that the landlord's fit-out works had not been completed.
- ALB sought various forms of relief from the court when Bexgrove had not completed the fit-out works by 30 April 2023, which ALB argued was the agreed date for completion of those works. However, the court disagreed that a completion date for the Bexgrove fit-out works was specified in the lease.

ALB argued that because the landlord's fit-out works had not been completed, it was denied possession of the premises. Accordingly, ALB argued that, in the circumstances, the rule that the obligation of a tenant to pay rent is suspended for the period in which a tenant is put out of possession of premises by the landlord should apply.

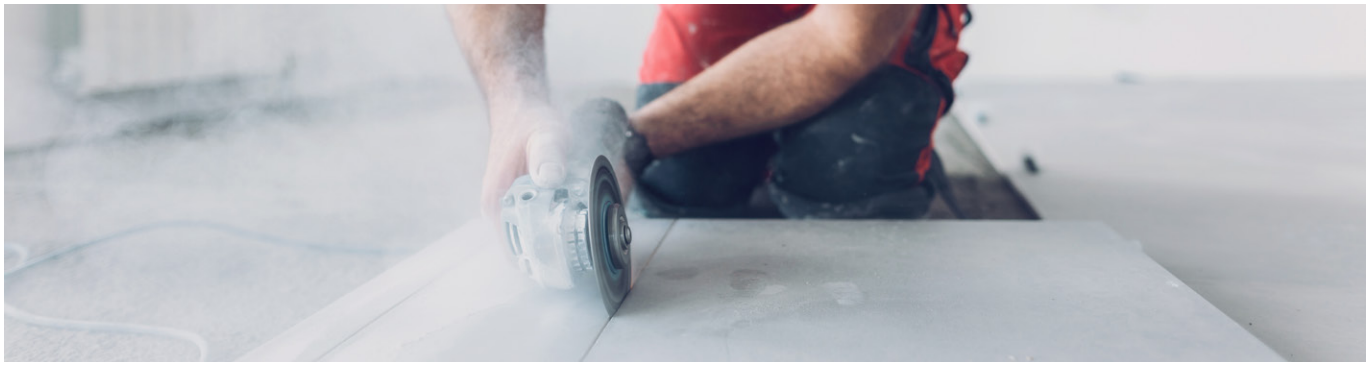
However, the court found that ALB had been given a set of keys to the unit to be subdivided to create the premises and was freely able to visit the premises, although it had decided not to go into occupation of the premises until the landlord's works were completed, which the court found was not the same thing as having been deprived of possession.

In the result, the Court refused to extend the circumstances in which the rent abatement rule applies, from the active denial of possession of premises to an omission to comply with contractual obligations (i.e. completing the landlord's fit-out works) relevant to the tenant's decision to go into occupation.

It appears that ALB may have elected to terminate the lease by reason of Bexgrove's default in not completing its fit-out works but did not wish to do so, possibly to preserve the option to purchase in the lease. Nor did ALB choose to stop paying rent, which may have entitled Bexgrove to terminate the lease.

Takeaways

1. A tenant should ensure that a lease or, as is common practice, a preliminary agreement for lease, clearly covers the situation where there is a delay in completion of landlord's fit-out works.
2. If rent and/or outgoings are payable from the date of commencement of a lease, despite the fact that landlord fit-out works have not been completed, a tenant should secure appropriate remedies in the lease, such as rental abatement or suspension from a fixed works completion date, and, if appropriate, liquidated damages.
3. Where landlord and tenant works are integrated, a landlord should ensure that it is not prejudiced by any delay on the part of the tenant in obtaining statutory approvals or providing plans and specifications or other required details for the tenant's fit-out works.



Modifying or Removing Restrictive Covenants – The Preeminence of Purpose

The Victorian Supreme Court, in *Viva Energy Refining Pty Ltd v Sumervale Pty Ltd & Anor (No 2) [2023] VSC 396*, has shed some light on the circumstances in which a restrictive covenant will be removed by the court, despite the objection of the beneficiaries under the covenant.

The facts in *Viva v Sumervale* were as follows:

- Land owned by Viva was subject to single dwelling covenants and prevented any building being erected on the land other than a dwelling house, school, church or hall, and also prevented any trade or business being carried out on the land.
- Viva intended to construct a service station on the land, which, unless modified or removed, the covenants would prevent.
- Viva applied to the court for the removal or modification of the covenants.
- Sumervale and Sunyhill Pty Ltd opposed the application.

It is important to note that Sumervale and Sunyhill were companies in the United Petroleum Group, which owned land practically benefitted by the covenants since United Petroleum Group owned a service station approximately 1.1 kilometres from Viva's land.

Viva's application to remove or modify the covenants was made under Section 84(1)(c) of the *Property Law Act 1958*. This section relevantly provided that the court had power to remove or modify a covenant upon being satisfied that "the proposed discharge or modification will not substantially injure the persons entitled to the benefit of the restriction."[1]

Evidence was given on behalf of Sumervale and Sunyhill that Viva's planned service station would adversely affect profitability of the United Petroleum site.

Viva argued that the question of injury, as referred to in Section 84(1)(c) of the *Property Law Act*, must be understood in the context of the covenant's purpose. Viva argued that the purpose of the covenants was to create a quality residential community free from abandoned clay pits, which existed at the time the covenants were created (i.e. prior to the Second World War).

The court agreed with Viva's argument and stated that:

"The benefits intended to be conferred [by the covenants] were the benefits associated with living in a residential neighbourhood of low density, quality, and residential amenity. The restriction on use, that is, no trade or business being conducted [on Viva's land], was intended to confer the benefit of residential amenity."

And later:

"There is nothing in the terms of the covenants to suggest an intention to confer a benefit of not having a trade or business conducted on [Viva's land] which competed commercially with businesses operating on benefitting land [i.e. Sumervale's and Sunyhill's land]."

While the court accepted that Sumervale and Sunyhill experienced a practical benefit from not having a commercial competitor operating a service station on Viva's land, this was not a practical benefit intended to be conferred by the covenants on the beneficiaries of the covenants. Accordingly, the court exercised its discretion to discharge the covenants burdening Viva's land.

Takeaways

1. A restrictive covenant that affects land to be developed may not be fatal to development.
2. It is the purpose for which the covenant was originally created that matters, not that it confers a different benefit on the current owner of the burdened land.
3. Before applying to the court for removal or modification of a covenant, first consider whether alternatives may exist; for example, reaching agreement with the party benefitted by the covenant, requesting extinguishment of the covenant for obsolescence, or using the planning process to override the covenant.

1 Similar legislative provisions to Section 84 of the *Property Law Act* are to be found in New South Wales and Western Australia. Queensland, Tasmania and Northern Territory provisions are broader.

Caveat Emptor – Vendor Disclosure and Purchaser Due Diligence in Property Transactions

Most real estate investors are familiar with the Latin principle "*caveat emptor*" – let the buyer beware – meaning that a purchaser buys a property at its own risk and is responsible for making its own enquires to ensure that there are no problems or issues of concern with the property, before entering into a contract.

The introduction of vendor disclosure laws in Australia, under which vendors have statutory obligations to disclose information about a property, has resulted in a significant change to this position. In addition, a purchaser may, in certain circumstances, be able to resort to a claim for misleading or deceptive conduct on the part of a vendor under Section 18 of the *Australian Consumer Law*. A recent example of such a claim was considered by the Federal Court in *Elanor Funds Management Ltd v Alceon Group Pty Ltd (2003) FCA 1291.*

The facts in Elanor and Alceon were as follows:

- Elanor entered into a put and call option agreement to purchase Bluewater Square Shopping Centre in Redcliffe in Queensland. Elanor subsequently exercised the call option and entered a contract to purchase the centre for AU$55.25 million, less adjustments. The contract was duly completed.
- Elanor alleged that documents provided to Elanor, along with statements made in a meeting by a director of the asset manager CPRAM Investments Pty Ltd, misled Elanor as to whether certain food outlet tenants were in arrears of rent, the commencement date of leases for some food outlet tenants, the expected passing rent and the extent to which food outlet tenants had received lease incentives. It was alleged that there had been a failure to disclose these matters, which amounted to a misrepresentation by silence.
- Elanor commenced proceedings for misleading or deceptive conduct on the part of Alceon and CPRM under Section 18 of the *Australian Consumer Law*.

As is common in major transactions, Alceon had established a data room, which contained relevant documents, including leases, incentive deeds and tenant arrears reports. Elanor's senior executive had access to the data room throughout the due diligence period. The court specifically noted that the data room included documents relating to a potential mixed-use redevelopment of the property.

The court also noted that "Throughout the due diligence period, Elanor had available to it all documentation in the data room. No relevant questions were asked through the question-and-answer facility and no additional documents were sought for the purpose of resolving ambiguities" in tenant arrears reports.

In the result, having noted that Elanor was "a sophisticated investor" and "an experienced acquirer of real estate assets, including shopping centres", the court found that there was no misleading or deceptive conduct established. The court found that Elanor had not relied upon representations, noting the other motivation for the purchase, namely a possible mixed-use redevelopment of the property, and the number of food court tenants in arrears was immaterial to Elanor's decision-making process.

In any event, the court found that Elanor had failed to prove that it suffered damage in consequence of the alleged misleading or deceptive conduct, as the property was worth at least US$55.25 million as at the date of settlement of the purchase by Elanor.

Takeaways

1. Even though the *caveat emptor* principle has been substantially eroded in Australia over the years, a prudent purchaser should always act as if the principle is still alive and well.
2. During due diligence, irrespective of how extensive disclosure is, a prudent purchaser should ask the vendor to clarify or confirm any queries with, or ambiguities in, the disclosed documentation.
3. A purchaser should rely upon proper due diligence and a well drafted contract to protect its investment.

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