



The enforceability of clawback provisions

BY **ANTHONY HERRO** - MAY 03, 2024 8:25 AM AEST

SNAPSHOT

- Provisions requiring the repayment of a lease incentive will generally be unenforceable.
- Where the tenant also has a right of termination, a Court or Tribunal may determine the repayment provisions to be enforceable.
- One way to 'work around' this problem is to record the incentive by way of a rent abatement throughout the term of the lease.

It is common in retail and commercial lease transactions for a landlord to offer a financial incentive to entice a tenant to enter into a lease.

Standard leasing practice: Incentives

These incentives can be in the form of rent-free periods, rent abatements, landlord works – or, as is commonly the case, in the form of a monetary contribution towards the tenant's fit-out costs.

Tenants generally consider fit-out contributions attractive as they alleviate them having to finance all of their fit-out costs up front.

A landlord will factor in the incentive in determining the rent – the rent is notionally higher to take into account the incentive.

Landlords do not wish the incentive to be recorded within the registered lease. Rather, the incentive is recorded in a side document, typically referred to as an incentive deed, which is not registered to avoid the incentive being in the public domain.

It further assists a commercial landlord (not retail) as market reviews under commercial leases generally ignore incentives and side deeds, and are determined on the face value of the rent in the lease.

For retail leases where the *Retail Leases Act 1994* (NSW) ('**Retail Leases Act**') applies, the valuer is entitled to access to all such side documents because, under the *Retail Leases Act*, a market review must be an effective market review which takes into account lease incentives.

In nearly every side deed, there is a provision ('**clawback provision**') which requires pro-rata repayment of the incentive on the occurrence of a trigger event.

The usual trigger event is termination of the lease due to the tenant's default. However, it can also include assignment of the lease, change of control of the tenant, parting with possession, or a surrender at the request of the tenant.

As an example, if the landlord provides the tenant a fit-out contribution of \$500,000 and the lease is terminated due to the tenant's default after one year of a five year term, the clawback provision requires the tenant to repay the landlord 80 per cent of the \$500,000, namely, \$400,000.

Are clawback provisions enforceable?

Despite the fact clawback provisions are industry standard, the question arises as to whether they are enforceable. This question took centre stage in *GWC Property Group Pty Ltd v Higginson* [2014] QSC 264 ('**GWC Property**').

The Court held that the clawback provision relating to the fit-out contribution, rent and signage fee abatements, contained in the incentive deed and triggered by the tenant's breach, were penalties and unenforceable.

The Court considered the incentives were part of the consideration provided by the landlord which enticed the tenant to enter into the lease. By the bargain contained in the lease and incentive deed, the landlord obtained the benefit of the lease, including the contractual right to receive rent, outgoings and other agreed amounts for the term of the lease. Had the lease been performed according to its terms, that is what the landlord would have been entitled to receive.

‘To establish that they are penal, the defendants needed to show that the impugned clauses stipulated for repayments which were extravagant and unconscionable in comparison to the maximum loss that might be suffered on breach of contract. The test is an objective one not related to the parties’ states of mind. Matters are to be judged as at the time the contract was made. In my view the repayment clauses here do impose obligations which are substantially in excess of any genuine pre-estimate of damages. In addition to contractual damages for breach of the lease, the landlord was entitled, by the repayment clauses, to recover monies to which it would never have been entitled had the lease run its course’ (at [39]).

NSW Supreme Court: *Alamdo*

In light of the recent NSW Supreme Court decision of *Alamdo Holdings Pty Ltd v Croc’s Franchising Pty Ltd* (No 2) [2023] NSWSC 60 (*‘Alamdo’*), it can no longer be said that *GWC Property*, as a Queensland decision, has only persuasive impact in NSW.

In *Alamdo*, the landlord paid a \$250,000 contribution to the tenant towards its fit-out. The lease was terminated by the landlord due to the tenant’s breach. The incentive deed stated upon termination of the lease, the landlord was entitled to repayment of a proportion of the fit-out contribution calculated on a pro-rata basis by reference to the balance of the initial term of the lease.

The tenant did not dispute the landlord’s summary of the relevant principles as follows:

‘In order to be a penalty, the Incentive Repayment Terms must each be properly characterised as a threat which operated *in terrorem* against Croc’s permitting the Lease to be terminated during the currency of its initial ten-year term, or to punish Croc’s for permitting that circumstance to arise. Conversely, the Incentive Repayment Terms will not be void as penalties where they serve a legitimate purpose in guarding the legitimate interests of Alamdo (and are not “out of all proportion” to such interests), including where they reflect a genuine pre-estimate of the damage to Alamdo in the circumstances of their operation’ (at [288]).

The two questions to be determined were (at [289]):

1. ‘can the clawback provisions be characterised as a threat... or as a punishment’ for failing to comply with the lease?
2. do the clawback provisions serve to ‘guard the legitimate interests’ of the landlord, was it ‘not out of all proportion to such interests, and reflect a genuine pre-estimate’ of the landlord’s damages?

In *Alamdo*, the Court referred to and applied the principles articulated in the *GWC Property* case.

As the landlord was entitled to rental arrears and loss of bargain damages, the clawback provisions went further than necessary to protect the landlord’s legitimate interests. As such, the clawback provisions were characterised as a punishment for breaching the lease and were unenforceable as a penalty.

Queensland Supreme Court: *BMG SP Pty Ltd v YFG Strathton Pty Ltd*

The question has recently been considered again in *BMG SP Pty Ltd v YFG Strathton Pty Ltd* [2023] QSC 52 (*‘BMG’*).

The tenant was to operate a business known as Birdies Mini Golf. The incentive deed provided for a fit-out contribution of \$1,250,000 which was payable in four instalments. The lease was validly terminated by the landlord due to the tenant’s repudiation. The termination triggered the clawback provisions. The tenant contended the clawback provisions constituted a penalty. The Court stated contractual provisions imposing a penalty are unenforceable at common law ‘without the discretionary intervention of equity’ (at [167]).

The Court applied the following principles:

1. The doctrine of penalties limits what may be agreed and enforced under a contract.
2. A penalty is a punishment for non-observance of a contractual stipulation which imposes an additional liability upon breach of that contractual stipulation. The Court referred to the High Court decision in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662:

‘The law of penalties, in its standard application, is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum which exceeds what can be regarded as a

genuine pre-estimate of the damage likely to be caused by the breach’.

3. A payment will be held to be a penalty if the sum stipulated is extravagant and unconscionable in comparison with the greatest loss that could be proved following a breach. There should be an enquiry into whether the amount is ‘out of all proportion’ to the interests damaged or sought to be protected.

The entitlement to claim the repayment only arose on termination of the lease and would not have arisen otherwise. The Court considered that, *prima facie*, the clawback provisions constituted a penalty. The Court then considered whether the clawback provisions were extravagant or out of all proportion to the landlord’s legitimate interests.

The Court held as follows:

‘The amount of rent payable under the Lease was no doubt agreed having regard to the Fitout Contributions to be paid by the Landlord... If the Lease ran its course, the Landlord would effectively “recoup” the Fitout Contribution amounts paid by it through the total rent received from the tenant. In that way, it may be considered that the rent payable would notionally include a component for repayment of the Fitout Contribution payments made by the Landlord.

Upon termination of the Lease due to BMG’s default however, the Landlord would be entitled to claim contract damages. This would include any loss of bargain damages. The Landlord would *prima facie* be entitled to damages to compensate it for any period of lost rent and once the property is re-let, any difference there may be between the rent it expected to receive under the bargain it had struck with BMG and the rent it would be able to receive from the new tenant. The rent “shortfall” reflected in such an award of damages would notionally include the component of the rent the Landlord expected to receive to recoup the Fitout Contribution payments it had made.

The Landlord would therefore be compensated for the “loss” of the Fitout Contributions paid’ (at [190]-[192]).

The Court held the clawback provisions imposed a punishment for the tenant’s default, did not serve to protect any legitimate interests of the landlord and were thus unenforceable.

Practice note

Standard leasing practice can no longer ignore the clear message from the Supreme Court.

Based on the principles discussed above, clawback provisions are generally not enforceable, unless there are exceptional circumstances.

One circumstance where a clawback may be enforceable is where the parties have negotiated for the tenant to have a right of termination, for example, if turnover does not reach a certain level by the end of the second year of the term and this may involve a termination payment. One can appreciate in this situation, as the landlord would not be entitled to loss of bargain damages, the parties agreeing to a clawback payment would be reasonable and enforceable.

If the heads of agreement require you to draft clawback provisions, it is recommended to advise your client that such provisions will most likely be unenforceable.

One also must consider whether such provisions constitute unfair contract terms as they may be held not to protect any legitimate interest of the landlord.

One way to overcome this would be to grant a rent abatement across the term of the lease, evenly apportioned on a monthly basis. In this way, the incentive would be apportioned across the term of the lease and if the lease was terminated for default, there would be no obligation on the landlord to pay any further incentive and there would be no requirement on the tenant to repay the rent abatement already applied.

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