



Valence Law Group, PC

COVID-19 IMPACT ON COMMERCIAL LEASES REAL ESTATE ALERT

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On March 19, 2020, California Governor Gavin Newsom issued Executive Order N-33-20 (the “Order”), requiring that all individuals in California stay at home, with certain exceptions for essential business and to maintain critical infrastructure. The Order is in effect until ‘further notice.’ Other states and cities have enacted similar measures.

As a result of the Order and other local mandates, office buildings, warehouses, R&D facilities, retail stores, and other commercial properties are now sitting vacant, and it is not clear when tenants will be able to re-occupy. Understandably, tenants leasing these properties want to know what impact the COVID-19 pandemic and the Order may have on their lease obligations and how they may secure rent relief during this crisis. This is a critical question to tenants, many of whom are facing substantial economic losses due to the impact the pandemic has had on the market. Landlords are also deeply concerned about the pandemic and want to understand how to best respond to tenants who request rent relief, as many landlords rely on rents collected to pay loans secured by the property.

While this is a very fact-driven analysis and will depend on the express language in the lease, we prepared this summary to outline issues that should be considered by landlords and tenants as they evaluate the impact the COVID-19 pandemic will have on their leases.

FORCE MAJEURE

Many leases include a ‘force majeure’ clause, which may excuse or temporarily suspend a party’s performance due to the occurrence of an unanticipated event beyond the control of the party. Typical examples of force majeure events include acts of God, strikes, labor disputes, terrorist acts, civil commotion, and extreme weather. A force majeure clause may also reference “orders or directives of a governmental body” or other “government action,” which would include restrictions imposed by the statewide shelter in place order and similar government orders. A more detailed force majeure clause may also specifically reference epidemics, pandemics, or public health emergencies, though this is less common. Often, a force majeure clause will also reference a broad catch-all phrase such as “any other cause beyond the reasonable control of the parties,” which may encompass a disruption in performance due to the COVID-19 outbreak if the clause does not specifically reference ‘pandemics’ or ‘public health emergencies.’ That said, force majeure clauses are typically read very narrowly and will only apply if the specific event was enumerated in the clause or reasonably captured by the catch-all phrase.

Most notably, a force majeure clause will almost always explicitly state that it does not excuse a party's obligation to pay rent or to perform any monetary obligation under the lease. Thus, even if the COVID-19 pandemic is included in a force majeure clause, it is unlikely to excuse a tenant's obligation to pay rent or a landlord's obligation to pay an allowance.

Even if the force majeure clause may not justify an abatement of rent, the provision may have an impact on other lease obligations of the landlord or the tenant. For example, if tenant's performance of initial improvements is delayed due to force majeure, then the 'build out' period (and rent commencement date) could be extended, depending on how the lease is drafted. Similarly, if a landlord is currently performing tenant improvements for the tenant, the force majeure clause may delay the applicable trigger dates for any late delivery penalties negotiated by the parties. For retail tenants, the clause will excuse tenants for failing to comply with covenants to open, continuously operate and maximize revenue from the retail location.

Many force majeure provisions include detailed notice provisions requiring that the party seeking to excuse or delay performance notify the other party of its inability to perform due to such event. This notice should be sent in accordance with the notice clause in the lease. However, in light of the current crisis, sending notices to office addresses which may not be occupied due to the shelter in place order may not be practical. Thus, we recommend that parties also send notices via email. Parties should carefully review the force majeure clause to determine how it applies and what steps it must take to ensure that it may properly utilize the provision.

IMPOSSIBILITY AND FRUSTRATION OF PURPOSE

If a lease does not include an express force majeure clause, other common law theories may be relevant. The 'doctrine of impossibility,' which is codified in California Civil Code Section 1511, may serve as a de facto force majeure clause. Civil Code Section 1511 excuses a party's performance of a contractual obligation when performance is 'prevented or delayed by operation of law' or by an 'irresistible, superhuman cause.' The doctrine of impossibility requires that the unforeseeable event was directly responsible for the party's inability to perform. While this doctrine would likely excuse failure to perform a non-monetary covenant (such a maintenance obligation or duty to operate) due to the shelter in place orders issued in response to the COVID-19 pandemic, it is unlikely to excuse the obligation to pay rent unless the tenant can show that the pandemic directly caused the tenant's inability to pay rent. Importantly, financial difficulty, on its own, would not be sufficient to justify relief. Instead, the tenant must demonstrate a clear link between the event and the inability to pay rent. This doctrine may be applied differently to a mom-and-pop retail tenant than it would to an office tenant. Like force majeure, it may support providing an extension of construction periods if tenant improvement work is delayed due to COVID-19.

Another common law doctrine getting a closer look these days is 'frustration of purpose.' Frustration of purpose allows a party to terminate a contract if, after the contract is executed, an intervening event occurs which renders the purpose of entering into the contract meaningless. Unlike force majeure or impossibility, the party does not need to show that performance under the contract is impossible. Rather, the party must show that the primary reason for entering into the contract has been substantially frustrated and is no longer achievable. The most famous example of the



frustration of purpose doctrine is from *Krell v. Henry*, where a tenant rented an apartment for the sole purpose of watching the coronation of Edward VII. When the coronation was cancelled, the tenant was able to terminate. Even though nothing was wrong with the apartment and the tenant could occupy it, the purpose of the lease was entirely frustrated when the coronation was cancelled.

This is a very high bar and is unlikely to apply to most commercial leases. However, it would likely provide relief to parties that leased stadiums or conference centers for events that were cancelled due to the COVID-19 pandemic.

BUSINESS INTERRUPTION INSURANCE

Many leases require that tenants carry business interruption insurance policies as part of a tenant's property insurance policy. Business interruption insurance covers financial loss, including rental payments, which a tenant may incur due to 'direct physical loss or damage' to its premises from a 'covered cause of loss.' While 'direct physical loss or damage' typically requires a physical casualty such as a fire, 'contamination' may sometimes constitute 'direct physical loss.' Thus, a tenant which vacated its premises due to the known presence of COVID-19 in its premises or building may be able to satisfy the 'direct physical loss or damage' requirement. However, even if a tenant can demonstrate that its premises was contaminated due to COVID-19, many policies expressly exclude coverage for claims caused by virus or bacteria, though some policies narrow this exclusion by way of optional endorsements. These policies may also include 'civil authority' coverage, which provides coverage for loss of business income when access to premises is prohibited by order of a 'civil authority' as a direct result of physical damage to adjacent or nearby property.

Notably, New Jersey and Ohio have recently introduced new legislation that would retroactively amend existing business interruption policies to cover losses due to the COVID-19 outbreak, even if they contain an express virus exclusion. New Jersey's bill, for example, would be limited to policies in force as of March 9, 2020, and to insureds located in the State with less than 100 full-time employees. While promising for many small businesses, it is uncertain that the bill will pass considering the fierce criticism it has drawn from the insurance industry. Although the bill would allow insurers to seek reimbursement from the state, it may not be enough to offset the cost of shifting the financial burden of the outbreak onto the private insurance companies who have carefully assessed covered risks to come up with the premiums. Moreover, the proposed bill stands on shaky constitutional grounds so, even if passed, it will undoubtedly be challenged in the courts.

Tenants should closely review their insurance policies and consult with insurance counsel to determine whether these policies may provide coverage for losses incurred due to the COVID-19 pandemic. Landlords should also review their own rent loss insurance policies to determine whether they have coverage for lost rent arising out of the COVID-19 pandemic.

INTERRUPTION IN SERVICES

Many leases include clauses abating rent if the landlord fails to provide an essential service to the premises or if the premises are rendered untenantable for more than a certain period of time (often 3



to 5 business days). These clauses are typically drafted quite narrowly and only apply if the interruption was caused by the landlord's negligence and are under the landlord's control to correct. However, we have reviewed broad interruption provisions that provide rent abatement if the premises are rendered inaccessible due to a 'government action' which was not caused by the tenant or if a landlord otherwise prevents the tenant from accessing the premises. While broad abatement clauses are rare, the lease should be carefully reviewed to confirm whether it could apply to building closures relating to the COVID-19 pandemic.

TEMPORARY TAKING / CASUALTY

Some tenants have asked whether mandatory shelter in place orders constitute a 'temporary taking' of property. Many leases specify that in the event of a 'temporary taking,' rent will not abate but tenant will be permitted to file a direct claim against the government entity directly for lost rent. Some leases specify that in the event of a 'temporary taking,' a tenant shall be entitled to an abatement of rent during the course of the taking. If a lease includes this language, a tenant may be more likely to push for an abatement based on a takings argument. However, we are not aware of any caselaw which would support characterizing temporary shelter in place orders as a temporary taking.

If a tenant's building were evacuated due to COVID-19 contamination, a tenant may try to characterize such damage as a 'casualty,' entitling tenant to abatement until the casualty is abated. Some leases simply state, "if the premises is damaged by fire or *other casualty*...then rent shall abate until the casualty is repaired" and do not define casualty. Other casualty provisions are more specific and clear that they apply to 'physical destruction' (e.g. fire, etc.). We are not aware of a casualty provision being utilized for something like the COVID-19 pandemic and whether it would be successful. However, tenants will likely closely review the casualty provision in the lease as they evaluate the impact of COVID-19.

UNDERSTANDING THE IMPACT OF DEFAULT

If a tenant is unable to pay rent due to the COVID-19 pandemic or chooses to withhold payment of rent because it is unable to use its premises, a tenant needs to understand what impact such non-payment may have on its rights and obligations under the lease. For example, some leases permit a landlord to draw down on the entire amount of a letter of credit due to a tenant's default. In such event, the landlord may deposit unused amounts in an account and treat it as a security deposit, including electing to apply the cash deposit toward rent as it comes due. Additionally, some leases include a 'claw back' clause for rent abatements which provide that if the tenant commits a default, the tenant may be required to pay back rent abatements it received at the beginning of its term (or forfeit future express abatement rights). A tenant may also lose the right to exercise an option to extend the term of the Lease or to expand the premises, as those provisions are sometimes conditioned on a tenant not previously being in a monetary default. A tenant should carefully review the lease to confirm how a non-payment may affect its rights before electing to withhold rent.



SMALL BUSINESS ASSISTANCE IN THE CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY (CARES) ACT

While not directly related to the lease, tenants with under 500 employees should also monitor the CARES Act (2019 Federal Senate Bill 3548) which was introduced on March 19, 2020, and expected to be approved by the House this week. Among other things, the CARES Act will provide SBA loans to eligible businesses to use toward payroll expenses and rent paid during this crisis. Notably, the loan program provides for loan forgiveness of specific amounts required to maintain 'payroll continuity.' We are continuing to monitor the CARES Act and will provide updates as to how it may help landlords and tenants.

NEGOTIATED RESOLUTION

Even if the lease does not expressly provide for rent relief for tenants, we believe it is in the best interests of both landlords and tenants to work together to find a mutually beneficial solution. After all, a lease is a long-term relationship between a landlord and a tenant, both of whom need to work together collaboratively. It does not benefit a landlord if its tenant goes out of business because it is not able to pay rent. Similarly, tenants are not ultimately benefited if their landlords fail to make their debt service payments due to tenants failing to pay rent. The most appropriate resolution will depend on numerous factors, including the facts and circumstances of each particular lease, availability of insurance proceeds, relief offered by government actions, the severity of the impact on the parties, and market factors.

Since our practice is focused almost exclusively on commercial real estate transactional matters, the COVID-19 pandemic has directly impacted nearly every client of our firm. We are dedicated to helping our clients proactively navigate these issues, and we will continue to monitor developments that arise in this arena. Above all else, we hope all of our clients and their families remain safe and in good health. We are all in this together.

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