

**Professional Perspective**

# **Commercial Lease Defenses During Covid-19**

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# Commercial Lease Defenses During Covid-19

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In a brave new world where there are far more questions than answers, tenants and landlords alike are grasping at straws. As a result of government-mandated shutdowns and a teetering economy, the foundational principles of commercial leases may be as suspect as a house built from those same straws. While landlords often come from a position of strength, they are just as vulnerable in this Covid-19 economy as the many tenants who can't or won't pay their rent (not to mention common area maintenance charges, tax, and other fees).

In this unique legal environment, there are myriad legal defenses—some of which were previously relegated to the theoretical with only academic applications—that are now viable and may provide relief and even escape for tenants from what are ordinarily ironclad commercial leases with no defense short of bankruptcy.

In California, landlords breathed a collective sigh of relief when the Senate Appropriations Committee failed to pass Senate Bill 939, which would have entitled commercial tenants to renegotiate and even unilaterally terminate their lease with minor penalties. Even so, California governor Gavin Newsom issued an executive order allowing local governments to impose restrictions on commercial lease evictions through September 2021.

Cities and counties across California have taken this newly granted authority in stride and enacted temporary eviction moratoriums. The same has been true for much of the country. Although landlords are struggling to cope with the sudden cessation of lease payments, this relief is temporary and only delays payment (or defers default).

But for tenants who are unhappy with their lease terms and even unable to pay rent at all, the question remains, what now? What relief can be found when confronted by the draconian and uncompromising one-sided terms contained in most commercial leases? Can landlords still recover all payments due for the lease term?

To make matters worse (ultimately for landlords), some tenants—after working remotely for some period of months—have realized that they have no need for an office and are looking to terminate their lease agreement altogether. Others are content to remain in their space, albeit under different terms and seeking abatement for the time their offices were closed.

## Defenses Under the Lease

### **Force Majeure**

A force majeure clause is a contractual provision that may allow a party to alter the terms of their lease or excuse nonperformance in the face of unforeseen circumstances beyond the parties' control. When determining whether a force majeure clause has been triggered, courts will typically examine whether the underlying event qualifies as force majeure under the contract and whether the contract's performance is rendered impossible.

Given the declaration of Covid-19 as a pandemic, force majeure clauses that explicitly account for pandemics have been automatically triggered. However, the presence of such language in a force majeure clause is few and far between. More common events triggering a force majeure include "acts of God" and "acts of government."

While courts have yet to come to an agreement on the applicability of these terms in the context of Covid-19, it is not easy to imagine another phenomenon that fits the bill better. What is more akin to an act of God than the effects a global pandemic reminiscent of biblical plagues? And in the wake of government regulation on both the state and federal level, such orders certainly constitute "acts of government."

The first wave of cases is just now moving through the courts but early cases support enforcement of force majeure provisions as a result of Covid-19 closures and related government orders. However, many force majeure clauses contain explicit exclusions for rent and, in that case, tenants must look elsewhere for relief.

### **Co-Tenancy**

Most commonly found in retail leases, co-tenancy clauses provide tenants with protection if surrounding stores are not open or operating. Just as many landlords depend on anchor stores to pull other businesses to their shopping center, tenants similarly value a space based on the presence of major retailers or even a promise of a particular volume of foot

traffic. Indeed, a landlord may represent or even project certain foot traffic to attract new tenants. Hundreds of retailers have already declared bankruptcy and stores are closing their doors in malls across America, which may only be the first wave of such filings and closures. Co-tenancy clauses may give tenants a basis to reduce their rent or even terminate their lease under these circumstances.

## Common Law Defenses

If the lease does not include a force majeure or co-tenancy provision or there is an exception for rent, multiple common law defenses may apply for commercial tenants. Even though counsel tend to discount the applicable common law defenses in the context of modern commercial leases, largely because of the very limited circumstances in which they apply, Covid-19 may present exactly those circumstances. As such, landlords and tenants should both understand these formerly theoretical defenses, their impact on any litigation, and their value for the purpose of negotiation and dispute resolution.

### ***Covenant of Quiet Enjoyment***

In every lease, there is an implied covenant that the tenant shall have the right to possession, occupancy, and beneficial use of every portion of the leased premises. As Covid-19 regulations place a heavy burden on commercial tenants to comply with social distancing standards, landlords may be responsible for modifications to the leased premises and to make it safe from "dangerous conditions."

Tenants must give their landlord notice of the problem and a reasonable amount of time to remedy it. However, if the resulting condition is so bad that it renders the property substantially unsuitable for the purpose for which it was leased, or seriously interferes with the beneficial enjoyment of the property, tenants may be entitled to rent abatement.

Indeed, if the tenant is in a high-rise building where access can be made only by use of an elevator, the building has a shared HVAC system, or the building has other unavoidable common use areas (shared bathrooms, stairs, cafeteria, etc.), then the landlord may be unable to sufficiently remediate the space to make it safe to return to work under the current conditions.

### ***Frustration of Purpose***

The ability to open and operate a business is the principal purpose of a commercial lease, which should be distinguished from the tenant's intended use of the leased premises. The failure of that principal purpose may wholly discharge tenants from their lease obligations. This "frustration of purpose" defense occurs when performance remains possible, but the purpose for which the tenant entered into the lease is "substantially frustrated." Frustration of purpose is different from the defense of "impossibility," because it does not require that the tenant cannot comply with terms of the lease.

As such, the defense is available even if a tenant could pay its rent but the purpose of such payment has been defeated. To have a valid frustration of purpose claim, a tenant must show:

- A supervening event that severely impaired the value or worth of the purpose for which the agreement was entered
- The supervening event was through no fault of the tenant
- Non-occurrence of the supervening event was a basic assumption of the contracting parties
- The contract language or surrounding circumstances did not indicate that the tenant assumed a heightened duty to perform

In other words, if government-mandated closures or health and safety regulations have substantially impaired or negated a tenant's very ability to conduct business in the leased space, the tenant may be permitted to terminate the lease. Whereas, if the tenant is only limited in its use (e.g., for takeout versus dine-in service), then the landlord may be able to defeat a frustration defense.

### ***Temporary Impracticability***

Under the Restatement (Second) of Contracts § 269, impracticability of performance or frustration of purpose that is only temporary may "suspend" a tenant's duty to perform under the lease, while the impracticability or frustration exists.

However, the tenant's duty will not be entirely discharged unless performance after the cessation of the impracticability or frustration would be "materially more burdensome than had there been no impracticability or frustration." When evaluating the validity of a tenant's claim, courts will typically ask:

- How uncertain is it that the impracticability will end?
- How much prejudice will result from keeping the parties bound by the contract?

If there is no end in sight and performance under the lease will substantially prejudice one or both parties, the courts may choose to discharge them. However, if the impracticability ceases to exist, then the courts may only temporarily suspend a party's duty to perform. In that case, for example, a tenant may seek abatement of rent for the period during which the space was closed as a result of the pandemic, even if it was able to reopen.

## Other Strategies

### ***Businesses Interruption Insurance***

Business interruption insurance has become a hot topic amidst the current pandemic. While tenants and landlords may carry business interruption insurance policies, whether they apply to losses incurred as a result of Covid-19 is currently being litigated. Many business interruption insurance policies only cover physical loss or damage and specifically exclude pandemics or communicable diseases from coverage. However, some policies include "civil authority coverage," which may allow landlords and tenants to recover from government-mandated business closures.

With business interruption insurance carriers denying coverage to landlords and tenants, it wouldn't be a surprise to see rent guarantee insurance become commonplace. In either case, tenants should consider challenging any denial by their carrier of a claim for business interruption. For example, one early decision suggested physical damage could include loss of inventory, in the context of a restaurant business, and losses resulting from employees who test positive and force a closure, remedial measures, or suspension of business operations.

### ***Business Work-Out***

Where there are no clear legal defenses or a work-out is the best business solution, landlords and tenants may consider various options including blend and extend and other transactions. A blend and extend transaction is one in which the remaining lease term is extended, and the rental rate is blended with a newly negotiated one. As stores close their doors at a rapid pace, landlords may be more willing to trade reduced rental rates for the promise of a long term tenant. But work-outs can take on many forms and tenants should be creative to find the best solution for their business. Landlords may be willing to voluntarily forgive rent for a period, if the tenant agrees to start paying rent and affirms the remainder of the lease. Or, tenants may be able to negotiate temporary rent relief, with rent for a period of time now amortized as an additional monthly payment in 2021.

### ***Bankruptcy Lease Rejection***

If a resolution cannot be reached with the landlord, bankruptcy may be the only or best option for tenants. Under section 502(b)(6) of Chapter 11 of Title 11 of the United States Code, a tenant has the option to reject the lease. When a lease has been rejected, the claims allowable to the landlord under the lease are capped. Any recovery by the landlord would be limited to either one year or 15%, not to exceed three years, of the remaining lease term following the earlier of the petition date or the date on which the landlord repossessed or the debtor surrendered the property.

And to even be entitled to recover that amount, the landlord must prove and substantiate the claim as to both the incidence and the measure of damages. As a result, and if a tenant is seriously contemplating bankruptcy as an option if the landlord refuses to release the tenant from the lease, landlord and tenant may use the lease rejection cap as a point of negotiation (which may permit a resolution without the need for bankruptcy).

### ***Declaratory Judgment***

Where a tenant has negotiated a favorable force majeure provision or where a tenant has other strong defenses (and perhaps even affirmative claims to recoup rent paid during closures), a declaratory judgment may be pursued affirmatively against the landlord or as counterclaim after litigation has been filed. A declaratory judgment is a binding judgment from the court defining the legal relationship between parties and, in this context, the parties' rights under the lease. As a

precursor to any declaratory action or in conjunction with the various strategies and defenses discussed above, tenants can present these arguments in advance of any litigation in a demand letter or in a pre-litigation mediation.

## What Should Landlords and Tenants Do Now?

A return to the world as we knew it before the pandemic is unlikely to occur any time soon. Rather, work-from-home has started to transition to a more permanent way of doing business. As a result, demand for office and retail space will likely continue its downward trend, amid surging infection rates and hospitalizations. Landlords and tenants would be well advised to take a long-term view of the business and financial fallout from the coronavirus. The focus may necessarily be on a tenant's request for immediate rent relief but could only succeed in kicking the can down the road. It is unclear when businesses will be able to fully re-open and, even so, whether customers will return in the same numbers.

Tenants and landlords should engage counsel to explore the options available to them, not only to navigate the current pandemic but to protect themselves against the next "new normal." For tenants, this may include temporary relief, business work-outs, and lease termination. For landlords, this may include negotiating rent relief in exchange for affirmation or extension of the lease, which may be preferable to no tenant or chasing after rent in litigation. In either case, parties should review lease terms, consider possible claims and defenses, evaluate strategies for moving forward in an uncertain market, and be prepared for new law and legislation to change the commercial real estate landscape.