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THE RESOLUTION ISSUE

2021 real estate trends and ADR

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The impact of the worldwide pandemic on the real estate sector has been unprecedented. Most notably, commercial property owners and tenants are grappling with the severe disruption and economic hardship that has resulted from a series of governmental shutdowns and ensuing lease defaults. Businesses across many industries have been forced to curtail operations, threatening the rental income stream upon which many landlords depend. The ripple effects of trends we are experiencing will likely be felt for years to come.

Burdened with a growing backlog of cases, and courts that are unlikely to address these issues anytime soon, this article considers how current trends will develop in future ADR proceedings. Now more than ever, the singular advantage of mediation and arbitration is the opportunity for a timely and efficient resolution.

COMMERCIAL PROPERTY LEASES

Force Majeure

Mounting lease defaults have driven an examination of arcane lease provisions such as force majeure, bringing fresh attention to legal principles often overlooked. A force majeure provision allocates the risk for events outside the parties' control — something unexpected or unforeseeable at the time the contract was executed — such as war, terrorism, disasters, labor strikes and governmental prohibitions, which render performance impossible. *Pac. Vegetable Oil Corp. v. C. S. T., Ltd.*, 29 Cal. 2d 228, 238 (1946). These clauses temporarily excuse performance for a period equal to the period of the delay. Oosten v. Hay Haulers Dairy Emp. & Helpers Union, 45 Cal. 2d 784, 788 (1955). The obligation to pay rent, however, continues in most leases, not¬withstanding the occurrence of a force majeure event. *Citizens of Humanity, LLC v. Caitac Int'l, Inc.*, 2010 WL 3007771, at *15 (Cal. Ct. App. Aug. 3, 2010).

Absent a force majeure clause, tenants may seek relief under various common law doctrines, though the evidentiary burden is high. One contract defense, frustration of purpose, focuses less on the ability to perform than on the value of that performance to the contracting party. Where a party's principal purpose in entering into the contract has been destroyed, a court may discharge future performance. *La Cumbre Golf and Country Club v. Santa Barbara Hotel Co.*, 205 Cal. 422, 426 (1928).

The pandemic is so extraordinary in scale and scope that courts can be expected to go beyond the actual lease language to invoke equitable doctrines and public policy in deciding COVID-19-related claims. Businesses closed by governmental orders will seek relief under Civil Code Section 1511(1), which excuses a delay or prevention in performance by operation of law even though parties may have contractually agreed to the contrary.

A reason that commercial lease disputes are currently ripe for negotiation is that parties can bargain over what is valuable to them, based on their own preferences and priorities. There are a range of terms that can be traded, among them rent deferrals and abatement, length of the lease term, and size of the premises. Parties to commercial leases have been negotiating these provisions since the first shutdown orders were announced.

As the pandemic enters its second year, it appears many tenants have become comfortable with remote work, both for themselves and their employees, and may not need as much office and retail space in the future. This will leave a glut of space on the market, potentially reducing property values. Landlords may want to consider the potential for converting some

of that commercial space to mixed use or residential. Lenders or local zoning authorities should be consulted if their approval is necessary to effectuate such a change. At mediation, determining whether the landlord is amenable to modifying a lease's "Use" provision could be a productive inquiry.

Business Interruption Insurance

Commercial property tenants have pursued separate tracks to mitigate financial losses. Besides engaging their landlord about a modification of lease terms, some have also submitted insurance claims for business interruption. Although COVID-related insurance coverage litigation is still in the early stages, many courts have sided with the insurance industry position that government-ordered closures do not satisfy the "direct physical loss or damage" requirement to trigger coverage for business interruption losses. This is especially true where the policy contains an express virus exclusion.

While these disputes will be protracted and court outcomes will vary by jurisdiction, policyholders have won some victories. Most striking, perhaps, is a recent North Carolina case involving a group of restaurant owners whose businesses had been shuttered. They persuaded the court to rule that the plain and ordinary meaning of the phrase "direct physical loss" in the policy includes "the inability to utilize or possess something in the real, material, or bodily world" and therefore "describes the scenario where business owners … lose the full range of rights and advantages of using or accessing their business property." *North State Deli, LLC v. The Cincinnati Insurance Co.*, 20-CVS-02569 (N.C. Gen. Ct. Justice, Durham Cnty.) (2020). Importantly, the court interpreted the phrase "direct physical loss" as including "the loss of use or access to covered property even where that property has not been structurally altered."

Collectability

For landlords who can establish an unexcused breach by a tenant, the biggest hurdle may be collectability. The pandemic undoubtedly has caused many tenants to struggle financially or put them on the brink of bankruptcy. A landlord confronted with a tenant who claims an inability to pay will want to confer with their mediator about a possible inspection or exchange of financial documents that would allow the landlord to have confidence that such a representation is true. If parties decide to go forward on that basis, then additionally, they should discuss with the mediator protocols for maintaining confidentiality and how payments can be creatively structured. When litigation is pending, payment can be secured by a properly drafted stipulation for judgment.

If bankruptcy is not an idle threat, counsel will want to review 11 U.S.C. Section 502(b) (6), which caps a landlord's claim in bankruptcy for damages resulting from the termination of a real property lease. Under that section, a landlord/creditor is entitled to rent reserve from the greater of one year, or 15%, not to exceed three years, of the remaining lease term. The cap operates from the earlier of the petition filing date or the date on which the landlord repossessed, or the tenant surrendered the leased premises. The landlord also retains a claim for any unpaid rent that accrued prior to the earlier of those dates.

Also, last year saw a trio of new appellate decisions favoring judgment creditors who proved alter ego liability. In *MSY Trading Co., Inc. v. Saleen Automotive*, as a matter of first impression, the court held that a post-judgment independent action to establish alter ego liability for a judgment on a contract is subject to an award of attorney fees to the prevailing party. MSY Trading Co., Inc. v. Saleen Automotive, 51 Cal. App. 5th 395, 403 (2020)

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RESIDENTIAL PROPERTY SALES

Compared to the havoc affecting commercial properties, the residential market has shown astonishing resilience. Robust sales have been propelled by historically low interest rates, the desire of some buyers to optimize their living environment now that they are working remotely and a shrinking inventory of homes for sale. The surge in home prices over the past year encouraged some sellers to jump into the market when presented with what they believed was an extraordinary price, only to discover that they could not afford to move, and then cancel the transaction.

During periods of rapid price appreciation, it is not unusual for claims alleging that a seller or agent failed to disclose material facts about a home's condition to taper off. When the market turns, however, and prices decline, a buyer who believes they overpaid will scrutinize the property disclosures they received more closely for omissions and misrepresentations.

The standard form real estate purchase agreement used throughout California contains a mandatory mediation provision — a buyer or seller who ignores this requirement or refuses to mediate forfeits their right to recover attorney fees, even if they are the prevailing party. Numerous appellate decisions have upheld the enforceability of the clause. *Frei v. Davey*, 124 Cal. App. 4th 1506, 1511 (2004).

CONCLUSION

Parties to commercial leases need a timely resolution of COVID-19-related disputes so that essential business interests are satisfied with the least disruption. In many instances, they are best served by an efficient and effective ADR process. ■

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