

A 'Partnership in Pain' for Landlords and Tenants

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By Mark Loeterman

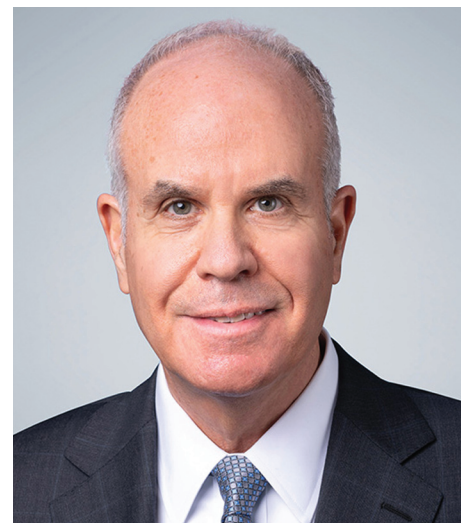
Commercial landlords and tenants face unprecedented challenges caused by the COVID-19 pandemic. The impact has been most acute to businesses deemed “non-essential.” Shuttered by government “safer at home” directives since mid-March, many cannot afford to pay the rent. The specter of mounting lease defaults is forcing an examination of arcane lease provisions such as force majeure, bringing fresh attention to legal principles often overlooked in a robust economy. Saddled with a large backlog of cases, courts are unlikely to address these claims anytime soon. Given the difficulty of predicting how force majeure clauses will be interpreted, considering the breadth of the health care emergency, both landlords and tenants may be motivated to negotiate a re-

structuring of their respective lease obligations.

Force Majeure

A force majeure provision allocates the risk for events outside the parties' control, such as war, terrorism, disasters, labor strikes and governmental prohibitions, which render performance impossible, impracticable from a commercial perspective, or not serving the contract's primary purpose. These clauses typically suspend performance for a period equal to the period of the delay. Notably, the obligation to pay rent and other charges continues in most leases, notwithstanding the occurrence of a force majeure event.

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-



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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.

Party Motivations

Many tenants need rent relief now. Their willingness to pay is tied to the income their

businesses generate. Besides an agreement on rent, tenants will be looking opportunistically for other potential lease modifications. Going forward, a tenant who envisions more of its employees working remotely may be interested in returning some portion of its space to the landlord.

For landlords, each tenant request must be examined on its own merits, with a view toward the exposure that a default may create. If the landlord is carrying debt on the property, the loan terms may be a complicating factor, limiting the landlord's flexibility in modifying lease obligations without lender consent.

Landlords will be more amenable to a rent deferment if the tenant offers documentation that supports their inability to pay and a meaningful plan for repayment. At the outset, they will insist on showing that governmental restrictions related to COVID-19 were, in fact, the actual cause of the tenant's default, as opposed to some other circumstance. Some landlords have already started requiring tenants to submit applications to SBA for Paycheck Protection Program loans, which can be used in part to pay rent, as a condition to making a rent concession. Confidentiality surrounding these discussions will be

important, as landlords will not want to treat all tenants equally.

Restructuring Options

There are many options for a lease restructuring, which can be used in combination with one another. The parties may agree that payments are deferred for a specified period, with the accrued rent being repaid in installments or a lump sum before the lease expires. Tenants will want that period linked to the lifting of governmental restrictions, and preferably, to the re-opening of businesses. From the landlord's perspective, a fixed period of deferral is more advantageous, leaving the possibility of additional relief for future discussion.

Similarly, the parties may negotiate a rent abatement. One scenario is that an abatement applies only to base rent, without affecting the tenant's responsibility to reimburse ongoing property expenses for maintenance, taxes, and insurance.

Either a deferral or abatement can be coupled with a lease extension. This may be important to the landlord, as well as its lender and a prospective buyer, who set a property's value based on an evaluation of its income stream. In the context of an extension, a landlord might offer a tenant allowance to improve or refurbish the premises, or

even relocate the tenant to a more desirable location in a retail center or office building, in return for an updated personal guaranty.

Another alternative is to introduce or modify a percentage rent component which, in effect, protects the tenant from current obligations it cannot afford while giving the landlord the benefit of a potential upside when the market improves.

These options and more are ripe for mediation. Parties can develop proposals tailored to their specific needs, in a confidential setting and avoid the time and expense of having lease defaults adjudicated by an overwhelmed judicial system.

Conclusion

Hampered from exercising their traditional court remedies and facing unprecedented uncertainty, landlords and tenants have many reasons to cooperate in restructuring leases during the pandemic. As one real estate insider put it, a new "partnership in pain" is emerging.

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