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Restructuring Commercial Real Estate Leases in the COVID-19 Era

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We are currently at the forefront of an economic downturn driven by conditions that none of us have experienced in our lifetimes. Unlike the "great recession" of 2008-2012 which was triggered by a systemic financial collapse, the worldwide business community and financial markets are currently grappling with a global economic shutdown induced by a viral pandemic and resulting increasingly restrictive government declarations that have severely disrupted many businesses. From a real estate perspective, the impact has clearly already taken hold and the ripple effects will undoubtedly continue to run far and deep throughout 2020. One area of particular pain and concentration is the landlord-tenant relationship.
Due to the abrupt and severe economic shutdown, tenants across various industries are unable to maintain operations to varying degrees, which has in turn threatened the recurring rental income stream which represents the life blood of landlords’ real estate investment assets. The topic du jour within commercial real estate circles is the “force majeure” provision contained in most commercial leases (discussed in more detail below). In short, a force majeure provision allocates relief and risk among the parties in events such as natural disasters, war, terrorism, labor strikes, governmental orders and prohibitions, “other causes beyond the parties’ control,” and in some cases, pandemics. Although force majeure provisions are no longer “boilerplate,” they generally provide for extension of timeframes, automatic extensions or otherwise excuse temporary non-performance of a party’s contractual obligations. In many cases, however, force majeure provisions will expressly provide that a tenant’s rent payment obligations will not be excused or delayed on account of any force majeure event. In other words, in those instances, the tenant would typically remain contractually liable for its monthly rent obligations even if pandemics such as COVID-19 are otherwise covered under the definition of “force majeure” in its lease, and even if the tenant’s business were subjected to closure for some period of time while the emergency continues.

With that said, because of the unique nature of the root cause of the current real estate shutdown, landlords and tenants will likely be more inclined to “play nice in the sandbox” as it’s truly a collective problem and challenge that we are all facing. In addition, the landlord-tenant dynamic is further complicated by virtue of government mandated business shutdowns in various jurisdictions and the new federal COVID-19 stimulus package (CARES Act) that has been launched, including, with respect to any property encumbered by a mortgage, the landlord’s lender’s role in all of this – and in particular, considerations that landlords need to be very cognizant of relative to full recourse carveouts that often exist under non-recourse loans. Today, more than ever, the playing field has been set for landlords and tenants to engage in a meaningful, transparent and genuine lease restructuring dialogue. While these lease restructuring scenarios often run the gamut with respect to the tenant’s economic and other performance-related requirements, they frequently could involve one or more of the following key aspects.

**Lease Restructuring Alternatives**

1. **Full or Partial Rent Abatement** – The parties may agree upon a temporary rent abatement (or more likely, deferral, as more fully described below), which may range anywhere from a full abatement of all rent payable under the lease (i.e., including the tenant’s common area maintenance, real estate tax, and insurance reimbursement obligations) to a partial abatement of base rent only. The latter is more frequently employed as it represents an equitable middle ground, in light of the landlord’s ongoing property-level expenses (and in some cases lender-mandated reserves).

   From a tenant’s perspective, the tenant should push for as much discretion as possible to determine when the temporary rent abatement period should end (e.g., upon re-opening of tenant’s business). From a landlord’s perspective, the landlord would prefer to see a fixed “ending” date to any such temporary rent abatement, whether the abatement is for a fixed period of time (e.g., a 1-month abatement, with the understanding that the parties can re-visit the following month as needed) or includes a fixed outside date (e.g., abatement until the earlier of (i) tenant’s re-opening for business, and (ii) August 1, 2020).

2. **Rent Deferral** – Rather than providing for rent abatement, the parties may agree simply to defer rent, by providing the tenant with a full or temporary rent deferral for some period of time, with the tenant being responsible for repaying any deferred amounts under one of various alternative scenarios. For example, if the lease calls for base rent of $5,000 per month, the parties may agree to provide tenant with a full deferral of base rent during April and May, with the tenant being responsible for re-paying landlord those abated amounts in four (4) equal installments by paying landlord base rent of $7,500 per month in each of June, July, August and September (and beginning with October, tenant’s monthly base rent obligations would revert back to the original $5,000 per month). In negotiating any rent deferral, each party would want take into account the considerations referenced in No. 1 above.
3. **“Blend and Extend” Scenarios** – Alternatively, a temporary rent abatement or deferral may be handled via a tenant’s agreement to extend the lease term. For example, the landlord may agree to a full deferral of base rent for nine (9) months, in exchange for the tenant agreeing to add an equivalent nine (9) month period to the end of the lease term. Theoretically, this avoids the impairment of the value of the asset as the landlord maintains the number of rent-paying months that existed pre-COVID-19, which directly impact the value and income production realized from the lease, and which figure a lender, future buyer or investor will utilize in calculating the property’s appraised value and/or purchase price on the basis of a market cap rate.

4. **Tenant Improvement Allowances** – Coupled with an extension of the lease term through a “blend and extend” scenario as contemplated in No. 3 above, the landlord may agree to provide the tenant with an allowance for space improvements and/or refurbishment of the tenant’s furniture, fixtures, and equipment. An opportunistic tenant may seek to have their landlord fund all or a portion of certain space improvements and/or FF&E replacements that the tenant may already have been contemplating in the near-term prior to the COVID-19 emergency. From a landlord’s perspective, the landlord would likely only agree to provide any tenant improvement dollars to a strong credit tenant during “normal” times rather than the current market uncertainty at hand, though it could be well worth it to do so if in exchange for a significant extension of lease term.

5. **Credit Enhancements; Percentage Rent** – The universe of potential lease restructuring options is vast. For example, the parties could agree upon deferred rent coupled with a new corporate guaranty; or, in exchange for a rent abatement or deferral in connection with retail or restaurant leases, the parties may agree to add (or increase) a percentage rent component to tenant’s rent obligations. This would foster a “quid pro quo” approach in which the landlord participates in the downside of the tenant’s current cash flow constraints but by the same token, realizes a benefit and upside when the market improves and the tenant hopefully sees a significant increase in gross revenue. Ultimately, the parties will be limited only by the parties’ respective imaginations.

6. **Early Termination** – Rather than negotiate a lease restructure, the parties may wish, in certain instances, to negotiate lease termination, liquidated settlement, and release of any guarantors and/or security deposits. This is likely an option of last resort, though may make sense to address situations where there is little hope of the tenant’s business recovery or the duration of the remaining lease term is limited. It’s important for a tenant to assess its overarching goal when embarking upon a lease restructuring dialogue.

7. **CARES Act** – The recently passed federal COVID-19 stimulus package legislation has quickly become relevant in the context of lease modification discussions between landlords and tenants. Under the Paycheck Protection Program, loans are available to small businesses to permit them to keep employees on staff and to pay rent, with the potential for partial loan forgiveness if program criteria are met. Many landlords have taken the proactive step of mandating that a tenant apply for relief under the Act as a condition of entertaining a rent relief dialogue. As of the date of this Article, our Firm’s real estate attorneys continue to work in tandem with our Washington, D.C.-based policy and government relations team in an effort to navigate the web of requirements and criteria associated with seeking funding under the Act.

**Government Mandated Closure of “Non-Essential” Businesses.**

**Shifting Legal Landscape and “Stay Home” Orders**
As the public health crisis continues, various state and local governments have issued “stay home” or “shelter in place” orders mandating the full or partial closure of “non-essential businesses” and allowing only “critical infrastructure” or “essential businesses” to continue operating. It should be noted that the federal CISA critical infrastructure sectors are intended as guidance only, with the states remaining empowered to determine what constitutes an essential business. On March 19, 2020, California Governor Gavin Newsom issued the nation’s first state-wide “Stay Home” order (Executive Order N-33-20), closing all non-essential businesses and ordering residents to limit their activities outside the home. Since Governor Newsom’s order, the majority of states including the State of New York (original order defining essential businesses; stay home order mandating certain closures) have issued similar orders, along with various cities, counties, and Native American tribes. While not all state or local orders use the same language or restrictions, California is instructive in what many states and cities have identified as an “essential” business. As of the date of this article, most of these orders are in effect through April, although extensions appear inevitable.

Georgia Governor Brian Kemp announced on April 1, 2020 that he would sign a statewide “stay home” order on April 2, 2020. A week and a half earlier, Atlanta Mayor Keisha Lance Bottoms issued a “Stay Home” Executive Order affecting City of Atlanta residents, and other Georgia localities followed suit. In Florida, Governor Ron DeSantis issued a statewide “Safer at Home” order dated April 1, 2020, after having signed previous half-measures covering only certain counties, and vacation rentals, bars and restaurants across the state. Similarly, North Carolina issued a stay-at-home order on March 27, 2020, following several relatively limited-in-scope orders closing all entertainment venues and restricting the operation of restaurants to drive-through, takeout, and delivery services only. Other states also began with earlier measures mandating the closure or very limited operation of bars and/or restaurants prior to issuing broad shut-down orders affecting all non-essential businesses. Many K-12 school districts and universities are closed, including some through the end of the 2019-2020 school year.

**Effect on Commercial Leases**

From a commercial tenant’s perspective, these various orders, to the extent applicable to a particular tenant’s operations (i.e., with respect to any business operations deemed “non-essential”), may provide a legal basis for temporarily ceasing operations at the leased premises, as most leases expressly require tenants to comply with all applicable laws and governmental regulations affecting occupancy and/or business operations at the premises. This lease requirement can typically be found, depending upon the lease, in a standalone “compliance with laws” provision, in the “permitted use” or “continuous operation” provisions, the landlord’s representations allowing for the use of the premises, access requirements in favor of the tenant, or in sections addressing the landlord’s default and breach of representations. The force majeure provision in particular may provide a commercial tenant with the right to cease or suspend occupancy and operations at the leased premises during a governmental declared disaster or emergency with associated limitations on businesses (although few, if any, typical leases signed prior to the COVID-19 crisis will specifically address a pandemic situation or “stay home” order). Tenants may likewise have grounds to withhold rent payments, but this requires a “deeper dive” into the specific language of the force majeure clause in a particular lease, as well as the overall background and related factors impacting the grounds for withholding rent. The recent state and local orders, if they shut down a tenant’s particular business sector, will be well within the definition of the “applicable governmental regulation” referenced in many force majeure and “compliance with laws” provisions.

Tenants should be cognizant of any provision that requires them to officially notify the landlord of a force majeure event in order to receive the benefit of force majeure protections, as well as any carveouts excluding certain lease obligations from the protections of the force majeure clause, such as the obligation to pay rent or continuously operate. Examples of this include:

- “...provided that the party claiming force majeure must give notice to the other party within 10 days of the occurrence of the event.”
- “...provided, however, that nothing in this Agreement shall excuse Tenant from the payment of Rent.”
“The provisions of this [Force Majeure] section shall not operate to excuse Tenant from prompt payment of rental and other charges.”

Depending upon the jurisdiction, an argument may still be made for “impossibility” or “illegality” as discussed, for example, in the brief recap of selected relevant Georgia case law at the end of this Article, or, in other jurisdictions, “frustration of purpose.”

From a landlord’s perspective, these governmental orders also provide legal cover when dealing with a lender who is looking to the landlord to ensure its leases are fully operational (more on landlord and lender perspectives, below). In addition, several localities have temporarily suspended commercial and residential evictions and/or foreclosures during the crisis, such as the March 17, 2020 executive order by New York Governor Andrew Cuomo which prohibits the enforcement of residential and commercial evictions and foreclosures for a period of 90 days from the order. California Governor Gavin Newsom signed an Executive Order on March 16, 2020, allowing local governments leeway to impose substantive limitations on commercial or residential evictions where “(i) The basis for the eviction is nonpayment of rent…arising out of a substantial decrease in household or business income…and (ii) The decrease in household or business income…was caused by the COVID-19 pandemic, or by any local, state, or federal government response to COVID-19, and is documented.” Governor Newsom took a step further on March 27th, temporarily suspending all residential (but, as of the date of this article, not commercial) evictions filed for nonpayment of rent in connection with COVID-19.

Applicable COVID-19 Commercial Real Estate Case Law in Georgia, Florida, North Carolina, and California

Each state will have its own interpretation of the current COVID-19’s impact on enforceability of commercial lease obligations. On the basis of the large concentration of commercial real estate holdings and operating store and/or retail locations by various clients of our Firm, we have provided a brief recap of selected relevant case law to the COVID-19 issues in California, Florida, Georgia, and North Carolina at the end of this article.

Lender-Related Considerations

Should the landlord’s ownership interest in the property be encumbered by a mortgage, the landlord’s flexibility in negotiating any lease restructuring, or in agreeing to any waiver or forbearance of enforcement of any particular tenant breaches relating to current conditions, will be driven, in significant part, by lender considerations. While these particular considerations will vary based on the specific provisions of the applicable loan documents, loan agreements typically require the borrower (i.e., the landlord, in the context of commercial property leasing) to obtain the lender’s consent to any material lease amendment; and many subordination, non-disturbance and attornment agreements, to which the tenant would also be a party, often require the tenant to ensure that such lender approval is obtained, as well. For this reason, any landlord whose property is encumbered by a mortgage would be well-advised to have a tenant sign a “pre-negotiation agreement” in advance of embarking on a lease restructuring dialogue, which agreement, if properly drafted, would protect the landlord by having the tenant formally acknowledge that the mere act of negotiating is not legally binding and that, until such time as a formal written agreement is entered into and any required lender approvals have been obtained, the terms of the lease will continue to govern and control.

From a non-recourse loan perspective, particular care should be taken by landlords to read their loan documents very carefully to avoid any unintended consequences. Specifically, while communications between landlords, as borrowers, and their lenders will considerably vary, any admission by a landlord that it is incapable of being able to pay its debts in due course will often trigger a non-recourse carveout of the loan (and, in turn, potentially expose any guarantor(s) to personal liability thereunder). Further, with respect to lease modifications and amendments in connection with a desired tenant restructuring, this too may very well run afoul of the non-recourse limitations if the landlord fails to obtain the requisite lender consent.
Construction & Development - Pending Leases, Development and Construction Contracts

All pending deals, including those currently under negotiation, need to be closely examined in recognition of the evolving market dynamics. The terms of the lease, work letter and any other applicable contractual agreements dictate a customized approach to each situation. Where some construction projects should continue to proceed, some might benefit from a contractual suspension, and others may require a termination, perhaps to restructure the deal when the market turns positive (and perhaps construction costs decline).

A few noteworthy aspects:

- Buildouts and delivery of new (or expansion) leased premises need to address force majeure delays and the impact on the delivery timeline. This is acutely important from a tenant standpoint when a “hard” rent commencement date has already been established under the lease (i.e., the rent start is firm irrespective of when the construction work is complete).

- For ground leases and other agreements that hinge upon municipal development approvals, these contingency periods require immediate adjustment. For the reasons discussed above (and in the state specific case law below), reliance on force majeure clauses alone is tenuous; rather, specific COVID-19 conditional performance provisions should be inserted as stand-alone provisions or force majeure provisions need to be expressly enhanced to address delays in submitting permit applications, obtaining required governmental approvals and receipt of the final certificate of occupancy.

- Construction budgets, tenant improvement allowances and expense caps will need to be re-examined due to shortages of materials and labor. Pre-COVID-19 construction budget pricing and the parties’ allocation of costs will invariably be influenced by the current crisis. Hence, as an example, a tenant responsible for all costs associated with its new premises buildout over a stated dollar amount per square foot will want to carefully evaluate likely budget increases that will result in an allocation of greater expense to the tenant side of the ledger.

Conclusions & Next Steps

In light of the interrelated business and legal considerations involved with any commercial lease restructuring transaction, the so-called million dollar question is, “Which party has greater leverage at this point of time?” In short, our view is that the pendulum swings somewhat more favorably in the tenant’s direction – at least, over the short-term horizon. Landlords invariably hold a rent default and eviction “hammer”, so to speak, if a tenant fails to pay rent (or adhere to any contractual operating covenant that may exist in the lease). That being said, the aggregate of the circumstances associated with the current COVID-19 crisis have created not only potential legal and business arguments favoring tenants – but also equitable and economic grounds which some landlords and many courts could find compelling. Moreover, a rush to the courthouse is simply not pragmatic for landlords, or even legally possible in some areas, based on existing enforcement moratoriums and resource-related constraints in various jurisdictions located throughout the country. The final and ever-present factor is, in many instances, the landlord’s lender, and current trends have indicated a tendency for some level of loan forbearance to be offered, which will inevitably flow downstream to the tenant in the form of greater landlord-latITUDE in addressing tenant defaults and the need to recalibrate existing lease terms to sync-up with the ongoing business climate.

Applicable COVID-19 Commercial Real Estate Case Law
in Georgia, Florida, North Carolina, and California

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Georgia
Under Georgia law, force majeure provisions are construed very narrowly. In addition and independent from a force majeure clause, a party is excused from performing under a contract when performance becomes objectively impossible due to acts of God, i.e., events which are outside of a party’s control to prevent or avoid. In interpreting the relevant statute, Georgia courts have held that any event claimed to excuse performance must be extraordinary, unforeseeable, and unavoidable by ordinary prudence.

Impossibility of performance will also occur where, after the making of the contract, performance is made illegal. Given the fast-changing legal landscape referenced above, this defense will be asserted by many tenants. There may be a distinction between illegality which is essential to the bargain and that which is only incidental: in one early 20th-century case, a tenant claimed a partial abatement of rent because a part of the premises rented as a bar became unusable as such because of Prohibition. Among other reasons for denying relief to the tenant, the court found under the terms of the lease that it was permitted to utilize the premises for purposes other than the selling of liquor. Thus, similar to North Carolina (below), a Georgia court may look to whether the tenant has other options for operating under the terms of the lease while under a “stay home” order (such as, for example, continued take-out operations for a restaurant); or whether the permitted use is so narrow as to leave no other alternatives during the outbreak.

One end result of a successful defense of absolute impossibility (including illegality) of performance is that it can authorize rescission of the entire contract; however, this is unlikely where the non-performing party suffers only a temporary inability to perform. In addition, impossibility will defeat a claim for specific performance since equity will not decree the performance of an impossible act. A limit on the defense of impossibility is the idea of “subjective impossibility.” Under this doctrine, impossibility which is personal to the promisor and “does not inhere in the nature of the act to be performed,” such as the inability to obtain money for whatever reason, is no excuse in the absence of an agreement to the contrary. Specifically, “financial inability does not excuse contract performance as impossible.”

**Florida**

Florida courts have held that for a governmental action to excuse performance under a force majeure provision, the party claiming this defense need not show the governmental action rendered performance impossible; however, the party must show that the act of government had more than just an “attenuated effect” on the contract. One Florida court cited the following examples of attenuated governmental actions insufficient to excuse contract performance: unprofitability arising from the collapse in world oil prices caused by the actions of Saudi Arabia’s government (found insufficient to excuse performance of a fixed-price coal contract); monetary control procedures and the deregulation of savings institutions put in place by the U.S. government in the early 1980s resulting in a slump in the timber market (not enough to excuse a party from timely performance of a lumber sales contract); and governmental modification of a Medicare/Medicaid program (did not excuse nonpayment of rent under the force majeure clause of a lease for a nursing and assisted living facility whose revenue was largely derived from such program). By contrast, the various, recent “stay home” orders directly impact the ability of affected non-essential business to operate and indeed to access their leased space. Depending upon the circumstances and the contractual language, Florida courts would likely distinguish the present situation from those cited above.

**North Carolina**

North Carolina has taken a more conservative and stringent perspective on the interpretation of force majeure clauses. A North Carolina court recently held a tenant’s inability to operate a leased premises for the intended use due to “government action” (denial of the tenant’s license to operate a law school) was not enough to excuse the tenant’s obligation to pay rent. In that case, the lease specifically excepted the obligation to pay rent from protections of the force majeure clause. The court also rejected the tenant’s defense of “frustration of purpose” because the lease allowed the premises to be used for “any lawful purpose,” and not just for the intended use; further, the lease allowed the tenant to assign or sublet the premises for another purpose. But the current situation, with government orders mandating temporary closure of many businesses, is likely distinguishable and will present a stronger argument for temporarily excused performance.
California

Under California law, failure of performance is excused when performance is prevented “by the operation of law, even though there may have been a stipulation that this shall not be an excuse…” New laws, regulations and other governmental acts that render performance impossible provide a defense to the obligor. For example, a Prohibition-era case in California found that a lease for certain premises to be used specifically as a liquor store was rendered inoperative by Prohibition. However, if performance is merely rendered more difficult or more expensive by such government order, the defense is unavailable.

In another California case, the force majeure provision of a supply agreement between a supplier of hypertension medication and a pharmaceutical company, excusing breach by the supplier caused by regulatory or governmental action, did not (either under the express terms of the provision or California common law) encompass the Food and Drug Administration’s (FDA) shutdown of a plant which produced the drug for violations of federal regulations. The force majeure provision was held to be vague and boilerplate, and thus did not indicate an assumption of risk by the pharmaceutical company, and the agreement contained an additional provision requiring the supplier to maintain manufacturing capacity sufficient to satisfy its obligations under the agreement. This case is helpful from a landlord’s perspective. From a tenant’s perspective, this case may be distinguishable from the current situation because California’s current “stay home” order is not personal to a single tenant unlike the FDA shutdown of a plant.

This was written with contributions by Bradley J. Denson, Mark VanderBroek, and Robert Alfert, Jr.

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