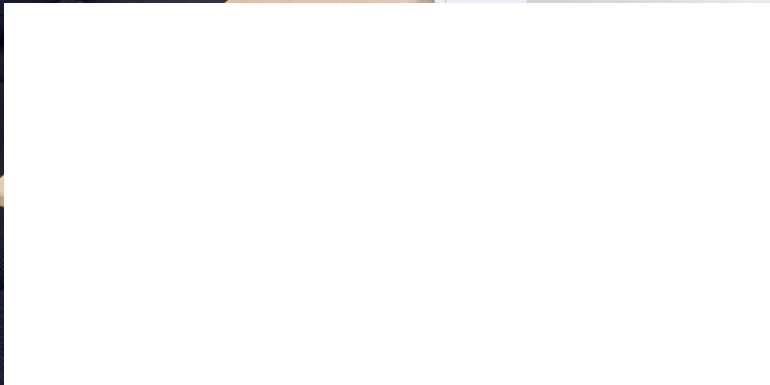


# Breaking Ground

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## WHAT COVID CHANGED (So Far)



**MBA**

# FINANCIAL PERSPECTIVE

## LESSONS LEARNED; HOPEFULLY, NO BRIDGES BURNED: THE COVID-19 PANDEMIC AND ITS IMPACT ON COMMERCIAL LEASING

BY MARK STADLER

### BACKGROUND

Approximately 18 months have passed since the first coronavirus (COVID-19) shutdowns were imposed. Much has changed.

In the commercial lease environment, tenants confronted the prospect of paying for space that had no real value for them during the shutdown (at least in their minds). Numerous phone calls were made. "You don't expect me to continue paying for this space when I'm basically out of business, right?" "Surely you're going to provide some sort of abatement or deferral while this all plays out, are you not?"

Landlords did not respond in a uniform manner. Some were willing to compromise. (A typical deal included some temporary abatement or deferral, often coupled with an extension of the lease.) Others adopted a harder line.

When confronted with this harder line, tenants carefully scrutinized various lease provisions previously deemed "mere boilerplate." Threats were made, strident positions were taken, suits were filed, motions were made to dismiss those suits, arguments were submitted, much money and time was expended, and ultimately settlements were crafted, judges were called upon to issue decisions, or cases remained pending, awaiting resolution by trial.

**The first course of action for most tenants post-shutdown was to contact their business interruption insurance carrier. Most were disappointed to discover that, after the SARS epidemic of the early 2000s, most insurance companies added endorsements to these policies specifically excluding virus events of this type from coverage.**

To this mix various government agencies added loan and grant programs, most notably the PPP loan, intended to directly address the impact of the tenant's ongoing rent burden during the shutdown.

In a nation consisting of 50 states and several territories, each with their own separate body of landlord/tenant law,

uniform consistent outcomes were never likely. Of course, the language of the relevant leases differed significantly. Certain parties involved in these disputes were more likable and sympathetic than others. Advocates made arguments of divergent craft and quality. The political and economic climate varied in the communities where the suits were filed, as did the particular disposition, temperament, and inclinations of the involved judges. In short, the parties to these disputes faced all of the manifold issues and uncertainties typically at play in any piece of litigation while also confronting numerous somewhat novel legal issues and theories arising as the result of a once in a century pandemic.

This article attempts to determine whether any meaningful patterns have emerged, and the extent to which it is possible to use those to inform future landlord action.

### LESSONS LEARNED

Generally speaking, landlords have done reasonably well on the COVID-19 battleground. However, tenants have also tasted some victory. [For those interested in reading actual judicial opinions, compare and contrast the following favorable tenant outcomes: 267 Dev., LLC v Brooklyn Babies & Toddlers, LLC, No. 510160/2020, 2021 BL 97086 (N.Y. Sup. Ct. Mar. 15, 2021) and UMNV 205-207 Newbury, LLC v. CafféNero Americas Inc., Case No. 2084CV01493, 2021 BL 90820 (Mass. Super. Ct., Feb. 8, 2021) with the significant landlord victory achieved in The Gap Inc. v. Ponte Gadea New York LLC, No 20 CV 4541-LTS-KHP (United States District Court for the Southern District of New York March 8, 2021)].

While, of course, each case is unique and highly dependent on the particular facts and lease language at issue, some broad general lessons were learned during the last 18 months.

*Landlords Were Not Held Blameworthy or Responsible for the Tenants' COVID-19 Plight*

The practical overarching issue in all of the lease disputes boils down to: who should properly bear the burdens of the COVID-19 government shutdowns? In the classic scenario: landlord owns property; landlord leases some or all of that property to tenant over a stated period of time in return for negotiated payments; tenant operates its business at the property; all goes well until the government dictates that the public can no longer freely visit tenant's establishment due to the health risks inherent in a global pandemic. Whose problem is that? The landlord has done nothing to stop the tenant from enjoying the benefits of the lease. Tenant can still occupy the space, store its personal property there, and conduct certain business activities there so long as they do not involve direct in-person contact with the public. The landlord still has to

pay its lenders and its employees, contractors, suppliers and providers. Under these circumstances does it make sense that the tenant should be excused from paying rent? Does it matter that there exist generous government grant and loan programs to assist tenants with their rent obligations? Viewed in this context, most have concluded that the COVID-19 burden most appropriately falls on the tenant and it should not be absolved of its obligation to pay rent.

#### *At the Same Time, Landlords Were Wise to Not Overplay Their Cards*

Even though a tenant's obligation to pay rent remains in place, should a tenant be subject to eviction and substantial penalties and fees for late payment of rent? While most courts may have been inclined to side with the landlord on the tenant's ongoing obligation to pay rent, a landlord's efforts to evict a tenant or impose significant penalties, even if supported by the lease language, were much more troublesome and likely to encounter judicial resistance. This was especially true whenever the tenant engendered sympathy and had been a longstanding and historically compliant tenant. While Oregon, for example, did impose a moratorium on commercial tenant evictions, the majority of the states did not. Nonetheless, during the actual course of the COVID-19 shutdowns, pursuing eviction of commercial tenants was problematic at best. The landlord's ongoing relationship with the tenant should be important. When tenants are suffering due to circumstances they did not create, it is wise to work with them as collegially as possible, especially if the landlord cares about keeping them as tenants. Come renewal time, tenants will remember how they were treated during the pandemic.

#### *Temperatures Cooled Quickly Once the Shutdowns Were Lifted*

It was amazing how many disputes were resolved once the shutdowns were lifted, tenants reopened their businesses, and revenue streams returned.

#### *Efforts to Contort Lease Language to Address a Highly Unique Situation Were Generally Ineffective*

Attorneys are more than capable of analyzing lease language and crafting arguments in support of their client's claim for rent relief. Here is brief summary of those arguments:

- a. *Quiet Enjoyment.* The COVID-19 shutdown deprived tenant of its right to quietly enjoy the leased space. It may have prevented tenant from making as much money as expected under the lease, but generally it did not prevent tenant from having access to and occupying the space.
- b. *Force Majeure.* The COVID-19 shutdown was an act of God preventing tenant from using its space, thereby entitling tenant to relief. Most force majeure clauses include language stating that a force majeure event does not excuse the obligation to pay rent. In any event, most tenants were not precluded from using their space, they suffered losses because the public could not visit that space.
- c. *Eminent Domain.* The COVID-19 shutdown constituted a taking of the property by the government. While the government shutdown orders did impose some restrictions regarding use of the space, that did not rise to the level of an actual taking.
- d. *Frustration, Impossibility, Failure of Consideration.* The shutdown frustrated tenant's purpose in entering into the lease, made it impossible for tenant to perform its obligations, and deprived it of the benefit of the bargain it made with the landlord. The typical response was: tenant continued to have access to and use the space it leased. While tenant was not making as much revenue as it expected, that fact did not justify relief unless tenant negotiated specific provisions to that effect in the lease.
- e. *Compliance with Law and Continuous Operation Requirements.* Most leases require tenants to comply with all applicable legal requirements and to maintain continuous operations. Did this present a Catch-22 for tenants requiring that they be freed of further lease obligations? (By honoring the shutdown order, they were precluded from maintaining continuous operations.) These requirements exist in leases for the benefit of the landlord, which can choose to waive temporary non-compliance.
- f. *Casualty.* Was the COVID-19 shutdown a "casualty" which rendered the leased premises unusable? Most courts (and dictionaries) thought not.
- g. *Co-Tenancy.* Some mall leases contain a co-tenancy provision which provides relief to smaller tenants when one or more anchor tenants terminate their leases and/or cease operations. However, few anchor tenants actually terminated their leases, and most continued to conduct some operations at their leased space during the shutdowns. Hence, no relief.

Some or all of these arguments may have succeeded in limited circumstances, especially for highly sympathetic tenants who had advantageous lease provisions. For the most part, however, the courts viewed these theories as an attempt to fit a square peg in a round hole.

#### *Business Interruption Insurance was Not a Source of Relief for Tenants*

The first course of action for most tenants post-shutdown was to contact their business interruption insurance carrier. Most were disappointed to discover that, after the SARS epidemic of the early 2000s, most insurance companies added endorsements to these policies specifically excluding virus events of this type from coverage. Some litigation is ongoing, but the insurance companies have been winning most of these cases.

#### **FUTURE IMPACT**

For commercial landlords and tenants, what changes are expected?

### Reduced Space

It is clear that tenants will want to reduce their space footprint due to fewer employees being regularly present at the office. This will also decrease demand for amenities such as parking, health facilities, and on-site retail and food service. Conversely, landlords will want to get people back into their properties. More people present means more business activity, leading to fewer defaults and vacancies. In the short-term a tenant-friendly market is likely, as landlords offer incentives to fill vacant space and to encourage tenants to return to full use of their space as soon as possible.

### Virus/Shutdown Specific Lease Language

Landlords can expect demands to address these issues through either (a) specific lease language providing tenants with rent relief in the event of similar shutdowns in the future, or (b) modification of some or all the lease provisions (a through g) referenced above.

### Percentage- Based Rent

It's not uncommon for leases to contain a provision where at least a portion of the tenant's rent is a function of the revenue it derives from the space. Tenants may press approaches seeking to tie a larger portion of their rent to their revenues or profitability.

### Triple Net Leases

There is a perception among tenants that landlords profited from full-service leases during the shutdowns when the provision of lease-related services was limited or not existent. In short, tenants were paying for services that weren't necessary or were provided at a reduced level. Hence, it would be wise to expect an increased interest from tenants in triple-net leases.

### COVID-Specific Improvements

We are now all well-versed in the methods of COVID-19 mitigation, especially social distancing. These will impact how tenant space is designed and marketed. Large open areas are likely a thing of the past. Enclosed spaces will return. Tenants will also want enhanced health-related amenities, particularly high-end air filtration systems and touchless features like automatic doors and soap dispensers.

### Shared Pain

More generically, tenants are going to want assurances that the pain of future shutdowns will be shared more equally. While one can argue whether tenants are entitled to this, landlords would do well to foster this sense of sharing and a recognition that both sides will do best when their relationship is one of partners rather than adversaries. **BG**

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