Coronavirus and Commercial Lease Considerations in the New York Metropolitan Area

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The novel coronavirus outbreak and subsequent national lock-down has had a major impact on the business operations of commercial tenants in New York, New Jersey, and Connecticut (the "Tri-State Area"), as well as across the globe. Forced closures of non-essential businesses and social distancing measures have severely cut profitability, leading businesses to inquire whether the law may afford relief from their leasehold obligations.

In this advisory, we provide a summary of the applicability of common law theories to the novel coronavirus, and discuss the mounting governmental response within the Tri-State Area. We conclude that neither of these provides commercial tenants and landlords with the immediate relief or long-term solutions they seek: instead, the parties will likely need to negotiate the terms of relief by mutual agreement. In doing so, tenants and landlords need to think about what they have to offer, and what other considerations they should keep in mind.

Common Law Theories

Much attention has been paid in recent weeks to the availability of various common law theories to shift the obligations of landlords and tenants under their current leases. It is unlikely that any of these theories will excuse a commercial tenant from its duty to pay rent.

Force Majeure

A *force majeure* clause reflects the agreement of the parties regarding their obligations in case of an intervening event beyond their reasonable control. New York law requires courts to interpret *force majeure* clauses to excuse performance only for events actually named in the clause and of which the parties could not have been aware when they entered the agreement. Typical *force majeure* clauses cover such specific matters as: acts of God; war, insurrection, or civil disturbance; natural disasters like earthquakes, fire and floods; transportation disruptions; strikes and labor disturbances or labor shortages, etc. A *force majeure* clause may also include a "catch-all" provision, for example, "any other emergency beyond the parties' control, making it inadvisable, illegal, or impossible to perform their obligations under this Agreement."

If the *force majeure* clause in a commercial lease specifically covers such things as epidemics, pandemics or diseases, of course, it is likely that the current pandemic would trigger the *force majeure* clause. Likewise, if the clause includes a reference to a "governmental shutdown" or the like. At the same time, if a catch–all provision includes "other emergencies," it too could very well capture a party's inability to perform due to the pandemic in light of the various declarations of a state of emergency and the corresponding governmental restrictions on commercial activity. As

demonstrated by the case *International Automobile Showcase, Inc. v. SMG*, 2004 Conn. Super. LEXIS 1908 (Sup. Ct. July 21, 2004), how broadly the term *force majeure* is defined will be paramount in determining whether a particular event qualifies. In that case, the operator of a municipal coliseum had contracted to rent the facility for an automobile show, but was unable to perform when the municipality voted to close the facility because it was no longer financially viable. The court held that the closure of the coliseum, which was beyond the control of the operating authority, could be construed to fall broadly within the scope of the rental agreement's *force majeure* clause which covered any "unforeseeable cause beyond the control of [defendant], including, without limitation, acts of God, fires, floods, epidemics, quarantine restrictions, strikes, failure of public utilities or unusually severe weather." *Id.* at *5. It is important to note however that the court found that the obligation of the authority to make the facility available was a non-financial or non-monetary obligation.

Monetary obligations such as a tenant's obligation to pay rent generally are not excused by *force majeure*. *Force majeure* clauses frequently contain language that clearly states that rent and other purely financial obligations are not affected by the occurrence of a *force majeure* event. Even if the lease does not explicitly so provide, however, the law of *force majeure* is such that a party's obligation to perform monetary obligations (for example, to pay rent) are not directly impacted by the *force majeure* event, and therefore will not be excused.

Impossibility

Impossibility is a doctrine that, like *force majeure*, will excuse performance - - perhaps even entitle a party to terminate its contractual obligations - - when an unforeseen event occurring after formation of the contract renders performance impossible. Performance must be truly impossible, not just more expensive or even cost prohibitive.

Under certain circumstances, New Jersey courts have signaled a willingness to consider the doctrine's applicability to excuse purely monetary obligations. In *Directions, Inc. v. New Prince Concrete Constr. Co.*, 200 N.J. Super. 639 (Sup. Ct. App. Div. 1985), the defendant had hired the plaintiff to direct traffic at a work site but before his work could commence, the city ordered that he be fired so that uniformed officers do the work instead. The court held that summary judgment should not have been granted in favor of the plaintiff before considering whether the defendant's payment obligations were excused under the doctrine of impossibility, since the defendant might not be required to pay the plaintiff the contracted amount in light of the city's order.

There is some precedent for invoking the doctrine of impossibility based on a pandemic. Following the Spanish flu pandemic of 1918, defendants in civil actions often raised impossibility as a defense to non-performance, with varying degrees of success. Then, as now, courts will generally determine whether or not an event was truly unforeseen with reference to the contractual terms.

However, the courts will generally preclude a finding of impossibility where a *force majeure* clause exists in the contract and, as with *force majeure*, will generally not excuse the performance of monetary obligations.

Frustration of Purpose

Another variation on the *force majeure* principle, the doctrine of frustration of purpose, discharges a party's duties to perform under a contract where an unforeseen event has occurred which, in the context of the entire transaction, destroys the underlying reasons for performing the contract, even

though performance is possible. The doctrine of frustration of purpose is applied narrowly and only when the frustration is substantial. Frustration of purpose excuses performance when a 'virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party'. It is not enough that the transaction has become less profitable for the affected party or even that he or she will sustain a loss.

As with impossibility, commercial frustration applies only where the parties could not have provided for the frustrating event through contractual safeguards. If a party could reasonably foresee an event that would destroy the purpose of the contract, and did not provide for the event's occurrence, then that party will be deemed to have assumed the risk. If a contingency is reasonably foreseeable and the agreement nonetheless fails to provide protection in the event of its occurrence, the defense of commercial frustration is not available. For example, in the case *Sage Realty Corp. v. Jugobanka, D.D.*, 1997 U.S. LEXIS 9301, at *1-2 (S.D.N.Y. 1997), a federal district court applying New York law held that a presidential order blocking all Yugoslavian entities from accessing U.S.-based assets did not excuse a Yugoslavian bank from paying rent because the parties, at the time of entering the lease, were aware of escalating tensions between the two governments, rendering the presidential sanctions reasonably foreseeable.

Although the scale of the public health crisis wrought by the novel coronavirus was unexpected, viral pandemics are a known occurrence and their effects, while material (and even catastrophic) are temporary. As such, it is unlikely that frustration of purpose would apply in the context of the coronavirus.

Implied Warranty of Habitability/Suitability

Residential leases are deemed to include an implied warranty of habitability which requires that the premises be suitable for habitation. Some jurisdictions have a commercial analogue. In Texas, for example, the judiciary has developed the implied warranty of suitability which requires that commercial premises leased for a particular purpose will remain suitable for that purpose. Neither New York, New Jersey, nor Connecticut has expressly adopted the implied warranty of suitability for commercial leases. Furthermore, in jurisdictions where the doctrine is applicable, whether the implied warranty has been breached is generally keyed to violations of the building code or at least to characteristics directly relating to the condition of the premises themselves. If the ability of businesses to use their leased premises is impacted by the viral pandemic and by the resulting governmental orders restricting commercial activity, rather than any defect or condition relating to the demised premises, the implied warranty of habitability or suitability will not apply.

Governmental Intervention

In the Tri-State Area, governmental response to the coronavirus was swift once the scale of emerging health crisis became clear. A moratorium on evictions and foreclosures has been declared on behalf of commercial tenants and landlords in New York; commercial tenants in New Jersey and Connecticut are yet to receive such governmental protection.

NEW YORK

Eviction and Foreclosure Freeze

On March 7, 2020, New York Governor Cuomo declared a state of emergency due to the emerging COVID-19 public health crisis. On March 20, 2020, he issued Executive Order 202.8, the “New York State on PAUSE” order, which provides in part:

There shall be no enforcement of either an eviction of any tenant residential or commercial, or a foreclosure of any residential or commercial property for a period of ninety days.

The order formalized a judicial memorandum issued by the Chief Administrative Judge of the State of New York Unified Court System earlier that week which suspended all eviction proceedings and pending evictions orders until further notice.

Governor Cuomo followed up his PAUSE order with Executive Order 202.9, which deemed it an unsafe and unsound business practice for any bank subject to the jurisdiction of New York's Department of Financial Services not to grant forbearance to any person or business who has had financial hardship as a result of the pandemic for a period of 90 days. The 90-day period applicable both to orders will end on June 20, 2020, and a subsequent order to extend that date remains a possibility.

These orders will have limited long-term effect, however. They do not grant any form of financial relief to tenants. Rather, they simply prevent landlords and lenders from taking enforcement actions against tenants and borrowers during the 90-day period. At the end of the 90-day period, tenants who have been unable to pay their rents will be in default, and potentially owe up to four months' rent, with minimal income from which to pay. Many commentators expect a flood of evictions and foreclosures to occur upon the expiration of the orders.

Potential Rent and Mortgage Relief

A pair of substantively identical bills, S8125a and A10224, have been introduced in the New York State Senate and Assembly that would waive rents for a 90-day period for any residential or small business commercial tenant that lost income or was forced to close as a result of the pandemic. Landlords affected by this waiver would receive similar "forgiveness" on any mortgage payments up to the total dollar amount of lost rent (though the bill presumably is not meant to forgive the repayment of principal, it is unclear exactly what kind of forgiveness is intended, whether forgiveness of interest, or deferral of debt service payments without interest, or some other form of relief). The bills would further trigger automatic renewal of leases at the current rent charged if the lease expires during the 90-day freeze. Qualifying businesses must be registered in the state, independently owned and operated, not dominant in their field, and employ not more than one hundred people.

The bills are currently before the judiciary committee, which will evaluate the bills and decide whether to report them to the floor for a vote. Although the bills have amassed some support in the form of co-sponsors, there appears to be little bipartisan support. A spokesperson for Governor Cuomo has declined comment on whether he would support the bills.

NEW JERSEY

Potential Commercial Relief

A bill that would authorize Governor Phil Murphy to permit an emergency rent suspension for certain "distressed" small business tenants has passed the New Jersey Senate and Assembly.

- Under the bill, distressed small business tenants would be entitled to notify its landlord that it is asserting an emergency rent suspension due to the COVID-19 pandemic. As defined, only businesses employing 50 persons or fewer that have seen at least a 20% drop in revenue would qualify.

- The bill provides for up to three months' rent suspension.
- The bill sets a repayment schedule that the small business tenant must adhere to.
- The bill would freeze evictions relating to nonpayment of rent during the pendency of the rent suspension.

However, before the bill can take effect, Governor Phil Murphy must issue an executive order to permit the emergency rent suspension. As of May 1, 2020, no such issue has been ordered.

Eviction Freeze

On March 19, 2020, Governor Phil Murphy issued Executive Order No. 106, directing that no tenant or homeowner may be removed from a *residential* property during the coronavirus crisis. The order is effective for no longer than two months follows the end of the Public Health Emergency or State of Emergency established by Executive Order No. 103, whichever ends later, unless revoked or modified in a subsequent order. The order permits evictions or foreclosure proceedings to be initiated or continued, but provides that all judgments for possession, warrants or removal or writs of possession are stayed while the order is in effect. The executive order does not affect rent that is due.

Rental Assistance

The New Jersey State Senate passed Bill No. S-2332, which establishes a $100MM temporary emergency rental assistance program for *residential* tenants who have suffered an income loss due to the COVID-19 crisis. The bill must be passed by the New Jersey General Assembly. If passed, the program would pay certain amounts of rent due for tenants who are at least 30 days past due on a rent payment, unable to pay rent without assistance and have suffered a demonstrable loss in income due to the COVID-19 crisis.

- The bill specifies that funding for the $100 million would come first from federal funding, with the remaining amounts appropriated from the state.
- The bill will allow the state to provide rental assistance to tenants before they face eviction;
- The bill will allow the state to provide rental assistance to tenants of "medium income" (in addition to tenants of low and moderate incomes). Tenant of "Medium Income" are households with greater than 80% of the area median income and up to 120% of area medium income.
- The program would be administered by the Department of Community Affairs, which would distribute an amount of program funds for each county and applicant based, in part, on the fair market rents in each county, according to the most recent fair market rents published by the U.S. Department of Housing and Urban Development.
- Under the bill, the Commissioner of the Department of Community Affairs would provide funds to each Homeless Prevention Program agency to be used exclusively for providing emergency rental assistance payments for eligible tenants, but the Commissioner would be authorized to process applications and disburse emergency rental assistance payments in more populated, and more densely populated, counties.
- The bill, if passed, would take effect immediately and would expire upon the completion of processing of all applications for assistance submitted on or prior to the 90th day following the

end of the eviction moratorium ordered by Governor Murphy.

CONNECTICUT

Commercial Tenant Protections

Although Connecticut Governor Ned Lamont has yet to issue an executive order halting evictions of commercial tenants, some commentators believe such a mandate may be on the horizon. The Governor's spokesman has confirmed that the administration is working on expanding rental protections without providing further details. Although it remains to be seen whether the Governor will provide such relief (or any relief) to commercial tenants, the Connecticut courts have stayed "all issued executions on evictions and ejectments" through May 1, 2020.

Commercial **and Residential Landlord Relief**

The Connecticut judiciary has rescheduled all foreclosure sales previously scheduled to have occurred in April or May to June 6, 2020.

No Rent Freeze

There is no residential or commercial program in place in Connecticut that prohibits landlords from charging or increasing rent during the COVID-19 pandemic.

Federal Relief

The CARES Act. So far, the federal government has not offered any specific relief to commercial tenants or landlords. However, the CARES Act makes available an expanded SBA loan program that a qualifying small businesses may apply toward essential expenses such as rent, mortgages, utilities, and payroll.

Negotiated Solutions

Because common law doctrines such as *force majeure* and frustration of purpose are unlikely to excuse the payment of rent, and governmental initiatives to date offer temporary relief at best, landlords and tenants are left with no course but to negotiate rent relief on mutually acceptable terms.We've outlined below some guidelines and considerations to bear in mind.

Pre-Negotiation Letter

Before entering into any negotiations to modify a lease, as with any restructuring landlords will generally want to set the ground rules in a pre-negotiation agreement.This will generally entail an outline of the circumstances and understandings on which the negotiations are based, including:

- Confirmation that the lease is in full force and effect, and that there are no amendments, supplements or side agreements other than those listed in the pre-negotiation agreement;
- Confirmation of the tenant's obligations, including the amount of rent and additional rent then payable;
- Confirmation that the tenant has no claims, defenses, offsets or counterclaims against the enforcement of its obligations under the lease; and
- Confirmation that there is no current default either on the part of the landlord or the tenant,

except as may be specified in the pre-negotiation agreement.

Such an agreement typically will also confirm that neither party is under any obligation to agree to any lease modification, that either party may termination the discussions at any time, and that no communications during the course of negotiations may be used as evidence in any legal proceeding, nor will either party be bound by any modification unless and until it is committed to writing and signed by both parties.

The landlord may also request certain financial information from the tenant as a condition to entering into negotiations, both to help determine the extent to which the tenant actually needs the relief requested, and to assure that the tenant is capable of fulfilling its lease obligations going forward.

Agreement for Rent Relief

Challenging times call for creative solutions, and consensual agreements between landlords and tenants may take many forms.However, the most common structure tends to involve an abatement of rent, in whole or in part, for some period of time corresponding roughly to the time during which the tenant expects to be unable to conduct its business, and a deferral of the abated rent so that it is payable in installments once business is expected to resume.For example, a typical deferral arrangement might look something like this:

- First, all rent must be brought current through March 2020;
- Rent for the months of April, May and June 2020 will be reduced by 50% (or by some other percentage, or abated in full);
- Beginning July 1 (presumed to be a reasonable approximation of the time when the tenant will be able to return to some state of normalcy), the tenant will resume payment of rent in full;
- In addition, the abated rent will be paid, beginning July 1, 2020 (or January 1, 2021, or some other date) in equal monthly installments over a period of twelve (12) months (or twenty-four (24) months, or some period to be negotiated).

The parties may agree that if the tenant defaults in the payment of rent (or assigns the lease, or some other event) the deferral agreement will be of no further force and effect and all deferred rent becomes immediately due and payable.Of course, a default may also result in termination of the lease and acceleration of all rent for the balance of the term, but revocation of the deferral may afford the landlord a less drastic and therefore more palatable option.

The parties may also consider extending the term of the lease, not only to provide additional time (if necessary) over which to amortize the deferred rent, but also as a means of creating potential value for the landlord in consideration for its agreement to restructure the rent.

Note that retail leases, particularly those located in shopping centers, pose an additional series of considerations.For example, a retail lease may include a co-tenancy clause that provides the tenant certain relief in the event an anchor store closes, or a certain percentage of other stores close, or if the shopping center closes entirely.A tenant in these circumstances may be entitled to various forms of relief (including the right to terminate its lease), and in any case will have leverage to negotiate.Additional provisions typically found in retail shopping center leases such as continuous

operating covenants, exclusive use, recapture rights and others, may trigger rights remedies on the part of the landlord or the tenant, and may factor into negotiations concerning a lease modification.

Another element specific to retail leases that may afford a vehicle for rent relief is percentage rent.Instead of reducing or deferring fixed rent, for example, retail landlords and tenants may consider basing the rent on a percentage of the tenant's sales, either or some fixed period of time or until a breakpoint is achieved.The principle is simple but, as one might imagine, the potential combinations and variations on this theme are endless.

Landlord/Borrower Considerations

In negotiating with a tenant to modify its lease to provide for rent deferral and/or other relief, the landlord must bear in mind that it also has obligations to its lender.For example, loan documents generally include an assignment of leases and rents, and often provide that any lease amendment - - or at least any amendment of a major or material lease affecting the property - - must be approved by the lender in advance.Also, transfer restrictions should be reviewed carefully, as a new lease, or modification of an existing lease, may be deemed a transfer that requires the lender's prior approval.

In order to consider a request for approval to modify a lease, lenders will typically want pertinent financial information which may include the following: (i) year-end 2017, 2018 and 2019 financials; (ii) YTD 2020 financials; (iii) current rent roll; (iv) 2020 pro forma; (v) current balance sheet and income statement on the borrowing entity; (vi) year end 2019 and current balance sheet and income statement at the property level if different from above; (vii) current financial statements on the primary principals of the sponsorship; (viii) details of equity distributions to sponsors going forward; (ix) specific correspondence between the borrower and tenant(s) if applicable; and (x) a write-up from the borrower, which may include the expected impact to net operating income, specific tenants that are impacted, when the economic impact from which the borrower is requesting relief start, and the specific relief requested.

Note that CMBS loans may present their own series of challenges to landlords/borrowers.CMBS servicers have a reputation for being slow to respond and less flexible than other institutional lenders.A related conundrum results from the fact that negotiations with a tenant over rent relief are often time-sensitive, as when the tenant is either in chapter 11 reorganization or preparing to file, and practical considerations may drive the landlord to make a deal with the tenant before the lender or servicer is able to process its approval.The failure to obtain prior approval for a lease amendment - - whether because the amendment is deemed a transfer, or simply because all leases and amendments require prior approval - - may trigger a personal guaranty or otherwise result in recourse liability.Further, a loan default resulting from a non-approved lease amendment to which the landlord/borrower has already committed may be difficult or impossible for the landlord/borrower to cure.

Finally, borrowers should use care in their communications with mortgage lenders and others regarding their financial positions. There exists a real risk that current market conditions will result in tenants not making their rent payments, thereby creating a cash shortfall for borrowers/landlords. Mortgage loan documents will often provide for full recourse to borrowers and guarantors if a borrower admits, in writing or in any legal proceeding, its insolvency or inability to pay its debts as they become due.

Loan Restructuring

The lease modifications and rent relief arrangements discussed above will naturally tend to set off a domino effect, leading landlords/borrowers to seek relief from their lenders.Real estate loan restructuring resulting from the pandemic is beyond the scope of this advisory, but because it is a predictable outgrowth of the kinds of negotiations discussed herein, we offer some high level thoughts.

The following are some of the more common requests lenders have been received from borrowers:

- Requests for interest only periods for loans requiring monthly principal and interest payments;
- Deferment of interest payments;
- Waivers of default interest and/or late fees;
- With certain conditions, permitting subordinate debt related to government assistance programs;
- Allowing flexibility in addressing issues with tenants;
- Delaying project completion timelines in the case of construction loans;
- Providing flexibility to suspend or modify certain required reserve deposits; and
- Redirecting certain reserve funds for uses other than their designated purpose.

Industry leaders have suggested the following guidelines for borrowers when requesting COVID-19-related relief from lenders or servicers:

- If possible, show good faith by keeping mortgage payments current while negotiating for relief or at least continue making some required loan payments (e.g., escrows, reserves, etc.).
- Make a reasonable request, based on the circumstances, and not merely a request to avoid payments altogether. Disclose the issues that warrant the relief requested and provide a full financial picture of the property that includes updated financials, property operating statements and projections that demonstrate the need for relief.
- Demonstrate to your lender or servicer that you are invested in the property. Provide the lender or servicer with a plan to maintain the property in the interim, as well as to deal with economic and other issues (such as rent abatements or other incentives to retain tenants and minimize income losses at the property), as well as provide a plan for repayment of any forbearance.