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The Third Ground: Renegotiating Office Leases Post-COVID

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Current circumstances present an opportunity for tenants to use new strategies to renegotiate or even terminate leases. This article takes a look at conventional legal strategies that may provide grounds for lease termination before turning to consider another, third, approach.

We live in unprecedented times where industries, business models and interpersonal rules all have shifted dramatically, thrusting a knife into the hearts of many businesses. Those businesses often have leases for office or retail spaces which were a valuable part of their business model in a pre-COVID-19 environment, but now, suddenly, these leases are burdensome and unusable.

We believe that current circumstances present an opportunity for tenants to use new strategies to renegotiate or even terminate leases.

We begin with a look at conventional legal strategies that may provide grounds for lease termination before turning to consider another approach.

The First Ground: Contractual Law

As always in a contract context, inquiry starts with the agreement's language. Two frequently occurring lease provisions address force majeure and quiet enjoyment.

Force majeure contract clauses have become a central focus for tenants looking to terminate office leases. These clauses provide that under limited, stated circumstances, one or both parties will be excused from performance under a contract. New York courts interpret these clauses narrowly, which means that if there is not explicit reference to the cause for non-performance in the force majeure clause, such as a reference to bacterial or viral infections, then there will be no excuse for failure to perform under that clause. Beyond that, the force majeure event must actually prevent a party's performance, not just make it uneconomic.

Most commercial leases have a provision that grants the tenant the right to "quiet enjoyment" of the premises; even without that provision, there is an implied right of quiet enjoyment.

However, the provision most likely will read "Tenant may peaceably and quietly enjoy the Premises without disturbance by landlord." If the landlord has kept the building open and available for occupancy, then there has been no "disturbance by landlord."

Moreover, New York common law also requires that the interference be caused by the landlord to excuse performance by the tenant. In either case, landlords are not the source of the COVID-19 pandemic, which would further undermine any such claim.

More critically in the present crisis, the tenant only wins this breach of covenant to provide tenant with quiet enjoyment claim if the tenant has continued to pay its rent.

The Second Ground: Common Law

Lease provisions aside, common law affords three possible approaches.

Doctrine of Impossibility. To invoke the doctrine of impossibility, there must be the destruction of the subject matter of the contract or the means of performance must be destroyed, such that performance is objectively impossible. The event also must be unanticipated. Mere financial disadvantage will not trigger the impossibility doctrine. Accordingly, the doctrine probably will not be effective to excuse a tenant's non-payment of its rent because payment of the rent was not made impossible by the shutdown orders.

Doctrine of Impracticality of Purpose. A second doctrine is impracticality of purpose. To apply, performance must have been made impractical by an unforeseen event which destroys one of the basic assumptions upon which the contract was made. This is a very demanding showing to make in New York courts, where it isn't enough that some event makes the contract economically burdensome. The event also must be unforeseen, and the concept of the contract must have assumed that the event would not exist. Again, this does not fit the current situation since there have been prior disease outbreaks, such as SARS.

Doctrine of Frustration of Purpose. This doctrine requires that the fundamental benefit of the contract no longer exists through no fault of the party claiming it as the basis for termination, and that such benefit was a principal basis upon which such contract was made. This is more likely to be a successful basis to void a contract because, while the rent almost always could be paid, the purpose of the lease may have been frustrated. But it is challenging to convince a factfinder that the principal purpose of a lease has been so completely frustrated that the lease is valueless, especially if the closure amounts to only a few months out of a multi-year lease. Moreover, bringing the lease to an end is unlikely to further the tenant's attempt to keep its business afloat and so makes little sense.

The Third Ground: Context

The COVID-19 pandemic is a worldwide event unlike any other in recent history. It has created many financially impaired businesses that need a route to recovery. While well-established legal skills grounded in precedent will make up a big part of the legal services provided to these businesses, a different approach will be required in some circumstances owing to one or more of the following circumstances not seen at any other moment in most of our lifetimes:

1. Many companies still would have viable businesses except for the financial hole caused by suspension of operations.

2. The fundamental economics of some businesses have changed for at least the next year or two, perhaps permanently, while they remain locked into pre-COVID-19 business structures and contract terms. National restaurant chains with major presences in New York City are now attempting to renegotiate their store leases. These restaurants have leases based upon pre-COVID-19 worlds which no longer exist. Owners may be able to establish social distancing rules in their restaurants, but the rents in their leases make sense only if they can use their original seating plans. The same goes for Broadway and off-Broadway theaters, movie houses, Yankee Stadium, Shea Stadium and Madison Square Garden.

3. This is not a local event, but a national, indeed global, one. It impacts everyone. A clear understanding of distribution channels and the matrix of other relationships in which every business operates will be important in knowing how and to what extent contracts can be renegotiated.

Reaching out to a landlord with a thin legal claim is not always going to get a tenant the headway it wants. But lining up the financial reality of a tenant's situation under this new reality might. It demonstrates that a tenant has carefully considered the circumstances and that it is dealing with substantial issues, not just trying to take advantage of an "emergency" situation.

It will be hard for a landlord to argue with the economic reality confronting your tenant client once the numbers are laid out. Your commercial tenant also is unlikely to be the landlord's only tenant facing such problems, nor is it likely just now that there will be a line of potential replacement tenants waiting to sign a lease.

But keep in mind that landlords are asking tenants seeking abatements or delays in rent payments for certain information, such as financial statements for the tenant and guarantors, if any; relief programs for which the tenant has applied; and other information which the landlord can use to assess the situation. Landlords strongly prefer delay in receiving rent over an abatement, because the latter means a lowering of the building's value, which lowers the amount that can be borrowed against it – and the landlord, too, may be seeking additional financing.

Bert Rosenblatt, a co-founder of Vicus Partners, a New York City commercial real estate firm that represents tenants, states that "landlords are cutting deals, even the ones with the toughest reputations."

"Mostly they are agreeing to deferments, not abatements, because abatements lower the value of the building." A typical deal, according to Rosenblatt, is where a certain percentage of March, April and May rent is deferred, and then spread out over the following six months. Or they might take the rent out of the tenant's security, to be repaid back over future months.

"Retail is different. Landlords see a retail store as an amenity, so large landlords which are sufficiently capitalized to absorb the reduced cash flow are giving restaurants a lot

of relief, such as agreeing to a percentage rent where there is no rent from zero to one million dollars, and then four to six percent on revenue over that."

Rosenblatt also said that he was surprised to see how many law firms outside of the largest firms are planning to go virtual, forsaking any significant office space.

Standstill Agreement

Lastly, a standstill agreement, where the parties agree to hold back on enforcing their rights for a certain period of time, may be the most important document in starting the negotiation process. This will give the parties a chance to work things out without the expense of litigation running at the same time, which may encourage cooler heads to prevail.

In any event, with any litigation likely to occur in state courts that will be chock-a-block with a flood of new cases after months in limbo, coming to a consensual agreement where rental income is flowing to the landlord may be the least bad result achievable. Given the chance to engage in negotiations, other alternatives may become apparent, such as extending the lease term or spreading unpaid rent over the balance of the lease.

David Leffler *is a partner at Culhane Meadows, focusing on corporate and real estate matters. He can be reached at* dleffler@cm.law. David Jacoby *is also a partner at the firm and is an adjunct professor at Fordham Law School. He can be reached at* djacoby@cm.law.

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