

A Changing Landscape: Balancing Rights and Interests in Retail Leases

This article seeks to examine key current issues, and offers practical advice to landlords and tenants seeking common ground to address the ongoing financial toll of the pandemic, and suggests approaches that should be considered when drafting and negotiating lease provisions.

By Fredric P. Lavinthal and Eric M. Finkelstein – Chiesa Shahinian & Giantomasi PC

October 21, 2020

The coronavirus has afflicted over seven million people in the United States and has caused over two hundred thousand deaths in our country. The disease has fundamentally altered our lifestyles, working conditions and our consumer driven economy. It has devastated certain retailers, crippled others and, as a consequence, caused landlords and tenants to re-think (and, in many cases to renegotiate) their short term and long term contractual relationships. This article seeks to examine key current issues, and offers practical advice to landlords and tenants seeking common ground to address the ongoing financial toll of the pandemic and suggests approaches that should be considered when drafting and negotiating lease provisions such as force majeure, early termination rights and co-tenancy obligations.

The Pandemic's Effects

Landlords and tenants are breaking established conventions to try to assure their survival. These efforts focus on the common theme of full or partial abatement of rent payments during periods of mandated closure or to afford relief due to diminished sales performance or a tenant's inability to fully utilize a leased premises. As numerous tenants in retail and office centers seek or require fiscal relief, landlords should be mindful of their loan covenants if the property is financed. Rent deferments, abatements or long term rent restructuring may trigger lender consent requirements or may simply be forbidden under applicable loan documents. Similarly, a careful analysis of loan covenants such as debt service coverage ratios and loan to value requirements should be undertaken to determine whether property that is financed remains in compliance with financing constraints and whether leases will, once modified, qualify if and when refinancing becomes necessary.

Before a landlord and tenant determine that their best interests may be served by reforming lease economics, consideration should be given to whether its better and safer to enter into binding commitments now instead of judging and reacting to facts and circumstances as they occur to allow for their effects to be judged. If the decision is to proceed, the following elements should be considered:

1. Fairly and realistically adjusting and resetting any early termination rights and co-tenancy protections contained in retail leases;

2. Deciding whether full or partial rent abatement is to be given or whether rent should be deferred and recouped over time;
3. Establishing a new base rent and coupling that with additional rent based on a percentage of sales;
4. Using security deposits to cover rent deficiencies and, if so, their replenishment;
5. Conditioning rent relief on application for and payment of funds received from government assistance programs and/or insurance proceeds; and
6. Expanding or contracting the term of the lease.

Clarity and flexibility must be maintained. Landlords should take care to restructure leases to only address the established impacts of the pandemic. Tenants continuing to struggle with the economic slowdown wrought by the pandemic should engage landlords to revisit and recalibrate previously negotiated relief which is now deemed insufficient.

Long Term Considerations

Force Majeure. The pandemic has reminded landlords, tenants and their respective counsel that force majeure clauses have historically been drafted to afford a party with the ability to toll performance of lease obligations, but typically not to afford a tenant the right to rent reduction or abatement or either party the right not to pay money when due. A force majeure clause commonly addresses exceptional, unforeseen circumstances that are outside the reasonable control of and not caused by either party. While the inclusion of the word “pandemic” in the traditional list of unforeseeable and uncontrollable events is increasingly becoming common practice, the pandemic presumably already qualifies as an event of force majeure.

The expansion of the force majeure provision into a basis for tenants to obtain rent relief is dangerous to landlords and perhaps not warranted. Force majeure is rooted in a cause and effect analysis on performance rather than payment obligations. New Jersey Governor Murphy’s Executive Order instituting a moratorium on non-essential construction likely triggered force majeure relief under many leases. It was a circumstance beyond the control of either party that directly impacted the ability for landlords and tenants to perform construction obligations under a lease. Best practice may be to continue to use force majeure provisions to extend the time for a party to perform a non-monetary obligation and to forgive a party’s failure to perform non-monetary obligations. To insert rent relief into a force majeure clause, both parties would need to be willing to address with specificity the instances of cause and effect that would trigger rent adjustment. Guessing about rent relief may not produce meaningful results and tenants and their counsel may be more successful in approaching rent relief scenarios with clear benchmarks elsewhere in a lease.

Despite the continuing barriers to rent relief, the utility of the force majeure provision to tenants in commercial leases should not be understated. The force majeure clause traditionally provides relief for obligations that commonly fall within the tenant's sphere, such as initial construction, repair and surrender obligations as well as opening and operating covenants. Landlords will likely continue to maintain the force majeure clause outside the purview of rent adjustment. Nonetheless, tenants who find themselves without a force majeure provision in their existing leases or in negotiation for new space should insist on its inclusion in lease amendments or new leases.

Early Termination Rights (the "Kick-Out" Clause). Landlords and tenants must use great care to reexamine and recast kick out clauses and use these clauses to address actual sales profit margins and rent payments in a manner that sets livable benchmarks. Tenants forced to exercise renewal options in the near term and facing an uncertain future may seek the benefit of a kick-out clause in return for a commitment to extend their lease. Landlords focused on maintaining rental income, satisfying loan covenants and minimizing vacancy rates (and their potential effects on existing and future tenants) can utilize kick out clauses to retain tenants, fill existing vacancies and prevent new ones.

Broader economic metrics of the lease will play a part. Landlords should protect their investments in constructing tenant space as well as brokerage commissions both of which may be amortized and reimbursed by a tenant who opts to terminate early. In the retail setting, tenants typically establish gross sales thresholds that, if not met, will afford a tenant the option to terminate. Landlords should exercise care to be sure that sales thresholds are reasonable and that options to terminate a lease early cannot be exercised if a tenant defaults under its lease or has not operated continuously. The kick-out clause has and continues to offer both sides a platform with which to creatively address fiscal uncertainty, which is rampant in retail, hospitality and office leasing sectors today.

Co-Tenancy Provisions. Prior to the pandemic, gross revenues at nationally recognized brick and mortar retailers were on the decline. E-commerce sales coupled with the pandemic's erosion of foot traffic in malls and forced closure of fitness facilities, movie theaters and restaurants has disrupted the synergistic operation of retail shopping centers and has forced many national and regional retailers into bankruptcy. With many permanent closures and the shaky future of so many retailers and big box stores, landlords and tenants should re-examine existing co-tenancy provisions and consider carefully any co-tenancy rights established in new leases. Loss of foot traffic and dark space are red flags for retailers, and tenants will likely continue to require co-tenancy protections to insulate against these possible eventualities. Landlords facing co-tenancy failures under existing leases or negotiating new leases with co-tenancy requirements may explore adjustments to a) the thresholds that trigger a co-tenancy failure; b) the definition of permissible replacement tenants; c) the actual economic effect of the failure on the particular tenant and d) extended cure periods. Of these considerations, the

convention that co-tenants must be replaced with a like-kind user may be a vestige of the past. Any user that brings traffic to a retail center should be considered. With present elevated vacancy rates, tenants who afford landlords more flexibility to satisfy co-tenancy requirements with a broader range of replacement options may in the face of these economic headwinds help themselves by keeping vacancy rates down and traffic and sales up.

Conclusion

The pandemic is upon us – not past us. Its effects inform us that not all scenarios can be anticipated, and that even the most well-crafted leases and negotiated provisions can come up short. Landlords should continue to calibrate the specter of bankruptcy, increased vacancies and the constraints of existing loan agreements with their willingness to offer short term rent relief to struggling tenants. Tenants should attempt to protect against economic uncertainty by requiring clearly stated protective benchmarks within new leases or lease amendments that tie underperformance or increasingly vacant retail centers to rent reduction or early lease termination. Landlords and tenants should attempt to address these competing interests collegially and collaboratively in furtherance of the mutual goal of successful tenancies. The watchwords of the day are to be careful out there and to keep in mind that landlords and tenants need one another.

Fredric P. Lavinthal is a Member with Chiesa Shahinian & Giantomasi PC and serves as chair emeritus of the firm's Real Estate, Development & Land Use Group. Eric M. Finkelstein is counsel with the Real Estate, Development & Land Use Group.

Reprinted with permission from the October 21 issue of the New Jersey Law Journal© 2020 ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved.