Freeborn

Your Future Is Our Purpose

Landlord/Tenant Disputes In the Wake of the COVID-19 Pandemic

by Adam C. Toosley

A FREEBORN & PETERS LLP CLIENT ALERT

Many businesses were significantly impacted by the stay-at-home orders issued by many governors throughout the United States over the past few weeks. As a result of those orders, certain businesses were completely shut down, while others have seen a marked reduction in their ability to generate enough income to pay vendors and lenders. For those businesses renting space in buildings, or for those that own buildings and rent to businesses, one question that continues to be asked is whether or not the responsibilities under their leases are modified due to these factors outside the control of either the landlord or the tenant.

From the tenant's perspective, some of the obligations in commercial leases that are potentially impacted include the responsibility to pay rent, insurance premiums, common area maintenance charges, real estate taxes and utilities as well as generally maintaining the space that is being rented. The failure to pay these expenses, without an express provision in the lease allowing for abatement during a force majeure event, can result in litigation and eviction from the space.

From the landlord's perspective, the obligations potentially impacted would depend heavily on the provisions of the lease, but could also include maintenance of the tenant's space, or if the tenant is one of multiple in a location, maintenance of the property as a whole along with real estate taxes and utilities. If the tenant cannot pay, the landlord will probably still have to shoulder the aforementioned responsibilities, because at the end of the day, it still owns the property and cannot let taxes lapse or get sold, insurance not get paid or the utilities turned off for non-payment. Further, if any tenants are still operating in the complex or building, then regular maintenance will need to be performed to allow customers and employees access. The failure to do so could result in liability for any personal injuries sustained. The impact of the tenant's inability or failure to pay rent and other expenses on commercial landlords has far-reaching ramifications and could potentially make it very difficult for landlords to continue to make mortgage payments, pay insurance premiums and operating expenses for the property they own.

This alert will outline some of the legal defenses to performance that are being raised by commercial tenants as well as a strategy to avoid or limit some of the negative consequences that have arisen as a result of the COVID-19 pandemic. The focus of this alert is on Illinois law,

but many of the key legal principals apply to other states as well. If you have specific questions about the application of a particular state's law to your lease, please contact a member of Freeborn's Real Estate Practice Group.

Force Majeure and Legal Defenses to Performance

Whenever a tenant (or a landlord) is unable to fulfill its obligations under a lease due to factors outside its control, the first place to look is the force majeure provision in the lease (assuming one exists). A force majeure provision in a lease provides that one or both of the party's responsibility to perform under the lease is excused when certain items outside the control of the party happens. Typical force majeure provisions include Acts of God and governmental shutdowns. Force majeure provisions are clauses that are designed to document an agreement as to which party would bear the risk that something would happen that makes performance difficult or impossible.

Most commercial leases specifically require that the tenant pay rent—even in the situation where a force majeure event happens. In other words, and even if it did not know it at the time, if rent is not explicitly abated during a force majeure event by the language in the lease, it is the tenant that bore the risk that it would be unable to perform due to an event like a pandemic, and the obligation to pay rent is not curtailed due to COVID-19.

On the contrary, most express force majeure provisions in commercial leases would provide a defense to a landlord continuing to perform certain maintenance responsibilities, especially if the vendors who perform the maintenance are unable to perform their work under the current stay-at-home order in effect for that particular property. A good example of this is landscaping. Under certain states' stay-at-home orders, landscaping is not considered an "essential" service and landscape companies are not allowed to operate. As a result, the landlord's responsibility to perform landscaping in that situation should be excused under a standard force majeure clause in a lease.

In the absence of an express force majeure provision, a party seeking to excuse its performance under a lease could look to legal theories such as impossibility of performance or frustration of purpose. In Illinois, the doctrine of legal impossibility excuses performance under a lease only when performance is rendered "objectively impossible". The real property lease cases in Illinois where legal impossibility have been discussed almost universally required the actual property to be destroyed. Therefore, impossibility is not a particularly strong defense to not paying rent (or common area maintenance and taxes) under these circumstances. Frustration of purpose is considered an extension of impossibility in Illinois. Frustration of purpose is a doctrine that allows certain parties to agreements to avoid performance when a particular condition or state of things no longer exists. In a situation where the parties must have known that a party could not perform without that condition or state, a condition will be implied into the agreement that allows the party to excuse performance when that condition or state no longer exists. However, at least in Illinois, the party asserting frustration of purpose must show that the event that occurred was not reasonably foreseeable at the time the agreement was executed. In the lease setting, the party asserting frustration to avoid a lease obligation would generally have to show that the purpose for which lease was entered into was "totally, or nearly totally, frustrated." In most leases, an event where the business is shut down is considered reasonably foreseeable, and as outlined above, already covered by an express force majeure provision. Therefore, as it was with legal impossibility, frustration of purpose is not a very strong defense to non-performance of a lease when any physical structure on the real estate has not been impacted or destroyed.

Some tenants who have been unable to operate as a result of COVID-19 are attempting to argue that provisions in the lease that cover casualty are implicated. In other words, the argument is that the premises should be considered untenable (in full or in part) as a result of the virus, and as such, the rent should be reduced or abated altogether until such time as the casualty event is rectified. Whether or not this is a viable claim very much depends on the language of the lease itself because in most leases, the casualty provision

is only implicated when there is an event that causes physical damaged to the property by way of things such as fire or flood. Further, it is unclear if courts throughout the United States will view this virus as an event covered by a casualty provision because there is very little precedent.

For a more detailed discussion about force majeure and other contractual defenses that could possibly be applicable, see Freeborn's prior client alerts on performance of commercial contracts from March 20, 2020 (**https://www.freeborn.com/perspectives/client-alert-commercial-contracts-time-coronavirus-am-i-still-required-perform**) and Force Majeure Clauses in Construction and Other Commercial Contracts in the Age of COVID-19 from March 13, 2020 (**https://www.freeborn.com/perspectives/client-alert-force-majeure-clauses-construction-and-other-commercial-contracts-age**).

Access to Courts/Evictions

One thing to consider when deciding whether or not the landlord and tenant should work out a temporary agreement related to their responsibilities under commercial leases is what impact the failure to work out such an agreement will have on both parties. In a normal situation, if a tenant defaults under a lease agreement, the landlord would send out a notice to cure (if the default is curable), and if the default is not cured, file an eviction action. In most states, commercial eviction actions are usually handled in an expedited manner wherein a landlord could usually get an eviction order in a matter of weeks after a default. However, in most states, including Illinois, access to the court system has been significantly curtailed as a result of stay-at-home orders and the Sheriff is not effectuating evictions. Some states have put a complete moratorium on both residential and commercial evictions. Even after any stay orders are lifted, it is anticipated that there will be a significant backlog of evictions that need to be acted upon. As such, evicting a tenant that has stopped paying rent could take many months from now.

Strategy and Negotiations

At this time, communication between the landlord and the tenant is critical. If you are a tenant in a space and your ability to pay rent and other expenses has been impacted, it is imperative that you immediately reach out to the landlord to try to work out a solution. Conversely, if you are a landlord, there are specific items to consider to avoid the worst-case scenario of a bankruptcy filing by the tenant (or the landlord) or a default and foreclosure of the property by the lender.

Step #1-Review the Operative Documents

The first step is to review the actual lease covering the property to determine the rights and responsibilities of the parties. Specific questions to consider include: (1) is there a force majeure provision? (2) does the force majeure provision cover governmental shutdowns or pandemics? (3) if there is a force majeure provision that covers this situation, does it impact the responsibility of the tenant to pay rent? (4) does the lease provide that the landlord can stop providing services to the property if the tenant is not paying rent?

Additionally, landlords should also review mortgages and other loan documents that are potentially impacted by one or more tenants defaulting under their leases. Many loan documents require notice to be provided to lenders when tenants are in default and restrict the ability of landlord borrowers to negotiate rent abatements, lease amendments or forbearances without the lender's consent. There may also be more detailed provisions related to debt service ratios, tenancy level requirements and valuation of the property that may be implicated when one or more tenants is no longer paying rent. These provisions should be reviewed with counsel who can advise about the best way to approach the lender when a tenant defaults, or threatens to default, under its lease.

Step #2-Evaluate the Financial Impact

Both the landlord and the tenant should separately investigate and evaluate the financial impact of the shut down on both a short-term and long-term basis. This detailed analysis will require both parties to evaluate all vendors and whether or not payment of certain expenses can be delayed and whether or not it makes financial sense to continue to operate in the space once any stay is lifted.

If you are the tenant and have applied for financial assistance from any lender, governmental agency or insurance, be prepared to show those applications to the landlord and discuss where those applications stand. Along with these documents, as the tenant, you should be prepared to provide financial statements, projections, lists of secured and unsecured creditors, and a history and plan going forward for once any stay is lifted.

Step #3-Attempt to Negotiate a Solution

Depending on the results of the aforementioned review and analysis, it may make financial sense for the landlord and tenant to sit down and negotiate a temporary or permanent solution that lessens the financial impact to both parties. Some solutions that have been considered by landlords and tenants (assuming that the solution does not violate a covenant in a loan document or has been approved by the party's lender) include:

1. A temporary reduction in or abatement of rent payments with the amount reduced or abated amortized over the remainder of the lease once the tenant is able to start operating in the rented space again. Such a reduction or abatement could be structured so that the tenant continues to pay common area maintenance, insurance, utilities and real estate taxes (if required to do so under the lease) or that the rent is increased to cover any abatement by a percentage of business generated by the tenant after any stay is lifted.
2. A temporary reduction in or abatement of rent payments with the amount reduced or abated converted into a "loan" paid back by the tenant over time.
3. A temporary abatement of rent payments for a period of time with a commensurate increase in the length of the lease at the back end of the lease.
4. A renegotiation of the terms of the lease with the addition of pledged collateral for the tenant, including the possibility of the provision of a personal guaranty in the event of further defaults by the tenant.
5. An agreement that the landlord can utilize whatever security deposit was pledged and it will be replenished by the tenant when the tenant is able to start operating again.
6. An agreement that, for the period of time that the tenant is not operating, the landlord's responsibility to pay certain expenses is abated.
7. An agreement to terminate the lease with the tenant financially responsible for any amounts expended by the landlord to find a new tenant and any difference between the amounts collected and what was owed by the tenant over the remainder of the lease term.

Conclusion

COVID-19 and the governmental stay-at-home orders already have had a profound impact on commercial tenants and landlords. Analyzing your legal rights and minimizing the long term effects of minimized or shuttered operations is critical to avoid worst case scenarios of bankruptcy, loan defaults, foreclosures and increased vacancies. Communications between the landlord and tenant, and between those parties and their lenders is of the utmost importance to attempt to have a viable business relationship moving forward. That being said, each situation is different, these issues need to be analyzed on a case-by-case basis, and all decisions should be made only after the impact of the failure to negotiate a resolution is fully evaluated.

If you have any questions about commercial landlord/tenant disputes, please contact Adam Toosley (atoosley@freeborn.com; (312) 360-6789), or another member of the Freeborn & Peters LLP Real Estate Practice Group. More information can be found on Freeborn's COVID-19 webpage.

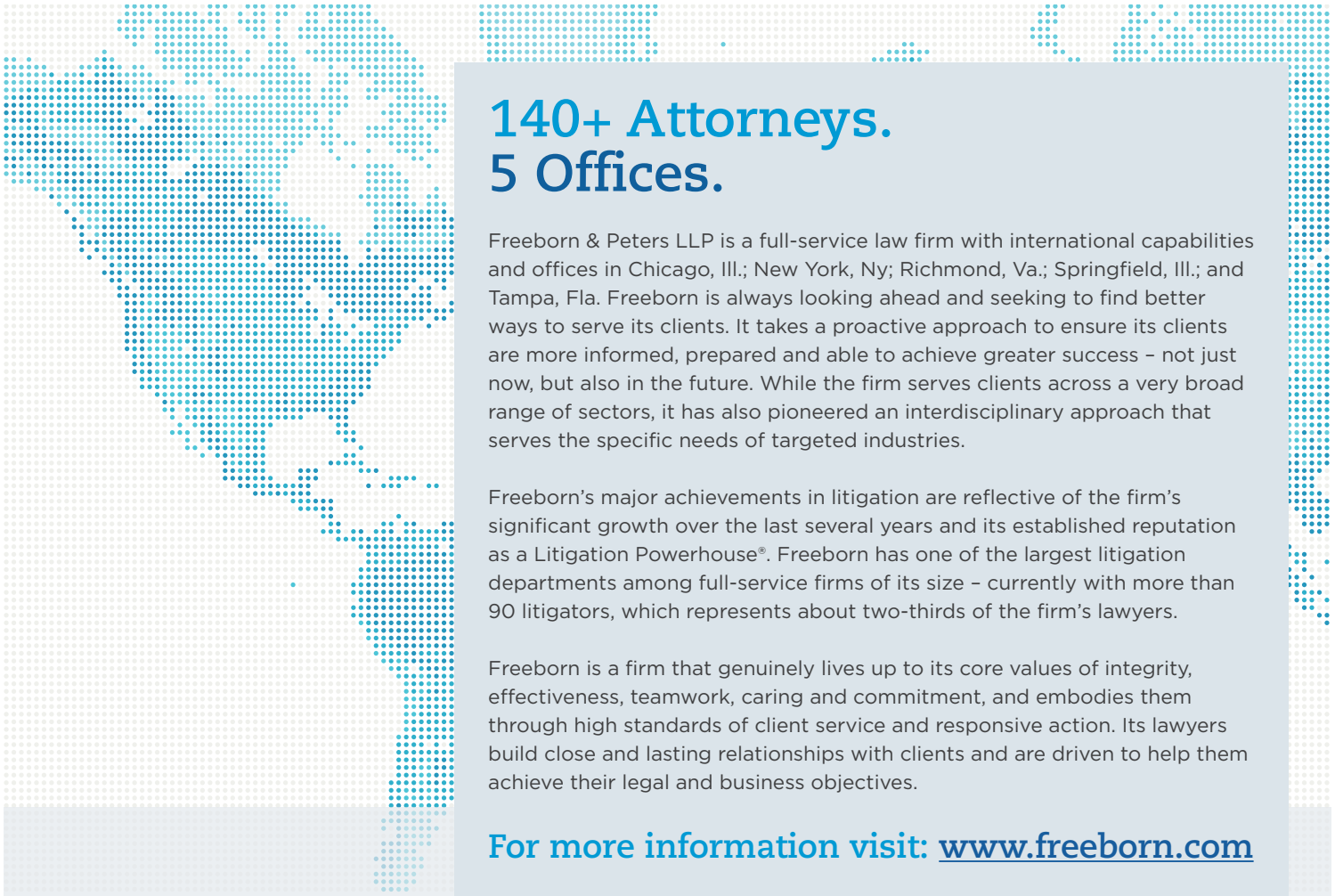
ABOUT THE AUTHOR

Adam C. Toosley
Partner
Chicago Office
(312) 360-6789
atoosley@freeborn.com

Adam Toosley has extensive experience in the handling of many different types of commercial disputes and transactions with a primary focus on construction, real estate litigation and financial services litigation. His experience in the lending and finance arena includes the representation of national lenders and loan purchasers in workout, asset seizure, transactional, bankruptcy and collection matters, the negotiation and preparation of commercial agreements, including loan documents, purchase and sale agreements (real estate and corporate), construction contracts, deeds in lieu of foreclosure and forbearance and modification agreements.

Freeborn

Your Future Is Our Purpose



140+ Attorneys. 5 Offices.

Freeborn & Peters LLP is a full-service law firm with international capabilities and offices in Chicago, Ill.; New York, Ny; Richmond, Va.; Springfield, Ill.; and Tampa, Fla. Freeborn is always looking ahead and seeking to find better ways to serve its clients. It takes a proactive approach to ensure its clients are more informed, prepared and able to achieve greater success – not just now, but also in the future. While the firm serves clients across a very broad range of sectors, it has also pioneered an interdisciplinary approach that serves the specific needs of targeted industries.

Freeborn's major achievements in litigation are reflective of the firm's significant growth over the last several years and its established reputation as a Litigation Powerhouse®. Freeborn has one of the largest litigation departments among full-service firms of its size – currently with more than 90 litigators, which represents about two-thirds of the firm's lawyers.

Freeborn is a firm that genuinely lives up to its core values of integrity, effectiveness, teamwork, caring and commitment, and embodies them through high standards of client service and responsive action. Its lawyers build close and lasting relationships with clients and are driven to help them achieve their legal and business objectives.

For more information visit: www.freeborn.com

CHICAGO
311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

NEW YORK
230 Park Avenue
Suite 630
New York, NY 10169
(212) 218-8760
(212) 218-8761 fax

SPRINGFIELD
217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

RICHMOND
901 East Byrd Street
Suite 950
Richmond, VA 23219
(804) 644-1300
(804) 644-1354 fax

TAMPA
1 Tampa City Center
201 North Franklin Street
Suite 3550
Tampa, FL 33602
(813) 488-2920