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Anticipating The Pandemic's Impact On Retail Leases

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News has come fast and furious over the last few weeks about COVID-19, the risks it creates, and the actions that federal, state and local governments have taken in response. Across the country people are sheltering in place, businesses have closed, and everyone is wondering what will happen next.

Few industries have been as impacted as much as brick-and-mortar retail. Shopping centers and retail stores (other than those providing essential services) have closed and retailers and landlords have been talking to their lawyers. It is certain that the advice retailers and retail landlords have been getting is “we need to read the lease language, understand the specific facts, and see what law there might be that deals with similar situations.”

Just a couple of weeks ago, there were questions about whether stores and shopping centers had to be closed, should be closed, and could be closed. But that has changed rapidly. Now stores and shopping centers have closed, and the decisions made by retailers and retail landlords to close are not being questioned.

Closing stores has had a dramatic impact on sales for many retailers. While many retailers have online businesses, the vast majority of their sales still come from in-store sales.

The only reason a retailer enters into a lease is to operate its business in the specified space — meaning to sell its merchandise to customers in the store. With both stores and shopping centers now closed, the opportunity for those sales is gone and the lease provides the retailer no benefit.

For the past two weeks, retailers have faced questions regarding the payment of rent. For brick-and-mortal retailers, rent is a major expense across their portfolio of leased space. For many major retail chains, rent payments total tens, and in some cases hundreds, of millions of dollars a month. Alternatively, rent payments are the primary source of revenue for retail landlords.

So what do 100-page retail leases say about the circumstances retailers and landlords face in these times? There are few leases (we have seen none) that consider the impact of a pandemic. Retail leases are instead filled with language that recognizes the fundamental nature of the bargain the parties struck: The landlord will provide a space for the retailer to operate its business, and if the retailer has a space to operate its business then the retailer will pay monthly rent.

Retail leases also contain agreed-upon provisions regarding anticipated risks that could prevent retailers from operating their businesses. For example, leases frequently contain provisions addressing physical damage to the leased space that prevents the retailer from operating its business. Similar provisions deal with other contemplated risks, including condemnation and hazardous materials.

The construction provisions of most retail leases similarly reflect this concept, providing that the payment of rent begins only after the tenant can open its store and begin to operate its business. All of these provisions recognize the fundamental bargain struck between retailers and landlords: To the extent that the retailer cannot operate its business, rent will not be required for the time and extent that the business cannot be operated.

Co-tenancy provisions are currently not satisfied, providing tenants with additional arguments.

Given the widespread closure of stores, co-tenancy provisions provide retailers with additional support for not paying or abating rent under the lease. A key aspect of shopping centers is that they gather tenants together in one location so that each tenant can benefit from the customers that other tenants bring to the shopping center.

Retail landlords in many leases agree that rent will vary depending on which tenants, and how many tenants, occupy and operate in the shopping center. These clauses are called co-tenancy provisions and they provide that if certain specific tenants (often referred to as “key” or “anchor” tenants) are not open and operating in the center, or if the percentage of total space occupied by operating tenants who qualify under some agreed-upon definition falls below a certain level at the center, the rent the tenant owes will be lower.

The language of these clauses varies. In interpreting these clauses, courts have found the provisions are not promises by the landlord, but instead conditions that, if not, met allow tenant to pay “alternate rent.” For example, in Old Navy LLC v. Center Developments Oregon LLC,[1] the court found:

> The Lease does not require [Landlord] to keep Key Stores at the Mall, and [Landlord] does not promise to keep Key Stores at the Mall .... If the conditions for operating the Old Navy store at the Mall are not met, Old Navy may choose to close its store and continue paying rent or it may choose to pay Alternate Rent-thus, invoking a tiered rent structure. In other words, Article 13.4 does not provide for damages if [Landlord] fails to keep certain tenants at the Mall. If [Landlord] leases to an entity that does not qualify as a Key Store, it is not in breach or default of the Lease and it does not owe Old Navy any damages. Rather, it must notify Old Navy of the Key Store closure, thereby triggering Old Navy's right to either pay Alternate Rent or close its store and pay Minimum Rent.

While landlords are relying on force majeure provisions to respond to tenant arguments regarding rent obligations, retailers have strong counterarguments.

Landlords, in response, are arguing that retailers should pay full rent even though they are not able to

operate their stores in the rented space, and are pointing primarily to a single paragraph in each lengthy lease: the "act of God" or force majeure provision. That paragraph often says something like this:

> If either party is delayed, hindered, or prevented from the performance of an obligation because of strikes, lockouts, power failure, restrictive governmental laws or regulations, riots, insurrection, war, or another reason not the fault of the party delayed, but not including financial inability, the performance shall be excused for the period of delay. Tenant shall not be excused from the payment of rental, additional rental, or other payments.

Landlords rely on this lone paragraph to argue that if a force majeure event takes place, then landlords are excused from all obligations under the lease. But landlords go even further to claim that even though a retail tenant no longer has a space to operate its store, that tenant must still pay the full amount of its regular rent. Landlords' argument here relies on language in force majeure provisions that says the retail tenant's payment "is not excused."

Retailers can point to many problems with landlords' force majeure argument.

First, tenants may point out that the provision has no application because the retail tenant's right to not pay rent does not arise because of a force majeure event. Rather, the tenant's right to not pay rent arises because the tenant no longer has a space to operate its business. The current situation is covered by numerous other provisions throughout the lease that provide that if tenant does not have a space to operate its business, it therefore does not have to pay rent.

Second, any reasonable reading of the force majeure provision in the context of the entire agreement makes clear that language specifying that the tenant is not excused from paying rent applies only in situations where the tenant cannot pay rent because of an unforeseen event (e.g. the tenant's headquarters has been destroyed and it can't process rent checks). But such language has no application to the current situation, in which a tenant has no space to operate its business.

An interpretation of force majeure language that excuses landlord from its obligations but requires tenant to pay regular rent runs contrary to express language the parties agreed to elsewhere in the lease regarding known risks, such as fire and condemnation.

Third, courts have long held that force majeure provisions should be narrowly interpreted. That rule raises doubts that a force majeure provision that does not specifically include pandemics has any application to the current situation. The rule further weighs against any interpretation that creates a situation (contrary to other provisions in the lease) in which a tenant must pay rent even though it has no location to operate its business.

Landlords also contend that force majeure provisions negate the carefully negotiated co-tenancy provisions found in leases. Landlords contend that force majeure provisions excuse landlords' "performance" in satisfying the co-tenancy occupancy levels. The obvious problem for landlords is that co-tenancy is a condition that determines what rent is paid — not an obligation of the landlord.

Existing legal authority supports retailers' argument that where the landlord fails to provide a space for the retailer's operations, rent obligations are excused.

Beyond simply reading the lease, attorneys for retailers and retail tenants are looking for past decisions involving analogous situations. As just one example, there is interesting law from Prohibition-era cases examining the impact of Prohibition on leases for businesses that sold alcohol. In those cases, courts

determined that if a contract was legal when it was made, "and the performance of it is rendered illegal by a subsequent law," then both parties would be discharged from their obligations.[2]

There are also more recent decisions regarding frustration of purpose and impossibility that have application here. For example, in Saab v. Norton Family Inc.,[3] a retailer and a shopping center owner entered into a commercial lease that expressly provided that the retailer was to use the leased premises only for the purpose of running a restaurant and serving liquor.

After operating a restaurant for two years, the retailer's restaurant and liquor licenses were revoked by the city and the retailer abandoned the leased premises. The shopping center responded by suing for unpaid rent.

Applying the doctrine of frustration of purpose, the court found that the retailer was "clearly warranted" in terminating its obligations under the lease. The court explained that "it was physically possible for [the retailer] to remain in possession and continue to pay rent, but it would have received no value in return because it could not do the one and only thing for which it had leased the premises and which it was permitted to do under the Lease; namely, operate a restaurant."[4]

Conclusion

So what do we know?

First, retail tenants and landlords do not agree on what their leases provide regarding the obligation to pay rent in the current situation. Second, in situations in which the parties understood that a retail tenant would not be able to operate its business, the parties agreed that tenant would not pay rent. Third, in the past when courts have considered situations in which a tenant was unable to operate its business in the leased space, courts have concluded tenant should not pay rent.

Today, retail tenants are not able to operate their businesses in the spaces they leased. Despite that fact, landlords are pressuring the tenants that cannot operate their businesses to pay rent. We will see what happens over the virtual (for the time being) negotiating tables and in virtual courtrooms across America.

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[1] 2012 WL 2192284, at *11 (June 13, 2012, D. Or.).

[2] Heart v. East Tennessee Brewing Co., 113 S.W. 364 (Tenn. 1908).

[3] 2000 Mass. App. Div. 200-02 (2000).

[4] Id. at 201–02 (internal citation omitted).