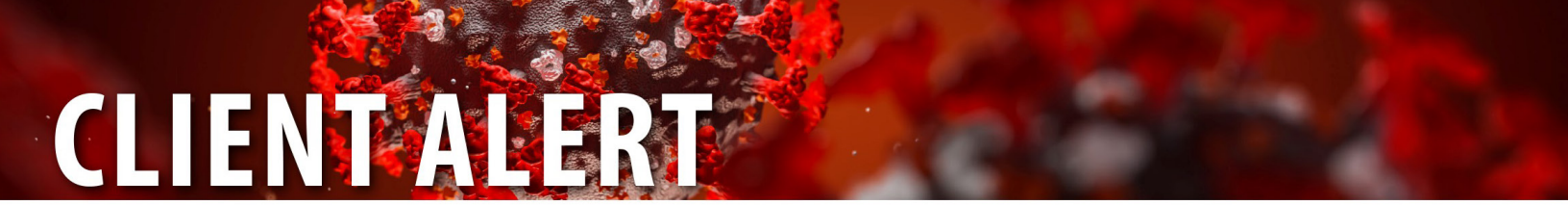

COVID-19 AND ITS IMPACT ON PERFORMANCE OF COMMERCIAL LEASES: A REVIEW OF FORCE MAJEURE, IMPOSSIBILITY OF PERFORMANCE, AND FRUSTRATION OF PURPOSE

by Michael J. Lusardi, N. Courtney Hollins, and Connor E. Phalon

As COVID-19 spreads throughout the United States and governors issue "shelter-in-place" orders and mandate the closure of non-essential businesses, landlords and tenants have encountered new and evolving challenges in meeting their leasehold obligations. Tenants have been unable to generate income to pay their rents, and landlords have been unable to pay their creditors as a direct result. This has caused landlords and tenants to scramble to review their leases to best determine their next course of action (or inaction) and what opportunities may be available to reach a compromise that will facilitate both the landlord's and tenant's ability to work with their respective creditors, owners, customers, and the like in a rational way under these unprecedented circumstances. To assist in that review, this article will explore three legal doctrines that commercial parties commonly invoke to be excused from their obligation to perform under a lease (including the obligation to pay rent) and examine how these doctrines may be applied today.

1. Force Majeure

An analysis seeking to excuse nonperformance by a party to a lease will generally begin with reviewing the express terms of the agreement to determine whether it contains a "force majeure" clause. Force majeure translates to "superior force" and is a contractual provision that allocates the risk of certain unanticipated and unforeseeable events that may result in the delayed performance or nonperformance of a leasehold party. Some common examples of qualifying events include "acts of God", government action, strikes, wars, terrorism, riots, labor disputes, and natural disasters. Typically, in commercial and retail leases, these clauses will contain carve-out language clarifying that a force majeure event will not excuse a party's obligation to pay rent, and will often set a "cap" on the period of time in which a party can claim that force majeure applies.

As the COVID-19 pandemic magnifies, there is an increased likelihood that tenants will look to this specific clause when asking to be excused from their obligation to pay rent or otherwise perform under their lease. To properly invoke a force majeure clause, the affected party must demonstrate that: (1) the unanticipated event was beyond its reasonable control; (2) it was prevented from performing its obligations as a direct result of the event; (3) it has taken all reasonable steps to mitigate damages and avoid nonperformance under the lease; and (4) it has provided notice in full compliance with the lease terms.

Historically, courts have interpreted force majeure clauses narrowly, and have been reluctant to allow a party to rely upon such a clause to excuse its nonperformance unless the unanticipated qualifying event was specifically listed or referenced in the clause itself. Courts have gone so far as to refuse to excuse a party's nonperformance even when performance would have been economically disadvantageous or resulted in financial hardship for the affected party. While courts may opt to more liberally construe these clauses in light of the ongoing pandemic, leasehold parties should closely review their force majeure clauses for specific references to a "pandemic," "epidemic," "disease," "public health emergency," "government restriction or action," or similar language, prior to assuming that COVID-19 or a resultant government action qualifies as a force majeure event excusing nonperformance under the lease.

2. Impossibility of Performance

In the event a lease is silent as to force majeure, a party should begin to assess the applicability of common law doctrines to excuse its nonperformance. One common law doctrine often put forth by parties to excuse nonperformance is the doctrine of "impossibility of performance." To have a viable claim under this doctrine, the affected party must show that the performance of the lease is rendered objectively impossible as a result of an unforeseeable event, and that such event was not the fault of the affected party.[1] Further, the non-occurrence of the event must have been a basic assumption of the lease agreement.

This doctrine has historically been applied on a limited basis by the courts. Only in extreme circumstances, such as the destruction of the subject matter of a contract by an "act of God" or where government laws made performance under an agreement objectively impossible, have courts found the doctrine to apply. That being said, as the pandemic continues and more tenants and landlords fail to meet their leasehold obligations as a result, we anticipate that courts may allow affected parties to more freely avail themselves to the protections afforded under the doctrine of impossibility, which could include being excused from the obligation to pay rent.

3. Frustration of Purpose

If a force majeure provision is not present in a lease, and the specific facts at hand do not support the applicability of the doctrine of impossibility of performance, then a party may consider the common law doctrine of "frustration of purpose" when seeking to excuse its nonperformance. Unlike force majeure and the doctrine of impossibility, this doctrine analyzes whether a qualifying event obviated the principal purpose of an agreement, rather than whether the partieswere able to perform their obligations as a result of the event. To properly invoke this doctrine, a party must show that the qualifying event was reasonably unforeseen at the time the contract was formed and that the event substantially frustrated the principal purpose for which the agreement was entered into for.

Similar to the doctrine of impossibility, courts have applied this doctrine narrowly over the years. This is due to the high bar needed to demonstrate that the frustrated purpose of the agreement was, in fact, the principal purpose behind its creation and execution. That being said, this standard of review may be relaxed by the courts in light of the COVID-19 pandemic and the mandatory closure of businesses across the United States.

Market Trends and Looking Ahead

Much like the public health landscape, the commercial real estate landscape continues to change almost daily. Some jurisdictions have elected to place a temporary moratorium on eviction proceedings against commercial and residential tenants, and landlords throughout the country are considering entering into forbearance or similar rent relief agreements with their tenants for the coming months. How a landlord and tenant navigate these unchartered waters will largely depend on the relationship between the two, the express terms of their lease, and how each court system elects to apply the legal doctrines discussed in this article.

In these uncertain times, we will continue to monitor the impacts of COVID-19 on the real estate sector and provide further updates with guidance on any new legal or business developments.

ABOUT THE AUTHOR

Michael J. Lusardi is Chair of the firm's Real Estate Practice Group and a member attorney in the firm's Troy office. He is currently barred in Michigan and can be reached directly at (248) 433-7254 or mlusardi@dickinsonwright.com.

N. Courtney Hollins is a member attorney in the firm's Nashville office. She is currently barred in Tennessee and can be reached directly at (615) 780-1108 or chollins@dickinsonwright.com

Connor E. Phalon is an associate attorney in the firm's Columbus office. He is currently barred in Ohio, New Jersey, and New York, and can be reached directly at (614) 744-2944 or cphalon@dickinson-wright.com.