

The impact of COVID-19 on Commercial Leases

The landscape regarding COVID-19 is shifting quickly. Following the New Zealand Government's announcement that all non-essential businesses are to close, tenants may find that they are unable to pay their lease rental and landlords are becoming increasingly frustrated about how the outbreak is likely to impact their rental income.

At Lewis', we have received an influx of queries from both landlords and tenants in relation to commercial leases. Below, we have provided answers to some of the most frequently asked questions that we have been receiving.

Can a tenant bring a commercial lease to an end as a result of the coronavirus?

Generally, no. A tenant can only terminate a lease prior to the established expiry date if they have a break right to terminate the lease. Break rights are not included in the standard form Auckland District Law Society ("ADLS") lease and, in most cases, need to be negotiated by the tenant and added as an additional term.

A tenant may attempt to argue that the COVID-19 outbreak amounts to a 'force majeure' event – which refers to the occurrence of an event that is outside the reasonable control of a party and which prevents them from performing their obligations under a contract. This is not a default entitlement; therefore, it must be clearly and expressly set out in the lease itself. In our experience, this is not a clause commonly found in modern commercial leases.

A tenant may also attempt to rely upon the doctrine of frustration (discussed below).

The newest edition of the standard ADLS lease includes a no access provision. It is possible that a tenant may be able to terminate the lease if it is unable to access the premises for the no access period defined in the lease, or alternatively, if the tenant is able to prove with reasonable certainty that they may be unable to access the premises for the no access period. The no access period in standard ADLS leases is usually 9 months; however, this may be varied. Whether a tenant can terminate the lease on the basis of a no access clause will depend entirely on the wording of the lease itself. At this early stage in the national lockdown, it is unlikely that a tenant could prove with reasonable certainty that they are unable to access the premises for more than 4 weeks.

What are the options for the Landlord, especially if the tenant requests a freeze on rental and outgoings?

- 1. Communication.** Talk to your tenant. Work through and assess the financial impact of COVID-19 and the tenant's ability to sustain rent payments given the uncertain time ahead. Is the tenant able to sustain any business by working remotely? Offer mutually acceptable solutions to your tenant that serve the interests of both parties. Possible solutions will obviously depend heavily on the tenant's industry sector, size and financial robustness.
- 2. Advise Tenant of Government Packages.** You should sit down with your tenant and advise them of the government support packages that they may be able to access during this difficult time.
- 3. Variation.** A lease can be varied at any time by mutual agreement of the parties. Any agreement to vary the lease should be formalised in writing. A landlord may wish offer any of the following:
 - Freezing the current rental.

- Agreeing to defer (or waive) a market or CPI rent review.
- Eliminating the requirement for the tenant to pay rent while we are at Alert level 4 and potentially for a reasonable period to follow, either via a rent holiday or a rent deferral.
- Share the pain: for example, a split sharing arrangement (i.e. 50/50).
- Share the burden: accommodating a rent-free period, on the basis that the term of the lease (or future terms of the lease) are increased in length.

4. Business Interruption Insurance or Loss of Rent Insurance. Your tenant may hold business interruption insurance and this policy may extend to cover the current situation. These policies however, typically require direct physical loss of, or damage to, insured property to trigger coverage. A landlord's loss of rent insurance may also cover rental lost due to the lockdown. We suggest you review your insurance policy carefully to assess whether either it is applicable in the current economic climate. It is common for a pandemic to be listed as an exclusion in policies of this nature; however, this will vary from policy to policy.

5. Invoking the No Access in Emergency Clause. If your lease is signed in the ADLS format (6th edition onwards, from 2012), clause 27.5 (No Access in Emergency) provides that if the tenant cannot gain access to the premises to fully conduct its business because of reasons that include:

- Safety of the public;
- The need to prevent reduce or overcome the hazard, harm or loss that may be associated with the emergency; or
- A restriction on occupation of the premises by any competent authority (which would include the New Zealand Government);

then a "fair proportion" of the rent and outgoings shall cease to be payable from the date that the tenant was unable to access the premises to fully conduct its business from the premises to the date that the tenant can regain access.

We would point out that there is no general restriction on the occupation of any premises. More accurately, there is a restriction on movement during the lockdown period. Ultimately, the critical consideration in clause 27.5 is a tenant's access to fully conduct their business from the premises. Generally, this is no longer possible for non-essential services for the duration that the Level 4 Alert is in place.

What does a "**fair proportion**" mean?

Generally, in assessing what proportion of the rent should be reduced (for example, in the case of a partially damaged premises), a valuer is engaged to assess the damage and the degree to which the tenant's business has suffered as a result i.e. by determining the percentage of the building destroyed or damaged. However, this is an unprecedented time where all non-essential services are forced to close.

The physical closure of doors will have varying impacts on businesses, depending on whether they can continue to operate remotely and to what extent this impacts on their revenue stream.

It is yet to be determined how a Court will interpret the application of the no access in emergency clause insofar as it applies to the present circumstances. We expect it would apply given that a national state of emergency has been declared.

In general terms, we consider that it is possible that a “fair proportion” would equate to a substantial reduction in the rent payable in the context of the current situation, however this is influenced by the industry sector, size and impact on business profits. With offices, for example, it is unlikely that the full amount of rent could be withheld by a tenant, given that the tenant is presumably still utilising the premises for storage of their stock and other business assets (for example IT systems that may facilitate – or be critical to – remote working). In some instances, businesses will be able to operate wholly or partly from remote locations and income fluctuations as a result of their ability to continue to operate will also inform the discussion as to what constitutes a “fair proportion”. For the retail and hospitality sector, the impact on business cash flow is more severe.

A tenant that is considered an essential service but has voluntarily chosen not to operate during the lockdown period is in a very different position to a non-essential business who is forced to close its doors, since it may be considered that it is contributing to its own losses.

We therefore recommend that the tenant and landlord engage in a discussion early, with the hope that they can reach a mutually acceptable solution. If this is not possible, parties should otherwise engage at an early stage in a mediated dispute resolution process. Tenant businesses that are able to financially endure the lockdown period will want some certainty that their tenancy is secure and available when business is to resume as usual.

6. **Invoke the guarantee.** In some instances, it may be possible to call on the tenant’s guarantor to recover any rent arrears. However, a guarantor will only be liable to pay rent that is or was actually payable by the tenant.
7. **Mutual termination of the Lease.** If both parties agree that there is no possibility of financial recovery after this crisis ends, mutual termination is a viable option. Landlords should be mindful that they are clearly taking more of a risk here given that finding a replacement tenant is not feasible during the lockdown period. Some landlords may also have mortgage repayment obligations and fixed/non-metered outgoings to pay on the premises notwithstanding that they are not occupied.
8. **Cancel the Lease for non-payment of rent.** This possibility should be reviewed carefully, especially given that this is a rapidly evolving situation and the Government has the ability to issue new orders in this area as it rolls out financial relief for impacted businesses. We are hopeful this is the next area of reform that the government will turn its attention to but as at the date of writing, there have been no government announcements directly concerning commercial leases.

We recommend that you formalise any changes to the Lease in a written document for clarity and certainty, and also to ensure that any personal guarantors are bound by the variations.

Can a tenant rely upon the doctrine of frustration to terminate its lease?

Frustration brings a contract to an end in circumstances where an intervening, post-contractual event has occurred, through no fault of any party, by which performance of the contract has become impossible, or radically changed. A temporary change such as a short-term closure of premises would ordinarily not amount to frustration, even if premises are closed for an extended period of time. Hardship, even if severe, does not generally constitute frustration.

The legal consequence of a contract which is found to have been frustrated is that the contract is automatically terminated at the point of frustration. The contract is not void *ab initio* (“from the beginning”); only future obligations are discharged.

This is a particularly complex area of law; therefore, we recommend that a tenant seeks to obtain legal advice before attempting to rely on this doctrine.

Will the Government impose new measures in the area of commercial leases?

We are continually monitoring the details of all Government announcements and orders in this area.

The Government has broad powers to enable the effective management of COVID-19, including making new orders and swift legislative change needed in the face of COVID-19's spread, treatment and its impact on business owners and landlords.

In the United Kingdom, for example, the Government prohibited evictions for a 3 month period.

Any specific advice for franchisees?

We recommend that franchisees make contact with their head franchisor in the first instance. Often franchisors will address property matters on a national level via their head office.

Practical advice

If you have a long-term reliable tenant, now is the time to be patient and accommodating in reaching a resolution that serves both parties. Given the current lockdown and the impending economic downturn, it could be very difficult to replace a tenant should the lease be terminated. From a practical sense, subsidised rent is better than no rent.

Should your tenant withhold rent without advising you of their intention to do so, or without you reaching an agreement on the matter, you may be entitled to charge penalty interest for the rent in arrears provided it remains unpaid for the required period of time. There is a prescribed process for doing so and we recommend you engage us to assist you with this process.

Whilst almost all leases do provide recourse for non-payment of rent, it is important to be aware of the practical and legal implications of enforcing these clauses. A landlord wanting to terminate a lease for non-payment of rent must give their tenant reasonable notice of their intention to terminate under the Property Law Act 2007. We suspect that a Court may view "reasonable notice" as taking into account the lockdown period, and possibly also a margin of time after the lockdown ceases to enable a tenant to re-open the premises and re-establish trade. A tenant can also apply for relief from forfeiture and a Court could find in the tenant's favour if the tenant has a history of making timely rent payments and is able to clear the arrears immediately. To terminate a lease for non-payment of rent could be risky at this uncertain time.

Landlords should also be aware that they are not permitted to enter the premises from 11.59pm on Wednesday 25 March, or they are in breach of the lockdown and self-isolation rules.

Please note that is general advice only and will vary for each specific lease. In addition, this continues to be an evolving situation. For specific and current advice relating to your unique situation, please get in touch with an expert from our Commercial Property Team:

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