CLIENT ALERTS & INSIGHTS

COVID-19: Focus on the Impact on Commercial Real Estate

MARCH 13, 2020

The Coronavirus Disease 2019 (COVID-19), is the latest viral outbreak affecting the physical and economic health of the world. With a global impact and over 1,600 reported cases identified in the United States (as of the date of this bulletin), the World Health Organization classified the outbreak as a pandemic on March 11, 2020.

COVID-19 belongs to the same classification of viruses which caused Severe Acute Respiratory Syndrome (SARS) and Middle East Respiratory Syndrome (MERS) and has already had a significant impact on business operations throughout the country as state, local and national governments have declared states of emergencies, which include, halting of trade with China, cancellation of some domestic and international flights, closing of schools and public gathering places and many more daily disruptions that have had a swift impact on individuals and businesses.

As COVID-19 continues to spread across the United States and world, commercial tenants and landlords, as well as buyers and sellers of real estate will encounter challenges in meeting contractual obligations due to the fluid nature of the outbreak and governments' continued and ever-evolving attempts to contain it. Landlords and tenants are actively analyzing the impact on supply chain reductions and decreased retail traffic due to "social distancing" mandates. Buyers and sellers face the possibility of travel restrictions preventing on-site third party due diligence review and site inspections as well as standard tenant interviews. Additionally, the containment efforts may disrupt debt availability from local and regional lending institutions and cause a possible back log of deed and mortgage filings in the event state and municipal government recording offices are required to close their doors. Relevant questions companies should address are (i) whether the failure to perform contractual obligations due to COVID-19 related causes constitutes a breach of contract or default, (ii) whether there is an exemption under contractual force majeure provisions for such pandemic causes, (iii) whether government or quasi-government (Civil Authority) directed closures and shut downs due to COVID-19 are covered by insurance and (iv) whether events caused by or related to COVID-19 constitute a material adverse change under the terms of a contract.

Force Majeure

Force Majeure contract provisions generally address events, beyond the reasonable control of either party, that may prevent the parties from performing their obligations under a contract. Force majeure provisions may apply to contingency clauses in purchase and sale agreements and/or lease contracts that require performance within a specific period of time or by a date certain that could be delayed due to a pandemic event. The typical force majeure event is a natural disaster, such as a hurricane, or a government prohibition that causes the performing party to be unable to perform their obligations under the contract. Force majeure provisions excuse the performing party from defaulting under the contract due to the performing party's inability or delayed performance due to such event. It is important to note, however, that most force majeure provisions do not apply to monetary obligations (e.g., payment of rent, earnest deposits, etc.), only non-monetary obligations that require performance. Further, force majeure provisions do not protect non-performing parties in the event the force majeure event occurs after the non-performing party delays performance. Most force majeure provisions have detailed notice provisions that require the party claiming delay or failure to perform due to force majeure to notify the other party of their inability to perform due to such force majeure event. Any clients with current contractual obligations are encouraged to review each force majeure provision and governing law provisions in detail to determine if the events related to COVID-19 are effectively captured in the current provision.

If your contract is silent as to force majeure, the courts in your jurisdiction will determine whether to excuse such performing party's performance during the force majeure event based on the foreseeability of the event and the jurisdiction's common law precedent.[i] For example, the Uniform Commercial Code (UCC) excuses a seller from timely delivery or for non-delivery of goods where its performance has become impracticable either: (A) By the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made; or (B) By compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.[ii]

Generally speaking, we advise all clients to evaluate the impact of COVID-19 on your business and contractual obligations, notify your contractual partners as soon as possible in writing of any disruptions, adopt and document measures to mitigate losses, and if necessary, discuss and negotiate with your contractual partners on how to proceed. If you are considering including COVID-19 language in your current force majeure provisions, or if you have received a force majeure claim from a counterparty or are considering making a force majeure claim, please contact a member of the firm's Real Estate and Environmental Practice Group for further guidance.

Insurance

While Force Majeure provisions cover set time periods of performance in contracts, a much larger concern for landlord and tenant clients is the potential loss of business due to general fear, the direction or guidance from Civil Authority, such as the recommendation to engage in "social distancing," or orders by Civil Authority not to attend events or the decision to shut down certain facilities, agencies or services and general directives to stay home.[iii] This disruption to normal activity will severely impact businesses generally, particularly restaurants, theaters, gyms and other retail or physical destinations, and will result in an adverse effect on rental streams, the ability to effectively maintain or operate physical structures or businesses, or build out and maintain construction obligations.

During these unsure times, insurance can provide comfort to both landlords and tenants but it is important to read your policies carefully and confirm that your policies do, in fact, cover such disruptions. Additionally, courts may look to the governing state's law in determining whether recoupment is possible under such policies (as opposed to factual circumstances). It is important to understand local statutes or precedents in making any insurance claims.

Typically, business interruption insurance protects against the loss of prospective earnings because of the interruption of the insured's business caused by an insured peril to the insured's own property. Most business interruption coverage policies require property damage in order for a party to recoup a loss due to such interruption of business. However, contingent business interruption (CBI) insurance often has a broader scope of coverage and can be obtained through an endorsement or rider. CBI insurance can protect against the loss of prospective earnings because of the interruption of the insured's business caused by an insured peril to property that the insured does not own, operate, or control (such as leased property).[iv]

However, it is important to understand your policy provisions in reference to governing state law. For example, in a case where an event organizer intended to lease space at the Jacob Javits Center in Manhattan shortly after 9/11, the City of New York (the Civil Authority, in this case) utilized the Javits Center as an operational hub following the attacks (and therefore, "ordered" it closed to non-first responder personnel) (*Penton Media, Inc. v. Affiliated FM Ins. Co., 2007).* The U.S. Court of Appeals, 6th Circuit, held that "based upon consideration of the whole contract, and even viewed 'liberally in favor of the insured,'[v] it is not reasonable to conclude that [the] 'described locations' in the Civil Authority clause include a location described in a provision which explicitly applies only to physical loss or damage, and not to prohibition of access due to order of Civil Authority. This is consistent with the rule, 'well-established in Ohio[,] that where two clauses of a contract appear to be inconsistent, the specific clause prevails over the general.' [vi] The Civil Authority provision states generally that loss resulting from order of civil authority is covered for 'described locations'; the CBI provision states specifically that at supplier locations, coverage is provided only for 'direct physical loss or damage.'"

Under more traditional "interruptions to business" (such as strikes, lockouts, down utilities, acts of God) where there has been a physical loss or damage to property, both parties can be compensated (and rent can continue to be paid) under such insurance policies, but it is unlikely (without physical damage) that business interruption and other current forms of coverage will compensate either landlords or tenants for loss of business or rent merely because the government recommends potential customers to stay home.

While there is case law[vii] permitting claim recoupment solely based on Civil Authority "orders" preventing access to specific locations, those policies in question had no requirement of "physical loss or damage." Additionally, the cases in which the courts ruled in favor of the insured are now over 40 years old, and insurance providers consistently and continuously update policies to avoid future losses following events that result in major claims being paid. For example, due to the global outbreak of SARS in 2002-2003, many insurers have excluded viral outbreaks from standard business interruption policies, and such coverage may only be procured through special endorsements or riders purchased at the time of coverage.[viii]

We recommend that all our clients review their insurance policies to determine whether business interruptions relating to COVID-19 are covered by their insurance carriers and review any notice requirements tied to making any claims, as well as analyze your state's laws in the event you seek coverage.

MAC Clauses

Purchase and sale agreements typically allocate significant financial, business feasibility and property condition risks (including tenant stability) to the buyer. Most buyers will seek to mitigate this risk by including seller representations, warranties and covenants in the purchase agreement. Sophisticated buyers will also negotiate for material adverse change (MAC) clauses in these contracts that give the buyer an "out" where certain circumstances occur resulting in a material or adverse change to the condition of the property prior to closing. MAC clauses generally are expressed either as (1) a closing condition that enables buyer to terminate the purchase and sale agreement if there is some MAC between the trigger date (typically the date of signing of the agreement or expiration of the due diligence period) and the closing date, or (2) a seller representation that as of the closing date no such MAC has occurred between the trigger date and closing date.

MAC Clauses are typically not tied to adverse global economic conditions, but instead are focused specifically on the business of the buyer or the physical condition of the property (or immediately surrounding area) that the buyer is contractually obligated to acquire. Further, the MAC must have occurred following the pre-determined trigger-date, and impacts relating to COVID-19 could be difficult to pinpoint. Additionally, if you are a seller in a contract currently being negotiated with a MAC Clause, it would be beneficial to preemptively carve-out the impacts of COVID-19, as the parties know about the threat while negotiating the terms of the deal and thus its impact should not be a factor in the deal pricing or contingencies.

Similar to force majeure clauses, the validity of MAC Clauses can ultimately end up being determined by litigation, in which event the courts in your jurisdiction will determine whether the buyer's decision to terminate the contract based on a MAC was due to a circumstance that was reasonably unforeseeable and has a long and lasting impact. There is little case law on the validity of MAC Clauses, as most are negotiated in settlements outside of courts.

Conclusion

If you are currently negotiating a contract and would like to specifically address COVID-19 considerations in your force majeure provisions, insurance provisions or purchase agreements generally, please contact a member of the firm's Real Estate & Environmental Practice Group.

Kelly D. Noll at knoll@beneschlaw.com or 216.363.4506.

Benesch, including the Real Estate & Environmental Practice Group, stands ready to assist with any questions as we closely follow COVID-19 developments and support our clients' response efforts in all areas of their business. For more information relating to COVID-19, please see:

Client Bulletins | March 13, 2020
U.S. Department of Labor Offers Guidance on COVID-19 Wage Related Issues

Client Bulletins | March 06, 2020
COVID-19: Focus on Employment Law Considerations

Client Bulletins | March 02, 2020
COVID-19: Health and Legal Considerations Convene

Client Bulletins | February 21, 2020
Reduction and Exemption of Chinese Employer's Contribution to Social Insurance

Client Bulletins | February 13, 2020
2019-nCoV Outbreak and Related Legal Concerns for Enterprises in China

---

[i] Force Majeure Clauses: Key Issues, Practical Law Practice Note 5-524-2181

[ii] UCC § 2-615(a)

[iii] https://www.cdc.gov/coronavirus/2019-ncov/specific-groups/high-risk-complications.html

[iv] 245 Fed.Appx. 495 (2007)

[v] Andersen, 757 N.E.2d at 332

[vi] *Gibbons-Grable Co. v. Gilbane Bldg. Co., 34 Ohio App.3d 170, 517 N.E.2d 559, 564 (1986)*

[vii] Sloan v. Phoenix of Hartford Ins. Co., 207 N.W.2d 434, 437 (Mich.Ct.App.1973); Allen Park Theatre Co., Inc. v. Michigan Millers Mutual Ins. Co., 210 N.W.2d 402 (Mich. Ct.App.1973); Southlanes Bowl, Inc. v. Lumbermen's Mutual Ins. Co., 208 N.W.2d 569, 570 (Mich.Ct.App.1973)

[viii] https://www.wsj.com/articles/why-many-businesses-will-be-on-the-hook-for-coronavirus-losses-11582282