New York Law Journal

Leasing After COVID, Part 1: Casualty Provisions Then and Now

By Ann E. Ryan and Adrienne B. Koch

June 9, 2021

In their new Commercial Leasing column, Ann Ryan and Adrienne Koch begin a three-part series discussing the state of commercial lease negotiations today as opposed to the pre-COVID days. This article's focus is on casualty provisions.

The Covid-19 pandemic's immediate effect on commercial leasing in New York was obvious. Businesses, compelled by executive order to reduce in-person operations or even to cease operation altogether (*see, e.g.,* NYS Exec. Orders 202.3, 202.6, and 202.8), looked for relief from their rental obligations. Commercial landlords, who were subject to a state-ordered eviction moratorium but no corresponding state-ordered mortgage forbearance (*see* NYS Exec. Orders 202.8 and 202.9; 3 N.Y.C.R.R. § 119(f) and (k)), faced the prospect of losing the income they needed to support ongoing expenses such as mortgage payments, taxes, insurance, and maintenance costs. Landlords, tenants, and insurance companies are still negotiating and litigating over how that financial impact should be apportioned.

But the pandemic is also having a longer-term impact on the way commercial leases are negotiated. Whereas in the past parties have not wanted to spend a significant amount of time discussing and negotiating events that seemed unlikely to occur, post-pandemic lease negotiations are placing a greater emphasis on seeking protection against such events. This article is the first in a three-part series that will examine specific aspects of this shift. Its focus is on casualty provisions.

Covid-19 and Casualty

Standard casualty provisions in commercial leases often leave the term "casualty" undefined, loosely describing such events – which often result in a rent abatement or termination

right – as a fire or "other casualty" that renders the premises "uninhabitable" (or "untenantable," "inaccessible" "unusable," or a similar descriptor), in whole or in part. Claims that the pandemic (and associated restrictions on business operations) constituted a casualty that would relieve a tenant of its rent obligations during the period when the tenant was not able to use its premises have met with mixed results in the courts. The prevailing view, however, appears to be that the pandemic and the restrictions it brought were not a casualty. Under that view, "casualty" refers to "singular incidents, like fire, which have a physical impact in or to the premises." *See Gap, Inc. v. Ponte Gadea New York LLC*, 2021 WL 861121, *6 (S.D.N.Y. Mar. 8, 2021) (Swain, J.) (noting that many other New York courts have "concluded that the pandemic is not a 'casualty' as that term is generally used in commercial leases") (collecting cases); *cf. 188 Ave. A Take Out Food Corp. v. Lucky Jab Realty Corp.*, 2020 WL 7629597, *6 (Sup. Ct. N.Y. Co. Dec. 21, 2020) (Kelley, J.) (issuing an injunction based on a finding that the tenant was "likely to succeed" on its claim that the pandemic and resulting suspension of its business constituted a "casualty" that relieved it of its obligation to pay rent).

The case law is still sorting out the extent to which standard casualty provisions will apply to the pandemic. But landlords and tenants, guided by this case law, are reevaluating their approach to casualties and similar events in new leases. Landlords are seeking to clarify that references to "other casualty" and events that render the premises "uninhabitable," "untenantable," "inaccessible," or "unusable" relate only to specific, one-time events that cause physical damage to the premises or the building. Tenants, on the other hand, are seeking protections against a broad range of events that impact the income stream from which they must pay their rent.

In other words, landlords want to limit the circumstances that will excuse the payment of rent, while tenants want to expand them. But landlords and tenants also need to work together:

there can be no lease unless both parties are willing to sign it, and neither party will be (or should be) willing to sign a lease whose provisions might put it out of business. The result has been an effort to find resolutions keyed not to theoretical rights, but rather to actual economic realities.

Balancing Interests Through Creative Solutions

In this new dynamic, a tenant seeking a provision that will abate its rent based on certain kinds of events should be prepared to show its landlord that it will actually *need* such rent relief. Many tenants suffered severe financial losses as a direct result of not being able to remain open for business during the Covid-19 pandemic, and would likely suffer similar financial losses if such a thing happened again. But that is not the case for every tenant. Certain kinds of businesses (such as service professionals, or membership organizations) may continue to have a meaningful income stream even when they cannot use their premises. Others (such as not-for-profit organizations) may have funding sources that do not disappear entirely (or even at all) upon a temporary physical shut-down. Accordingly, parties need to consider the actual financial impact for both sides.

As the Covid-19 pandemic highlighted, traditional "casualty" provisions do not seem to cover events that prevent a tenant from using its premises without causing physical damage. While *force majeure* and related provisions may cover some of these events, they rarely provide rent relief. To address these situations, commercial landlords and tenants have been crafting and negotiating new provisions, including:

- Provisions that give the tenant a rent deferral or a rent abatement for a limited period of time (for example, up to 60 days, or not to exceed 60 days during any 12-month period) if, as a result of a governmental order, the tenant cannot and actually does not open its business in the premises to the public.

- Provisions that would allow the tenant to pay rent based on a percentage of its gross sales from the premises, rather than the "fixed" or "base" rent otherwise due under the lease, for a certain period of time (such as up to six months, or up to a year), if the tenant's operations in the premises are materially restricted due to a governmental order or mandate. Such "material restrictions" might include a reduction in the maximum number of customers or patrons that the tenant can serve at any given time, a reduction in operating hours, or, in the case of a restaurant, limits on serving customers food and drink indoors.
- Provisions stating that if the tenant is forced to close its business in the premises to the public as a result of a governmental order, (a) the tenant will receive an abatement of rent during the period of the closure, but (b) the term of the lease will be extended for a period equal to the number of days that that the tenant's business in the premises was closed (and the rent for such extended period will be the then-escalated rent).

Many of these provisions continue to be specific to business disruptions related to the Covid-19 pandemic. Consistent with this focus, many landlords who agree to these kinds of provisions also insist that any rent relief be conditioned on the tenant using diligent efforts to apply for any governmental assistance or insurance proceeds that the tenant may be entitled to receive, and applying the benefits of any such assistance or proceeds to any abated or reduced rent. But the underlying point – balancing the needs of both parties, recognizing that it is in neither side's interest for the other to fail financially – is plainly not limited to Covid-19.

The Importance of Bargaining Power

The extent to which a tenant will be able to obtain any of these kinds of provisions will depend in large measure on bargaining power. Landlords that have a significant amount of retail

space available, for example, may be more willing to include a prospective rent relief provision in a lease with a tenant they perceive as "strong" – an anchor tenant, a good credit risk, or the like. Conversely, the kinds of provisions described above may be out of reach for a tenant in a less advantageous bargaining position.

Such a tenant may, however, be able to persuade its landlord to agree to a provision stating in substance that if the tenant is precluded or severely restricted from operating its business in the premises as a result of a government mandate, the landlord will participate in good faith, reasonable discussions to restructure the rent in a manner appropriate to the circumstances. While this kind of provision gives the tenant no guarantees, it does provide at least some comfort that the landlord will come to the bargaining table. For the landlord's part, it preserves the opportunity to assess at the time its ability to give the tenant rent relief based on then-current circumstances. This represents a different kind of balance but, again, recognizes the symbiotic nature of the landlord-tenant relationship.

Conclusion

The Covid-19 pandemic has created a widespread disruption in businesses that is unlike anything that most of us have seen in our careers. But it is not the first event to cause broad scale business interruptions that do not meet the standard understanding of what constitutes a "casualty," and it will undoubtedly not be the last. By focusing on the economic impacts to be ameliorated and seeking to balance their interests, landlords and tenants (and the attorneys who advise them) can reach results that are more likely to be workable – and less likely to land them in litigation – in the next crisis.

Ann E. Ryan is a real estate partner and Adrienne B. Koch is a litigation partner with Katsky Korins LLP in New York, NY.

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