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Commercial Classroom: Post pandemic leases - by Ed Smith

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This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

The COVID-19 pandemic has had and continues to have a profound effect on both landlords and tenants; it will change lease terms for the future.

Traditionally it was best for tenants to have a relatively long lease, five years or more and/or renewal options. If business was going well remaining in the same location was preferred unless they needed to move due to growth. Landlords too like longer leases as vacancies disrupt their cash flow and cause additional marketing expenses. But currently the trend is for shorter lease terms and multiple renewal options, tenants and new businesses are unsure of the future. When will this pandemic really end or will there be another resurgence? A two-year lease and three one-year options may be requested by tenants also concerned about product and materials availability and sales activity. Landlords will reluctantly go along with the shorter terms rather than have the space vacant.

Tenants are seeking an “exit plan” for any future events that prevent their business from operating as usual. Many leases do not have sub-lease and assignment clauses. Tenants need these clauses in their leases which would allow them to sub-lease all or part of their space or assign the lease to another tenant. Tenants, especially in the office category, may be looking to shrink their footprint as a result of a portion of their workforce working from home full or part time. They would want the lease to allow them to “giveback” to the landlord that unused space. Landlords may not want to do that due to concern about finding another tenant. A solution for these situations would be if the tenant would take responsibility for finding a replacement tenant themselves. Thus, giving the tenants exit options and the landlord not having any period of vacancy.

Both landlords and tenants were unprepared for COVID-19 repercussions of government mandated shutting down of businesses. The business closures affected tenant’s ability to pay rent, and landlord’s ability to pay their mortgages. Although many commercial leases have a “force majeure” or “Act of God” clause, allowing tenants to reduce rent payments or terminate leases in extraordinary circumstances. A pandemic was never contemplated, and the word is not included in the typical definitions of what “force majeure” events are, as a matter of fact “pandemic” has yet to be clearly defined. One of the things changing in new leases will be a clearer definition of “force majeure” events including defining government shutdowns.

In the future sales may be tied to what happens when a “force majeure” event is triggered. If a retail store is closed will the rent be totally abated and if so, for how long? If the store is then partially opened, what is a fair amount of rent to be a paid to the landlord? For example, a restaurant was initially closed, then it was reopened but only for take-out, doing only 25% of their previous sales. This contingency would need to be defined in the lease, what we may see in retail leases is a shift to “percentage leases” during these periods; tenants paying a percentage of their monthly sales as rent.

We will also see more tenants requesting “co-tenancy” provisions in their leases. If an anchor tenant or neighboring stores “go dark” (close) as a result of these “Acts of God” events, the tenants rent would automatically be reduced or be abated or allow for lease termination.

Historically mall developers seek “anchor” tenants; major retailers who draw people to their stores through their advertisements and merchandise mix. To entice them to open in their location, landlords offered “sweetheart” leases with very low rents; the tenants do pay their share of the taxes and common area maintenance charges. Smaller size merchants (inline tenants) seek to open their business near these anchor stores to get the benefit of the customer traffic; and pay high rent to do so. With one or more anchors and 25 -100+ smaller stores you have a regional shopping center with the largest ones, often enclosed, called malls.

What happens when these anchor stores like Sears, Macy’s, Kmart, JC Penny, Sports Authority, or even the neighboring stores in a small strip center, “go dark?” Without the traffic to the shopping center the sales in the remaining stores plummet. Co-tenancy clauses are designed to protect tenants when other stores become vacant but seems to have a new application in the post pandemic era.

Co-tenancy clauses can take many forms, generally they allow the tenant, when the other stores go dark, to reduce their rent payment to a predetermined amount or convert their rent obligation to a predetermined percentage of their sales. They may also allow the tenant to terminate their lease if the anchor or other stores are not rented or reopened within a certain time frame. Now the definitions of the co-tenancy clauses are seeking to be applicable and triggered if we have another pandemic or government mandated closures.

Another ramification of the pandemic were mammoth delays in processing permits and zoning applications, and getting inspections and appraisals completed. Most of these workers are back to work now processing this backlog. But construction and buildouts are being hampered by a backlog of materials and supplies. We’ve heard of the over 100 cargo ships in California harbors that may not be unloaded until 2022!

Leases are often subject to buildouts (alterations or new construction) being delivered in a timely manner or before the tenant can move in. These delivery issues will now have to be addressed in the leases, whoever is doing the work will request as much time as possible, without penalty when delivery delays are out of their control. A tenant doing their own build out may want the ability to push back the lease commencement date for delays in obtaining materials or permits. Landlords have the same concerns and issues if they are responsible for construction.

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