

REVISITING THE LEASING ENVIRONMENT ONE YEAR INTO AN ERA OF UNCERTAINTY.

What has been the reaction of tenants to the pandemic?

When COVID-19 first broke and everything shutdown, the general reaction was some level of panic, which was understandable. Office tenants were thinking, “I can’t go into my space, the economy is going to go south, what’s going to happen to my business, etc.?” And I think that was a natural reaction. The main questions that followed were, “Can we get out of our lease?” and “Can we stop paying rent?”

I went through the dot-com bust in the early 2000s, and the “I just want to stop paying rent” reaction was similar. Well, you can’t. It’s a contract for a significant amount of money and you can’t just ask for a do-over. As time has gone on, people have realized that this is a long-term issue and it is impacting all of us in some capacity – but the world has not ended.

What about force majeure?

The force majeure clause will not generally protect tenants against their obligation to pay rent. Right before the shutdown occurred last March, we were already being asked to check leases for force majeure language. That language protects one or both parties from having to perform certain obligations under their lease in the event of unforeseen circumstances that are beyond a party’s control. The force majeure clauses we’ve seen are very specific about what type of circumstances are covered and which party or parties it protects. They all have different levels of specificity, and typically all state that the tenant is still obligated to pay rent. One clause I recently reviewed that specifically addressed a pandemic also stated the tenant had to pay rent – so even a tenant who specifically addressed the issue was still obligated to pay their rent.

It’s also important to remember that most of the office buildings never officially closed. They were, and continue to be, fully operational. Although many employees are still working from home, buildings are still being cleaned and security is still on-site.

How did tenants and landlords resolve the rent issue?

Some office tenants requested some form of rent relief. Most landlords did not agree to simply forgive rent for X amount of months, but were largely willing to offer some level of deferral with the parties agreeing to extend the lease term for that period of time – some form of rent relief over the last 12-months with payment on the back end. But it was on a case-by-case basis depending on the tenant’s situation, i.e., whether or not the tenant was truly financially impacted by the shutdown.

Should tenants expect to assume additional costs related to the pandemic?

More than 12-months into the pandemic and that still remains to be seen. As an example of an event impacting costs, after 9/11 there were a lot of questions with regard to insurance costs, which went through the roof. Those costs were passed through to tenants, and it was a big financial hit initially. All of a sudden, we were negotiating specific language to address an expense that was the result of a very specific event. Tenants were not

comfortable with it at first, and it took some convincing to get them to understand it was fair. As time went on, that language became standard because tenants grew to understand the landlord's position, given that it was a very specific occurrence that happened and the 'what if?' factor still remained.

I think we're going to see some changes in the leases going forward because I expect operating expenses are going to go up, but only time will tell if it's for the short-term or long-term. When the pandemic hit, some clients thought, "My expenses should start going down. We're not in there, so I don't expect to be paying as much." In some cases, this has proven true, but so far, we've seen no clear-cut trend. In some instances, building operating expenses did decrease during 2020, and in other instances they increased slightly. There are so many factors to take into consideration. Were those buildings largely unoccupied during 2020 and now the first half of 2021? The costs that typically vary depending on occupancy, electricity, and cleaning, to name a few, vary most in a no occupancy vs. occupancy scenario. Meaning, you're not going to see electricity and cleaning costs decrease exponentially if, during the past 18-months, tenants had 10% or 25% of their employees in their leased space. Whether there are 10, 25 or 100 employees in the office, electricity is still generally used and the landlord still provides cleaning. Going forward, the future is still unclear. I'm sure there will continue to be more information emerging in terms of how the virus is spread and what tenants expectations of landlords are as far as cleaning, security, etc. As more science-based information becomes available, we may see an impact on the costs if, for instance, major filtration upgrades to HVAC systems are necessary. Unfortunately, because of all the variables at play right now, it's impossible to know what's going to happen with certainty.

What should tenants be focused on right now with regards to their lease(s)?

Tenants should continue to focus on understanding their current lease(s). They can ask their real estate advisory firm to assist with that but should first make sure they have executed copies of their leases and any related documents (amendments, estoppel certificates, commencement date letters, SNDA's, etc.). Tenants should also request an abstract of their leases. If your real estate provider has a lease administration team, even better because they typically review hundreds of leases a year due to the nature of their jobs and can see market trends regarding lease language and what types of costs landlords are passing through to tenants. The abstract will provide a tenant with an accurate summary of the terms of their lease, including financial obligations, i.e., base rent, operating expenses, and taxes. It will also include the tenant's rights as far as term extensions and termination options, maintenance and repair clauses, etc.

A few lease clauses we've been focusing on for our clients are: cleaning, maintenance, and with regard to 2020 CAM statements, gross-up provisions. Tenants need to understand their and their landlord's obligations surrounding the cleaning of both the common areas and the tenant's space and who pays for it. Are there additional COVID-related costs for cleaning beyond the scope of standard cleaning specs? Does the tenant pay for that? As far as maintenance is concerned, who is responsible for what? Tenants will want to understand their maintenance obligations from both a performance and payment standpoint. They may not be consistently occupying their spaces again this year, but that doesn't absolve them from performing their maintenance obligations or any of their other lease obligations for that matter. Most leases have a gross-up provision, which impacts operating expenses that vary with occupancy, such as janitorial costs, utilities, and trash removal. If they haven't already, tenants should soon be receiving their 2020 year-end statements; they should be sure to look at those variable costs related to their gross-up language.

What should tenants think about regarding lease language in the future?

What's foremost on a tenant's mind right now is flexibility and costs. The whole "working from home" concept is still being addressed with most employers. How much space do they need now, what will their space needs be going forward? The logistics of determining "work from home" policies and what that looks like for each employer is a huge undertaking. There is still a lot of uncertainty around it. I imagine more than ever all tenants will be thinking about ways to address expansion/contraction rights going forward and how that will play out with landlords when signing a new lease or renewing. Lease costs are always at the forefront of a lease deal, but now there's another category, COVID-related costs, to consider. "If we sign a lease or an extension, is there any way to protect us from paying rent in the event of another pandemic?" It'll be interesting to see how that concept pans out. Will landlords be open to having that discussion and including language that provides tenants some level of rent relief should there be another outbreak? If yes, what does that rent relief look like? Will it be a deferral? A true abatement? How will terms such as "pandemic" or "business closure" be defined? Will landlords push back and tell tenants to look to their insurance providers for coverage if there's another outbreak? Will that result in another type of insurance coverage or will it be an option for business interruption insurance?

Additionally, tenants are concerned about operating costs, some potentially not yet addressed, and what tenants will be expected to absorb. We have seen a few recently negotiated leases where a capital carve out was included, so that the landlord could pass through costs related to any required air filtration upgrades necessitated by COVID. Will that language become industry standard? Only time will tell.

Tenants always want to protect themselves and make sure they have a lease that's fair to both parties, but is also in-line with market standards and limits their financial exposure. As a tenant, you want to pay what's fair but don't want to pay more than you have to. It's now been more than 12-months, and while we know a lot more than we did a year ago, the future is still unclear. Given the global impact and the nature of what this entails, it could be many more months or even another year before we have a clear picture of how this will impact the tenants, the landlords, the expenses – everything.



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