



UNDERSTANDING THE LEASING ENVIRONMENT IN AN ERA OF UNCERTAINTY.

A Conversation with Jennifer Elia, SVP of Lease Administration, McCall & Almy

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’s a natural reaction. The main questions that followed seemed to be, “Can we get out of our lease?” and “Can we stop paying rent?”

I went through the dotcom 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’s going to impact all of us in some capacity – but the world is not going to end.

What about force majeure?

The force majeure clause will not generally protect tenants against their obligation to pay rent. Right before the shutdown occurred, 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 as to 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 have never officially closed. They were fully operational, and it was the government, and subsequently employers, that advised employees to work from home. Buildings are still being cleaned and security is still onsite. And if the building remained open, then why shouldn’t landlords be able to collect rent? The flip side to that is some tenants are still thinking, ‘I’m not using my space, why am I paying for it?’

How are tenants and landlords resolving the rent issue?

Some office tenants are requesting some form of rent relief. I haven’t heard about very many landlords agreeing to simply forgive rent for X amount of months, but most are willing to offer some level of deferral with the understanding that the lease term will be extended for that period of time – rent relief now with payment on the back end. But it is on a case-by-case basis depending on the tenant’s situation, i.e. whether or not the tenant is truly financially impacted by the shutdown.

On the landlord side, much depends on how heavily they are leveraged. For many landlords, if tenants don't pay their rent, then they can't pay their lenders. So that leads to the question of whether they have debt on their building. If the answer is 'yes', then what type of relationship do they have with their lender? If the landlord is well capitalized, it has more control over whether or not it can offer some sort of rent relief, but then there's the question of how it will impact their P&L for the year. Right now, many landlords seem to be in secure financial positions with minimal debt on their buildings – especially the large institutional landlords – but a discussion needs to be had so both parties can understand one another and find a mutually beneficial solution.

I should also emphasize that tenants need to initiate these conversations and be prepared to be fully transparent. Landlords are unlikely to proactively encourage tenants to stop paying their rent – that would be a first. In our experience, and mind you it's only been a few months, landlords are typically willing to work with the tenant as long as the tenant is forthright in terms of the financial impact the pandemic is having on their ability to pay rent.

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

That 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 do 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 may have thought, "My expenses should start going down. We're not in there, so I don't expect to be paying as much." And while it may be true for something like electricity within their space, expenses like cleaning are most likely going to increase, given that it will be occurring more frequently due to COVID-19. Some buildings will also be setting up temperature checks in the lobby so that anybody with an elevated temperature will be denied access to the office. I'm sure there will be more information emerging in terms of how the virus is spread, and 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 with certainty what's going to happen.

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

Right now tenants should 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 are able to 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. We're seeing that landlords want to work with their tenants, but it's up to the tenant to show the landlords they've been fiscally responsible and that they understand the rights they have under their lease if they're looking for some form of rent relief.

A few lease clauses we've been focusing on for our clients are: cleaning, maintenance, and looking ahead to 2021 when CAM statements come in, gross-up provisions. Tenants need to understand their and their landlord's obligations surrounding cleaning of both the common areas and the tenant's space and who pays for it. Are there additional 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 for the next 12-18 months or so, 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. In Q1 2021, when tenants start receiving their 2020 year-end statements, they should be sure to take a look at those variable costs in relation to their gross-up language.

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

Obviously, what's foremost on a tenant's mind right now is this: "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? It'll be very interesting to see where we end up.

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 only been three to four months, so I think more changes are coming in the future. Given the economy and the nature of what this entails, it could be months or well over a year before we have a clear picture of how this is going to impact the tenants, the landlords, the expenses – everything.



Jennifer Elia | Senior Vice President, Lease Administration | +1 617.420.8066 | jelia@mccallalmy.com
Jennifer has over 20 years of experience focusing on a wide range of lease administration services to provide our clients with accurate lease portfolio data and reporting. Her legal background and expertise reviewing commercial leases give her a broad understanding of market standards and how the business terms of a lease can impact a client's tenancy.