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COVID-19 – the legal implications for landlords and tenants

The World Health Organization declared COVID-19 as a public health emergency of international concern on 30 January 2020. Governments in many countries are implementing drastic measures to curtail the number of infections and combat the ongoing outbreak.

It appears that the Australian Government continues to react with more robust mitigation strategies on a daily basis and many nation states have implemented extreme measures (including travel bans, border closures, prohibitions with respect to public gatherings and a myriad of domestic health and wellbeing procedures) which are causing significant disruption to businesses around the world. Global financial markets have adversely reacted to these measures and Australia's share market has suffered unprecedented losses with the ASX200 now losing 30.5% of its value in the three and a half weeks of trading since 20 February 2020.

Reducing the human cost remains a global priority. However, the economic cost is becoming more significant and obvious. The purpose of this paper is to identify how the real estate industry might be affected.

Economic impact on real estate and development

The volume of transactions will be directly affected (at least for the short term) by quarantine and travel restrictions. Potential investors (both local and international) may hold off seeking opportunities until the impact subsides resulting in a temporary reduction in off-shore capital particularly from investors located in China and other worse affected areas.

Investors typically have a long term outlook with respect to real estate (due to the asset class not being as liquid as securities) and would therefore have a stronger and more determined outlook to weather uncontrollable shocks to the economy. However, the uncertainty with respect to COVID-19 (and the length by which global economies will continue to decline) may result in a situation where it is more difficult to raise capital, borrow or meet existing debt commitments prompting a need to divest real estate assets.

Investors may be minded to hold off making investment decisions in the hope that the persistence of COVID-19 may present opportunities in the market if there is a possible downward trajectory in real estate prices.

It is imperative that in view of this uncertainty landlords monitor the financial health of existing tenants in an attempt to preserve existing yields and mitigate against any easing of capitalisation rates. Assets used in connection with retail, tourism, education and hospitality will be hit hard in view of the measures taken to stop the spread of the contagion.

Tenant considerations

Impact on Trade and Supply Chains

All businesses reliant on a supply chain involving China (including Chinese customers including tourists and students) may experience significant disruption following the shut down of manufacturing. This could place a strain on rental commitments and may influence tenants to delay making major decisions involving taking new space or exercising rights of renewal to secure tenure to existing space.

Potential Vacation

Government guidance continues to change on a daily basis and the recommended combative measures are becoming more onerous for businesses to comply with. If the Government's guidance changes to require buildings to be vacated, the tenants of buildings would be expected to comply with guidance notices or orders issued by public and statutory authorities. Most commercial leases contain a covenant requiring the tenant to comply with all statutes or notices or orders made by competent authorities. A tenant would be in breach of this covenant if it fails to comply with Government directives to close offices or require staff to work from home to contain the spread of the virus.

Force Majeure and Frustration

Tenants may be committed to serving long term leases which do not provide for early termination. Leases generally do not contain force majeure clauses allowing parties to end the lease where a party is affected by an unavoidable or unforeseeable event. Instead, it is possible that tenants may look to the doctrine of frustration as a basis of terminating their lease if a tenant is prevented from occupying their premises. The lease will be automatically terminated by operation of law upon the occurrence of the frustrating event.
Whilst the doctrine of frustration could be applied to determine a lease, the bar is set extremely high and it is extremely difficult to establish and has a narrow scope. In the decision of *National Carries Ltd v Panalpina (Northern) Ltd* [1981] A.C. 675, the concept of frustration was defined by Lord Simon of Glaisdale as follows:

"Frustration of a contract takes place when there supervenes an event (without default of either party and for which the contract makes no sufficient provision) which so significantly changes the nature (not merely the expense or onerousness) of the outstanding contractual rights and/or obligations from what the parties could reasonably have contemplated at the time of its execution that it would be unjust to hold them to the literal sense of its stipulations in the new circumstances; in such case the law declares both parties to be discharged from further performance."

The circumstances in which the doctrine of frustration can apply to leases are exceedingly rare and the following factors are relevant:

1. duration of the lease – long leases would rarely be frustrated in circumstances short of total destruction of the land that was the subject matter of the lease or permanent change in a physical characteristic of the leased premises;
2. the nature of the lease is important – if the lease is merely incidental to the commercial undertaking of the tenant the effect of the act of frustration may not be sufficient for the doctrine to apply to the lease;
3. the duration of the frustrating event – in *Li Ching Wing v Xuan Yi Xiong [2004]* 1 HKLRD 754 (a case tried in Hong Kong), a tenant subject to a 10 day isolation order due to the outbreak of the Severe Acute Respiratory Syndrome (known as SARS) took action to terminate the tenancy agreement on the basis that the tenancy agreement was frustrated by the making of the isolation order. The court rejected the tenant's argument on the basis that the period of about 10 days of which the tenant was not allowed to stay in the premises by virtue of the isolation order was insignificant in terms of the overall use of the premises;
4. the existence of a supervening event outside the power and control of the parties which renders the use of the property during the leased period unlawful or impossible – the supervening event must have the effect that, without default of either party, a contractual obligation becomes incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract (*Ooh! Media Roadside Pty Ltd v Diamond Wheels Pty Ltd* (2011) 32 VR 255 at [70] per Nettle JA).

The destruction of premises by fire, flood, or demolition as a dangerous structure, has been held not to constitute frustration of particular leases. Similarly, the closure of a street for 1½ years which rendered the leased premises inaccessible by vehicles had not been held to constitute frustration (*National Carriers Ltd* v *Panalpina (Northern) Ltd* (1981) AC 675; (1981) ANZ ConvR 73).

It is unlikely that in the context of COVID-19 a tenant could successfully argue that its lease has been frustrated if the change is temporary or transient (which seems likely to be the case at the moment).

A viable option for tenants would be for them to approach their landlord to negotiate rental abatements or a surrender of their lease (presumably at a premium) to address any significant diminution in their business and ability to trade. Landlords are at liberty to decline any attempt by a tenant to re-negotiate the terms of the existing lease.

Withholding of Rent

Most leases do not permit the tenant to withhold payment regardless of the circumstances.

The payment of rent is an essential covenant and material term of any commercial lease. The non-payment of rent is not an option for a tenant as it is common for commercial leases to expressly provide the landlord with the right to terminate the lease and re-enter the premises where any payments payable on account of rent under the lease are greater than fourteen days late (whether or not formal or legal demand has been made for such payment).

A tenant may apply to a court for relief against forfeiture of a lease where the landlord terminates and re-enters for breach of the covenant to pay rent. This involves an application for an injunction supported by an affidavit seeking an order that the landlord allow the tenant to move back into the premises. It is usually necessary to prove that the landlord failed to give reasonable notice of the breach (except for arrears of rent), that there was no breach, that the breach is trivial or that the breach will be rectified promptly. Relief will generally not be given because the tenant will suffer undue hardship by virtue of the forfeiture of a lease. Generally, where rent payments are up to date at the time of proceedings for relief, then unless there are other very special circumstances, a tenant will be relieved. In essence, the court must be satisfied in relieving against forfeiture that there is a reasonable expectation that the tenant will honour the lease obligations in the future. Although a rental breach or default may be established, the court must take into account other breaches of lease to determine whether the conduct of the tenant is sufficiently reprehensible to deny relief.

Trading Covenant

It is not uncommon for retail leases to include a covenant requiring the tenant to keep their premises open for trading. These provisions have the potential to cause disputes between landlords and tenant particularly if a tenant is required to close to comply with a health and safety direction issued by any competent government authority or emergency legislation.

For public policy reasons and in the context of COVID-19, we suspect that a court would view the compliance-with-statute covenant (refer to comments above) as taking priority over the keep open for trading covenant – the dichotomy of these covenants will likely be a cause for a dispute. This would also give rise to a dispute as to whether the tenant will be required to pay rent in circumstances where a tenant is required to close their premises to comply with a compliance-with-statute covenant as rent abatement provisions in commercial leases are usually limited in their application to circumstances where the premises are damaged or destroyed. It is likely that landlords will be able to continue to enforce the rental provisions in such circumstances– however, it remains to be seen how courts will treat an action by a tenant to dispute the payment of rent in such circumstances.

It would be prudent for any tenant to check whether it has business interruption insurance cover and whether it covers pandemics such as COVID-19.

Landlord Considerations

Although landlords do not presently have any explicit obligations at law to take appropriate measures to prevent or contain COVID-19 in their premises, or to provide extra cleaning services to prevent COVID-19 spreading in their premises, we are noticing that many landlords are taking pragmatic steps. In particular, in the management of common areas, landlords are providing more frequent and thorough cleaning of common areas and are also making hand sanitizers available for the use by occupants of the building. Supplying these extra cleaning services will have cost implications and landlords should review the outgoings provisions in their leases to ensure such charges are recoverable.

The position as to the recovery of outgoings is not uniform for commercial premises. For leases relating to an entire building subject to a long term commitment, it would not be unusual for the tenant to assume full repair and maintenance obligations for the building (with a structural carve out) and responsibility for all rates, taxes and operating expenses.

In portion of land leases used for commercial office accommodation, it is not uncommon to see the tenant's financial responsibility being limited to the payment of rent (with outgoings captured in the gross rent). In some leases, the tenant's liability is confined to rates and taxes and in some cases may include the lessor's insurance premiums. In shopping centres the tenants are frequently liable to reimburse the entire operating expenses of the lessor (other than land tax, where the *Retail and Commercial Leases Act 1995 (SA)* applies).

In any circumstance, the recoverability of a landlord's costs will be subject to any tenant negotiated outgoings cap or specific exclusions. Most leases require outgoings to have been reasonably and properly incurred in order to be recoverable against a tenant – further arguments could arise on the interpretation of what constitute reasonable costs.

Landlords and managing agents may also owe a duty of care to notify tenants of the occurrence of a COVID-19 infection occurring within their building and to notify of any reported cases of persons carrying the virus who may have been in occupation of their building.

It is not uncommon for commercial leases to require tenants to immediately give written notice to the landlord and to the proper public authorities if any infectious illness transpires on or about the premises and to thoroughly fumigate and disinfect the premises at the tenant's own expense and to the satisfaction of such public authority. Landlords should be scrupulous as to how they respond to such notifications (being careful not to assume more responsibility than the law requires of them).

Landlords should also review any provisions in their lease permitting an abatement to rent with such clauses traditionally

limiting an abatement in circumstances where the premises are damaged or destroyed. However, particularly with more sophisticated tenants, these provisions may have been negotiated to permit a rent abatement or termination of the lease in circumstances where the premises are not able to be occupied due to an unavoidable or unforeseeable event.

Concluding Remarks

The events to date are unprecedented. Those involved in the real estate sector must be prepared for further disruption and should start with identifying the scope of their obligations under the lease agreements and the risks (and opportunities) which may be presented if contractual obligations are severely impacted. Landlords should review and consider the security arrangements under their leases and implement an action plan if obligations which are secured cannot be performed. If a tenant attempts to re-negotiate a lease, landlords should maintain records of critical communications and correspondence to justify actions if disputes later arise. It is important for landlords to ensure that they do not communicate, or make promises to reduce rent, in a manner which may give effect to an estoppel against the landlord or prevent the landlord from requiring rent to be paid in the manner prescribed in the lease and other obligations to be complied with by their tenant.

Piper Alderman is assisting clients on the spectrum of legal issue arising from the pandemic. Please see our COVID-19 webpage for more information on areas including ***employment***, ***industrial relations***, ***construction law***, ***government & defence, insolvency*** *and* ***property***.