Excusing Contractual Performance in Real Estate Agreements in the Age of COVID

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Since the outbreak of the COVID-19 pandemic, local municipalities and state governments throughout the country have implemented stay-at-home orders and mandated closures of businesses and restaurants to lower the spread of the disease. California, after having permitted much of the state to reopen businesses, has seen a recent spike in COVID-19 cases and on July 13th implemented a new statewide order to curb the increase, reimposing certain business closures.[1] As a result of these mandated closures, many businesses have elected to cease operations either temporarily or permanently, resulting in a dramatic change in the normally stable relationship between landlords and tenants.

Recently, the United States Bankruptcy Court for the Northern District of Illinois in *In Re Hitz Restaurant Group* held that the State of Illinois' mandated shutdown of restaurants with respect to on-premises dining constituted a "force majeure" event under its lease agreement and that the force majeure event was not subject to the exclusion of the obligation to pay rent. This article will discuss force majeure in further detail below. By agreeing with Hitz Restaurant Group that the mandated closure amounted to a "government action" as contemplated in its force majeure clause, the result of the court's ruling was that Hitz was not obligated to pay its rent in full, but merely a small proportion thereof based on Hitz's ability to conduct take-out and delivery orders.

In addition to the *Hitz* decision, recent cases filed by L Brands against two of its landlords in New York will likely have far greater consequences for tenants and landlords nationally. In its actions, L Brands filed to annul leases for its flagship Victoria's Secret and Bath & Body Works stores in Midtown Manhattan, asserting numerous claims including frustration of purpose and other common law doctrines. These cases are now pending in New York state court.

As the L Brands cases highlight, force majeure is not the only doctrine parties may consider to avoid enforcement of a real estate agreement—L Brands' claims of frustration of purpose, as well as commercial impossibility and impracticability, are likely defenses that will be utilized as more cases are filed attempting to enforce contract obligations. This article will examine each of these legal doctrines in the context of California law to provide general guidance on when they are applicable and what outcomes may generally be expected if such defenses are used. Please note, however, this discussion is meant to be taken in a broad manner and

to the extent you may be involved in a matter involving these potential claims, we urge you to reach out to counsel to discuss the unique facts of your particular case.

Force Majeure

Most real estate contracts, including leases and purchase and sale agreements, contain "force majeure" or "act of God" clauses. Force majeure clauses have traditionally been seen as boilerplate language added to the end of contracts with the intention that they are rarely (if ever) utilized. These clauses are used to assign risk between the contracting parties and excuse performance of certain obligations if a specified event—such as a riot, war, natural disaster, labor strike or government action—occurs. In general, California courts have been inclined in the past to excuse performance following a force majeure event if the event itself prevents the obligating party from performing.

When analyzing the effects of a force majeure clause, the most important factor to consider is what events are included—and conversely, excluded—from the list. While certain states provide that an occurrence cannot be deemed a force majeure event unless specified in the force majeure list, California courts have historically interpreted force majeure clauses more broadly to also include events that were "unforeseeable at the time of contracting."[2] Still, the first place a California court will look to is the language of the contract itself to determine if the purported occurrence qualifies.

COVID-19 presents a unique situation for courts in California as many force majeure clauses omit language related to pandemics and epidemics. On first blush, such an omission may prevent a party attempting to use a force majeure defense since the plain reading of the clause excludes such an event from being deemed a force majeure. California's history of applying equitable principles, however, may supersede the omission as the test for a court is "whether…there was such an *insuperable interference…as could not have been prevented by the exercise of due diligence*."[3] Notwithstanding the application of this equitable principle, the California Supreme Court has made clear that a party invoking a force majeure defense must show that there exists not only "*extreme and unreasonable difficulty, expense, injury, or loss involved*,"[4] but also that the party has demonstrated it made reasonable efforts to avoid the impact of the claimed force majeure event.

Most well drafted force majeure provisions contain language explicitly exempting payment of rent from any other obligations that may be excused upon the occurrence of such an event. Tenants may argue that a rent exemption in a force majeure clause should not be enforceable as the entire purpose of a commercial lease is to allow a tenant to rent space so their business can make money (the bankruptcy court in *Hitz* appears to have accepted that argument); but it is likely that California courts will reject this argument since they tend to give strong deference to negotiated terms within a contract. As such, it is important to look at the specific language addressing the obligation to pay rent.

It should be noted that no reported case in California has specifically dealt with a virus or pandemic in relation to a force majeure clause. While precedent is helpful in understanding how courts might rule on such a claim, we do not want to issue a sweeping declaration stating how a California court will actually balance all of the foregoing factors. Regardless, parties to real estate contracts should be reviewing their force majeure clauses to determine if a litigation fight is worth the expense, or if it is better for the parties to come to a mutual understanding separately to avoid the issue. Additionally, parties are advised to consider expanding their force majeure clauses in future contracts to be over-inclusive in order to account for all of the effects that have resulted from the COVID-19 pandemic.

Frustration of Purpose

The doctrine of frustration of purpose is an equitable remedy offered where an event has transpired that has rendered the principal objective of the contract so stymied that performance should be excused.[5] California courts have interpreted frustration of purpose to require a showing that (1) performance remains possible, (2) conditions have changed so dramatically that the bargained for performance is worthless or nearly worthless, and (3) that the changed conditions were not reasonably foreseeable or caused by the party seeking to excuse performance under the contract.[6]

While it is likely to be conceded that COVID-19 is an event that was not foreseeable by the contracting parties, courts applying the frustration of purpose doctrine will look at the severity of the restrictive nature of an applicable stay-at-home order and also analyze whether or not a business can even open partially during such time. Even if the value of a contract has been significantly diminished, or a loss is guaranteed to be sustained, courts have held that a contract's purpose is not necessarily frustrated since the crucial question is not loss of monetary value, but a negation of what the parties intended to each receive under the contract.[7]

Traditionally, courts in California have narrowly applied the frustration of purpose doctrine except in the most extreme of circumstances, as there is an equitable basis for the courts not to disrupt a bargained-for exchange. While it would not be an expected result given the history of the courts, the government-mandated business shutdowns resulting from COVID-19, however, do provide tenants with at least a potential argument that if their businesses are unable to open their doors, the purpose of their contracts have been frustrated. Even if courts are not willing to accept that a contract's purpose has been completely frustrated, it is possible a court may reason such contract's purpose was temporarily frustrated and therefore tenants may be entitled to limited relief for the applicable shutdown period.[8]

Impossibility and Impracticability

The excuses of contractual impossibility and impracticability are additional equitable doctrines closely related to frustration of purpose. Unlike frustration of purpose, however, impossibility and impracticability do not concern the underlying purpose of a contract, but instead the actual ability of the parties to perform their obligations.[9] Specifically, a contractual obligation is excused by virtue of impossibility and impracticability "when it is prevented or delayed by *an irresistible, superhuman cause*, *or by the act of public enemies* of this state or of the United States, unless the parties have expressly agreed to the contrary."[10]

Impossibility and impracticability are considered sister doctrines as the only difference between them is the severity of the intervening event. As the courts have explained, "impossibility as excuse for nonperformance of a contract is not only strict impossibility but includes impracticability because of extreme and unreasonable difficulty, expense, injury, or loss involved."[11] Even if the burden to show impracticability of performance is lower than that of full impossibility, however, the bar is still high enough that the difference in cost to perform one's obligations must be so great that performance is manifestly unreasonable.[12]

It is in these equitable doctrines that a tenant may find its best hope at avoiding performance of its obligations, including payment of rent. If a tenant's performance under its lease would directly contravene a government mandate to shelter-in-place and close business operations, there is a likelihood that a court would excuse the tenant's performance because it would be a violation of law to act otherwise.

Notwithstanding the likelihood of such a decision, courts will likely need to look at two additional factors to determine how much relief to grant to a party raising these defenses: (1) the amount of term left on the contract and (2) the length of the mandated closure. If there is a significant amount of term left on a lease or other real estate agreement, courts will be less inclined to grant a complete termination of obligations thereunder, while similarly if the mandated business closure was only for a brief period, it would not be equitable to grant relief in excess of such period of closure. These considerations also fall in line with the primary treatise on contracts which states that temporary or limited relief is more appropriate when the intervening event is limited in its duration.[13]

Conclusion

The COVID-19 pandemic has caused a significant shift in how real estate contracts are being viewed and interpreted due to the sudden and severe nature of the outbreak. The ultimate applicability of a contract's force majeure provisions, as well as the equitable doctrines of impossibility, impracticability, and frustration of purpose, will be dependent on the individual facts of a given case.[14] What can be expected, however, is that these defenses are likely to be raised by tenants in the upcoming months and it is important for all parties to understand their options when a claim is asserted. We note that landlords are likely to vigorously defend

against any such claims using these arguments, and that not only will court proceedings and related pleadings add expense for tenants, litigation will also likely place a security deposit and any lease guaranty at risk.

Buchalter is committed to helping our clients assess their rights with respect to COVID-19 and stands ready to assist in navigating these uncharted waters.

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[1] July 13 California Department of Public Health Statewide Public Health Officer Order, found here.
[2] See *Autry v. Republic Productions* 30 Cal.2d 144 (1947).
[3] See *Pac. Vegetable Oil Corp. v. C.S.T., Ltd.*, 29 Cal.2d 238 (1946).
[4] See *Metzler v. Thye* (1912) 163 Cal. 95, 98.
[5] See *Restatement (Second) of Contracts* §265.
[6] See *Cutter Laboratories, Inc. v. Twining*, 221 Cal. App. 2d 302, 314–15 (1963).
[7] See *FPI Dev., Inc. v. Nakashima*, 231 Cal. App. 3d 367, 399 (1991).
[8] See *Lohman v. Ephraim*, No. B207755, 2010 WL 6901 (Cal. Ct. App.) (2009) ("When the obstacle to performance is only temporary, the duty to perform is not discharged but merely suspended until cessation of the impracticability.").
[9] See *El Rio Oils, Canada, Limited v. Pacific Coast Asphalt Co.* 95 Cal. App. 2d 186 (1949) (the inability to perform "must consist in the nature of the thing to be done and not in the inability of the obligor to do it.").
[10] See *Cal. Civ. Code §1511(2).*
[11] *Autry*, 30 Cal.2d at 144.
[12] See *Mineral Park Land Co. v. Howard* 172 Cal. 289, 293 (1916).
[13] See *Restatement (Second) of Contracts* §269.
[14] Other legal doctrines, such as breach of quiet enjoyment and casualty and breaches of a representation of landlord to operate the project should be considered, although they seem to have lesser validity, absent unique facts or language in the lease.