

COVID-19: Real Estate market implications. Particular insights into Lease Agreements



Introductory aspects

Since its outbreak in November, 2019 in China, COVID-19 has rapidly spread across Europe, the general opinion being that the peak is yet to come. The aggressive rate of spreading of COVID-19 has marked the financial markets, which now indicate a decrease of the earnings expectations.

As the evolution status is changing from day to day, more restrictions are expected to be implemented on travel and movement of goods, with significant impact in sectors which rely on supply chains and tourism.

Moreover, due to all the uncertainty that gravitates around COVID-19 and the customers' fear to be infected, the consumers' demand and the domestic retail is expected to register a decrease.

The travel restrictions, the fear to exposure, the impact on China economy (the largest partner for EU imported goods), the European countries' decisions to close borders, to limit multiple activities, to impose general quarantine or to declare state of emergency, most probably will affect the European GDP growth.

With consequences generated in all life aspects, the real estate market was not spared by COVID-19.

2. How does COVID-19 affect each sector of the real estate market?

The restrictions triggered by COVID-19 evolution may be identified in the main sectors of the real estate market:

A. Investment & transactions sector

In many European countries, including Romania, the public authorities have already decided to declare the state of emergency.

Establishing the state of emergency at national level involves measures such as: reorganizing the activity of public administration authorities to avoid as much as possible the direct contact between people, gradual prohibition of traveling, closing of public institutions/spaces.

Limitation of the activities carried out in public spaces or in spaces that normally involve a large number of people indirectly affects the financial resources in many industries.

The travel restrictions, the gatherings prohibitions, the financial instability, the isolation or the quarantine of the people, the constant fear to the exposure, all of these are causes which generate difficulties and delays in obtaining technical and urbanistic documents, performing various operations, fulfilling conditions precedent (e.g., obtaining a building permits, cadastre operation) to develop and sell a real estate project.

The cancelation of the face to face meetings, as well as the limitations of the public notary activities and site visits also contributes to delays in executing transactions and impossibility to meet the contractual terms and conditions.

Moreover, due to the state's restrictions on people gatherings (depending on the evolution stage of COVID-19, the restriction may refer to gathering over 100 people, 50 people or 10 people), the works on sites may be suspended, triggering delays in delivery and directly affecting the agreements concluded with the materials or services suppliers.

In the above mentioned situations, the parties may usually rely in their contractual relationship on the application of the general protective legal provisions (e.g., force majeure, hardship clause), as detailed below at point 3.

In case the parties agreed by the transaction contract to exclude the application of some of the protective regime indicated above, an in depth analysis of the contract is recommended, to assess other contractual clauses which may protect a party from the other party's impossibility to fulfil its obligations.

Therefore, in case of:

- seller's delay to fulfil conditions precedent, to obtain technical and urbanism documents or to perform some other operations, as well as

- developer's/contractor's delay to develop a project, due to impossibility to perform works or to keep its personnel on site and/or due to supply problems with construction materials or equipment,

some contractual clauses (such as the material adverse change clause) may be activated.

B. Leasing sector

Retail

What problems trigger COVID-19 to the parties?

When it comes to the Tenants of the commercial centres, they are expected to confront with problems such as:

- Lack of personnel due to quarantine/self-isolation measures and the obligation to pay indemnities to these employees (in case of quarantine, the employer has the obligation to pay an indemnity of 75% of the average gross monthly income for the last 6 months);

- Lack of clients due to the people's fear to exposure and the state's strong recommendations to avoid the crowded spaces;

- Legal obligations to implement special safety measures implying additional costs (e.g., premises disinfection) or taking protective measures (e.g., change of working schedule, scaling program starting/end hours to avoid traffic congestion);

- Insufficient supply to the store due to travel restrictions and/or supply problems.

All the above may trigger difficulties to tenant's financial status, while it has to continue performing its contractual obligations, paying the rent (and other financial obligations) and keeping the premises open to the public, as provided under the lease agreement.

The lease agreements may also provide for some obligations to the Landlord, which may trigger difficulties (e.g.,

to provide the useful and quiet use of the premises, to provide minimum level of visitors to the commercial centre, to provide continuous services and utilities).

In the context of the state emergency generated by COVID-19 extension, the landlord has the obligation to implement various safety and protection measures (e.g., disinfection of the entire area), which put him in the impossibility to keep the commercial centre open according to the initial schedule, agreed by the parties.

May the parties adapt or suspend the lease agreement?

Considering the parties' difficulties to properly fulfil their obligations, they may apply or request the other party for the application of some legal provisions (save for the case their application was limited by the agreement), such as:

Either party may invoke the force majeure or the hardship clause, subject to the conditions detailed at point 3. below, obtaining the adaption or the suspension of the agreement during the restrictions and while the state's recommendations are applicable (or a period agreed by the parties) or

The tenant may invoke the impossibility of using the good, as detailed at point 3. below, requesting the suspension of its own obligations until the landlord shall be able to ensure again the useful premises and good custom. Depending on the impossibility extent, the parties may agree a reduction of the rent and its other financial obligations instead of suspension of the entire agreement and closure of the premises or

The tenant may invoke the exception of non-performance, as detailed at point 3. below, having the possibility not to perform its obligation (or to perform it partially, by paying a reduced rent) until the landlord shall be able again to perform its own obligations.

The landlord and the tenant have the responsibility to adopt the necessary measures to ensure the protection and safety of the people under their coordination, as well as of their clients or customers. Therefore, in case the Romanian authorities shall take the measure of suspending/limiting the commercial activities and to close the commercial centres and other similar units, the suspension of the lease agreements becomes inevitable.

Each of the above remedies has to be analysed on a case-by-case basis, depending on the activity carried out by the tenant, the type of the premises, the problems of the tenant, the shopping centre location and how their activity is affected.

The urgent measures imposed by the authorities have mainly referred to closing/limiting the activity of restaurants, hotels, coffee shops, clubs, casinos and other public places, maintaining instead the activities of food stores and pharmacies.

Office

The impact on the office market is limited so far.

Unlike the commercial centres, which usually become of public interest and subject matter of the state regulations and restrictions due to their capacity of being attractions for public gatherings, the office premises are less impacted due to their natural limitation of use.

The office activity is under direct coordination of the tenant and the useful and peaceful use of the premises is not dependent of the landlord capacity to ensure a certain level of customers. Moreover, many of the activities performed in offices may be carried out remotely or may be adapted so to ensure their continuity.

However, both the landlord and the tenant have the responsibility to implement sanitary regulations to ensure the prevention and the reduction of the risk of illness.

May the parties adapt or suspend the lease agreement?

Adapting the agreement or the suspension of its execution may occur in cases such as:

- the risk of illness is too high and the tenant has no other possibility to perform its activity (e.g., the tenant's activity cannot be performed remotely);
- the tenant's employers were affected by COVID-19 and the premises are closed by the public authorities;
- the public authorities decide to limit the people's movement, and, in the absence of any other possibility to perform the activity, the tenant shall not be able to carry out its activity anymore.

The legal remedies detailed at point 3. below have to be analyzed according to each scenario and specific activity.

Industrial & Logistics

The industrial and logistic activity may face important challenges due to transportation restrictions and supply problems. Therefore, the tenant's activity may be directly and objectively affected by the consequences of COVID-19.

Depending on the exact damage that the tenant is suffering and the agreement's provisions, the tenant may request the amendment/suspension of the agreement, based on contractual remedies, or on the legal remedies detailed at point 3. below.

C. Operating sector

The operating agreements are agreements that essentially depend on other activities that have a main character.

In most cases, the operating agreements shall face the same difficulties and delays as the other activities from the real estate market.

3. What legal/contractual remedies may be activated in the context of COVID-19 epidemic?

Provided there are no contractual clauses regulating the parties' relation in case of epidemic, the following provisions/clauses may become applicable, depending on the activity carried out by the parties and the particularities of each case:

FORCE MAJEURE – is provided by art. 1351 par. 2 of the Civil Code as an external event, unpredictable, absolutely invincible and inevitable.

The force majeure implies an objective impossibility of predicting an event when executing an agreement. Also, the force majeure has to be an event absolutely invincible and inevitable, outside of the parties' control and without any possibilities of the parties to avoid the consequences, by implementing alternative solutions already agreed in the contract.

Invoking the force majeure allows the party unable to perform its obligations to be permanently or temporarily exonerated of its liability.

The contract performance impossibility may lead to:

- the contract's termination;

the contract's suspension until the force majeure event ceases or the adjustment of parties obligations (e.g., proportional reduction of rent), during their impossibility to perform their activity.

Is COVID-19 a case of force majeure?

COVID-19, by its rapid spreading capacity and its restrictions over the economic and social life, may represent a case of force majeure, but the analysis shall depend on each economic activity and the facing consequences.

For example, in case of a lease agreement having as subject matter premises within a commercial centre, the tenant may invoke the force majeure for the rent suspension in case of legal interdictions regarding the activities in commercial centres and the implicit significant lack of clients.

However, in the same context, the tenant of an office premises may not have the same results, as long as his activity might not be directly affected by the legal restrictions and it has alternative solutions to carry out his activity (e.g., remote work, alternative work schedule).

As a general note, the mere existence of a more onerous situation does not trigger automatically the application of the force majeure.

The Romanian Chamber of Commerce and Industry has announced that the county chambers shall endorse, based on a prior analysis of the agreements, the force majeure cases, without having the ability to declare a certain situation as national case of force majeure.

HARDSHIP CLAUSE – is provided by art. 1271 Civil Code and defines the situation according to which, as result of exceptional changes of the circumstances existing when the agreement was executed, the execution of one party's obligation becomes excessively onerous.

The party benefiting of the hardship clause has the possibility to renegotiate the agreement, obtaining cost reduction, suspension of the contract performance or other facilities. In case the renegotiation does not have the proper results, the party with the excessive obligations may claim the agreement's adjustment in court.

The hardship clause may be a good alternative for the situations when the force majeure conditions are not fulfilled, but a basic condition for its application is that the parties to not have renounced to its application by the agreement.

IMPOSSIBILITY OF USING THE PREMISES – is provided by art. 1818 of the Civil Code and regulates the situation of a partial or total impossibility to use the premises subject matter of the lease agreement.

The impossibility to use the premises should be, in all cases, fortuitous, independent of the parties' will/actions.

In case of a partial impossibility, the tenant may choose between agreement's termination and rent reduction, while the definitive impossibility triggers the agreement's termination.

May the impossibility of using the good be invoked in case of COVID-19?

Most probably this legal provision may have the greatest applicability in the retail sector, when the landlord cannot ensure anymore the availability and functionality of the premises due to the implemented protection measures, legal restrictions and impossibility to ensure the commercial centre activity.

However, the legal provision might not be excluded for other real estate sectors either, in case the quarantine is enforced or more travel and movement restrictions are implemented by the public authorities.

EXCEPTION OF NON-PERFORMANCE – is provided by art. 1556 Civil Code and implies the existence of an agreement with interdependent obligations for both parties (e.g., the landlord has to ensure the quiet and useful premises, while the tenant has to pay the rent).

In case the party which has to execute its obligations first does not execute them (irrespective of the reason), the other party may claim the exception of non-performance to not execute its own obligations to the same extent.

How to apply the exception of non-performance in the lease agreements?

One of the essential obligations of the lease agreements is the landlord's obligation to ensure useful and quite premises. This is the basic and first reason for the payment of the rent.

Therefore, in case the landlord can no longer ensure (entirely or partially) the useful and quite use of the premises, the tenant may invoke this exception, refusing to pay the rent.

The parties may negotiate a rent reduction or, in the case, a rent suspension or other adjustment of the agreement, to accommodate the new situation.

In case the negotiation will not lead to favourable results and the landlord pursues the tenant for paying the rent, the tenant may also invoke the exception of non-performance in court.

OTHER CONTRACTUAL CLAUSES

Depending on the parties' negotiations, the agreements may include other clauses which may become applicable in the context of COVID-19.

One of such clauses is the Material Adverse Change clause (the MAC clause) which may provide protection to a party from negative aspects which may influence the contract or performance of obligations.

The negative situations which may be covered by such clause are: negative due diligence, drastic monetary fluctuations, unforeseen changes of the financial situation (including the emergency state created by COVID-19 and its direct and indirect consequences on the market).

4. When the legal/contractual remedies can be invoked?

Although in most European countries COVID-19 is present for several weeks or even months, the consequences for the real estate sector may not appear simultaneously with the virus outbreak.

Therefore, a special attention should be paid when invoking the legal or contractual remedies described above, to correctly identify the start and extent of the negative consequences.

In many cases, the start of the consequences shall relate to the public authorities' restrictions or objective limitations of business/activity, while, in other cases, some of the legal remedies may not be applicable yet (until the public authorities shall adopt more restrictive measures).

In all cases, a special analysis of the parties' agreements is recommended prior to claiming any of the possible remedies against the other parties, in order to avoid any abuse of right or disproportionate actions, which may lead to damages or penalties to be imposed by such other parties.