

The shape of things to come? California considers tenant right to terminate leases

Landlords and tenants suffering the effect of Covid-19, and thinking what if anything more our Government might propose as a solution, might now look, with concern or hope, over the pond to California. Legislation is working its way through the Californian Senate which if passed would allow certain types of business tenant to serve notice to terminate their tenancy, without liability for future rent, if a period of good faith renegotiation of its rental terms fails.

Everyone in the property industry in England and Wales will be familiar with the Coronavirus Act 2020 and the moratorium on forfeiture for rent arrears imposed by s82; members of our Chambers have written extensively about it here: <https://www.falcon-chambers.com/news/coronavirus-act-2020-safeguards-against-forfeiture-for-commercial-tenants-i>, and about the question of where the balance between landlord and tenant in this crisis should and does lie, for example here: <https://www.falcon-chambers.com/publications/articles/rent-during-covid-19-landlords-still-hold-the-strongest-hand> and here: <https://www.falcon-chambers.com/publications/articles/does-a-tenant-really-have-to-go-on-paying-rent-during-lockdown-perhaps-we-s>

On the other side of the Atlantic, states face similar issues, and many have introduced similar legislation to s82. One such state is California, which has introduced Californian Senate Bill 939 (SB939). This was introduced in March as a state-wide moratorium that would prohibit landlords from evicting certain types of businesses unable to pay rent during the coronavirus emergency. Like our own domestic legislation, the moratorium would not affect actual rental liability, or allow for tenant termination of leases.

The thinking of those in the Californian state legislature may now be changing, in reaction in particular to the plight of those in the hospitality industry who see the destruction of businesses, jobs and livelihoods. Earlier this month, an amendment of SB939 was advanced which, if passed, would allow tenants in the hospitality sector (think restaurants, cafes, pubs, entertainment venues), small businesses, and non-profits, provided they are not publicly traded companies, a chance to terminate their leases if negotiations with their landlords are unproductive.

Here is how the current draft of SB939 works. First, the tenant must show a drop in revenue of 40% or more, or capacities declining by at least 25%, because of social-distancing mandates. Secondly, such a tenant must show that it has entered into negotiations in good faith with its landlord to restructure its lease. Thirdly, if it has been unable to reach an appropriate agreement in 30 days, such a tenant may then terminate its lease, provided that it owes at the most three months past rent – and that rent must be paid within 12 months of a termination notice. This proposed legislation is designed to be in effect until the end of 2021 or two months after the end of the emergency, whichever is later. The current legislative draft is to be heard in the Senate Appropriations Committee in June.

So could that happen here – and with what effect?

The June quarter date is looming. It seems likely that the lockdown will still be in place by the time the next quarter's rent is due, at least to some extent. The businesses which would be covered in a Californian-type amendment are likely still to be suffering lockdown effects. For example, even if restaurants are allowed to open, the social distancing requirements they are likely to have to observe will still impact their revenues substantially. The Government will face calls to keep the current possession moratorium in place, and the example from across the pond will provide further food for thought.

Let's first consider the impact of this upon tenants in the hospitality sector. Some, perhaps most, in the hospitality industry will, we think, want to take any reasonable step to stay in business. They will have vested years of effort in building their customer base into a product of which they are proud, and will want to keep their leases. Thus negotiation for example of new rental arrangements such as turnover rents (see https://www.falcon-chambers.com/images/uploads/articles/Turnover_Rents_-_Janet_Bignell_QC_May_2020.pdf) could help revitalise the market. Other tenants, burdened by debt, and less successful, will not even be able to pay down the rent required to take advantage of the current draft legislation.

What about landlords? This kind of legislation would cause difficulties for landlords servicing debt. Landlords will on the face of it hate UK939, and would likely lobby against it, and consider legal challenges to it. Yet in the current climate, the choice is not necessarily between rent or no rent if tenants simply cannot pay rent. Moreover, even for landlords, it is not simply all about the rent. In the case of standard commercial leases, so long as premises are tenanted, the rates liability falls upon the tenant; the premises remain subject to a repairing and insurance liability, and all that is better than empty premises, especially where the chances of finding another tenant will remain slim.

So, if a version of SB939 finds its way into our legislative thinking, the results could be hard to predict. Much would, of course, depend on the details of any such scheme. If, for example, the right to terminate were conditional on negotiations having been unsuccessful, we could expect to see numerous disputes as to whether negotiations proceeded in good faith. However, the approach of such legislation could see a new equilibrium in the market, with both parties forced to adapt to our changed circumstances. That could be a lot better than the destruction we may find when lockdown ends.

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