

COVID-19 Impact on leases of business premises

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INTRODUCTION

The negative economic consequences of the COVID-19 coronavirus pandemic and the restrictions imposed have affected the daily business of many entrepreneurs. Closure of state borders, problems with the supply of raw materials, the mandatory closure of most shops and commercial premises for a temporary period, and the fact that many workers carry out business activities from home and not in the employer's premises are just some of the consequences of government measures that have significant repercussions on a daily basis on the business of the entrepreneur.

The business premises are a very important part of everyday business for almost all entrepreneurs, but they also represent one of the significant fixed costs. Namely, the business premises of many entrepreneurs are not owned by them, but are used by entrepreneurs on the basis of a lease agreement. Therefore, such a contractual relationship is, for the most part, a fixed monthly expense in the form of rent payments, which is one of the major expenditure items for many businesses. It is common for entrepreneurs to take into account their foreseeable needs and current market conditions when negotiating lease terms (rent amount, lease area, use of common areas, etc.).

Given the new situation and the consequences caused by the coronavirus pandemic, which affect the day-to-day (lack of) running of business activities on business premises, entrepreneurs could be in a difficult financial situation because of the lease agreements. Namely, most of the entrepreneurs, when negotiating the terms and contractual provisions related to the lease of business premises, probably did not think about the possible pandemic and its negative consequences.

Therefore, the question arises as to whether the occurrence and spread of the COVID-19 coronavirus is a justifiable reason for seeking an amendment or even termination of the lease of business premises or whether the entrepreneur is obliged to fully respect the basic principle of *pacta sunt servanda* contractual laws (contracts should be respected).

Here we provide a general outline of the legal options available to entrepreneurs regarding changes or terminations of existing business space leases.

Changed circumstances as an exception to the principle of the duty to fulfill contractual obligations

Invariable adherence to the principle of contract absoluteness and unconditional insistence on its fulfillment in certain situations can lead to unfair solutions, that is, to infringe other fundamental principles of contract law, in particular the principle of equal value of acts.

From the moment of conclusion of the contract until the moment of its consummation or during the consummation of contracts concluded for a long period of time, such extraordinary circumstances may occur which, even with the utmost care, could not be predicted, eliminated or avoided.

In certain cases, such exceptional circumstances make the position of one party to the contract excessively difficult or even cause the contract to lose any business ratio of existence.

In such a situation, absolute adherence to the principle of *pacta sunt servanda* can cause serious adverse consequences for one of the parties, solely because of circumstances beyond the fault of the affected party.

At that point, it is crucial to ask the following questions:

1. What has been agreed on by specific legal acts regarding the extraordinary (changed) circumstances and their effects on these legal acts?
 2. Are the legal requirements for applying the institute of modification or termination of the contract due to changed circumstances fulfilled?
 3. What are the legal options of the parties in the event of changed circumstances?
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Analysis of the authoritative provisions of a specific lease agreement

Business premise lease agreements may include a definition of extraordinary circumstances and the legal effects of those circumstances on a particular contract.

In the event that a pandemic is contractually defined as an exceptional circumstance and the spread of coronavirus disease COVID-19 is declared a pandemic and therefore falls in this category, further contractual provisions on the consequences of the occurrence of such an extraordinary circumstance should be checked.

Otherwise, the relevant legal provisions apply.

Advice:

Seek legal assistance from an internal legal team or outside legal counsel (lawyer) regarding contract analysis, alternatively, provisions on changed circumstances (*clausula rebus sic stantibus*).



Legal presumptions for applying the institute of modification or termination of the contract due to changed circumstances

If you have verified by review that a particular lease agreement for business premises does not contain any provisions on the effects of changed circumstances, then legal provisions will apply to the contract in question.

The Law on Obligations (Official Gazette 35/05, 41/08, 125/11, 78/15, 29/18; hereinafter: "ZO") recognizes the institute of changed circumstances as a possible reason for the modification or termination of a contract, and states:

"If, due to exceptional circumstances arisen after the conclusion of the contract, which could not have been foreseen at the time of the conclusion of the contract, the fulfillment of the obligation by one contracting party would become excessively difficult or cause it excessively large loss, then the party may require the contract to be modified or even terminated."

Thus, if the COVID-19 coronavirus disease pandemic has affected the regular business activities so that because of it the fulfillment of the obligations arising from the specific lease relationship becomes difficult, or causes excessive loss to the tenant, the tenant is not obliged to bear all the negative consequences of the situation and under certain circumstances is entitled to seek a modification to certain contractual provisions or even seek termination of the contract.

Please note that the lessor could, in principle, also invoke the changed circumstances. Namely, one of the common ways of calculating rent (especially with shopping centers) is to pay (all or more often, part) of the rent based on the revenue generated by the tenant at a particular location. Therefore, in such a lease relationship, when the tenant does not generate any income the landlord also does not earn the agreed rent, that is, the income of the tenant also significantly affects the amount of rent that belongs to the lessor.

The following assumptions must be fulfilled in order for a contracting party to invoke this institute:

- ▶ in question must be a **two-sided reciprocal** contract, which a contract on the lease of business premises certainly is
- ▶ a **change of circumstances** must occur - it is a reasonable assumption that the occurrence of the coronavirus pandemic is a natural and significant new event, and in this respect the state protective and restrictive measures taken represent a change in ordinary circumstances in the business world,
- ▶ with regard to the **period of occurrence of a change of circumstances**, it is essential that the change of circumstances occurred after the conclusion of the lease of business space,
- ▶ **extraordinaryness, unpredictability, ineluctability and inevitability** - objective unpredictability in the context of a business relationship that you are in or one that could not even have been foreseen by a conscientious contractual party - here particular emphasis is placed on the fact that the event occurred was unpredictable at the time of the conclusion of the contract.
- ▶ and, lastly, that the **consequences of the changed circumstances** are such that the fulfillment of the obligation becomes excessively difficult for one of the contracting parties or would cause it severe losses - this assumption depends on each specific legal act and position of the contracting parties, and needs to be analysed in detail in each individual case.

Does the coronavirus pandemic represent a changed circumstance?

In view of the coronavirus situation and the state measures taken to curb the spread of the infection, it is a reasonable assumption that these can be characterised as changed circumstances that may affect the lease of business premises

However, the question of the consequences of these changed circumstances arises, namely the question of proving that the fulfillment of the obligation by the tenant is excessively difficult or that it would cause him serious losses.

In this case it is important to consider fully the impact of the changed circumstances on the position of the individual depending on the case.

It is important to note that a contracting party that is affected by the changed circumstances, and which plans to consume subjective rights for the occurrence of those circumstances, is obliged to **inform** the other party of its intention as soon as it becomes aware that such circumstances have occurred. Failure to do so shall result in the counterparty being liable for damage suffered by the other party for failure to notify the claim in a timely manner.

Legal possibilities of the parties in the event of changed circumstances?

After the fulfillment of all the above circumstances has been established, the contracting party affected by the changed circumstances has two options available:

1. request that the premises lease agreement shall be modified, or
2. request termination of the business premises lease agreement.

Notwithstanding the aforementioned possibilities, it is worth mentioning that some local and regional self-government units have made decisions that, due to the situation caused by the coronavirus pandemic, they will in a certain period not charge or will delay the collection of utility and other public obligations as well as rents for business premises owned by them.

Advice:

Seek assistance of an internal legal team or outside legal counsel (lawyer) regarding the existence of such decisions made by local and regional self-government units.

Change of lease agreement due to changed circumstances

If one contracting party proposes to change the contract on the lease of the business premises due to changed circumstances (as a rule it is the tenant but it may also be the lessor), the other contracting party must agree to the contract changes for these changes to be valid. Namely, the modified contract is actually a new legal transaction, that is, an amendment to an existing one that both parties must agree to. Without the consent of both contracting parties, modification of the contract is neither possible nor would it be binding on a contracting party which does not accept such modification. As a rule, this option should have priority over termination.

If the contracting parties do not agree on the modification of the contract, the contracting party requesting the modification may ask the competent court to modify the contract through its decision.

In doing so, the court is not bound by strict formal rules, but is obliged to take into account the general principles of compulsory law, such as the principle of conscientiousness and honesty. In particular, the court should take into account the purpose of the contract itself, the division of risks, the duration and impact of extraordinary circumstances, and the interest of both parties.

Therefore, the lease agreement can be modified in all contractual provisions with the goal that the contractual fulfillment will not be unduly difficult for either contractor or to avoid their excessive loss by fulfilling the contract.

In this sense, the provisions on the subject of the lease (e.g. reduction of the leased area), the amount of the rent (reduction or increase of the rent), the manner and deadlines for payment of the rent (deferral or installment repayment), etc. may be altered.

Specific changes must be accepted by both parties or determined by a final court decision.

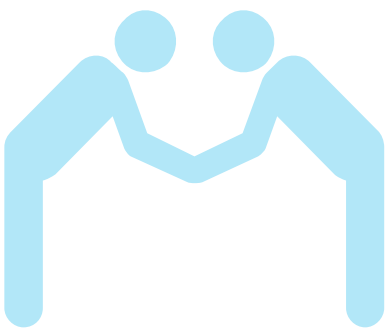


The usefulness of contracting parties to negotiate new lease terms

Negotiations are based on communication with one another to achieve certain goals. It is quite clear that the new market conditions caused by the COVID-19 coronavirus pandemic have caused the interests of the contracting parties to change and that the need for negotiation will be particularly pronounced in the coming period.

It is reasonable to assume that by reducing demand, the turnover of the tenant will also fall, but with this also the potential value of the lessor's premises.

Therefore, there is a need to open up creative mechanisms that would at least try to sufficiently specify the current uncertainty in the lease relationship, for example by an immediate reduction in rent, but also by a (possible) increase if the same level of income is restored, allowing better control of the *cash-flow*.



Advice:

Seek the legal assistance of an internal legal team or external legal counsel (lawyer) in negotiating possible and permissible models of changing contract terms.

Termination of the lease due to changed circumstances

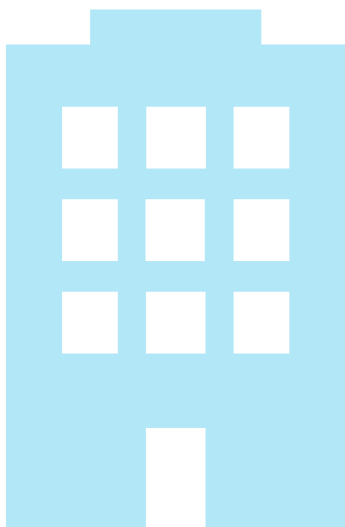
Alternatively, in the event that it is impossible to reach an agreement by both parties about a modification of the contract, it is possible to request a termination of the lease agreement.

The contract can be terminated either by agreement or by virtue of a constitutive court decision.

However, the contract will not be terminated if the other contracting party offers or agrees to modify the relevant provisions of the contract fairly. In that case, the contracting party which did not initiate termination may maintain the contract in force, and the other contracting party may not object.

In addition, it should be borne in mind that in the event of termination of the contract, the contracting party requesting the termination must compensate the other party for a fair share of the damage suffered by the latter.

Therefore, we certainly recommend that you make a quality analysis of the cost-effectiveness of such a proposal before deciding whether to modify or terminate a specific business premise lease agreement.



Conclusion

We believe that the current situation due to the pandemic caused by the COVID-19 coronavirus disease and the introduction of restrictive measures by the competent state authorities that are implemented to prevent the further spread of the infection, can in principle be characterised as exceptional (changed) circumstances which in principle may require the modification or termination of the contract on leasing business premises.

However, on a case-by-case basis, there is a possibility that the *rebus sic stantibus* clause is not always applicable to the lease relationship because the period during which the tenant is unable to use the space is only temporary and there is a potential for harm reduction (e.g. orientation to web sales channels etc.). However, we would not a *priori* rule out the application of this institute, despite the fact that the success of such litigation is not fully known (especially as it is not yet known what the ultimate consequences of the COVID-19 coronavirus disease will be in terms of longer work stoppage and the effects on the side of demand).

In any case, a detailed analysis of all the circumstances affecting the application of the *rebus sic stantibus* rule must be made before any concrete decisions regarding the lease of the business premises are taken.

Also, a contracting party affected by the current situation and suffering certain negative consequences should, when proposing a modification to the lease agreement, provide the other party with valid evidence proving that the fulfillment of that contract has become excessively difficult for the party or that it will cause it an excessively large loss.

If, after presentation of all the evidence, the other contracting party is not willing to accept the arguments and agree to the modification of the lease agreement, the contracting party which proposed the modification may initiate appropriate proceedings before the competent court.

The termination of the contract must be a last resort and before initiating court proceedings to determine the termination of the lease contract, the contracting party which suffers losses must analyse in detail all the possible consequences of the termination of the contract and the fact that in the event of a dispute it must be able to prove that the termination of the contract was the only option. However, even if the court determines that the conditions for termination of the contract are fulfilled, there is a possibility of determining a fair compensation to the other party.

Therefore, it is desirable to seek to achieve the purpose of the said institute with this sequence, and all with the aim that the contracting party affected by the extraordinary circumstances should try to adapt its contractual position in the lease relationship to the new situation caused by the spread of the COVID-19 coronavirus disease.

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