

Commercial Lease Workouts During the COVID-19 Pandemic

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Real Estate, Finance and Financial Restructuring Alert
4.6.20

The COVID-19 pandemic is adversely affecting commercial real estate (CRE) as it continues to wreak havoc in industries throughout the economy. For many years, the primary declining CRE sector has been brick and mortar retail stores. However, the retail sector is no longer suffering alone, as the COVID-19 outbreak is hurting most other CRE sectors: office, hospitality, multi-family, restaurant, personal services, entertainment and construction.

Federal, state and local governments have ordered business shutdowns and social and travel restrictions limiting most social and commercial activities. As a result, commercial tenants throughout the country are going out of business, temporarily closing, curtailing operations, laying-off employees and suffering sharply declining revenues. Even so-called "essential" or "life-sustaining" companies that are largely exempt from governmental restrictions are experiencing declines in business.

Our commercial leasing and financial restructuring teams have been advising clients on these developing issues since the outbreak of COVID-19. This alert is intended to provide general guidance to help commercial landlords and tenants evaluate their options and workout solutions. With certain important exceptions, leasing parties should exercise patience, restraint and consider practical short-term workouts only.

Leasing Defaults and Issues Due to COVID-19 Pandemic

Commercial landlords and tenants are facing a number of critical, immediate issues in the short-term and possibly foreseeable future. How should parties address a tenant's business closure or workforce reduction and revenue losses affecting its ability to operate, pay rent and repair its leased space? How should a landlord respond to a tenant's default or request for rent or other relief, taking into account the landlord's own responsibilities to pay maintenance costs, real estate taxes and debt service on the property? These questions must be resolved whether the lease is a triple net lease, gross lease or hybrid one, and whether the CRE is a stand-alone single-tenant property, multi-tenant office building, shopping center or multi-use facility.

For many commercial tenants who have gone out of business permanently, discussions will focus on typical end of lease topics: turnover of the space to the landlord; damage to and, if applicable, restoration of, the leased premises by the tenant; and potential settlement of unpaid present and future rent obligations. Most of these tenants will wind down and liquidate their businesses outside of bankruptcy.

Many of them will seek bankruptcy protection, though it will be a difficult market for Chapter 11 debtors to reorganize or for tenants or Chapter 7 trustees to find interested or creditworthy buyers to purchase store locations and take over "above market" leases. Under the Bankruptcy Code, a debtor-tenant (or its buyer) is generally required to pay all rent in arrears and provide adequate assurance of future performance by the buyer of tenant obligations in order for a debtor-tenant to be permitted to assume and assign a lease to a purchaser. These requirements will likely be more difficult to satisfy because of COVID-19's continuing negative impact on most companies who would be interested in purchasing a debtor's entire business or individual lease. Landlords will need to consider modifying leases and rent concessions to induce buyers or to bring in new tenants. Otherwise, landlords risk potentially lengthy marketing periods before finding suitable replacement tenants at acceptable rental rates while local CRE markets begin to recover as the COVID-19 pandemic eventually diminishes.

Short-Term Leasing Workouts with Tenants Still in Business

Many other tenants, however, are still fully or partially operating or temporarily closed but lack sufficient cash flow or access to additional working capital to pay some or all of their rent and may be in violation of operating covenants and other non-monetary obligations under their leases. Landlords may respond to lease concession requests by these tenants in several ways:

- Landlords may immediately start lease enforcement actions against tenants, guarantors and any collateral provided as security (after the expiration of any grace or default notice and cure periods).
- Landlords may hold-off taking any action or simply declare tenants in default and reserve their rights and remedies.
- Landlords may engage in workout discussions with tenants before or after taking the above actions.

Holding workout discussions will require both sides to assess a variety of circumstances and issues, many of which are in a state of flux due to the uncertainty of COVID-19. At this early stage of the outbreak, the most practical approach is for landlords and tenants to focus on addressing key issues over the short-term through a lease amendment or forbearance agreement (Short-Term Workouts), such as:

- **Rent Relief:** Deferral versus abatement of base rent only or all rent including a tenant's share of pass-through obligations for operating expenses and real estate taxes.
- **Rent Repayment:** Repayment schedule for deferred rent including appropriate acceleration triggers for earlier repayment due to future lease defaults or adverse events such as a tenant's permanent closure of its business, bankruptcy filing or loan default.
- **Tenant Assurances and Reporting and Landlord forbearance:** Arrangements addressing a tenant's obligations to mitigate business interruptions and resume full operations; tenant reporting to landlord of ongoing financial condition, operating status and receipt of financial assistance under governmental relief laws; tenant and any guarantor providing additional security to landlord; and landlord forbearance.
- **Modification of Operating Clauses, Etc.:** Temporary suspension or modification of operating covenants, co-tenancy, kick-out clauses and other lease terms.
- **Third Party Consents:** Landlords and tenants obtaining required consents to lease modifications and rent relief from lenders and other third parties.

Key Legal, Practical and Financial Issues Affecting Short-Term Workouts

The ability of leasing parties to enter into Short-Term Workouts will depend on their evaluation of a number of critical legal, practical and financial issues:

- **Critical Lease Terms.** There are lease provisions that should be reviewed which may affect the parties' negotiations and the terms of any Short-Term Workouts, such as those addressing: tenant operating and compliance with law requirements; co-tenancy; kick-out, early termination, recapture or surrender of space rights; renewal options and deadlines; defaults and remedies; security deposits and other collateral; and force majeure. For further information regarding force majeure clauses, see Coronavirus: Key Issues for Commercial Leases.
- **Status of Tenant's Business.** The parties must review COVID-19's impact on a tenant's business operationally and financially to assess a tenant's ability to pay rent and comply with its other lease obligations. Tenants need to consider their business options including closing underperforming locations, consolidating operations, limiting expenses, keeping key employees and maintaining operating funds and reserves. Landlords should request a range of information regarding a tenant's financial condition and status:

bank statements; recent profit and loss statements; financial statements and tax returns; the status of a tenant's business with its lenders and critical suppliers, vendors and customers; and whether a tenant is treated as an "essential" business.

- **Tenant's Short-Term Outlook or Business Plan.** Does the tenant intend to close in the short-term or continue to operate and at what capacity? Tenants will need to discuss with landlords their plans, however uncertain, to stay in business, capabilities to operate remotely, wind down certain parts of their business and/or resume operations as governmental closure orders and restrictions begin to lift and business improves over time. Landlords will need to evaluate tenants' plans and ability to continue to operate and resume paying rent in the near and long-term.
- **Access to Government Relief Programs.** Landlords and tenants should determine if they are eligible for loans, grants and other benefits available to both large and small businesses for working capital, rent and mortgage payments, payroll and other qualified purposes under recently approved federal, state and local laws, including The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) passed on March 27, 2020.
- **Landlord Ability to Recover Leased Space.** Landlords will also need to assess their own ability to find a suitable replacement tenant if workout negotiations fail or they opt to repossess leased spaces. Reletting CRE will most likely be difficult in the short-term. How quickly can a landlord evict a defaulting tenant if the tenant does not voluntarily turnover the premises? Many courts have already closed, limited operations and/or suspended evictions and foreclosures until further notice. Similarly, many states have issued moratoriums prohibiting residential and commercial evictions and foreclosures. For further information regarding such moratoriums, see COVID-19: Loan Enforcement and Foreclosure-Related Actions. Consequently, in the short-term it may be impossible for many commercial landlords to start evictions or obtain writs to repossess space.
- **Landlord Ability to Prepare and Fit-out Premises for Reletting.** After securing possession, landlords will need additional time to make repairs and market space for reletting, and to negotiate new leases. State and local governments across the country are also imposing restrictions on construction activities (except for construction related to "essential" businesses). These restrictions may significantly delay tenant improvements under new leases, whether performed by the landlord or the new tenant, and push back related rent commencement dates.

Conclusion

Generally, commercial landlords and tenants should only consider Short-Term Workouts due to the uncertainty of when tenants will resume full operations and improve their cash flow and when the CRE market will rebound, as COVID-19 declines.

If you have questions related to your lease workouts or other leasing matters, please contact Steven Ostrow (ostrows@whiteandwilliams.com; 212.714.3068), C. Jason Kim (kimcj@whiteandwilliams.com; 212.714-3077), Patrick Haggerty (haggertyp@whiteandwilliams.com; 215-854-6811), or a member of our Real Estate and Financial Restructuring Groups.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates here.

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