Alert

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COZEN O'CONNOR

What Landlords Should Consider in the Wake of Coronavirus (COVID-19)

The COVID-19 pandemic is an unprecedented event that has affected every facet of business. Over the past few weeks city and state governments have enacted numerous orders in the hopes of stemming and eliminating the threat from COVID-19. Some orders include mandatory remote working and, in the most extreme case, temporary business closures. However, as governmental orders evolve and change on an almost daily basis, landlords are left trying to manage a flood of tenant notices seeking to terminate their leases or abate their rent. Landlords have entered uncharted waters as it relates to a tenant's right to terminate their lease or abate their rent.

The reality is that many small businesses, such as restaurants and retail, that cannot obtain a small business loan, may not survive the temporary closure orders and will seek to terminate their leases. Other tenants may simply need more time to pay their rent while they seek emergency assistance or other financial assistance. Each case is different and a one-size-fits-all approach is not the best way to respond to the tenants. This Alert will provide some practical information to help landlords navigate these uncharted waters to avoid certain pitfalls in responding to their tenants while complying with the terms of their loan agreements. Please note that this Alert is not intended to apply to residential properties, provide an exhaustive list of legal factors to consider, or advise on the bankruptcy effects, if any, relating to COVID-19.

What to Expect in the Wake of COVID-19

Tenants, much like landlords, are experiencing financial hardship in the wake of COVID-19 and the fast-moving governmental orders requiring certain non-essential businesses to temporarily close. In response, tenants are trying to terminate their leases or abate their rent by relying upon legal terms such as force majeure (please see our previous Alert on this topic for more information), casualty (generally casualty applies to physical damage premised upon an insurance claim), eminent domain (governmental taking of all or a portion of the premises for public use), failure to provide essential services (common areas, bathroom supplies, cleaning services, etc.), impossibility to perform (cannot continuously operate due to governmental order), and even frustration of purpose. Alternatively, in some cases, tenants do not provide a basis for seeking to terminate their lease or request a rent abatement. No matter the basis of the tenant's notice, the question remains the same: How should I respond?

First, landlords must review the language of their leases with the tenant. Every lease is different despite boilerplate language. Second, landlords should consider their respective relationship with the tenant. Therefore, landlords should prepare their response on a case-by-case basis and consult counsel before agreeing to modify or amend the terms of the tenants' leases.

What Factors Should a Landlord Consider in Responding to Tenants?

The customary response to a tenant seeking to terminate their lease or an abatement of rent is to serve a notice of default. That initial response, may not be the most practical in the current climate. Landlords should consider that many jurisdictions, such as New York state, have issued a moratorium on commercial eviction proceedings and complete prohibition on filing any new actions in court. Until the moratorium is lifted, landlords are prohibited from commencing any actions to evict tenants. Tenants may have abandoned the premises or filed for bankruptcy long before the moratorium is lifted leaving the landlord without any legal recourse. Historically, tenant-filed bankruptcy proceedings have not been favorable to landlords, but it is unknown whether COVID-19 will have a different effect on bankruptcy proceedings. While service of a default notice may be advisable, commencing legal action may not be the best course of action and, in some jurisdictions, currently prohibited.

Marnie R. Kudon

Co-Chair, Leasing

mkudon@cozen.com
Phone: (212) 883-4926
Fax: (212) 509-9492

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In the alternative, landlords may consider a modification or amendment to the lease to preserve the revenue stream and maintain the landlord-tenant relationship. This alternative is more cost-effective and less time-consuming. Some tenants do not wish to terminate their leases, but are seeking some financial relief or accommodations. However, before modifying or amending the lease, landlords should consider some important factors, including, but not limited to:

1. Lease commencement and expiration;
2. Renewal rights, if any;
3. Was the tenant in good standing with their lease obligations;
4. The use and operation of the tenant's business at the premises (i.e. retail, eating and drinking establishment, office, etc.);
5. The type and amount of security deposit held (i.e. bank account, letter of credit, bond, etc.) (please be advised that there may be bankruptcy effects relating to COVID-19 that are beyond the scope of this Alert);
6. Tenant improvement credits or rent abatements for improvements;
7. Does the landlord have any obligations under the lease (i.e. Landlord's Work, buildout, etc.); and
8. Guaranties.

In negotiating a modification or amendment to the lease, landlords must also consider the manner of communication with the tenants. Many jurisdictions, like New York state, consider email communications agreeing upon material terms an enforceable modification to a contract. Given the remote work environment, email communication is the principal means of communication. Thus, landlords should be cognizant of any "consent" or "acknowledgments" of terms in response to a tenant's requests to modify their lease.

Ultimately, the manner in which the landlord responds to the tenant is a business decision. Therefore, it is critical that landlords respond on a case-by-case basis and consult counsel to determine their respective rights and obligations under the particular terms of the lease.

Landlords Must Consider the Language of Their Agreements Before Modifying the Lease

Loan documents may prohibit lease modifications without a lender's consent (or notice, in some cases), which could trigger an event of default under the landlord's loan agreement.

Significantly, landlords must also be careful not to inadvertently trip springing recourse under the loan documents by entering lease modifications. Many loans secured by real property are made on a non-recourse basis, with the lender's recourse following a default limited only to the assets it holds as collateral. Typically, there are exceptions to such limitation that allow a lender to pursue a guarantor for the lender's losses due to the borrower's "bad acts." Certain bad acts may also trigger full, springing recourse liability upon a guarantor for payment of the entire loan amount. Actions that trigger full recourse customarily include bankruptcy and insolvency actions, as well as transfers that are not permitted under the terms of the loan documents. Landlords/borrowers must also consider whether a lease modification will constitute an impermissible transfer, thereby making a guarantor fully liable for repayment of the loan.

If a landlord accepts a reduced rent from the tenant prior to the lender's consent, the landlord should include a reservation of rights in the modification of the lease. The reservation of rights may not protect the landlord from a potential claim of default under the loan agreement, but it may provide a basis to cure an event of default.

It is unclear at this time how the lenders will respond to an influx of requests for consent to modify/amend commercial leases, or if lenders will be waiving the requirement in response to COVID-19. However, to avoid any pitfalls or potential defaults, landlords should take the time to review their loan agreements and consult with counsel.