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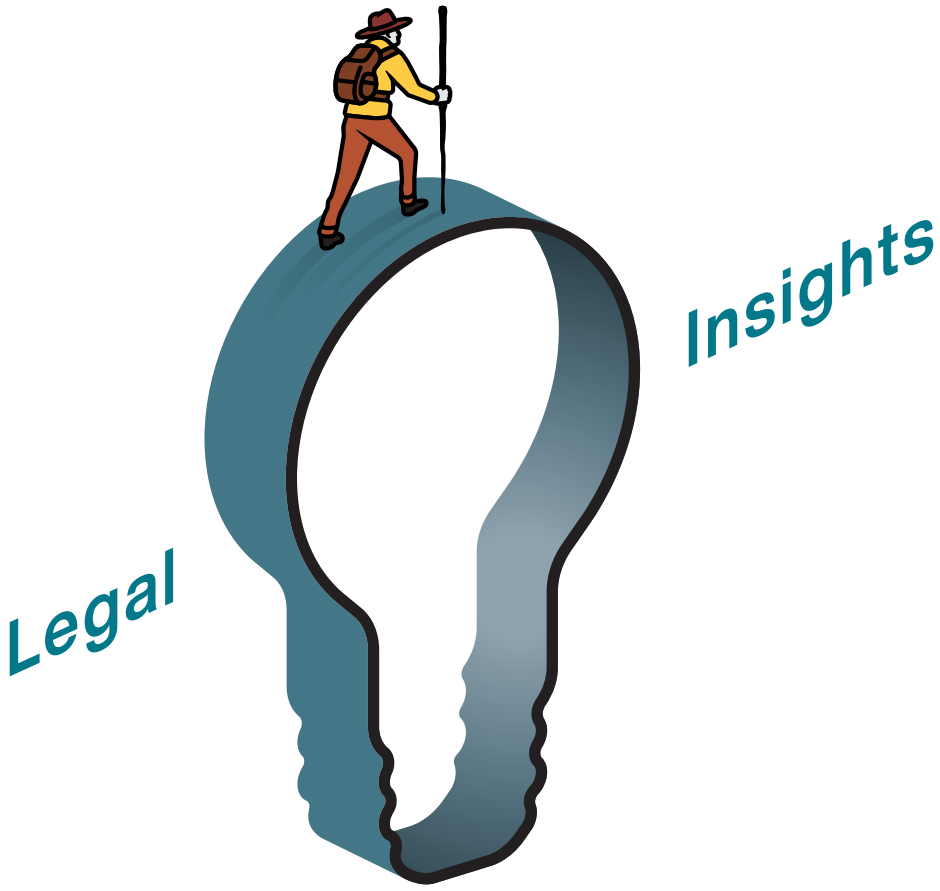
Commercial Lease Amendments in the Age of COVID-19

By Joshua Stein | September 22, 2020



EXECUTIVE SUMMARY

NEGOTIATE PRAGMATICALLY OR NOT AT ALL

Many commercial tenants in the age of COVID-19 have asked building owners for concessions. Sympathetic owners should respond to these requests pragmatically if at all on a case by case basis.

Owners that decide to negotiate a lease amendment should do so carefully, in writing with a disclaimer about deal formation. Consider requiring proof of financial distress from tenants to rule out those who don't really need help. Try to use the negotiations to fix any shortcomings in the existing lease and add improvements such as ongoing financial disclosures. Use a lawyer to review the final deal points.

AVOID BORROWER-LENDER TRAPS

Read any applicable loan documents prior to negotiations to prevent problems. Lenders may have the right to declare a default in the event of a rent reduction. Some guaranties are triggered by lease amendments. That can put the owner's personal assets at risk. Above all, owners should never admit in writing that they are having trouble paying their obligations.

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Owners, tenants, and their attorneys and other advisers have lately spent a lot of time negotiating lease amendments and waivers to give tenants breathing room in today's virus-driven shutdowns. These negotiations tend to deal with the same economic issues again and again. Most often, the tenant requests a partial or complete abatement of rent to recognize the tenant's loss of business.

Sometimes the parties agree to defer rent rather than abate it. This doesn't help the tenant much unless repayment of the deferred rent begins far in the future and then continues in small installments for a long time after that. From the owner's perspective, though, a deferral might just as well be an abatement if the tenant is gone by the time the deferred rent comes due – and the burden of having to repay the deferred rent may itself help drive a departure.

Some suggest that the tenant should, during the pandemic, pay only enough rent to cover the property owner's debt service, taxes, and operating expenses. They argue that the owner should suck it up and forgo profit during the pandemic. That's a nice heartwarming suggestion. In the real world, though, especially in large cities like New York, an owner needs nearly all its revenue just to stay above water. Owners don't just own real estate and get money. They have expenses – lots of expenses – a fact often forgotten by the "cancel rent" activists and the legislators who listen to them.

Whatever the proposal from the tenant, owners sometimes simply go along, signing formal abatement or deferral agreements. Owners may feel they have no choice. They see a dark future, and would prefer to have tenants in occupancy as opposed to vacant space in a market with rents that are lower and heading even lower. The fact that real estate is a marketplace, in which prices can drop, is another dynamic of the real world that activists and legislators forget or maybe never recognize.

In response to requests from tenants, some owners just want to be nice because it's a round world. As a result of all this, countless tenants and owners have been signing rent abatement or deferral agreements in the last six months.

In this process, the parties – especially owners – should look beyond the simple issues of abatement and deferral. They should think about some other elements of lease amendment negotiations that ought to be part of the package and, if not handled right, could produce unpleasant surprises later.

A careful owner will state in every communication that it isn't legally binding and it's just a conversation about a possible future lease amendment. An even more careful owner might insist on formal written communications.

This Learnpaper offers a roadmap for owners to avoid some pitfalls that can arise in lease renegotiations with tenants claiming financial distress from unforeseeable events such as pandemic-related laws.

Formalize Your Amendment Negotiations

It starts with the negotiation process. An owner will sometimes not want to deal with the problem, allowing unpaid rent to pile up. In the meantime, owner and tenant send some email back and forth about possible rent waivers or deferrals. If the owner isn't careful, a court might decide after the fact that the owner agreed to something, much to the owner's surprise.

Most leases contain protective language to prevent unintended lease amendments or waivers. Courts in a tenant-friendly mood – often most courts – sometimes ignore that sort of boilerplate language, so an owner should not rely on it.

A careful owner will state in every communication that it isn't legally binding and it's just a conversation about a possible future lease amendment. An even more careful owner might insist on formal written communications (signed letters back and forth) with appropriate caveats every time.

If the owner waits and does nothing, a court might decide, at a certain point, that the owner has waived some rights. So the owner shouldn't ignore the problem and hope it goes away. It won't. And the owner shouldn't expect the tenant to push these discussions along. It's often up to the owner.

Don't Forget About the Rest of the Lease

If the owner and tenant agree on some rent relief, how does that interact with other provisions of the lease? For example, perhaps the owner now agrees to a 50% rent abatement for four months because of the pandemic. But maybe the tenant was already entitled to a free month of rent during that abatement period. Does the tenant still get the free month of rent? Can the tenant apply that free rent to some other month?

Similar issues arise if the lease expresses future rent adjustments as a percentage of the previous rent. What happens if that "previous rent" got chopped in half? How do you calculate the future adjustments?

These are great questions. The parties should answer them in their lease amendment, rather than leave them for future debate.

During negotiations, an owner may want to ask some financial questions about the tenant and its guarantors such as:

- Exactly how is the pandemic causing financial hardship for your business?
- Please provide current financial reports demonstrating that impact.
- What government assistance or insurance coverage have you sought or obtained?
- How many employees have you kept, laid off, or furloughed?
- What is your exposure on other leases? What arrangements have you made there?
- Please provide current financials for tenant and its principals, including any guarantors.
- Although this location is presently shut, how has it performed for you over the years? Please provide sales reports or location-specific profit and loss statements.

By asking questions like these and indicating that the answers are the price of admission, an owner can sometimes stop the lease amendment process in its tracks.

If the lease amendment process goes forward, it can give an owner an opening to try to change the lease in ways that might benefit the owner. Lease amendment can be a two-way street. Has anything in the lease been a problem? Does anything need to be fixed? Did the owner make final concessions in the original lease negotiations that the owner might now have a chance to undo? If the lease allowed relatively free assignment, would the owner like to trim that back now? And might it make sense for the owner to try to obtain a lease extension – or a right to terminate the lease early – as part of the price of whatever concessions the tenant obtains?

How Much Legal Work?

Whether or not the owner already has in mind making any improvements to the existing lease, the owner may want its counsel to read through that lease, looking for problems or trouble. The problem, of course, is that owner's counsel can almost always find something that could stand improvement. The cost and timing of the search for inferior lease language may make no sense. The tenant will likely try to reject anything the owner proposes anyway.

So, although a full review of the lease may sound like a good idea, it's not something for which the owner should tolerate much delay or extra expense. Maybe counsel should just check for some crucial provisions. For example, this might be a good time to add a late charge and default interest, or any "magic language" necessary to exercise rights and remedies under state law, if the lease doesn't already contain these provisions.

Conversely, a tenant may want to add some new language that goes beyond rent abatements and deferrals in response to today's pandemic. Specifically, tenants – especially retail tenants – are starting to ask for built-in rent abatements or deferrals that would activate automatically if some future action by any governmental authority required the tenant to shut down its business without fault by the tenant. For example, a prominent food and beverage chain now tries to include in its new leases a 50% fixed rent abatement if a future mandatory shutdown reduces its sales by more than 25%, with a complete abatement of fixed rent if the business must shut down completely. It remains to be seen how much success tenants will achieve with such proposals. Lenders and owners don't want leases to allow any interruption of rental income. In the upcoming tenant-friendly leasing market, though, lenders and owners may have to relent if they want to sign leases.

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Once a tenant and an owner agree on a lease amendment, the tenant will typically try to keep the formalities as simple and quick as possible, helpfully providing a first draft of a very minimalistic and perhaps not very careful amendment that accomplishes only what the tenant wants to accomplish. The tenant may do this partly in the hope that the owner won't involve counsel at all, and won't think too much about the lease amendment. Lawyers only make things complicated, after all.

In most cases, an owner shouldn't just sign whatever lease amendment the tenant sends along. At a minimum, the owner should insist on having the tenant confirm the status of the lease. For example, does the tenant have any claims against the owner? Did the owner deliver the space as required? Does the tenant think it's entitled to any refunds? A lease amendment is a great occasion to tie down these issues and try to eliminate them. Ideally, the owner should require the tenant to waive and release any issues. Otherwise, the parties should negotiate a resolution in their lease amendment. The owner does not want to learn about the tenant's issues 20 minutes after accommodating the tenant's request for a lease amendment.

Consider Requiring Financial Disclosures and Other Concessions

Even though most leases typically don't require disclosure of financial reports by the tenant, the owner might decide it's time to start getting them. Traditionally, at least outside of malls, a tenant's sales and profitability were none of the owner's business. Now that owners have unexpectedly and involuntarily become participants in the downside of their tenants' businesses, perhaps it's reasonable for them to know how their tenants are doing going forward, even if the numbers might not always be entirely reliable. At a minimum, transparency about the tenant's financial picture will help the owner and its lender assess the likelihood of future defaults or future lease extensions.

An owner might reasonably ask the tenant to make some other concessions. The tenant might prepay at least some of any reduced rent. If the tenant pays real estate taxes, the owner might particularly insist on an early deposit of funds. Perhaps the lease should be extended for the duration of any rent holiday, or the owner should obtain a termination right. If the lease has burdensome pro-tenant clauses, such as purchase options or rights of first refusal, maybe the parties should remove them.

Before an owner waives or defers rent, the parties might explore other ways to cover the tenant's rent in the shutdown period. For example, if the owner still owes the tenant anything on account of a tenant improvement allowance, the parties might repurpose those funds and use them to pay rent.

Sometimes the parties will agree to release funds from the tenant's security deposit to pay some or all of the current unpaid rent. In that case, the lease will ordinarily require the tenant to immediately replenish the security deposit. Instead, the owner and tenant need to either waive that requirement completely or allow the tenant to replenish the security deposit on a very

slow schedule. Without that, the tenant hasn't accomplished much.

If the lease already allows the tenant to reduce the security deposit over time, how does that interact with today's lease amendment and possible release of funds from the security deposit? Will the tenant still have a right to the future reduction?

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In mixed retail/residential buildings, tenants have sometimes paid part of their rent by giving the owner gift cards, which the owner then distributes to residential tenants in the building as a form of marketing for both the owner and its retail tenant.

An owner might reasonably ask the tenant to cover the owner's legal fees in negotiating any lease amendment. As a practical matter, tenants generally refuse, because the whole exercise is driven by the tenant's statement that it is short of funds.

Rethink Notices in the WFH Era

As part of any pandemic-based lease amendment, the parties should think about how working from home might affect the practicalities of lease administration. Specifically, they might want to update the notice procedures of the lease to allow formal lease notices to be given by email rather than by physical delivery since very likely no one will be at the office to receive any physical notices.

Email notices raise some legal and practical issues and uncertainties beyond the scope of this article. In response, the parties to one recent lease renegotiation agreed that anyone giving an email notice had to give it to a total of four email addresses. It would not become effective unless at least two recipients affirmatively replied by email to confirm receipt.

Renegotiate With Third Parties Too If Necessary

Whenever the owner agrees to any lease amendment, the owner also must think about third parties as follows:

- The owner may still owe installments of brokerage commission to the broker who arranged the lease. The owner may want to try to renegotiate those payments, given that the lease wasn't as valuable as anticipated. The owner's leverage will partly depend on what the brokerage agreement says about conditions to payment of any future installment.
- The lease will often be backed by a guaranty. The owner should insist that the guarantor consent to the amendment and acknowledge the guaranty will still apply to the lease as amended. Without that, the guarantor might claim the guaranty went away as soon as the owner and the tenant signed their lease amendment. As a second issue, often a guaranty will terminate if the tenant peacefully moves out without having to be evicted (a

"good-guy guaranty"). In that case, as a condition to terminating the guaranty, the owner might want to require the guarantor to repay some or all of the deferred or abated rent.

- The owner needs to remember it probably has a lender that holds a mortgage on the property.

Avoid These Borrower-Lender Traps

If an owner (a.k.a. "borrower" in this section) accommodates even a handful of requests for relief from tenants, the owner may soon find it has trouble paying its mortgage. Before long, the owner may decide to approach its lender for accommodations like the those the owner gave its tenants. If an owner takes a wrong step in the process, though, it may find itself in default under its mortgage loan, at risk of losing its property through foreclosure.

Loan documents often require the borrower to obtain the lender's approval before waiving or deferring any rent payment or modifying any lease in any way. Those restrictions vary among loans and with the size, duration, importance, and type of leases. When restrictions do apply, if an owner accommodates its tenant without getting the lender's approval, the lender might very well have the right to call a default and ultimately foreclose.

A court might not side with the lender, but there's no guarantee. So, if the loan documents require it, the borrower ought to have a conversation with its lender, and get approval for any rent abatement or deferral. If the lender refuses to go along, the borrower might restructure the accommodation in a way that avoids the lender approval requirement, but this could result in its own set of issues.

Any rent waiver made without lender approval may produce bad consequences that go far beyond just allowing the lender to call a default.

In most commercial mortgage loans, the borrower's principals sign a nonrecourse carveout guaranty, in which it agrees to guaranty the loan – but only for enumerated violations such as a prohibited transfer of the property or a voluntary bankruptcy. As long as the borrower doesn't engage in these activities, the lender might foreclose but it won't have any recourse against the borrower or its principals if the collateral doesn't suffice to repay the loan.

The list of violations activating a nonrecourse carveout guaranty sometimes includes amending a lease, or waiving a tenant's obligations, without the lender's consent. So an ordinary accommodation to a tenant in trouble, if done without the lender's consent, might make the owner's principals responsible for payment of the entire loan, an exposure they otherwise would have avoided. This would be a disaster.

A borrower should consider another similar trap before approaching its lender for any relief. Almost all loan documents say it's a default if the borrower admits in writing to anyone its inability to pay its debts. This default usually appears in a long, dense, unreadable paragraph on insolvency-related defaults. If a borrower admits it can't pay its debt, this might help support an involuntary bankruptcy filing against the borrower. The lender might not want this to happen – not that the borrower's written admission will affect the ultimate outcome very much if the borrower in fact can't pay its debts.

Such an admission may even allow the lender to claim that the borrower's principals are now liable for the entire loan under a nonrecourse carveout guaranty. This is of course an absurd result, but no more absurd than some other recent results in litigation over similar guaranties. So the owner shouldn't say or write anything about its general inability to pay its debts, whether or not accurate.

Conclusion

Any real estate owner must proceed with extreme care both in accommodating its tenants and in seeking accommodations from its lender. Read the loan documents first. Do nothing to give the lender a hook on which to hang a default – or, worse, a claim under a nonrecourse carveout guaranty. And when negotiating with tenants, remember that lease renegotiations can work both ways.

Any rent waiver made without lender approval may produce bad consequences that go far beyond just allowing the lender to call a default.

Meet Joshua Stein

Joshua Stein handles a wide range of commercial real estate transactions and regularly serves as an expert witness. His firm, Joshua Stein PLLC, celebrated its 10th anniversary in August 2020. He is a member of the American College of Real Estate Lawyers and the American College of Mortgage Attorneys. He has written five books, including two on lease transactions, and 300+ articles on commercial real estate. Many appear on his website, joshuastein.com. He received his law degree from Columbia, where he was a Harlan Fiske Stone Scholar and a managing editor of the law review.

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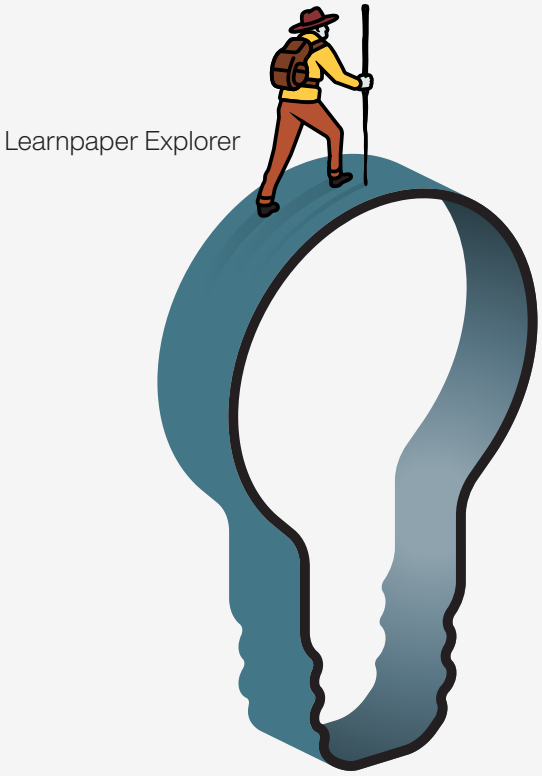

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