



## Solutions For Commercial Tenants Facing Rent Challenges

By Robert Cox (May 12, 2020)

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*COVID-19 has significantly impacted the commercial real estate industry. Restaurants, retailers, medical professionals and personal care businesses have been ordered by state governors and localities to shutter all or most of their businesses.*

*As income has dwindled, commercial tenants have struggled to pay rent. While some businesses have received a lifeline through the Paycheck Protection Program, approximately 75% of the money must be spent on employee payroll, leaving only 25% to cover rent, utilities and other expenses.*

*In addition, the PPP funds will only cover a few weeks of operating expenses. As states begin to relax restrictions, many tenants will still need months, perhaps a year, to return to previous levels of monthly income.*

*Landlords want to keep spaces occupied and minimize lost rental income. Tenants want to keep space for continued business operations as state shelter-in-place and social distancing orders are relaxed while obtaining rent relief for the period of disruption to their businesses. This article explores ways for landlords and tenants to achieve their goals.*

### Remedies Within the Lease

The first place for a commercial tenant experiencing cash flow challenges to start is a thorough review of the lease. The lease may address situations such as the tenant experiencing business interruption or may tie rent to income from retail operation. Both the tenant and landlord should also review the lease to determine whether a force majeure provision is included in the lease and is potentially applicable.

### Force Majeure Provisions

Leases typically contain force majeure provisions that deal with significant events such as natural disasters, fires, riots, terrorism or acts of God. Force majeure is a contractual provision that excuses performance by another party due to an unforeseen event.

A force majeure provision typically: (1) suspends performance and/or (2) limits liability or damages. However, these provisions in leases often expressly exclude and do not relieve a tenant of the obligation to timely pay rent.

Force majeure provisions in typical leases generally only excuse performance due to an event outside of the party's control. Landlords look to these provisions if they are unable to perform material or time sensitive obligations such as obligations of the landlord to timely complete a buildout or to deliver space to the tenant. The tenant looks to this provision if they are unable to perform an obligation of the tenant to continuously operate its business from the premises.

It is possible that a forward-thinking landlord or tenant may have addressed a pandemic in this provision. More likely is that any potential termination of the lease under a force majeure provision would be under the acts-of-God or beyond-the-control-of-the-parties catch-all provisions. The good news for landlords and bad news for tenants is that most courts have interpreted these catch-all provisions narrowly.

With press coverage of pandemics since the 2003 SARS epidemic, it is difficult for a tenant to argue that a pandemic was unforeseeable at the time they entered the lease. However, the landlord and tenant should carefully research the applicable state law in this area. For example, civil authority orders may be viewed as a force majeure event by the courts in that jurisdiction.

#### **Litigation**

If the tenant and landlord enter into litigation, the parties should be prepared for a potentially lengthy process. Many states have temporarily suspended evictions. Tenants may be able to remain in properties in the near term without paying rent. Also, most federal and state courts are only hearing emergency hearings for the next month. Given the backlog in criminal cases that take priority, it may be a significant period of time before a landlord is able to obtain eviction of a commercial tenant.

#### **Business Interruption**

Finally, both the landlord and the tenant should review their insurance policies, particularly their property policies, to determine whether the policy may provide business interruption or civil authority coverage. Many insurers have been taking the initial position that these coverages are inapplicable for COVID-19 because a virus is either excluded in the policy or does not qualify as a direct physical loss.

However, several restaurants and theaters have filed suits throughout the U.S., including in the Superior Court of the District of Columbia, against insurers challenging the denial of coverage. Also, several states, such as Massachusetts, New Jersey, New York and Ohio are considering legislation that would require insurers to cover business interruption related to COVID-19.

#### **Lease Restructuring**

The greatest ability of a landlord and tenant to seek a win-win result in this challenging environment is through a lease restructuring. A landlord's primary goals are to maintain a full building, avoid a tenant default and have leases with as long a term as possible to ensure a stable and predictable monthly income.

A tenant experiencing cash flow issues due to the pandemic should approach its landlord to make the landlord aware of the business interruption issues and its affect on the tenant's business. Honest communication with the landlord is best if the tenant wants to remain in the premises. The landlord may be open to a rent deferral or restructuring of the lease.

#### **Rent Deferral or Reduction for Business Interruption Period**

The tenant should first inquire whether the landlord is open to abating, reducing or deferring rent payments until after the business is able to fully open. If a tenant has a good credit history, has timely paid rent and has more than a year or two left on the existing lease, the landlord may be open to 3-6 months in immediate rent relief.

Most landlords will not be inclined to abate rent entirely, but they may be amenable to rent deferrals. For example, the landlord may allow the tenant to not pay rent during a certain period if the tenant enters into a repayment plan following the rent abatement period. The tenant and landlord could agree to a payment schedule to allow the tenant to pay monies in addition to the monthly rent payment after reopening to address the arrearage.

Alternatively, the landlord may be open to a rent reduction where the tenant pays a certain percentage of the rent during the period the tenant believes will be necessary to rebuild its business. However, landlords are unlikely to agree to rent relief or deferrals longer than a six-month period. The tenant should enlist the assistance of its broker in this process.

### Extension of Lease Term

When a tenant signs a commercial lease, it is customary that the lease provides for an initial period where the tenant is not obligated to pay any rent. If the tenant is open to extending the existing lease by a certain period of time (e.g., 1-2 years), the landlord may be willing to restructure the lease to allow the tenant to pay no rent or reduced rent for a certain period of time with an extended term. A step rent rate increase can be built in to allow the tenant to pay a low rate of rent in the first year and then escalate the rate each year.

### Sublease

A tenant who plans to either close its business or a portion of its permanently should explore the possibility of subletting the space to another tenant. While the landlord reserves the right in the lease to approve any subtenant, a sublet provision ordinarily requires the landlord to not unreasonably withhold approval of a sublet.

Again, a tenant should carefully review the lease regarding subletting and notice to the landlord. However, in the current business environment, it will likely be difficult for a tenant to find a sublessee.

### Surrender of a Portion of the Leased Premises

If a tenant is in a building or area of a city that is experiencing high rates of occupancy, the landlord may be interested in taking back some of the leased space. If the tenant is not using all of its space and likely will not need all of the leased space going forward, a landlord may be open to taking back some of the space and reletting it to an existing tenant in the same building that needs more space or a new tenant. Again, given the current environment, this may not be a feasible option.

### Lease Buyout

A landlord may be willing to allow a struggling tenant to buyout its lease, particularly if the market for commercial space is good in that geographic location. This only is available to a tenant that has cash in the bank or who can obtain a loan to finance the buyout. Under a buyout, the landlord and tenant calculate the remaining lease term and apply a percentage discount to the amount of remaining rent.

Based on the time value of money, the landlord may provide an additional discount based on being able to obtain the money now rather than as an income stream over several years. The tenant may want the release of any guaranties as part of a buyout. The tenant may also want to ensure that it does not release the landlord from its obligation to return any security deposit.

### Tenant Purchase of the Premises

For the landlord of a small building who is struggling in this environment, the landlord may want to approach its tenant about purchasing the building. A tenant with cash or access to a lender for a mortgage may be interested in purchasing the building at a substantial discount.

### Tenant Bankruptcy

The final and least desirable alternative for both a tenant and landlord are for the tenant to file for bankruptcy. Both parties lose in this situation, but a cash and income depleted tenant may have no other option.

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