

CORONAVIRUS

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COVID-19 Effect on Commercial Landlord-Tenant Law: A 50 State Review and Practical Guide to Negotiating Lease Modifications

The widespread impact of the COVID-19 pandemic on the ability of businesses to continue operations in leased spaces should prompt landlords and tenants to have an open dialogue toward practical solutions. Because no current federal legislation can be directly applied to commercial leases, a review of common contractual provisions and defenses, bankruptcy issues, and updated legal frameworks in jurisdictions across the country is vital for landlords and tenants seeking to find a path forward.

Few tenants and landlords are weathering the COVID-19 pandemic without significant—if not total—lost revenue. More than 16 million people are out of work, and while labor costs may be mitigated by furloughs or layoffs, real estate costs, typically a company's second highest expense, is a contractual obligation that is commonly accompanied by personal or corporate guarantees, letters of credit, or cash deposits. Some states have issued executive orders temporarily prohibiting tenant evictions and mortgage foreclosures, but such short-term relief may not be enough to help the tenant's business to survive.

Landlords and tenants starting to visit lease accommodations should consider a practical approach aimed at achieving a long-term solution that allows the tenant's business and the landlord's income stream to return to pre-pandemic levels

and preserves the landlord-tenant relationship. Open and frank communication is important, allowing landlords and tenants to understand the business and economic conditions each face. While lawyer letters are the common means of landlord-tenant discourse, a tenant directly phoning the landlord to explain the reasons for lease accommodations may be more productive. And in negotiating with landlords, tenants should recognize that landlords may need lender consent to modify a lease and that reduced rent can impact a landlord in many ways, including affecting its ability to pay the mortgage.

Similarly, it is important for landlords to recognize that many tenants may not survive months of negative revenue. Landlords must be flexible when receiving lease accommodation requests from tenants, especially given that lease

payments may be the business cost causing a tenant bankruptcy. And since bankruptcy may cause the leasehold to remain unoccupied for months or longer with no rent being paid, and new tenants difficult to find, landlords may consider alternatives to demanding strict rent payment under the existing lease.

LEGAL FRAMEWORK

There is no federal legislation affecting commercial leases, and any future state action offering the equivalent of landlord-funded rent rebates, as many commentators hope, may be subject to constitutional challenge. But Congress may in a follow-up stimulus round extend financial support for businesses most severely impacted by the closures, such as hotel operators, restaurants, entertainment venues, and other retail establishments.

Current state legislation and executive orders are described in a chart at the end of this advisory. For landlords who also have multifamily housing, we include legislation and orders that affect residential units. Note that none of the legislation prevents landlords from calling guarantees, drawing down letters of credit, or applying deposits to rent defaults.

LEGAL AND CONTRACTUAL ISSUES

Leases are contracts that include terms and conditions that will be enforced by courts, but several defenses may be available:

- Most leases include force majeure clauses that generally provide for the postponement or suspension of performance due to circumstances beyond party control. Force majeure clauses typically protect against extreme weather, unavailability of utilities, government actions, riots, war, labor strikes and embargos, and similar events. Since the 2003 SARS epidemic, many force majeure clauses specifically refer to viruses, and the World Health Organization's classification of COVID-19 as a pandemic is important for force majeure clauses that expressly account for pandemics or similar events. But note that many commercial leases exclude the payment of rent from force majeure clauses, meaning a tenant may still be required to pay rent even during a force majeure event.
- Some leases have rent relief clauses tied to government-issued directives (often located in civil disobedience language) or closures not attributed to the tenant, including temporary condemnation by the government. Some well-heeled tenants may test claims against the government for inverse condemnation arising from directives to close all non-essential businesses and failure to provide just compensation as required by the Fifth Amendment of the Constitution.
- Some leases have expanded covenant of quiet enjoyment provisions that may be invoked if the landlord has enacted impediments to entry or contractual use, no matter the reason.
- Lease casualty clauses usually provide tenants and landlords the option to terminate or require a landlord to offer rent abatement in the event the property is substantially damaged. While a tenant's ability to operate has been disrupted by the pandemic, casualty clauses typically cover fire, floods, explosions, or similar occurrences that degrade the premises' physical or structural integrity. Depending upon the lease language, tenants may assert that government shelter directions prevent productive use of the space, rendering the tenant unable to physically use the space.
- There may also be non-contractual legal arguments that tenants may raise such as impossibility of performance or the doctrine of impracticability. Nonperformance may be grounded in these doctrines under the premise that the parties did not—and could not—have foreseen the unexpected intervening event of COVID-19, which materially impacts both parties performing under the lease, rendering such performance impossible or impracticable. Similarly, the doctrine of frustration of purpose focuses on whether an intervening event destroys the purpose of the contract rather than merely frustrating a party's contractual performance. The doctrine assumes the event frustrating performance was not a basic assumption of the contract, and queries whether the purpose of the contract was obviated.

BANKRUPTCY

The filing of a bankruptcy petition by a tenant creates an “automatic stay” that precludes landlords from attempting to collect rent or seeking to evict the tenant. A landlord may, however, seek to enforce a guarantee or call down a letter of credit to pay for past due rent, but cannot apply a security deposit. The proper procedure for asserting a claim for pre-petition arrearages is through the filing of a proof of claim with the Bankruptcy Court.

If the tenant is reorganizing, it has up to seven months to decide whether to continue with the lease or terminate it. During this period, the tenant is required to timely make rent payments. Recently, however, a number of tenants have filed motions seeking to suspend their bankruptcy cases during the pandemic and not pay creditors, including landlords. And at least two bankruptcy courts issued orders permitting tenants to remain in premises without paying rent due to the COVID-19 pandemic. But under the Bankruptcy Code, in order to assume a lease, a debtor must pay outstanding rent or provide “adequate assurance” that it will be paid “promptly” and provide “adequate assurance” that future rent will be paid. If rent is not timely paid, the landlord may ask the Bankruptcy Court to evict the tenant, a process that can take months. A tenant may decide to leave the premises and reject the lease. The rejection of a lease is not a termination of the lease, but rather is treated as a pre-petition breach of the lease. The landlord will have an unsecured claim for damages arising as a result of the rejection, i.e., for unpaid rent both pre-and post-petition. If the tenant liquidates, the landlord will retrieve the space, but may find it difficult to locate a substitute tenant.

SBA LOANS AND INSURANCE

While beyond the scope of this advisory, landlords should keep in mind that SBA loans are available for small businesses, which can be used to pay rent, and tenants should consider whether business interruption or other insurance is available to offset rent payments and other obligations (for further information, see Blank Rome’s advisories on the [SBA 7\(a\) loan program](#) and [insurance guidance](#) for losses related to the coronavirus).

EFFECT OF NON-PAYMENT

Rent often is backed by personal or corporate guarantees, letters of credit, and/or security deposits. If you do not pay rent, a landlord may call the personal guarantee, draw on the letter of credit, or apply the deposit. Landlords must recognize the affect this will have on the tenant or the guarantor, as well as the fact that it is likely to result in prolonged litigation.

- Seeking to enforce a personal guarantee will no doubt gain the tenant’s attention because the guarantor’s assets are at risk. While this often results in the tenant paying rent, it also can result in a time consuming and costly legal battle and will not foster a healthy landlord-tenant relationship. Similarly, enforcing a corporate guarantee, usually given by a parent company, is likely to result in litigation.
- If the landlord draws a letter of credit, the tenant will have to repay the issuing bank. And if the letter of credit is issued as part of a working capital credit facility or as part of a corporate revolver, the draw will accrue interest and possibly trigger a covenant default, further increasing the economic impact on the tenant.
- Applying a cash deposit will not directly affect the tenant, though it cannot be done if the tenant files for bankruptcy protection.

At the same time, tenants must recognize that landlords have financial obligations tied to tenant performance, such as mortgage payments, the absence of which may lead to foreclosure. In addition, landlords often must satisfy covenants in a credit facility, and typically non-payment of rent constitutes a material adverse event or default. Negotiating rent abatement or deferral is not as simple as the landlord agreeing to waive or defer rent, because such waiver often causes the landlord to default on concomitant financial obligations, especially if there are numerous investors in the property, each of whom may have their own obligations dependent on receiving monthly rent payments.

PRACTICAL GUIDANCE

The following guidance assumes that the landlord would like to the tenant to remain in the premises. If not, then the landlord should take contractually required steps, such as proper notice, drawing down and deposits, and calling guarantees, followed by eviction proceedings.

Tenants in jurisdictions that have enacted delays in enforcing rent defaults generally have the luxury of remaining in the premises for a limited period without the threat of eviction. New York may be an exception as leases often give landlords the right to terminate a lease for non-payment after notice and courts are unavailable to issue “Yellowstone” injunctions prohibiting termination until final determination. Also, the legislation does not prevent the landlord from enforcing guarantees, drawing down letters of credit or taking deposits. It also burdens tenants with paying several months’ past rent after the safe period ends. Accordingly, it may be productive to enter negotiations now.

- Tenants should undertake a deep financial dive and determine how much rent, if any, they can pay during the pandemic. Approaching a landlord with a plan informs the landlord that you are being candid, have thought through the financial issues, and are doing what you can to work towards a mutually beneficial solution. Where possible, offer to pay part of the rent on an ongoing basis and defer part. Merely deferring rent will leave the tenant with increased rent later, making it more difficult to survive. Alternatives include (i) tying rent to revenue such that the landlord is invested in your success; (ii) agreeing to percentage rent with certain steps and thresholds as the economy returns; and (iii) for tenants with numerous leases with the same landlord, agreeing to pay more rent for successful locations spaces to make up for less successful ones.

- Given the environment—for instance, some estimate that more than 50 percent of restaurants will fail—combined with changes in consumer brick-and-mortar shopping behavior reinforced by months of online purchasing, and the realization that business can work remotely, demand for retail locations, and office space likely will be reduced, landlords should consider taking steps to keep important tenants to ensure future prosperity. At the same time as giving concessions, landlords may want to consider asking the tenant to share in the upside if the tenant succeeds.

50 STATE REVIEW

A 50 state review of landlord/tenant implications, including state executive orders and judicial rules, is available at Blank Rome’s [COVID-19 State Impact Tracker](#).

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