Coronavirus Challenges for Commercial Landlords

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The COVID-19 virus is having negative effects on many aspects of life in the world, not least including economics close to home. Unfortunately, commercial real estate and capital markets are not immune to these effects. In light of the modern real estate investment, which almost always includes a substantial amount of leverage, landlords should take certain steps to begin proactively protecting their investments. Those steps will include looking upstream to soften revenue shortfalls from tenants and anticipating downstream problems that distressed tenants can create with the landlord's lender.

Tenants will likely be under stress, especially retail tenants, because of consumer and client inaction. Landlords need to review their leases to ensure they understand their rights in these unusual times, but also be prepared to have those rights limited by law or by social pressure. The current legal climate may become challenging as governments are taking extraordinary measures to help business and people survive the financial impacts of the COVID-19 outbreak. There has been discussion that this may include a suspension in the ability of landlords to evict (and also include the ability of lenders to foreclose)—though most of this has been limited to residential leases to date.

During this trying time, the key will be communication. Landlords would be wise to work with tenants to come up with creative solutions by agreement that would allow tenants to maintain operations and landlord to maintain compliance with its loan and other obligations. Many leases have continuous operation covenants tenants must abide by which require tenants to be open, lights on, for a certain period of time each day. Landlords may want to consider temporarily relaxing enforcement to help a particular tenant's operational margins.

If tenants seek rent relief, as appropriate, Landlords may also want to enter into short-term arrangements that provide partial base rent abatement, with or without interest, and that contain defined reinstatement dates and a repayment schedule. Landlords could incorporate concepts, again particularly in retail leases, that allow the landlord to recoup some lost rental when the economy rebounds—this can be through a percentage rent concept or other profit-sharing methods. Landlords should also encourage tenants, before entering into alternate pay structures, to reach out to their insurance providers to whether there may be coverage under a business interruption insurance policy, if such was required under the lease terms.

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Tenants will be affected by this pandemic one way or another, but a landlord's willingness to at least evaluate alternative arrangements may be beneficial both financially in the long term and gain the landlord goodwill from the tenant in the process. In doing so, however, landlords do need to consider their own obligations, particularly to their lenders, and the effect that lease modifications may have on their loan covenants.

Landlords should first review their loan documents to make sure they are aware of the requirements of the loans which affect their investments. Often there will be debt-to-income ratios and other covenants that require a certain amount of rental revenue on a monthly or annual basis. Any workouts with tenants will need to comply with those requirements, unless relief is negotiated with the lender. It is important to know what these covenants entail and actively monitor distressed tenants ensuring no adverse effect occurs to the landlord's ability to comply with its loan covenants. Additionally, depending on how sustained the economic effects of the COVID-19 outbreak lasts, there may be vacancy rate or tenant delinquency rate covenants that should be reviewed. If the strain to keep compliant with the loan requirements becomes great enough, there may be force majeure or other provisions absolving landlords of compliance with the loan documents given the extraordinary and unforeseen circumstances. These should be reviewed with counsel before any discussions with landlords' lenders.

Much like with landlords' relationships with their tenants, landlords should communicate with their lenders early to determine if a short-term loan modification is necessary or appropriate. Like good tenants, lenders will often make arrangements for good borrowers.

The economic effects of the COVID-19 virus are likely to weigh heavily on the commercial leasing industry. With open communication, landlords, tenants, and lenders can get through the turmoil and thrive in the future. However, ignoring a potential issue until it actually becomes a default under a lease or loan is a recipe for irreparable harm to the parties involved.