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Commercial Leases – COVID-19 Implications (Current as of April 15, 2020)

Many commercial tenants are reaching out to their landlords during these COVID-19 social distancing times (orders) to discuss their commercial lease and their monthly rental payment. For many business owners, the cash burn rate on their fixed expenses cannot survive weeks let alone months of zero or nominal revenue. Eyebrows were raised in the commercial leasing world when The Cheesecake Factory wrote to its many landlords across North America to advise they will not be making their April 1st rental payments. Since then, a number of other companies have written similar letters requesting rent relief or deferment from their landlords.

No Landlord Playbook

For landlords there is no page in their playbook for the current economic situation. No one on a landlord's property management team will have had experience with anything similar to the ever evolving COVID-19 business environment. Not only is the current environment unprecedented in modern times, but no one knows with confidence what the economic realities will be six months from now and when (or if) the world will return to "business as usual".

Similar to anxious tenants trying to triage their fixed expenses, the landlord will be keenly aware of its lender's expectation to receive regular mortgage payments, the municipality its property tax payment, the insurance company its insurance premiums and its employees their regular paycheques. None of these landlord creditors are going to give the landlord a pass on paying these fixed expenses.

Landlord Reaction

We anticipate that over the next few months landlords will deal with tenants on a case-by-case basis, before more definitive trends or workout arrangements become common in the industry.

It is likely that institutional landlords with large leasing portfolios will develop a more standardized approach to workout terms and the criteria they apply to determine the terms offered to each tenant. For example, a landlord with several restaurant tenants may develop an approach that is designed specifically for tenants in the restaurant industry. A further variation of that approach may be designed for restaurant franchisees.

We anticipate far more variety in the approach taken by private landlords, especially private landlords with smaller leasing portfolios. For private landlords who have significant debt servicing obligations, financial constraints may limit their ability to provide rent relief or rent deferral to their tenants without cooperation from their lenders. However, smaller private landlords often personally know their tenants. That personal face-to-face relationship may help the parties discuss and agree on creative solutions that would be harder to negotiate with a large institutional landlord or even a private landlord with a large leasing portfolio.

Shedding Bad Tenants or Tenants who Negotiated Sweet Deals

Some landlords will likely take this opportunity to “clean house” of a certain percentage of tenants from their portfolio who seek rent relief or deferral. Tenants in this category would include problem tenants who have missed several rental payments in the past or those who are frequently offside their lease covenants. However, some landlords may be opportunistic and terminate leases where the lease rates are (or were pre-COVID-19) far below market rates, tenants who occupy buildings that the owner plans to redevelop, or tenants with highly valuable or unique leasehold rights, such as rights of first refusal, expansion rights, non-compete rights, or undervalued rooftop or signage rights, to name a few. For leases that fall in this category, the landlord will reflect on whether now is the opportune time to terminate the lease despite the likely challenge to find a new tenant in the short term.

Where a landlord has previously ignored or forgiven a tenant’s failure to pay rent or let minor breaches of the lease agreement stand uncorrected, a tenant may take the position such breaches were accepted or otherwise acquiesced to by the landlord. The tenant may argue that these requirements were waived or suspended such that the landlord would be in breach by attempting to now terminate the lease, assuming the tenant continues to pay its monthly rent and is not seeking any rent relief from the landlord.

An assessment of the strength of a landlord’s position to terminate in such circumstances will be dependent upon the specific circumstances and a considered review of the lease language is recommended.

Approach to the Majority of Tenants

Back in early March 2020, when Purell and toilet paper were not classified as precious commodities, most landlords viewed the majority of their tenants as good or excellent tenants. If the landlord were to terminate a lease with a good or excellent tenant experiencing COVID-19 cash flow issues it is unlikely that the landlord will be able to find a replacement tenant who is not experiencing similar business and cash-flow challenges. The challenge is opportunity costs or, put another way, what is the landlord’s best alternative option?

The Landlord’s Angle

A landlord will be driven, in the short term (under 6 months), to achieve the following outcomes with its tenants that seek assistance:

1. preserving the maximum incoming rental income from each tenant in its building, complex or retail mall during this time of cash flow duress in order to service its expenses;

2. not prejudicing its position or its legal remedies should the tenant enter bankruptcy or CCAA proceedings, or seek further rent relief or deferral from the landlord later in 2020;
3. receiving more information about the tenant's financial state of affairs to assess the ability of the tenant to survive the crisis; and
4. requiring confidentiality as to the terms of any agreement reached with an individual tenant to prevent other tenants in the building, complex or retail mall demanding the same concessions (i.e. avoid a stampede of all of the tenants demanding the maximum concessions from the landlord).

Potential Options for Discussion

To address this short term cash flow crisis, some of the options landlords and tenants may discuss are:

1. a decrease of the rent payable under the lease for a set period of time (until the tenant's cash flow is back on line) and then an increase in rent that is spread out over a portion of the remaining lease term to offset the short term rent deferral provided to the tenant;
2. structuring rent deferral as a loan from the landlord for which security is provided and which may include personal covenants or indemnities from owners or tenant related parties, including security over their assets;
3. tenants consenting to security deposits held under the lease being transferred and released to the landlord now with a tenant obligation to reinstate the security deposit at a later date;
4. terms of the lease or renewal rights may be modified to: (a) assist in amortizing any temporary rent deferral the landlord provides to the tenant; (b) incentivize the landlord to make rent relief concessions in exchange for a longer term lease; or (c) assist the landlord in negotiations with the landlord's lender to increase the landlord's credit facilities;
5. extending the term of the lease to make it easier for the tenant to obtain additional operating financing from the tenant's lender;
6. for leases with percentage rent, increasing the percentage rent amounts for the spike in sales anticipated when retail businesses re-open for business;
7. in exchange for rent relief or rent deferral, the landlord may elect to amend the lease to include new terms in favour of the landlord such as an early termination right, relocation right, redevelopment right and/or a change to the most current BOMA standard used to measure space in the building; and/or
8. for a tenant with multiple premises leased from the same landlord, the landlord may agree to accept a surrender of a certain number of leases without any financial penalty to help the tenant reduce its overall monthly fixed expenses and provided rent is paid by the tenant under the other leases.

Tenant Liability for Breaching the Lease

A tenant should be aware of its liability exposure if it fails to pay its rent and the lease is terminated. In British Columbia, a landlord can sue a tenant for the rental stream owing on the unexpired portion of the lease term. Accordingly, if a tenant in month 14 of a 60 month (5 year) lease stopped paying rent, then at law, the landlord could sue the tenant for the present value of the rental stream owing for months 15 to 60. Although the landlord would have an obligation to mitigate its losses, with so many tenants being unable to pay rent, it may be impossible for a landlord to find a new tenant for its premises for quite some time. In these circumstances, a landlord could also re-let the premises, as the tenant's agent, and sue the tenant for any shortfall in the rental income received from the new tenant.

If an individual or shareholder has granted a personal guarantee or indemnity to the landlord with respect to the lease, the individual or shareholder would also be personally liable for the rent owing for months 15 to 60, using the example above.

We anticipate if a landlord terminates a lease from a tenant that was otherwise a good tenant pre-COVID-19 and long standing tenant, the tenant's legal counsel will argue the landlord's actions unnecessarily increased the landlord's damages beyond what they would have been had the landlord made some reasonable COVID-19 accommodations to the tenant. This argument would be made to limit the damages the landlord could claim against the tenant.

If a tenant, guarantor or indemnitor to a lease has deep financial pockets, the landlord has no obligation to accept the tenant's breach or surrender of the lease and can insist that the deep pocketed tenant, guarantor or indemnitor continue to make the monthly rent payments as they fall due for the balance of the lease term.

If a landlord opts for the so-called Highway Properties option, where the landlord terminates the lease with notice that it will claim damages, the claim for damages should include not only the unpaid rent and present value of the unpaid future rent for the unexpired term of the lease, but also any provable losses resulting from the tenant's breach of the lease. In the uncertain economic climate created by COVID-19, those additional losses may be significant.

The language of a Highway Properties notice should be drafted with care and legal advice to ensure that the landlord does not limit the damages it may claim at law.

How We Can Assist You

For both landlords and tenants it will be important to draft agreements properly if there are amendments to a lease to address issues of rent relief or rent deferral.

We have experience in negotiating lease settlements on behalf of landlords and tenants under a wide range of circumstances. By participating in many different landlord and tenant COVID-19 negotiations, we will be able to provide you with insight on current market trends and the solutions other parties are discussing with and without success. We will bring that experience to the negotiation table on your behalf to negotiate the best outcome for you.

We also have a strategic alliance with a leading litigation boutique firm in Vancouver, [Hunter Litigation Chambers](http://www.litigationchambers.com) (www.litigationchambers.com), who can handle all aspects of any litigation that arises between a landlord and tenant.

Please contact us if you wish to discuss further.

Policy Considerations and Proposals

Government policy on the COVID-19 impact on commercial leases is currently a work in progress. We have heard of a few proposals that different levels of government are considering to assist commercial landlords and tenants. It will be important for landlords and tenants to monitor any programs the government offers over the next few weeks and months and the applicable eligibility criteria.

So how can the federal and provincial governments and commercial landlords and tenants manage the COVID-19 cash flow crisis? Here are a few policy proposals to kick about. If you have any interesting ideas, please pass them on and, with your consent, we may add them to this article.

- 1. Landlord Super Priority Rights.** If a landlord provides rent reduction or rent deferment to a tenant during the COVID-19 window of March 1, 2020 to [date TBD] and the landlord expects the rent reduction or rent deferment to be paid back by the tenant at a later date during the term of the lease, the rent reduction or deferment should be recognized as a secured lien claim in the event the tenant later goes into bankruptcy or similar proceedings. Bottom line, if a landlord provides a tenant with a COVID-19 financial life line, the landlord should be protected like a secured lender with respect to the amount of the life line.
- 2. Tax Free Interest or Tax Credits for Loans Made by Landlords to Tenants.** If a landlord loans a tenant short term funds by reducing or deferring the tenant's rent payment, the landlord should be permitted to charge interest on those funds on a tax free basis or to receive a tax credit. The government could set a maximum interest rate that a landlord could charge the tenant and a time period by which the tenant must repay the loan to the landlord. For landlords who have available capital, this would provide a tax incentive for such landlords to provide COVID-19 loans to tenants to cover their rent costs, rather than burdening the federal or provincial governments or financial institutions to provide such loans.
- 3. Adjustments to the Landlord's Adjusted Cost Base.** In order to incentivize landlords to provide rent relief to tenants, for each dollar of rent relief a landlord provides to a COVID-19 impacted tenant within a designated COVID-19 time window, the landlord could multiply that amount by [x] (a figure set by the federal government or Canada Revenue Agency) and add the multiplied figure to the owner's adjusted cost base of its real property. This would ultimately reduce the landlord's capital gain taxes when they sold the property in the future and would not impact the tax revenue Canada Revenue Agency collects from property owners until the buildings are sold sometime in the future (i.e. loans are made in 2020 to tenants effected by COVID-19 but the impact on income tax revenue is spread out over many future years).

4. **Short Term RRSP or TFSA Withdrawals.** The government could permit any individual to access funds in their RRSP or TFSA account and allow the person to recontribute these amounts without penalty to their RRSP or TFSA over the next 3, 5 or 10 years. This program would be similar to the Home Buyers Plan. There is no reason why this option should be limited to business owners.
5. **Business Owner CMHC Mortgage Program.** Canada Mortgage Housing Corporation could set up a mortgage program for business owners to access additional capital from their homes or other real property assets in order to fund their businesses cash flow operating requirements. As the debt would be secured against real property and insured by CMHC, the interest rate would be less than what an owner would pay for an unsecured loan or a loan from a secondary private lender.
6. **Business Development Bank of Canada – Deferred Rent Guarantee.** The Business Development Bank of Canada could oversee a program for landlords that provide temporary COVID-19 rent deferment to their COVID-19 impacted tenants. The deferred rent amount plus an interest factor would be added to the rent payments for the balance of the lease, after the COVID-19 crisis passes. The tenant's payment of the COVID-19 rent deferment would be insured by the Business Development Bank of Canada to the landlord similar to how Canada Mortgage Housing Corporation insures mortgages in favour of lenders.
7. **Major Government Intervention.** It is possible the government will decide major intervention is necessary and pass specific legislation focused on commercial tenancies. For example, the government could pass legislation that limits the damages a landlord may claim from a tenant if the landlord terminates a lease during a defined COVID-19 time period. By way of example, the legislation could provide the landlord cannot claim any damages for the future rental stream of the remaining term of the lease. Alternatively, the government may provide the tenants with more negotiation leverage and allow tenants to unilaterally terminate their lease and only be required to pay the landlord relatively small compensation as a result of the early termination. This would hopefully encourage more landlords to negotiate compromises with their good tenants during the COVID-19 crisis.

Already, several US cities, including New York, Los Angeles, Seattle and Portland, are now imposing moratoriums on eviction of commercial tenants for a defined period of time.

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