

Don't be an April Fool!

The inevitable and unintended impact of NOT paying rent April 1st...

The impact of the COVID-19 virus and ensuing government decisions made to protect public health are having an unprecedented impact on our economy and business-as-usual norms. This has generated many inquiries from Cresa clients regarding their obligation to continue paying rent to landlords during this once in a lifetime (as we all hope it is) shutdown.

A number of real estate-related brokerage companies have communicated to the industry at-large regarding their ability to advise tenants in negotiating a rental abatement of some sort with their respective landlords. Remarkably, these offers are positioned as an option available to all tenants.

While it is true that renegotiation may be an option, it should definitely not be considered as a given.

From our collective experience at Cresa, including many years' experience working at some of the largest institutional landlords within the Canadian landscape, rent relief and abatement discussions are not met with any eagerness on the landlord's part. Most landlords in the Canadian marketplace are institutional owners or have institutional stakeholders, and/or have financial covenants, financing agreements and fiduciary obligations in place that preclude such renegotiation being available to all. Additionally, there must be supportable reasons to even entertaining a discussion, regardless of the probability there could be any actual positive outcome for the tenant.

While these extraordinary times and circumstances may result in landlords offering some sort of relief - as a goodwill gesture to help tenants during these days of such unique economic uncertainty and circumstances- it requires much more due diligence. Landlords may offer solutions in concert with industry-wide agreements and other far-reaching economic and quasi-governmental programs to support businesses struggling with reduced revenues, challenged to cover overhead and avoid potential layoffs of employees. However, it is important to know that they are currently under no legal obligation to do so.

Yes, economic circumstances are such that there may indeed be wholesale efforts across the industry to help tenants through these difficult times; but the reality is that the financial constructs of the real estate industry are complex and flexibility for rent relief should not be assumed as a given or a right.

Your business or organization is legally bound to abide by the terms of the lease, so it's important to know that any non-payment of rent without agreement from the landlord may have inevitable and potentially unintended consequences for tenants.

Choosing to withhold rent during a situation that is not caused by the landlord's actions may be detrimental to the tenant, as non-payment may provide landlords permission or legal cover to make changes to your landlord-tenant relationship as provided for in respective leases.

So, how do you find the right answer to your original question? And what can you do about it?

Review your lease... please!

It all starts with the lease. As a tenant, if you now (or expect soon to) need some form of rent relief, the first step to knowing the best answer to your question would be to review the document governing your obligations and relationship with the Landlord - your specific lease.

You may have wondered in years past why leases often range between 50 to 80 pages in length. Well now, you may better understand exactly why. The length is commensurate with the effort to reduce risk and exposure for all parties. These leases are the financial instruments on which landlords rely and are designed to be risk-averse.

Leases outline more than just the square footage a tenant will occupy and at what rental amounts and term. It also outlines:

- The appropriate use of the asset as a shared space with other tenants;
- Your rights to access and use the building/premises and its various common amenities including parking, storage, elevator access, common areas, etc.
- Your rights when it comes to the end of your lease, lease renewal or extension terms, your ability to sublet or even terminate or vacate the premises, as well as
- The remedies and protections tenants can expect in varying situations, and how to initiate these protections whether the situation is caused by the landlord, another tenancy or beyond a landlord's control, when all have impacted your business or organization.

From the landlord's perspective, the lease provides language that governs the tenant-landlord relationship and protects its physical asset, while maintaining stability of income in times of trouble, regardless of the unknown. We are all experiencing such as an unknown right now. And, while it may be an entirely new situation for us all, you can be assured that this unknown is covered off in most, if not all, leases.

Understand your legal obligations

Lease clauses that deal with Acts of God or similar situations where there is no property damage are the clauses to pay attention to. They can be quite lengthy, and will include:

- Force Majeure clauses which govern situations that occur beyond the control of the landlord and/or tenant, such as closures due to the COVID virus shut down, or a strike of construction workers;
- Pre-conditions of the lease include rights that are provided as long as the tenant maintains set prerequisites within a lease, including being in default of the lease. If there is a default, then landlords, more often than not, have the ability to reconsider rights afforded tenants in the lease. Tenants may be at risk concerning their ability to renew or extend, to expand or contract, to use parking or storage, maintain signage on site, etc. This list is not exhaustive. Landlords today include many items as being provided contingent on the tenant abiding by the terms of the lease. Payment of the rents due, for example, could be a prerequisite for all other terms of the lease being provided.
- Default related to payment of rent. Most leases make a distinction between default and material default of a lease. For the most part, though not always, material default refers to financial aspects of the lease which if not cured or remedied by the tenant within a specified period of time from the date of default, or sometimes based on notice provided by landlord, puts the tenant in breach of its lease obligations. Further, what is common with Canadian lease documentation is the use of indemnification rather than a mere guarantee. Why is this important? With a guarantee there is a responsibility for payment of rent and, if such a default occurs, another level of security is available to pay rent, whether it be a parent company, personal guarantees or other financial securities such as letters of credit or deposited funds. However, with indemnification, the parent or affiliated party indemnifying actually becomes a party to the lease, and is automatically responsible for all items of default, financial and otherwise. This is extremely problematic for companies, especially those based outside of Canada. This means the indemnifying party (such as a non-Canadian based parent company) often has automatically assumed the legal responsibility for the lease when in default, material or otherwise, which not only impacts on the rights referred to above, but may also have significant tax ramifications, as the indemnifying party has now effectively become the tenant, and is holding a lease under the indemnifier's corporate legal entity in Canada!

In addition to this, a default may also lead to serious financial and legal implications for your business and/or organization which may have long lasting effects for many years to come. Default will almost certainly impair the tenants' ability to offer a strong financial covenant in the future. More simply: a default may reflect poorly on the company's financial covenant and credit-worthiness, and make it difficult or financially punitive to secure alternative premises in the future.

Non-payment of rent comes with inevitable and unintended consequences! It often triggers a number of changes to a lease, and these changes benefit the landlord (or from the landlord's perspective, protect them).

If you read these sections, you will likely learn there are few, if any, options available to your business or organization to avoid paying rent due and expected on April 1, 2020 without significant consequences to you and your business or organization.

Understand your company's health for the near - and long-term.

Financial covenant of tenants is a crucial factor for any landlord's decision to enter into a lease agreement with any company or organization. The ability to pay rent over the lease term is the first hurdle of any lease negotiation, and with that comes an assessment of the business health of the prospective tenant over the full term of the lease.

Those of us with lengthy experience on the landlord side of the business would most definitely not have entertained requests to delay rents within the first month of any situation. Surely the credit-worthiness of the tenant and related rental stream should be able to withstand a month of economic change? And, if not, we would need to reconsider the financial viability of that tenant now and in the future regardless of unusual circumstances and the recent economic health issues.

Notwithstanding, depending on the individual business we would find it prudent to learn of any challenges to the business in the next quarter and be reasonable when warranted, regardless of fiscal responsibility under the lease. There are financial methodologies and structures that can be created for a win-win for all parties.

Start a Discussion with Your Landlord

Approach your landlord appropriately. Landlords typically do not negotiate against themselves unless they see a silver lining. Something important to keep in mind, though? Landlords are concerned, too!

The landlord's ownership in its buildings is a business and, most often in an institutional framework, is typically owned by a series of beneficial owners such as employee pension plans and their plan members. These are actual people depending on the revenue streams for their current day-to-day income, as well as their future income. The many years of a low interest rate environment has created challenges for these institutional landlords as well, and they may not have a fiduciary ability to very easily agree to new terms. They too have hurdles, rules and regulations to abide by.

Landlords themselves are not resistant to what is happening and if they are able, they will seek to work out a situation that is agreeable to both parties -- it is in their long-term interest to do so when warranted. We do not have purview into landlords' board meetings to understand financial positions and potential appetite for risk, but they also want to ensure they have continuity of revenue from financially healthy tenants. You might say landlords are somewhat incentivized to support their tenants in avoiding insolvency. There are structures that minimize risk for both parties, if they are open for discussion. They do not have to make concessions on behalf of tenants, but it is mutually beneficial to open up a dialogue and review.

Do your homework and have the conversation

You can only know the best course of action for your business by reviewing the terms of your lease, and understanding what your obligations are to your landlord. Knowing what specific impact withholding rent will have on your business or organization – from a financial and legal perspective, and for both the short and long term - will help you and your management team decide what appropriate actions to take. Be sure to have a realistic picture of your business' financial health to support those decisions, and how long you might need this relief. Discussing these options with your landlord, and working toward an agreeable solution for your business now, and for the future, are the smart next steps to take during a time when knowing what to do next is a big question mark for us all. The fiscal responsibility and accountability will be appreciated by your landlord.

