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## Navigating coronavirus: Considerations for rent modifications in the U.S.

As people across the country practice social distancing and are increasingly being asked to shelter-in-place in response to the coronavirus pandemic, Americans are drastically reducing visits to commercial real estate spaces. The effect that this has had on tenants that rely upon such visits to generate income has been severe and immediate. As a result, many tenants and landlords are struggling to deal with cash flow shortages.

We have received numerous inquiries from landlords, tenants, and lenders requesting legal guidance for structuring rent modifications for commercial tenants that are suffering from the economic hardships caused by the pandemic. In discussing these issues with our clients, we have identified the following items for consideration for landlords and lenders prior to approving any rent modifications with tenants.

### **Should a landlord grant a rent deferral or agree to a forbearance?**

If a landlord agrees to modify a tenant's rent payments, the landlord would need to consider the structure of the modification. The rent modification could either be structured as a deferral of rent for a certain period of time or an agreement that the landlord forbear on exercising its remedies against the tenant as long as the tenant makes rent payments based on an agreed upon payment schedule. Though this may seem like form over substance, this choice has important implications if a tenant subsequently declares bankruptcy. In bankruptcy, landlords generally have a claim to recover all rent that became due and owing prior to the tenant declaring bankruptcy. On the other hand, a landlord's recovery for rent amounts that become due and owing after the tenant declares bankruptcy are capped pursuant to Section 502(b)(6) of the Bankruptcy Code. Therefore, in a rent deferral scenario, if a court views the modification as an agreement to change the due date for such rent payment, the landlord's

claim to recover this rent could be capped. As a result, characterizing the rent modification as a forbearance instead of a deferral could maximize the likelihood that a landlord (or lender) is able to avoid having its recovery on the modified rent amounts being capped in bankruptcy. In determining whether a forbearance is the right approach, landlords should expect pushback from tenants that will prefer to take the rent deferral approach instead of being considered in default under the lease.

### **Should a landlord apply the security deposit?**

In lieu of agreeing to a rent modification, some landlords may wish to draw on a tenant's security deposit. Applying the tenant's security deposit could help landlords cover a short-term lapse in rent payments and ensure that the landlord can meet its near term obligations, but would not provide a long-term solution to providing the landlord cash flow from the tenant. If a tenant is unable (or unwilling) to keep current on its rent then it is also likely that the tenant will not be in a position to replenish the security deposit even though it would be required under the lease. Therefore, drawing on a tenant's security deposit will only provide temporary relief and the tenant's obligation to replenish the security deposit may further stress the tenant's financial situation in a way that will not allow them to recover when business resumes. However, if there is a provision in the lease that provides a burn-down of the security deposit over time, this mechanism should be paused during the rent modification period.

### **Should a landlord charge late fees and/or interest?**

If a tenant misses a rent payment or makes such payment after the due date, most leases provide for a

late fee and/or for interest to accrue on the outstanding amount. Many landlords are still charging such fees, but modifying them so that the payments become due once the tenant's rent payments increase to normal levels. In addition to modifying the payment date for such fees, lenders should also consider whether the payment should be required as a lump sum payment once the tenant has sufficient cash flow or whether the landlord would like to space out the payment of such additional fees so as not to unduly stress an otherwise performing tenant's operations.

### **Should modified rent payments be guaranteed?**

If the lease is not guaranteed, the landlord should consider requesting a guaranty from a creditworthy parent entity of the tenant in connection with a rent modification. The guaranty could be limited to covering the rent payments that are being modified (along with any fees that accrue in connection therewith) or could be a full guaranty of all of a tenant's obligations.

### **What other collateral should a landlord receive?**

Given the lack of liquidity for most tenants, delivering a letter of credit or an increased security deposit is not a realistic option for tenants seeking a rent modification. One option to consider is whether a tenant could post bonds or treasury bills held by the tenant. Or, consider whether a tenant may have additional collateral it can post in lieu of the usual options. Many leases already grant the landlord a lien on all of the tenant's assets used in connection with the demised premises. If your lease does not contain such a provision, then an amendment should be executed that would create such a lien. In determining whether that security interest will provide a meaningful avenue of recovery for the landlord, the landlord will need to consider what other claims may exist on the collateral by running searches (such as UCC and litigation searches) and may need to file a UCC financing statement or make other filings to perfect the landlord's security interest.

### **What other lease modifications should a landlord consider?**

If your tenant is otherwise a good tenant, consider whether you can extend the lease term in exchange for a rent modification to keep the tenant in place longer. Alternatively, given that tenants are asking landlords to take on their downside risk in the near term, landlords

should consider requesting the addition of a percentage rent structure in the lease (or an increase in the percentage rent if these provisions already exist) so that the landlord receives more potential upside for taking on this risk.

### **What additional things should a landlord consider if landlord is a real estate investment trust (REIT) or is owned by a REIT?**

A REIT must satisfy several complex statutory requirements on an ongoing basis in order to maintain its income status as a REIT, including the annual gross income tests and the quarterly asset tests. In addition, a REIT must distribute 90% of its taxable ordinary income to maintain REIT qualification and 100% of its taxable income and gains to eliminate income and excise taxes. A landlord that is a REIT (or that has REIT owners) must be cognizant that lease modifications, tenant defaults, and cash constraints (together with changes in asset values within a REIT's portfolio) may impact the REIT's ability to satisfy these requirements. Deferred rent should be analyzed on a case by case basis to determine if any income will be required to be accrued for tax purposes, while the resulting decreased cash revenues may affect a REIT's ability to satisfy its distribution requirements. All rent deferrals and other lease modifications or amendments, in particular those that add or modify any percentage rent structures, should also be carefully analyzed to determine if they result in basing all or part of the rent on the income or profits derived by the tenant from the property. "Profits based rent" may result in all or a portion of the rent from the property being disqualified for REIT testing purposes. Material lease amendments, together with changes in asset values within a REIT's portfolio, may affect the REIT's ability to satisfy the required tests. In general, a REIT may not own "securities" constituting more than 10% of the total value or voting power of the outstanding securities of any one issuer. Special care should be taken by landlords considering advancing cash loans or other funds to tenants, or taking equity interests in a tenant, as these positions may be considered "securities" with adverse consequences to a REIT's ability to satisfy applicable tests. In addition, the ownership of certain interests in tenants may risk converting otherwise qualifying rents into non-qualifying "related party rent" income.

The above represents our latest thinking in “real time” and will likely evolve over the coming weeks and months. Our teams of lawyers across the globe are continuing to compile the latest thinking and legal guidance on the coronavirus outbreak. To track our latest updates, which will include more specific discussions of particular contractual concepts, we encourage you to check the Hogan Lovells [COVID-19 Topic Center](#), which covers a wide variety of practice areas across the globe. To access guidance on similar topics provided by our lawyers in other jurisdictions please click [here](#) and [here](#).

*These are only general considerations and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed below.*

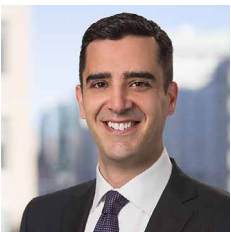
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