

Law & Accounting

Tenant protections from landlord defaults, financial trouble

EDITOR'S NOTE: This is the first in a two-part series. Part 2 will published June 5, 2024.

Lease negotiations often focus on what assurances a landlord needs that the tenant will pay and perform its lease obligations on time, but in a post-COVID-19 world, where many commercial owners and developers are facing distress due to market uncertainties, the roles have been reversed and tenants are focusing more on protecting themselves from nonperforming landlords. With the significant time and money that is expended moving into and building out new space, and the long-term nature of a commercial landlord-tenant relationship, it is important for tenants to complete diligence on a potential landlord and have appropriate protections and remedies in place in case a landlord defaults. There are three main ways to accomplish the foregoing. The first two ways, which this article will cover, are evaluating a potential landlord's financial strength and negotiating meaningful protections and remedies for a landlord's economic defaults. The third way, which will be addressed in the second part of this two-part series, is negotiating for robust protections and remedies for a landlord's noneconomic defaults.

Before dedicating significant time and money to lease nego-



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tiations, and certainly before signing a lease, tenants should do some basic diligence on their potential landlord.

■ **Review financials.** Just as landlords review tenant financials before committing to a lease, tenants should request a review of a potential landlord's financials. This will likely require signing a nondisclosure agreement, but can provide useful insight into the financial strength of the potential landlord and its ability to meet its debt service and other financial obligations that could affect building operations and the success of tenants.

■ **Do research.** One easy way to get some insight into a potential landlord is to simply Google it. Read any current news articles on the potential landlord, its parent company, principals or any known closely related affiliates. This could help shed light on whether its present operations seem to be stable, expanding or in distress.

■ **Complete public records searches.** Consider running litigation and bankruptcy searches



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on the landlord, its parent company and any known closely related affiliates. These searches can provide confirmation of no major lawsuits or bankruptcy actions of concern, or provide insight on current or possible legal and financial issues that could affect a landlord's ownership or operation of its asset.

■ **Review title.** If possible, obtain a recent title report or run a new title report. If there are significant judgments, encumbrances or other monetary liens on record, further inquiry is highly recommended and resolution may be necessary before lease execution. A title report will also show the covenants, conditions and restrictions that bind the property, which helps evaluate restrictions on the tenant's planned use, types of construction and use approvals required or other limitations and obligations that may impact the landlord's operation of or cost to operate the property (as tenants will likely be paying for such costs through operating expenses).

Once a tenant is comfortable with the landlord, the next thing

to consider is protecting the benefit of the economic bargain that the tenant struck. If a tenant negotiates for an improvement allowance or free rent period, the base rent will be increased accordingly, and while the tenant's out-of-pocket costs may be delayed, such tenant rental obligations will account for the tenant inducements and the tenant should ensure that it actually receives the benefit thereof.

■ **Set-off rights.** A common option is to negotiate for an off-set right in the lease, permitting a tenant to deduct any unpaid landlord obligations (i.e., tenant allowance) from its rent payments if the obligation is not paid. The tenant would still have to come out of pocket initially to cover costs that the landlord is responsible for, but the set-off provides a mechanism for tenant recovery, albeit tied to the amount of rental payments under the lease and only over a period of time. Note that in this case, a tenant should make sure that the subordination provisions of the lease and/or an SNDA (if applicable) require a foreclosing lender to recognize this offset right (as well as any free rent period).

■ **Letter of credit or guaranty for allowance.** Although not frequently given, a tenant can try to get a landlord to put up a letter of credit or guaranty from an upper-

tier entity to ensure that funds will be available to pay the allowance. This can protect against landlord bankruptcies or other financial difficulties, and may provide an alternate source of funds in the event a foreclosing lender does not agree to recognize a landlord's allowance obligations.

■ **Mutuality of force majeure.** Leases typically specify that force majeure does not extend a tenant's time frame to make rent payments, but this concept should be made mutual. The landlord should also not be able to defer payment of amounts owed to the tenant due to force majeure.

By doing some diligence up front, tenants can identify red flags to avoid signing a lease in a building with a landlord that is already showing signs of distress, and by negotiating for some of the above-described protections, tenants can help insulate themselves from the more immediate effects of landlord economic distress. Aside from protecting its economic interests, a tenant should also protect against a landlord failing to perform its other lease obligations and the longer-term implications of a nonperforming landlord, which will be addressed in Part 2 of this series. ▲

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