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Retail Lessons Learned: Savvy Landlords, Commercial Tenants Are in This Together

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The pandemic brought with it social distancing, enhanced telecommuting and other health protection policies, and it was followed by business interruption lawsuits, mothballed bankruptcy cases, fights over ongoing rents, certain government-sponsored loans, and tremendous uncertainty for retailers, restaurants and other consumer-based companies. The retail sector suffered economically, and retailers/restaurants with locations across the country filed for Chapter 11 bankruptcy. One of the primary

consequences was for financially distressed companies to utilize the Bankruptcy Code's provisions for rejection of above-market leases or underutilized real estate to reduce their physical footprint and related obligations.

Last year, in the midst of the pandemic, I wrote about "**The Ten Commandments of Landlord and Commercial Tenants in Bankruptcy**," which discussed some technical aspects of landlord and commercial tenants in Chapter 11 bankruptcy. There has been plenty of cases in the interim, which shape the landlord/commercial tenant dynamic both in Chapter 11 bankruptcies and in workouts.

In workouts inside and outside bankruptcy, landlords and commercial tenants have proven savvy and mutually symbiotic. These entities learned quick lessons during the pandemic to sustain the landlord-tenant relationship on adjusted footing or otherwise to provide an agreeable runway for a lease exit minimizing the damage to landlords and tenants. Three workout trends reflect this changing landscape that "we are all in this together."

Leverage Is Best Recognized But Applied With Restraint

For businesses behind on rent with long-term leases, landlord concessions and abatements provide an interim lifeline but are not outcome determinative. Economic footing remains unstable leading to litigation disputes between landlords and tenants. This creates a wedge between them without providing any certainty or resolution for the troubled relationships to keep locations filled, generate some revenue with corresponding rent payments, and enable streamlined businesses with more efficient commerce streams to provide products and services to their customers.

Outside of bankruptcy, negotiations focus on a variety of new lease terms like collateral substitution, increased financial reporting, and updating default mechanisms and remedies, etc. In addition, creative workouts are fashioning other hybrid mechanisms to ensure rents get paid at a minimum amount plus kickers for gross sales percentages or other modified profit percentages. Inside bankruptcy, agreements have been crafted to forgive pre-bankruptcy amounts (that is, negotiating discounted "cure" amounts), providing additional abatements of

continuing rent for certain periods, and providing for agreed lower percentages of stated rent to be paid during periods of future business closures due to pandemic-related government regulations.

Generally, landlords have more leverage outside bankruptcy, while commercial tenants have more leverage inside Chapter 11 bankruptcy. However, successful workouts tend to involve parties with leverage using restraint to close deals providing more certainty of result. Perhaps with less upside but also less downside for all involved.

Percentage Rent Mechanisms Refined

Percentage rent is negotiated as percentages of gross sales either added to or in place of minimum rent amounts. Historically, this was done with retailers and restaurants in which landlords wanted the upside of tenants' seasonal businesses or to address other variant liquidity measures. Typically, deals were done without caps on the percentage rent addition, where the set percentage applied in the agreed-upon manner and most always was based on gross sales.

However, "necessity is the mother of invention," with financial pressures mounting during the pandemic. Landlords do not want anchor tenants to vacate space, and tenants do not want remaining liquidity or lender/equity reserves to fund space not being used the same way as before (that is, it is more important now than ever to not work for the space, but have the space work for you). Thus, we have reached a new nexus.

Deals have been negotiated in the pre-bankruptcy workout phase for lower minimum rent or abated rent in this hybrid rent situation in exchange for a percentage of revenue (still mostly gross sales but some specific negotiations have been net of certain lender payments and essential nonowner employees) and with a capped aggregate rental amount. Such mechanisms have not been used for long-term rent situations but in transitional periods for companies reopening premises or transitioning out of the lease space entirely (more on that below). This limits the upside for the landlords but more of these deals are including minimum rent components, where prior deals had gross percentage sales as the only feature during start-up or seasonable periods without any minimum rent provisions.

Please Stay While You Go

The mutual goal for landlords and commercial tenants has been to avoid hitting rock bottom. Bankruptcies could be filed for distressed companies and personal guarantors, but are devastating for employees, creditors (including landlords) and consumers if it is a true shut-down liquidation. Some landlords have debt structures requiring them to avoid falling below certain vacancy thresholds, where interim abatements make sense pending hopeful stabilization. Thus, workout requests and accommodations have been prevalent since the pandemic outbreak.

However, when tenants decide to close or leave the premises unconditionally, then negotiations shift for tenants not to immediately surrender the premises and stay operating for an agreed period with only minimal monthly rent, or a pre-determined discounted rent amount, or even percentage rent, while landlords/tenants looks for a replacement tenant. In exchange, landlords resolve existing debt, release guarantees, etc. as parties work together to shorten the vacancy gaps between tenancies.

Conclusion

For larger retailer/restaurant entities with hundreds of storefront locations and many different landlords, negotiating workouts while under strict lending formulas and tranches of secured debt is a logistical problem best suited for a single forum in Chapter 11 bankruptcy. It is more expensive and with variant stakes for the parties, but workout negotiations also occur inside of the Chapter 11 proceedings. As noted, leverage shifts in Chapter 11 but restraint and leeway have proven successful for counterparties since the onset of the pandemic. For those retailers, restaurants and other businesses (and their landlords) that have a more manageable portfolio of locations, workout discussions avoiding Chapter 11 remain prevalent, quicker and less expensive, where savvy landlords work together with commercial tenants to address the parties' respective obligations and mutual interests.

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