

Lease Workouts: Should we even get started and can we really get there? (News Alert 1)

09.23.09

Winstead News Alert

This news alert is the first in our five-part series covering both the basics and current trends in various leasing topics, including (among other matters) lease modifications, workouts, lockouts, personal property matters and enforcement of remedies.

All too common today is the phone call from Tenant to Landlord asking for “relief.” Whether the request is for rent reduction, smaller premises, shorter term or a variation on one or all of those themes, Landlords feel pressure to be accommodating, even when they know that the relief being sought is not likely to prevent ultimate default. There are certainly good reasons to work with Tenants during tough times, but times like these do raise the question of how to evaluate the wisdom and efficacy of a Tenant’s request for lease modification. This alert will briefly explore some suggestions for how Landlords can make good short term decisions without undue harm to their long-term interests.

1. Is Tenant already in Default?

If Tenant has already missed rental payments or a material deadline, such as opening for business, Landlord should focus on the following:

Preserve the Default

There’s no reason to weaken Landlord’s hand while considering ways to assist the Tenant.

- Continue to send required notices and honor cure periods, and be certain to include appropriate caveats against future potential “waiver of default or remedies” claims. Not only does the Landlord maintain its superior legal position, but this keeps the Tenant grounded during negotiations.
- Require an executed “standstill” agreement, containing a straight-forward statement that negotiations are non-binding until an agreement is fully executed and delivered and a confidentiality statement that binds the Tenant not to discuss the terms of modification or even the existence of negotiations, as well as a drop-dead date for end of negotiations to encourage practicality on both sides.
- Anticipate failure of negotiations and eventual litigation—protect lawyer-client privilege and honor confidentiality procedures, maintain a small negotiating team, and emphasize caution with emails. If negotiations are likely to be contentious, adding the counsel of a real estate litigator at an early stage may be advisable.
- Require Tenant to contribute to Landlord’s legal fees, so long as the Tenant’s immediate financial condition will bear that cost (or consider other types of reimbursement, such as increased rent).

Be Realistic and Know Landlord’s Limits

- If Landlord is not in a position to waive monetary defaults or accept only a partial cure (or if Landlord’s lender or investors won’t allow it), then the requirement for complete cure should be announced early and without equivocation. If Tenant cannot comply, modification discussions become unnecessary.
- Understand the cause of and/or Landlord’s case for enforcing any non-monetary defaults by Tenant and address that exact problem early in negotiations. For instance, if Tenant is delaying opening because the larger project is behind schedule, Landlord should consider rent abatement while still requiring Tenant to open, thus giving Tenant time to establish target sales and providing Landlord a positive event (i.e., a store opening) on which to build. If Tenant is delayed in completing construction because its financing has dried up, Landlord

should quickly assess the realistic possibility of whether it can or should provide or increase a construction allowance. If additional Landlord support is not workable, it is unlikely that a lease modification will solve the problem.

- Identify issues caused in other leases by Tenant's proposed modification. If a delay in opening will trigger co-tenancy defaults or if rent abatement will cause a breach of loan covenant in Landlord's financing, evaluate whether the cost to Landlord of assisting this Tenant may exceed the loss to Landlord due to the Tenant's default.

2. Can Landlord Concessions Really Make a Difference?

Assuming Tenant is not already in default, an accurate determination of what plagues the Tenant, if anything, and whether the requested lease concessions will cure the problem is critical.

Due Diligence is Key

- Review the Lease to confirm basic terms (including Tenant parties and the existence of any guarantors) and Landlord's remedies in case of eventual default.
- Obtain from Tenant a current and accurate balance sheet and profit and loss statements, 12 months of sales reports (for retail Tenants) and debt/equity structure information.
- Require Tenant to prepare and provide a business plan for the remainder of the Lease Term (or at least the next 5 years). This will allow Landlord to assess whether the Tenant is being realistic about both its own performance and that of the Landlord's project.
- A refusal or hesitance of the Tenant to share such information should be a warning to Landlord that the Tenant may be either insufficiently managed or seeking modification on a purely opportunistic basis. In particular, national Tenants should not be indulged in attempts to use current economic conditions to demand rent concessions across the board, without regard to individual store performance.

Be Creative

Even if Landlord is not convinced that Tenant's specifically requested lease concessions, whether reduced or abated rental or a change in the lease term or premises, will allow the Tenant's business to survive, there may be a good reason to keep the Tenant under lease and open for business.

- Most co-tenancy provisions in retail leases are term limited, and Landlord can avoid potentially harmful rent abatements or termination by other tenants by keeping a key tenant operating through the expiration of the applicable critical term.
- If the applicable property has recently gone through foreclosure, immediate cash flow may be less important to the lender-now-landlord than the avoidance of "dark space," since the "dark space" may hamper attempts to improve the overall occupancy of the property.

Where it is determined that some relief is appropriate, note that the exact relief requested by the Tenant may not be. Many Tenants will go straight to the bottom line and want to shed the lease altogether or significantly reduce the base rent. Consider instead:

- Allowing a restaurant to reduce its minimum hours (such as closing just after the dinner rush) to avoid paying employee wages and utilities during non-peak hours. Tenant will achieve a cost saving perhaps equal to the requested rent relief, and everyone wins (so long as the reduced hours are not an image or co-tenancy problem for the Landlord).
- Offering building exterior signage or, under the right circumstances, building branding, to a quality office tenant seeking to obtain a better over-all value.
- Relaxing Tenant's assignment and subletting requirements rather than taking back a portion of the premises.
- Increasing Tenant's revenue by allowing tasteful sidewalk sales, contributing a lump sum to more effective signage or agreeing to have a retail Tenant's coupons distributed by the concierge to office tenants of a mixed use development.
- Relocating a struggling office Tenant from a prime location to more modestly priced space within the same building or to a less prominent building within an office complex.

Creative solutions can have the added benefit of avoiding conflicts between the Landlord and its lender or investors over reductions in income stream or caps on pass through expenses.

Lastly, finding innovative lease solutions or inducements may be as simple as reviewing the file for business terms requested but not granted to the Tenant in the original lease negotiations. What once seemed unappealing or unworkable may now represent an opportunity for Landlord to salvage, and perhaps even enhance, a relationship worth saving.

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