

Leasing In Troubled Times



Theani C. Louskos is a shareholder with Bartko, Zankel, Tarrant & Miller in San Francisco. She represents clients in a broad range of commercial real estate transactions including leasing, acquisitions and sales, financing and loan workouts. She represents both landlords and tenants in commercial leasing matters and

specializes in the representation of national retail tenants. Ms. Louskos is a frequent speaker at retail leasing programs and has written articles on retail issues for real estate publications. She can be reached at tlouskos@bztm.com.



M. Rosie Rees is a graduate of Loyola University Law School in Chicago. She is a partner with the law firm of Pircher, Nichols and Meeks, a real estate boutique law firm with offices in Chicago and Los

Angeles. Rosie is head of the retail leasing department in the firm and has specialized in retail leasing for over 15 years. She has represented both landlords and tenants and has done leasing for all size shopping centers from the smallest strip center to the largest regional mall. Rosie has particular experience in doing the initial lease-up of newly constructed centers. She frequently speaks on retail leasing panels and has written articles on retail issues. She can be reached at rrees@pircher.com.

Theani C. Louskos and M. Rosie Rees

Landlords and tenants are facing some difficult issues today, whether in negotiating new leases or in restructuring existing leases.

THE PAST THREE YEARS have been difficult for the retail industry. Landlords and tenants have learned some hard lessons. There has been an increase in tenant bankruptcies and more tenant defaults. These events, with the benefit of hindsight, demonstrate the importance to the landlord of getting security for performance of tenant's lease obligations, such as security deposits and letters of credit.

Tenants cut back on their expansion plans and dropped out of projects, creating co-tenancy failures. Many landlords learned the hard way the perils of granting co-tenancy rights and remedies to their tenants.

There have also been more landlord defaults, landlord bankruptcies and lender foreclosures, resulting in unfinished projects and stores. Tenants have learned from these events how important it is to obtain security from the landlord for the performance of landlord's build out and tenant allowance obligations and to negotiate the right to terminate the lease or to complete the build out of the tenant's store that the landlord started but did not finish. Given the increase in lender foreclosures against landlords, tenants have seen firsthand the importance of obtaining a subordination, nondisturbance and attornment agreement (SNDA) from the lender so that the lease

is not terminated when the lender forecloses. Because many foreclosures occur with respect to unfinished projects, the SNDA should specifically address what happens if the lender forecloses before construction of the shopping center or the tenant's store has been completed. Will the lender complete the work? Will the lender agree to tenant's termination rights or self-help rights to complete the work and deduct the cost from the rent if the lender will not complete the build out?

Many existing projects and individual stores have not done well in the poor economy. Tenants have learned the value of negotiating a gross sales termination right which gives them the right to terminate their lease if their store sales do not achieve a certain level.

Landlords are facing more requests for lease workouts and concessions from troubled tenants,

and landlords must evaluate whether it is better to grant rent relief or other concessions to a tenant or to refuse and therefore risk a tenant's default and cessation of operations, which could create co-tenancy failures and hasten the failure of the shopping center.

Finally, landlords are having to be more creative and aggressive about filling vacancies. Unfortunately they often find that existing shopping center use restrictions are inhibiting their ability to lease space to "atypical" shopping center uses.

The following is an outline of some of the key issues facing landlords and tenants who are negotiating new leases in difficult retail times, and who are restructuring existing leases, and dealing with co-tenancy failures.

1. Security For Performance Of Lease Obligations

a. The options available to landlord to secure tenant payment of rent and tenant build out obligations include cash security deposits, letters of credit, lease guarantees and construction bonds.

b. The options available to tenant to secure landlord obligations to build out tenant premises and/or to pay the tenant improvement allowance include letters of credit, payment guarantees, and escrow accounts for the deposit of construction funds and the tenant improvement allowance. Tenants may also negotiate self-help rights to perform landlord's build out of the tenant's premises if landlord fails to do so. Tenants should also negotiate the right to offset the amount of any tenant improvement allowance from rent if the landlord fails to pay the allowance.

c. Cash security deposits are easy to establish and to collect from, but the utility of cash security deposits may be limited if the party that has put up the deposit files bankruptcy. Letters of credit may have benefits over a cash security deposit in the event of the bankruptcy of the party putting up the letter of credit, as the letter of credit is often viewed by the courts as an independent obligation of the issuing bank and not a direct obligation of the debtor in bankruptcy. Guarantees of specific obligations from a creditworthy third-party guarantor may also be beneficial. (State laws should be reviewed for specific requirements for enforceability of a guarantee.)

Where construction obligations of the landlord, for example, are to be secured, the tenant may require a completion bond (which secures against the landlord's financial inability to complete the construction) and/or a payment and performance bond which is primarily used to protect against mechanic's liens and

contractor defaults. Alternatively, the tenant may require that the funds necessary for completion of the landlord's construction obligations be deposited into an escrow account. Self-help rights for the tenant (should the landlord fail to complete its obligations to build out the tenant's premises) may also be a useful form of "security." However, before the tenant undertakes self-help rights, the tenant needs to consider what work tenant should undertake. It is unlikely that the tenant will want to remediate hazardous materials or to perform any landlord construction obligations that are outside of the tenant's premises. If tenant's contractor performs the work, tenant's contractor and tenant could unwittingly assume liability for construction defects so tenant will want to obtain adequate warranties from its contractor to cover construction defects. Tenant also needs to consider who will have the ongoing repair and maintenance obligations under the lease for work that the tenant performs on the landlord's behalf. The tenant will want to ensure that any maintenance, repair and replacement obligations (including in case of a casualty) normally assumed by the landlord in the lease are not eliminated or modified merely because the tenant performed the initial work.

2. Gross Sales Termination Rights

The tenant may negotiate the right to terminate the lease if the tenant's annual gross sales do not exceed a specified amount ("gross sales threshold") during a particular period of time during the lease term ("measuring period"). The following are some of the key issues to address in any gross sales termination provision.

- a. Clearly define gross sales and exclusions and clearly define the gross sales threshold and the measuring period. Many disputes arise because the measuring period was carelessly drafted. Whenever possible, identify the measuring period with actual dates. If the measuring period is defined by lease years or rental years, be sure those terms are clearly defined in the lease.
- b. The tenant should consider getting more than one gross sales termination right in a long term lease; for example, a termination right if gross sales in the third year do not exceed the gross sales threshold, and another termination right in the sixth year if gross sales do not exceed another gross sales threshold.
- c. The landlord should require tenant to provide monthly statements of gross sales during the measuring period (and even for prior periods), and landlord will want the right to audit tenant's gross sales before the termination becomes effective.
- d. The landlord should require the tenant to deliver a gross sales termination notice within a fixed period of time after the end of the measuring period and require sufficient time before the effective date of the lease termination, so landlord has adequate time to find a replacement tenant.
- e. If the landlord has provided tenant with a tenant improvement allowance, the landlord may require tenant to pay landlord a termination fee to reimburse landlord for the unamortized portion of any tenant improvement allowance paid to tenant. Landlord may also require reimbursement from tenant of the unamortized portion of landlord's construction costs for a turnkey store or any broker's commission paid by landlord.

f. Although less common in the troubled retail environment (where many landlords are looking to have operating tenants even if the tenants are not performing well), the landlord may also negotiate a landlord gross sales termination right if the tenant does not meet a certain level of gross sales during the measuring period.

g. Tenants with existing gross sales kickout rights may not have achieved the required gross sales threshold and have the right to terminate the lease. However, the tenant may be willing to stay if it receives rent relief or if it sees the potential for better sales in the future, and if so, the tenant may want to postpone the exercise of its termination right in exchange for a current rent reduction. Some tenants have the right to terminate the lease due to a co-tenancy failure and they may negotiate with the landlord to delay exercising a termination right, to give the landlord additional time to cure the co-tenancy failure, in exchange for a current rent reduction.

3. Lease Workouts And Restructuring

a. **Rent Relief.** Many tenants are seeking, and landlords are often agreeing to, rent relief in order to avoid a tenant default and closure of a tenant's store. The tenant could request a temporary rent reduction of minimum rent while continuing to pay operating expenses and percentage rent), or the tenant could convert to paying a gross rent based on sales. If the tenant has prior past due rent payments and is able to negotiate a temporary or permanent rent reduction, the tenant will often negotiate for a waiver of all past due sums or at least get the landlord to forbear from collecting past due amounts for an agreed period of time. The landlord may even agree to a complete waiver of the past due sums if there is no new tenant default under the lease.

b. **Lease Extensions and Renewals.** Many tenants at the end of their term are faced with a decision whether to renew the lease or to exercise an existing option. The tenant may want a short lease extension (e.g., one year) instead of agreeing to a longer term extension or exercising an existing multi-year option. Because many tenants find that the minimum rent for their existing option rights are now "above market," they are negotiating reduced minimum rent for the option periods. In some cases, tenants are agreeing to exercise their option rights early, in consideration for the minimum rent reduction. Some tenants are negotiating a gross rent based on sales in lieu of exercising an option at a fixed minimum rent. Where tenants have agreed to longer term lease extensions, they are also negotiating early termination rights. Similarly, landlords who have agreed to lease extensions at a reduced rent are negotiating for early termination rights, so the landlord can replace the existing tenant with a new tenant willing to pay a higher rent and to commit to a longer term.

c. **Early Lease Terminations.** A landlord may agree to an early termination of the lease upon payment by tenant of a termination fee and a mutual release of claims. Landlords will want the tenant to agree that if in a subsequent tenant bankruptcy the landlord is required to return the termination fee, the termination of the lease will be void and any release of claims will also be negated. Any release of claims should carve out further third-party claims.

4. Dealing With Co-Tenancy Failures

Many landlords are facing co-tenancy failures in their centers which give other tenants the right to exercise co-tenancy remedies. Landlords need to assess their rights to cure or contest claimed co-tenancy failures. Landlords need to carefully consider the following issues.

- a. What co-tenants were required? Were specific required co-tenants identified by name? Where were the required co-tenants to be located?
- b. Does the lease require that a percentage of the total gross leasable area (GLA) of the shopping center be occupied by operating retailers; or, just a percentage of the number of tenants and occupants leasing space in the shopping center? If there is a required percentage of total GLA of the shopping center, how was the shopping center defined? Did the landlord agree to a “minimum GLA” of the shopping center so that even if the actual GLA of the shopping center is less, the minimum GLA will be the denominator for calculating the required GLA percentage?
- c. Can the required co-tenants be replaced? Is there a definition of an acceptable replacement co-tenant? Must the replacement co-tenant be approved by the tenant with the co-tenancy rights? Does the replacement tenant have to be in the same location as the co-tenant being replaced and occupy the same size space?
- d. What remedies does the tenant have for co-tenancy failure — rent abatement, a right to pay substitute rent, the right to terminate the lease, and/or a right to close if the tenant itself has an operating covenant? Is there a “fish or cut bait” clause whereby the tenant must either elect to terminate the lease or resume full rent if the co-tenancy failure continues for a certain period of time?
- e. If there is arguably a “noncurable” co-tenancy failure (i.e., if the co-tenancy required specific named tenants who the landlord will never be able to get due to such tenant’s bankruptcy, going out of business, or the like), what options does the landlord have?
- f. If the tenant can terminate, does the landlord have to pay tenant the unamortized cost of its tenant improvements? Does the landlord have to pay other costs? Is there a cap on the costs?
- g. Does the landlord have to affirmatively notify the tenant of the occurrence of the co-tenancy failure? Does the tenant have co-tenancy audit rights?

5. Effect Of Restrictions In Other Shopping Center Agreements On Landlord’s Ability To Lease The Shopping Center To Fill Vacancies And Cure Co-Tenancy Failures

Landlords need to be aggressive about filling shopping center vacancies. Unfortunately, landlords are finding that existing leases and other shopping center agreements restrict the landlord’s ability to fill vacancies and to cure co-tenancy failures. Landlords need to review existing leases and REAs to determine their options:

- a. Do existing leases and REAs contain restrictions on uses such as thrift stores, government offices, auto sales or auto repair locations, and even on restaurants and other entertainment uses?
- b. Can landlord subdivide empty big box spaces into smaller spaces or will that cause co-tenancy violations under other tenant leases?
- c. Does the landlord have the right to modify the shopping center site plan in order to accommodate new and different types of tenants or do existing leases and REAs limit the ability of landlord to modify the site plan or areas within an agreed upon tenant “control area”?

**To purchase the online version of this article,
go to www.ali-aba.org and click on “Publications.”**



Easy.

Can't attend a live course or webcast? It has never been easier to take advantage of the best CLE in the country! ALI-ABA's highly regarded courses and products are available to you in a variety of easy-to-use formats that fit your professional needs.

www.ali-aba.org

Online CLE: on-demand audio and video

ALI-ABA's nationally renowned courses of study now are available in segments or as a complete course. Free access to the archived course online is available to registrants who attend the live course or webcast.

On-Demand audio/mp3 Downloads

More than 500 recent lectures and course materials from ALI-ABA's CLE programs are available online. On-demand audio streams directly to your desktop and qualifies for self-study CLE credit in numerous states. Audio mp3 downloads can be downloaded from your computer to your handheld or mp3 player.

Books, Magazines, Articles & Forms

Access thousands of searchable course materials online, as well as hundreds of editable real estate, tax, and business forms; a growing library of estate planning, business, and litigation books; and all of ALI-ABA's periodicals.