



LAW JOURNAL  
NEWSLETTERS

# Commercial Leasing

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## In the Spotlight

### *Lease Audits: Adding Value in Troubled Times*

By Mark Morfopoulos

Nobody needs to tell you that times are tough. The retail industry has not seen a decline like this in decades, if not longer. As a tenant, you have been hearing about other tenants making successful demands to have their rents either lowered or partially deferred in the middle of their lease term. Although this may be an option for you, another opportunity to keep costs under control is to perform an audit of your landlord's compliance with various provisions under your lease. Not only can you, as a tenant, save money, you may also be able to pass the cost of the audit on to your landlord under certain circumstances.

#### **OPERATING EXPENSES**

To begin with, the most obvious clause to examine is the operating expense provision in your lease. Was this clause heavily negotiated? When you originally made your deal, did you add a number of exceptions to the definition of "operating expenses"? If so, there is a greater chance that your operating expense assessment may be incorrect. Look at your lease to make sure that the correct "proportionate share" of expenses is applied to you. Also check to see that the landlord is using the correct square footage calculation mentioned in the

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## Special Issue

### The Economy and Retail Leasing

## What Tenants Are Asking of Their Landlords In Challenging Economic Times

By Randall Arndt

The current economic slowdown has been particularly hard on the retail industry. Operating retail stores in times of economic uncertainty has placed most real estate professionals in uncharted waters. Tenants are looking to their landlords for economic relief to meet the challenges of operating their stores without incurring unacceptable losses during these turbulent times. This special issue of *Commercial Leasing Law & Strategy* discusses difficulties arising in the context of retail leasing.

No matter how strong a retailer's business, all tenants are concerned about the state of the economy and the considerable decline in retail sales in almost every sector of the industry. Tenants are asking their landlords for assistance so they can weather the storm. Many tenants need immediate relief and are frequently finding that their landlords are willing to work with them on various rent concession proposals and other lease modifications.

This article provides an overview of what tenants are asking for from their landlords, including base rent and additional rent reductions and other lease modifications relating to operating covenants, use restrictions, exclusives and transferability. Many of these issues are relevant to lease renewal negotiations as well as new lease negotiations. Rosie Rees' article on page 3 examines the strategies that retail landlords and tenants can utilize to keep the tenant in the premises and the rent coming in. Mark Morfopoulos' "In the Spotlight" (page 1) discusses how to utilize a lease audit to add value, and Ira Fierstein's article on page 5 outlines some procedures landlords should make certain they follow so that they are protected in case replacement tenants follow the footsteps of their predecessors, shut down

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PERIODICALS

# Trouble in Lease Land

## *A Guide to Retail Lease Workouts*

### *Part One of a Two-Part Article*

By M. Rosie Rees

Usually, the best thing that can happen to a lease after it is signed is for the parties to put the lease into a drawer (or, nowadays, scan it into the computer) and never look at it again until the term is about to end. Unfortunately, too often in recent times, when the lease is pulled out of the drawer, it is because either the tenant or the shopping center is in financial trouble.

In these situations, both the retail landlord and the retail tenant benefit from working together to identify the underlying problem and to pursue solutions that will keep the tenant in the premises and the landlord getting rent. The solutions often include modifications to terms of the original lease. Both sides need to understand the available alternatives and subsequent consequences of the lease workout.

This two-part article examines the strategies that retail landlords and tenants can utilize to keep the tenant in the premises and the rent coming in.

### **MUTUAL ADVANTAGE IN PURSUING WORKOUT**

Retail landlords know a tenant is in trouble when rent payments are late or cease altogether, when the tenant's store is not well stocked with new merchandise, or when the physical condition of the store deteriorates. Retail tenants know that a shopping center is in trouble when an increasing number of stores are

**M. Rosie Rees** is a Partner in the Chicago office of Pircher, Nichols & Meeks, a national full-service law firm that specializes in real estate and related industries. **Michael Soejoto** and **Marisa Doherty**, Associates, assisted in the preparation of this article.

dark, or the maintenance of the common areas or other services have declined.

In addition to the landlord's interest in getting timely rent payments, both landlords and tenants have an interest in the center having all stores open and operating. Thus, when a tenant cannot pay its rent, most landlords will first try to work with the tenant to keep it operating in the center while the tenant works out its financial difficulties. The landlord will meet with the tenant, find out what the problem is, how the tenant plans to address the problem, and how the landlord can help.

Also, when a shopping center is not doing well, most tenants are willing to give the landlord some time to re-lease or redevelop the center. The tenant's willingness to give the landlord additional time is often due to the tenant's substantial investment in the particular location, including unamortized leasehold improvements, inventory selected for that market, and customer recognition of that location. It is costly for a tenant to have to start over in a new setting.

Even in a new development that is still under construction, the potential failure of a tenant to accept possession and open its store impacts both landlords and tenants, and often triggers lease workouts. Landlords may be willing to modify lease terms in order to induce the tenant to open, because a tenant's failure to open in a new center may cause co-tenancy failures in other tenants' leases, which in turn may trigger rent reductions that reduce the lifeblood of the shopping center: the landlord's rent stream. A tenant that has signed a lease in a new development also has incentives to try to make a go of it, if the lease terms can be modified to make opening and operating feasible for the tenant. It may have rejected other possible locations, incurred lease negotiation costs and maybe even plan and design costs, or inventory purchases, for the new space. These are costs that it cannot recoup if it starts over

with a new landlord. Also, starting over may mean delaying the tenant's entry into a new market, for which it may have made commitments to its lenders and its investors.

### **PRE-NEGOTIATION AGREEMENTS**

Before the parties begin negotiations to modify a lease, they might consider entering into a "pre-negotiation" agreement, to assure that both parties are free to discuss settlement without consequences. The parties agree that nothing they discuss during negotiation of the lease modification is binding on the parties unless an actual agreement is signed by both parties. They also agree that nothing admitted by either party in the course of these discussions (for instance, liability for past due rent, if in dispute) will be admissible if the parties end up in court. Each party also agrees to keep confidential any financial and other information the other party supplies during negotiations.

### **METHODS TO KEEP TENANTS OPERATING**

Landlords and tenants can employ a variety of techniques to keep the doors open and the rent coming in.

#### **Rent Relief**

The most common approach to helping a troubled tenant to stay in existing premises, or open in new premises, is to give the tenant a break on the rent. The landlord can do this in several ways: reducing rent, deferring rent, converting past-due rent into a loan, and forgiving past-due rent.

#### **Rent Reduction**

The usual forms of rent reduction are reducing minimum rent, reducing or abating extra charges, or permitting the tenant to pay percentage rent based solely upon sales in lieu of minimum and percentage rent and extra charges like common area maintenance costs, real estate taxes, and promotional charges. If

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## Lease Land

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minimum rent is to be reduced, then the parties agree that for a certain period of time, often at least one year, minimum rent will be reduced to a level that the tenant can afford. If the tenant is paying percentage rent, the natural percentage rent breakpoint may be reduced. However, the landlord often will not reduce the breakpoint, thereby giving the tenant additional rent relief.

Often, the reduction of minimum rent is accompanied by a reduction or even a full abatement of the extra charges. In negotiating the rent reduction, the parties may loosely discuss abating "all rent," but generally it is understood that other forms of "rent" remain payable, for instance, utilities, late charges for late payment of rent, and the like. The lease modification document should make that clear.

The parties may instead fully abate minimum rent, percentage rent, and extras, and permit the tenant to pay

rent based entirely as a percentage of sales. With a full abatement of standard rent, the percentage of sales is often increased above what it would be if the tenant were paying minimum rent and charges. For example, if the standard percentage rate was 5%, gross rent may be payable at 8% or 10%. The tenant may require that the total percentage rent that is payable be capped at no more than the tenant would have paid for the full rent items had there been no abatement. Again, the rent items that are abated should be specified, to avoid an abatement of every item of "rent" payable under the lease.

### Rent Deferral

The landlord may agree to reduce the rent for a certain time period, but require the tenant to repay the unpaid rent at a later date. Usually, the parties agree to a schedule of payback at a later time, either in a lump sum or by increasing subsequent rent payments.

### Rent Forgiveness

If a tenant is significantly past due on rent payments, the landlord may

agree to forgive a certain amount of the past due rent, if the tenant remains current thereafter.

### Conversion to a Loan

Rather than outright forgiveness of past due rent, the landlord may agree to convert the past due rent into a loan payable over time in addition to the current rent that is due. The tenant signs a promissory note for the past due amount which includes the manner of repayment. The note will provide that the failure to pay the note will also be deemed a default under the lease.

The conclusion of this article will discuss conditions for rent relief, downsizing, kickouts, terminations, assignments, extensions, lender issues, tax considerations and considerations for new developments.



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## Challenging Times

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offer more opportunities and challenges than the co-tenancy provisions. Any thorough lease review should include due consideration to possession, opening and operating co-tenancies, and penalties and remedies upon breach thereof.

Many non-anchor tenants are more and more focused on comparable tenants as co-tenants rather than anchor stores are. For example, a 10,000 sq.-ft. men's clothing store is more interested in being located near comparably sized clothing retailers that are open and operating than anchor tenants in a shopping center. Tenants are focusing more on being located near industry-specific trade groups, like men's and women's clothing stores, than being tied into big box stores, bookstores, restaurants and service stores.

Tenants that make capital improvements to their premises will want to make sure they can get some remuneration in the event the co-tenancy

provisions are not met, so that if the tenant elects to terminate its lease because of the landlord's failure to satisfy the co-tenancy provisions, the tenant can also offset all rent and remain in its premises until it can offset such improvement costs against rent.

Landlords and tenants are revisiting use definitions, exclusive use rights, use restrictions and durations, and the exceptions and exclusions therefrom. As the tenant mix of centers changes, and centers evolve over time, tenants need to review, reconsider and renegotiate the rights, obligations and restrictions regarding use and operating provisions, including exclusives, restrictions and covenants.

Tenants also want to eliminate radius restrictions. They want maximum flexibility to open new stores in the best locations possible. Radius restrictions are viewed as unreasonably restrictive against a tenant's best interests in picking new locations.

Tenants are also asking for more leniency in assignment and subletting rights and for more defini-

tive standards with respect to what transfers are permissible without the landlord's consent, and otherwise requiring landlord to act reasonably. Landlords are also keenly interested in issues of transferability.

### GIVE AND TAKE

Tenants should be prepared to accommodate the major concerns of the landlord in exchange for some of the things they request. Many of the issues discussed above are also of concern to landlords, including operating covenants, exclusives, transferability rights, lease guarantors and issues of credit worthiness. One rarely gets something for nothing, and negotiating rent relief and other concessions from a landlord is certainly no exception.

### LEASE RENEWALS

Tenants with lease renewal rights, and those without who are interested in renewing a lease are frequently preferring shorter extension terms. Tenants have considerable anxiety regarding current market conditions,

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