

Lease Workouts in Troubled Times

As a result of the current economic recession, many tenants in commercial properties are increasingly finding themselves in financially precarious positions. There also are tenants who remain financially viable but view the current economic climate as an opportune time to seek rent relief. For both reasons, many tenants are or will be seeking to lower their overall occupancy costs. Consequently, now is a particularly good time to become familiar with the "ins and outs" of lease workouts.

Part one of this update discusses the perspectives of landlords and tenants in negotiating a successful lease workout and gives practical tips and pointers that will assist deal makers in evaluating and structuring requested relief. **Part two** provides insight into the forms of monetary and non-monetary restructuring and addresses commonly restructured terms. **Part three** is an overview of lease enforcement and tenant bankruptcies - the post-default alternatives to restructuring. **Part four** is a brief list of recommendations that property managers should consider to prepare them for responding to a struggling tenant.

I. Lease Workouts

By Dana Schiffman and Sean Southard

The Landlord's Perspective

The landlord may have a strong self-interest in facilitating a successful restructure if the need is *bonafide*. However, the landlord is forced to walk a fine line and may be at greater risk of additional losses should it do too little or too much. The ingredients for a successful restructure are numerous. For the landlord, the costs must be both affordable and less than the consequences of the tenant's breach of lease and/or bankruptcy. In addition, for both the landlord and tenant, the relief needs to be sufficient to allow the tenant to avoid a future default or bankruptcy, at least until the real estate market recovers.

Tips for Landlords

- *Know your position and the tenant's.* Most importantly, the landlord must understand market conditions and trends as applied to the specific premises and project. In the current economic environment, market rents are difficult to determine but landlord's negotiating posture will be influenced most by this information. It is also important for the landlord to understand the tenant's economic justification for rent relief. For example, some concerns in a retail context might be:
 - What are tenant's occupancy costs as a percentage of revenue?;
 - How critical is the use of the premises to the overall operation of the tenant's business?
 - What is happening to the tenant's overall business that may affect the tenant's credit and immediate space needs?

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- How does the subject request fit into the tenant's overall financial plan? (This is particularly important when dealing with multi-location tenants.)

Knowledge of tenant's core business, creditworthiness, supply and funding sources will facilitate landlord's evaluation of the rent relief request. Landlords also need to consider the additional factors of tenant mix and the impact that dark store fronts may have on the project. Losing a big-box or quasi-anchor also can have a domino effect on the business of other tenants in the project (both practically and through the operation of co-tenancy clauses). In addition, the landlord must have a firm grasp on its own financial condition and restrictions on its ability to modify leases such as the need to obtain any lender or partner consent to lease modifications in connection with any loan or joint venture agreement. The landlord should be particularly sensitive to the potential impacts that restructuring may have on its own ability to meet debt service and co-tenancy/operating requirements of other leases. Finally, the landlord should have a clear understanding of the terms and conditions of the subject lease, including default, remedy, assignment/subletting, first refusal, kick-out, reduction/expansion, opening and operating covenants, co-tenancy, and other critical provisions contained therein.

- *Bankruptcy.* The landlord needs to understand the consequences should the tenant file for bankruptcy protection.
- *Develop uniform procedures for evaluating tenant requests for relief.* Consider forming internal committees comprised of leasing agents, property managers and financial analysts for this purpose. The tasks of such committees usually include conducting credit checks, assessing inventory levels and supply sources, and reviewing the tenant's business plan and financial and sales statements. Often, when faced with such an information requirement, a tenant without a bona fide need for relief will drop it.
- *If relief is warranted, take a comprehensive approach to the type and terms of the relief as opposed to negotiating piecemeal deals.* Among other things, landlords will find it efficient to develop a standard approach to similarly situated tenants and create economies of scale with respect to any lender consent requirements.
- *Couple the relief with additional landlord rights under the lease.* Restructuring is an opportunity for the landlord to regain some of the concessions made during the original negotiation process. Examples include:
 - adding a termination or relocation provision;
 - extending the term of the lease;
 - reclaiming signage rights that can be used as an inducement to replacement tenants;
 - eliminating or reducing the scope of exclusive use protections and first refusal or first offer rights that may hamstring the landlord's ability to back-fill space;
 - eliminating co-tenancy clauses; and

- imposing new requirements on the tenant to regularly provide landlord with sales and financial information.
- *Duration of relief.* If significant relief is being requested, keep the period of relief short and consider requiring the tenant to agree to an ongoing at will right of landlord to terminate the lease.

The Tenant's Perspective

The tenant should be prepared to present the landlord with a complete understanding of why relief is necessary and the type of relief being requested. It should brainstorm creative ways to share the pain with the landlord, particularly if it has the most to lose if the lease is not restructured.

Tips for Tenants

- *Know your position.* Just as with the landlord, the tenant must also understand the market value of the premises and project. The tenant must have a firm grasp on its own financial condition and be prepared to demonstrate that although the tenant is financially threatened, it is not so greatly impaired as to be a lost cause. The tenant should also consider less obvious opportunity costs of restructuring:
 - By restructuring, is the tenant foregoing an opportunity to relocate to a superior premises or project (location quality, market, expansion opportunities)?
 - What is the likelihood that the tenant may be able to negotiate an even better deal by postponing its request for relief. Would the tenant be better off negotiating a payment to the landlord in exchange for termination of the lease?

Additionally, the tenant must also have a clear understanding of the terms and conditions of its lease, including default, remedy, assignment/subletting, kick-out, reduction/expansion, co-tenancy and other critical provisions contained therein. In short, the tenant must first determine whether the lease terms provide tenant with an exit strategy preferable to restructuring the lease. Finally, the tenant should analyze whether any landlord defaults exist and, if so, how assertion of its remedies against landlord may be part of its overall restructuring strategy.

- *Expect to provide all documentation supporting the request for relief.* The tenant should be prepared to be viewed similarly to a borrower seeking a business loan and, therefore, ready to provide financial data backing up the rent relief request. A smaller tenant should be prepared to share specific information regarding the operation of its business such as supply relationships and business plan.
- *Information on other locations.* A multi-location tenant should be prepared to provide the landlord with sufficient information regarding other locations to assure the landlord that the other locations are not affecting its long term viability and that the rent under other critical leases are also being addressed.

- *Utilize third party services.* Because the justification for rent relief requires detailed market studies and financial justification, some tenants may find it helpful to work with an outside consultant or broker specializing in restructuring leases.

II. The Restructured Lease/Commonly Restructured Terms

By Dana Schiffman and Sean Southard

Restructuring can involve much more than rent relief and landlords and tenants can choose from an arsenal of monetary and non-monetary types of restructuring. Linking rent concessions to modification of other lease provisions may be critical in devising a restructuring that is attractive to both landlord and tenant.

Types of Monetary Restructuring

- *Rent deferral with or without extension of term.* This is the most common form of rent relief whereby the landlord agrees to temporarily defer the tenant's rent obligations, to be repaid at a future date. Often the rent deferment is conditioned upon the tenant paying all or a portion of past due amounts and remaining in good standing throughout the remainder of the term.
- *Rent forgiveness/reduction with or without extension of term and/or increase in future rent.*
- *Temporary conversion to percentage rent only or change in percentage rent terms (rate and breakpoint).*
- *In the case of a new project, a right to open later.* This allows the tenant time to secure alternate sources of financing and reduce overall overhead expenses.
- *Deferral of non-critical maintenance obligations.* By deferring the tenant's required maintenance obligations, the landlord can help the tenant preserve its operating capital.
- *Reduction of/cap on CAM Expenses/Additional Rent Charges.* A potential pitfall associated with this type of relief is the possibility of "most favored nations" language existing in other leases affecting the project. These provide, among other things, that if any other tenant's CAM charges are reduced or capped, then so are the CAM charges of the tenant benefitting from the most favored nations clause.
- *Adjusting tenant allowances.* Although this is not common in workouts, the landlord may consider giving additional tenant improvement money or agreeing to perform an expanded scope of work. This may be very important in new lease deals.

Potential Additional Terms/Legal and Practical Protections – The Quid Pro Quo For Rent Relief

- *Add a confidentiality provision.* A well drafted confidentiality provision should provide that its breach is not only a lease default but also results in rescission of the restructured

terms. Confidentiality is important because the landlord may not want to treat all tenants equally.

- *Consider obtaining a stipulated judgment.* The landlord may be able to shorten the judicial process to recover possession or monetary damages for breach of the lease by obtaining a stipulated judgment as part of its consideration in granting relief to the tenant. While the landlord still must prepare and file an unlawful detainer complaint, a stipulated judgment may shorten the applicable time between filing, judgment, and eventual enforcement.
- *Add an estoppel provision.* If possible, a lease workout amendment should include estoppel statements such as no prior landlord defaults, no outstanding claims, delivery of premises and payment of tenant improvement monies owed.
- *Get a release.* The landlord should obtain a general release of all liabilities and/or obligations arising out of or related to the lease arising prior to the effective date of the restructuring, while preserving the lease as modified.
- *Delete or modify exclusives use and co-tenancy provisions and an ongoing termination right for the landlord's benefit.* Also consider adding a relocation right that allows the landlord flexibility to "moth-ball" all vacant space in one portion of the project.
- *Ask for additional security enhancements.* The landlord should consider asking for additional security, personal guaranty and/or lien on the tenant's personal property. A letter of credit would be desirable, but it is unlikely that one can be obtained from a troubled tenant.
- *Ask the tenant to pay the landlord's costs of drafting/negotiating the restructuring.* This may be difficult to obtain from a cash-strapped tenant.

Non-Monetary Restructuring – Operational Solutions

- *Agree to subdivide/reduce the premises.* This solution may not be ideal as vacancy rates climb, but it may be a way of keeping the tenant's lights on.
- *Change/expand the tenant's permitted use.* Many leases contain restrictive use clauses that limit the tenant from selling a broader category of goods or services. Consider expanding the use clause as necessary to allow the tenant to reinvent its business.
- *Host additional project marketing/special events aimed at increasing traffic.* These can include giveaways, charitable events and local festivals.
- *Increase amenities and customer service.* Many landlords are offering free valet parking and customer ambassadors as a way of attracting more customers to the project.

- *Creative use of dark locations:* Landlord should minimize the impact of vacant space by offering it for use by non-profit community groups, art galleries and/or seasonal sales/promotions.
- *Renovate facades, improve lighting and landscaping.*
- *Quid pro quo concessions in mixed-use projects.* In mixed use office or residential/retail projects the landlord should consider requiring a tenant receiving relief to provide landlord with discount coupons or other benefits for use in connection with landlord's leasing efforts in the non-retail component of the project.

III. The Alternatives to Restructuring: Handling Tenant Defaults

By Matt Marino

If restructuring is either unsuccessful or impractical, landlords and tenants need to be familiar with the judicial process for eviction and breach of contract.

- *Consider options – think twice before reflexively serving a Notice to Pay Rent or Quit.* In better economic times, the landlord's first response to a tenant default frequently was the service of a statutory Notice to Pay Rent or Quit as a prerequisite to eviction. However, in these times, where tenant demand for space is far less, eviction may not be the best option as it assumes that the premises can be re-leased to a more creditworthy tenant. Eviction also may result in a dark space that detracts from the desirability or appearance of a retail center.
- *A breach of lease action may meet the landlord's needs.* Even for tenants in default, eviction is not the landlord's only option. If the lease so provides, the landlord may sue the tenant for breach of lease to collect the rent due without evicting the tenant. This option may be lost if the landlord serves the tenant with a Notice to Pay Rent or Quit, and the tenant vacates the premises. While such a lawsuit may create an adverse relationship in the short term, it may lead to a judgment or settlement to collect some portion of the amount due while maintaining the appearance of the project. If the landlord elects this course, a default must be established under the lease, but it should not be by service of a statutory Notice to Pay Rent or Quit. Some leases may vary, but a short letter or Notice of Rent Delinquency, setting forth the amount due and the applicable cure period, likely will be sufficient to establish the default so that an appropriate action can be pursued.
- *If the landlord desires eviction, consider requesting voluntary relinquishment first.* If the tenant is without hope of recovery, in lieu of eviction proceedings, the landlord may consider requesting a consensual relinquishment of the premises while retaining its right to pursue tenant for damages for breach of the lease. Often tenants will accept the inevitability of their business failure, and a voluntary turnover of possession helps both landlord and tenant in that the landlord need not pursue an unlawful detainer and the tenant provides landlord the maximum opportunity to mitigate damages while minimizing enforcement costs. To effect this agreement, a written stipulation agreeing to tender possession is best, but any writing whereby the tenant states an intent to abandon the premises likely is sufficient. Unless reference is made to the statute that makes the tenant liable for post-termination rent, it is important that the landlord never "terminate"

tenant's lease obligations except by a formal termination agreement. Likewise, the landlord should avoid use of the word "surrender," which has an historical meaning that might be construed to release the tenant from post-surrender liability.

- *No self-help.* Regardless of the length or severity of the tenant's default, California law prohibits the landlord from engaging in any self-help actions to evict the tenant, such as re-keying the premises or denying the tenant any access or other privileges under its lease (such as parking, gym access, or similar amenities). Even after the landlord obtains judgment for possession in an unlawful detainer action, eviction must be effected by the County Sheriff pursuant to a writ of possession.
- *Tenant bankruptcy concerns: Apply deposits and terminate leases prior to filing.* Tenants frequently attempt to induce landlords into forbearing from legal action by threatening bankruptcy. Be aware that a landlord is legally free to pursue any enforcement actions against the tenant until it receives notice of an actual bankruptcy filing by the tenant itself (not related, parent, or subsidiary entities); however, any enforcement action after this filing and notice of the filing is voided by the filing. After such notice is received, all enforcement actions against the tenant must cease, including default notices, unlawful detainers, collection actions and application of security deposit. However, if the cure period under a Notice to Pay Rent or Quit or other termination notice has expired prior to the bankruptcy filing, the lease will not be part of the estate subject to bankruptcy protection and the landlord retains the right to exercise its rights and remedies. After filing, the bankruptcy trustee succeeds to the tenant's rights under an existing lease and has at least 120 days to accept or reject the lease. If the trustee rejects the lease, the landlord has a priority claim in bankruptcy for the rent due from the filing date through the rejection date. Any remaining unpaid or lost rent may be submitted as an unsecured claim in bankruptcy, subject to the applicable bankruptcy damages cap for claims of this type under 11 U.S.C. § 502(b)(6). The statutory language is complicated but, as a general matter, usually results in the landlord being limited to approximately 12 months worth of rent.

If the landlord is holding a security deposit from the tenant and fears that the tenant will file for bankruptcy, the landlord should consider whether to resort to the security deposit to cure outstanding defaults before any bankruptcy filing. The landlord needs to make sure that all contractual requirements for application of all or a portion of the deposit are satisfied. Once the bankruptcy is filed, the automatic stay will prevent the landlord from application of a security deposit absent relief from the bankruptcy court. While the landlord will ultimately be permitted to apply the deposit in satisfaction of its claims against the tenant (to the extent that the deposit is not greater than the cap on landlord's lease rejection damages provided by the Bankruptcy Code), the delay in the ability to resort to the deposit could be months and even years.

While letters of credit given as security for lease obligations are not considered to be part of the bankruptcy estate, similar issues may arise. Contractual requirements for a pre-bankruptcy draw must be met, particularly if the particular lease provides that a draw on the letter of credit must be based on an "event of default" and a default under the lease requires some form of notice to the tenant. If such notice has not been given (and has expired) prior to the bankruptcy filing, relief from the automatic stay is required to give the necessary notice and thus no draw may occur. There is no assurance that the

bankruptcy court will grant the relief. A draw without resort to contractual requirements may expose the landlord to damages for breach of lease as well as disgorgement of amounts improperly drawn. Additional issues may arise if the amount of the letter of credit is greater than the bankruptcy damages cap.

- *Abandoned premises.* An unlawful detainer action is not required to regain possession of abandoned premises. Possession of abandoned premises can be obtained through an expedited procedure (approximately 18 days) that does not require a court order; however, rent must be due and unpaid for 14 consecutive days and the landlord must have "reasonable belief" that the tenant has abandoned and must have complied with certain statutory notice requirements.

IV. Property Management Tips for Troubled Economic Times

By Sandy Jacobson

During troubled economic times, property managers need to anticipate the fallout of struggling tenants. Following is a brief list of suggestions that property managers should consider to prepare them for responding to a struggling tenant:

- *Have the on-site personnel observe the tenant and report deviations from the norm.* Observations such as less trash, less use of access cards, changes in signage, reduced inventory for retail tenants, and empty spaces are cues that the tenant is in trouble.
- *Review and update your lease files.* Property managers should take the opportunity to review its leases now to determine the notice requirements and owner's remedies in the event of a default. The review should focus on when and how the security deposit can be utilized and a letter of credit may be drawn upon. Note that the failure of certain larger tenants to operate may not be a basis for default and accordingly, property managers should understand which leases do not contain operating covenants. If information is missing from the lease file, updating it now will avoid complications if enforcement is required down the road.
- *Act promptly upon a tenant default.* Immediate action should be taken when a tenant fails to pay rent or comply with the material lease terms. However, property managers should not automatically send a Notice to Pay Rent or Quit as termination of the Lease may not be in the landlord's best interest (see discussion in Part III above). Leases should be closely reviewed to identify the appropriate notice requirements, as it is critical that written notice of default be delivered to the tenant strictly conforming to the notice requirements of the lease. Failure to comply with such provisions could extend any applicable cure period of the tenant and prevent the landlord from timely exercising its remedies. Moreover, if prompt action is taken upon a tenant default and, as a result, the lease is terminated, it may be possible to successfully prevent the lease from being included as property of the bankruptcy estate should the tenant subsequently seek bankruptcy protection.
- *Act promptly upon a tenant bankruptcy.* Any bankruptcy notice that is received by a property manager should be promptly reviewed and addressed to insure that the landlord's interests are protected. Many important events in a bankruptcy case occur in a

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hearing called "first day" motions, which typically occur on one of the first five days following the filing of a bankruptcy case. Once a bankruptcy proceeding is filed, the landlord's rights will become subject to jurisdiction of the bankruptcy court, and the owner no longer has the right to pursue any remedies or otherwise enforce any of its pre-bankruptcy rights under the lease without permission from the bankruptcy court. If, notwithstanding the bankruptcy filing, an owner takes action in a non-bankruptcy court or otherwise takes an action against the tenant without the approval of the bankruptcy court, the owner may be subject to penalties and sanctions by the bankruptcy court.

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