

Troubled Tenancies

Strategies for landlords and tenants in restructuring retail leases.

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In these troubled times for the retail sector, many tenants find themselves in financially precarious positions and are more and more frequently approaching landlords to request various lease concessions in an attempt to reduce their operating costs. The decreased availability of attractive replacement tenants and the desire of landlords to maintain high occupancy levels have caused landlords to be more receptive than ever to entertaining these requests. Relief for the tenant in this context typically comes at the cost of the landlord, gaining other related or unrelated benefits with respect to the terms of the lease, many of which are discussed in this article. Retailers are also reviewing their portfolios in an attempt to weed-out underperforming stores and, in some cases, are seeking to terminate those leases.

DO YOUR HOMEWORK

Market/financial analysis. Before entering into any discussions regarding a lease restructuring, both parties should have a general sense of the retail market in the area surrounding the center and the particular center itself, including how the store and the center are performing — whether there are any dark stores in the center, whether there are missing co-tenants and the state of maintenance at the center. Even before being approached by a tenant, landlords should keep current on how their tenants are performing. Signs that a tenant is in trouble may include a precipitous drop in monthly sales, an under-stocked or under-staffed store or a drop-off in advertising. Once a tenant approaches a landlord for help, the landlord should request copies of the tenant's financial statements to weed-out those retailers who are struggling from those who are just being opportunistic.

Review lease and relevant documentation. Both landlords and tenants will benefit in their negotiations from a care-

ful review of the lease, any reciprocal easement agreement (REA), any subordination, non-disturbance and attornment agreement (SNDA) and the relevant loan documents. The review of these documents by each party should be targeted toward gaining the greatest amount of leverage in negotiations. Some particular points to focus on in reviewing these documents are:

Operating covenants and go dark rights. One tool to minimize costs for the tenant is to stop operating its store, even though it will still be obligated to pay rent. If the lease allows for this (i.e., does not contain an operating covenant), then the threat of going dark may also provide the tenant with some leverage because most landlords prefer tenants to stay open rather than to close, both for the general health of the center and also for fear that the tenant going dark may trigger co-tenancy violations in other leases.

Assignment and subletting rights; permitted uses. It is important to understand whether the tenant has the right to assign or sublet with or without the landlord's consent. Use restrictions and exclusives should also be reviewed in this context, especially given that many of the currently available tenants have less desirable uses (i.e. gaming, medical offices, variety stores, second hand stores, etc.) than more traditional and sought after national and regional tenants.

Co-tenancy rights. Some leases provide the tenant with the right to go to reduced rent, go dark or even terminate if certain tenants are not operating in the center. Tenants will want to review these provisions to determine whether any requirements are going unmet. Landlords should also review these provisions, as well as those contained in other leases within the center to determine if the absence of this particular tenant from the center would affect any other tenant's co-tenancy

requirements.

Default provisions. The default provisions of the lease may contain strategies for the benefit of both the landlord and the tenant.

- **Landlord default.** The tenant should determine whether there has been a landlord default, and if so, what the tenant's remedies are in the event of such a default. Even if termination is not an express tenant remedy, the existence of a landlord default, especially a recurring material default, will provide the tenant with leverage in its dealings with the landlord.

- **Tenant default.** There are some instances in which the tenant may purposely pursue a default (by not paying rent or not operating its store where going dark would be a violation of the lease, for example) as part of an exit strategy, especially where the lease expressly obligates the landlord to mitigate damages or in jurisdictions where landlords have a duty to mitigate damages.

Lender consent. Landlords and tenants should also determine whether landlord's loan documents or the SNDA require the lender to consent to a modification or termination of the lease. If the lender's consent is required, then the landlord should either obtain the same prior to entering into any amendment or termination, make the consent a condition to any such agreement. Both parties should be aware that getting the lender's attention in this market may be difficult, especially if the loan is a performing CMBS loan.

LEASE RESTRUCTURING

In the event that the landlord decides to engage in a discussion about rent relief, and depending on the relative bargaining power of the landlord and tenant, the landlord should look for the opportunity to strengthen its position with respect to the lease. Some suggestions are:

Deferred rent. To the extent that the landlord provides rent relief, it should structure such relief as deferred rent. This is important so that the landlord can recapture deferred rent in the event of a subsequent tenant default or preserve a claim for deferred rent in the event of a tenant bankruptcy filing.

Percentage rent. In consideration of granting relief with respect to base rent, the landlord should require that the breakpoint for percentage rent be lowered so that the landlord may have the opportunity to recoup some of its lost income in the event that the tenant's sales rebound.

Enhanced security. The landlord may want to enhance its security by obtaining a guarantee or additional guarantees.

Conversion of renewal options. Where the tenant has unexercised renewal options, the landlord may require the tenant to exercise these options at the time of any lease amendment to increase the term of the lease.

Strengthening the bankruptcy protections in your lease. The landlord should consider how to best protect itself in the event of a subsequent bankruptcy filing by the tenant. Examples include converting cash security deposits to letters of credit, narrowing the use clause in the lease to take advantage of the shopping center amendments to the Bankruptcy Code and inserting a specific acknowledgement in the lease that the leased premises are located within a shopping center for purposes of Section 365(b) of the Bankruptcy Code. Section 365(f)(1) of the Bankruptcy Code was amended in 2005, for the benefit of owners of shopping center leases to make clear that a debtor-tenant in bankruptcy may not ignore a use restriction contained in its shopping center lease in connection with a proposed assignment of such lease to a third party.

Relocation rights. The landlord may want to insert a right to relocate the tenant to another space in the shopping center so that the landlord has increased flexibility in being able to lease the balance of the shopping center.

Deletion of special tenant rights. Generally, the landlord should consider stripping the lease of any special rights the tenant may have originally negotiated, including co-tenancy rights, assignment, sublet and change of use rights, exclusives, renewal rights, termination rights, expansion rights and rights of first refusal.

Insert confidentiality provision. The landlord should insert a confidentiality provision to discourage the tenant from discussing the relief with other tenants in the center. This provision should provide that a breach will result in a default under the lease and also a termination of any benefit to the tenant granted by the lease restructuring, including any rent deferral.

LEASE TERMINATION

Retailers, when seeking to survive, will also review their entire portfolio of stores and will likely identify stores that should be closed. In these cases, the retailer may attempt to negotiate a lease termination with its landlord. Typically, a lease termination agreement provides for the early termination of the lease in exchange for a lump sum payment or installment payments to the landlord. In drafting a termination agreement, the parties should consider including provisions establishing the condition of the premises when delivered to the landlord, as well as post-termination liabilities of both the landlord and tenant, including indemnities and true-ups related to CAM and real estate taxes. The parties should also ensure that the termination agreement provides for a full release of the landlord, the tenant and any guarantor of the tenant's obligations under the lease. Landlords should consider adding an acknowledgement that any termination fee is in consideration of the early termination of the lease and not in payment of any accrued but unpaid obligations under the lease. The lender's consent must be obtained if required by the loan documents or the SNDA.

In these difficult times it is important to remember that relationships are at the crux of any successful business. Landlords and tenants should be mindful that they are likely to meet again in the future at another store or another center, and both

parties should try to be reasonable and fair in their requests and in their negotiations. Understanding the marketplace and capitalizing on opportunities for obtaining leverage can aid both landlords and tenants in achieving beneficial results for both parties. **SCB**

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