

The Legal Perspective On Distressed Properties

Attorneys are at the frontline of distressed retail properties — from working out loans to figuring out strategies for retailers.

— *Randall Shearin*

One of the first phone calls that a troubled shopping center owner or retailer makes is to his attorney. Real estate attorneys are being called on to review leases, work out loans and generally figure a way out of entanglements that are creating distressed properties. It is not an easy position to be in real estate law today.

Attorneys are busy representing owners and retailers, both of who may be in the middle of distressed situations. For retailers, staying in business or staying in a specific location are the major issues. For owners, the chief causes of a distressed center these days is financing, the lack of tenants, or both.

“Some owners are distressed simply because they don’t have enough capital to make payments on properties that are struggling with cash flow,” says Abe Schear, a partner with Atlanta-based Arnall Golden Gregory. “If financing is coming due, and you don’t have the money to pay the difference between the old loan value and the new loan value, you have a distressed owner. The other situation occurs when owners aren’t able to borrow enough to refinance their existing loan.”

DISTRESSED BY RETAIL PERFORMANCE

Attorneys are seeing the definition of a distressed center first-hand. In some cases, it starts with the tenants. In addition to new leases — yes, attorneys report they are busy with leases backfilling vacant space — the other activity keeping landlord and tenant attorneys busy is lease modification.

Attorneys report that tenants are asking for rent deferrals, and many are receiving them, but only if they go through the arduous task of proving to the landlord that the modification is justified for the store to stay in business. And just what are tenants asking for?

“The basic menu still consists mainly of rent reduction, taking the form of abatement and/or deferral,” says Scott Silver, a Los Angeles-based real estate attorney. “This is either short term — usually 3 to 6 months — or longer term — usually 6 to 12 months or longer, or even up to 2 years or the remainder of the term. For tenants with leases maturing in the 12 months following the request, landlords will usually provide a ‘blend and extend’ approach whereby the rent will reset earlier than the lease term expiration to a newly negotiated market rate in exchange

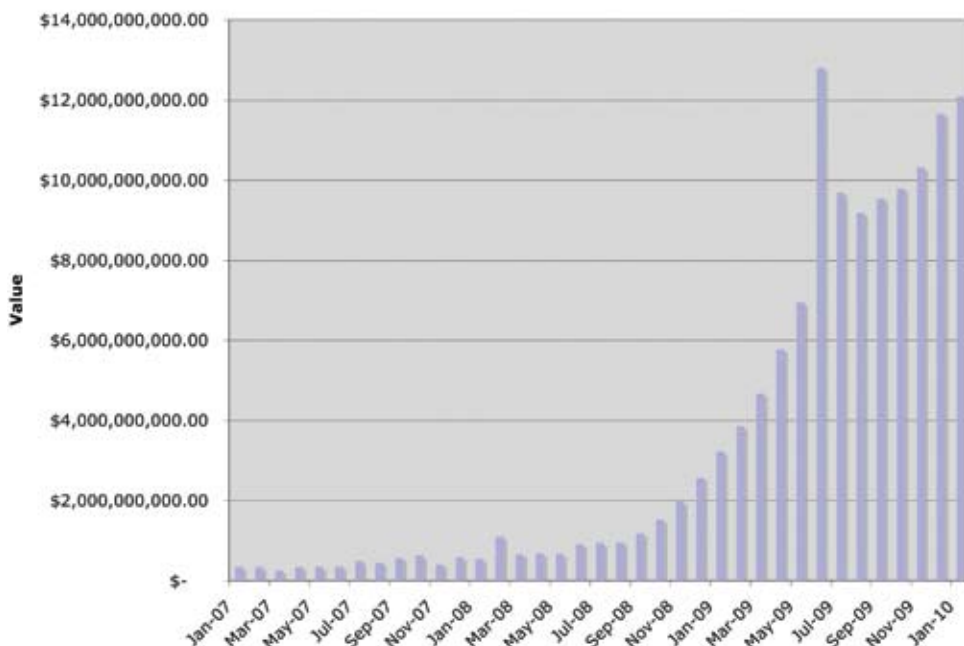
for renewal.”

Often, smaller tenants will work closely with the landlord to negotiate a compromise.

“Distressed tenants are trying hard to keep the landlord informed as to what their status is,” says Schear. “The wisest of the landlords are evaluating requests for rent relief on a deal-by-deal basis. Landlords are working hard to keep key tenants that drive traffic to their properties. Landlords are definitely interested in keeping some tenants or uses than others.”

Many landlords have been through a recession before, many with the same tenants who are asking for relief. Established owners know that they have to spend time examining the retailers’ business and needs before automatically granting a request for rent relief.

Retail Loan Delinquencies 2007-present



“In connection with almost every request for lease restructuring, rent deferral or rent relief, landlord clients have already done their due diligence with respect to the performance of the tenant, not only in the shopping center with the lease in question, but the entire chain,” says Nancy Davids, partner with Boston-based Goulston & Storrs. “Our landlord clients also want to make sure that they are not the only owner that’s being approached by the retailer. They want to be treated in a manner that’s consistent with how a retailer is dealing with all their landlords.”

Davids says that, whenever possible, rent deferral is preferred over rent relief, due to the continuing obligation of the tenant. Rent deferral also allows the landlord the decision later on to forgive the deferred rent or preserve the deferred rent as a claim in the case of a bankruptcy filing by the tenant.

Tenants aren’t the only ones who are using these lease restructuring techniques to their advantage. Landlords are looking at items in the lease other than the rent clause to make the lease more effective for them now and in the future. For instance, some landlords may take back some control in the original lease.

Some healthy retailers, who realize they are among the few healthy tenants in a center, are even negotiating rents based on their staying power and strength to a center.

“The co-tenancy provisions are very helpful in providing healthy retailers with leverage to restructure their leases,” says David J. Rabinowitz, a partner in the New York City office of Goulston & Storrs. “Typically, there are either specific tenants that are named as co-tenants or a percentage of GLA that has to be leased and open at the center in order for these provisions not to be triggered. If they are triggered, the retailer can typically pay reduced rent until the co-tenancy is satisfied, and may even have the right to terminate its lease if the co-tenancy is not satisfied within a certain period of time.”

“These provisions,” says Rabinowitz, “can be the death knell to a shopping center.” Because savvy retailers know that other tenants have similar provisions and that the last thing a landlord wants is to have these provisions triggered, the healthy retailer now has leverage to approach the landlord to restructure its lease with the veiled (or not so veiled) threat of

closing its store if an acceptable agreement is not reached, says Rabinowitz.

For their parts, owners may be willing to reduce rents, but they will generally want the lease restructured to remove or change the co-tenancy clauses to prevent the retailer from leaving after a concession is granted. Also, owners often use the opportunity to change prohibited uses specified in the lease so that they can lease to a wider variety of tenants.

“The more sophisticated landlords are using these discussions as an opportunity to better their leases,” says Rabinowitz.

“Creative landlords with the time and willingness to do so are reviewing the requesting tenant’s signage, marketing and operations and providing allowances for improvements,” says Silver. “But in many situations, the tenant is in dire need of direct rent relief and that approach alone won’t do the trick.”

Some property owners may also take the opportunity to do away with clauses on exclusivity and co-tenancy. In lease restructures, most landlords are insisting on including on an ongoing right to terminate the lease.

“The philosophy behind that clause is to enable the landlord to have flexibility when the market improves while still having a store open in the interim, albeit on less favorable economic terms for the landlord,” says Rabinowitz. “In a better economy, you might have three or four other tenants in a short period of time who would fill that space. These provisions also give the landlord more leverage in a bankruptcy situation.”

In the cases of distressed centers, attorneys are seeing a new party at the table in lease renegotiations these days — the lender.

“If you are negotiating to amend or terminate the lease, the elephant in the room is often the lender,” says Rabinowitz. “The lender will become involved because the loan documents typically have covenants that require the borrower to get lender approval prior to amending material terms of major leases or terminating these leases. If the landlord doesn’t do that, it will be in breach of its loan covenants, which could trigger the recourse provisions often contained in the loan documents,” says Rabinowitz. Rabinowitz also notes that, in addition, major retailers often have direct agreements with lenders, called subordination, non-disturbance and attornment

agreements, that require lender approval as well.

WHEN THE LIGHTS GET DIM

Try as they might to keep their doors open, there have been countless retailer store closures over the last 2 years. Even with lease modifications and rent reductions, a poorly performing tenant can’t always keep its doors open. With larger stores, some retailers have opted to “darken” the store by closing it down, yet continue to pay the rent. With smaller retailers, who often have operating covenants, when there is no choice but to close the doors, most default on the rent as well.

“They figure if they are going to be in violation of the operating covenant, they might as well default on the financial obligation as well,” says Davids.

Either the retailer files some form of bankruptcy or it closes the store and defaults on its operating covenants and rent obligation.

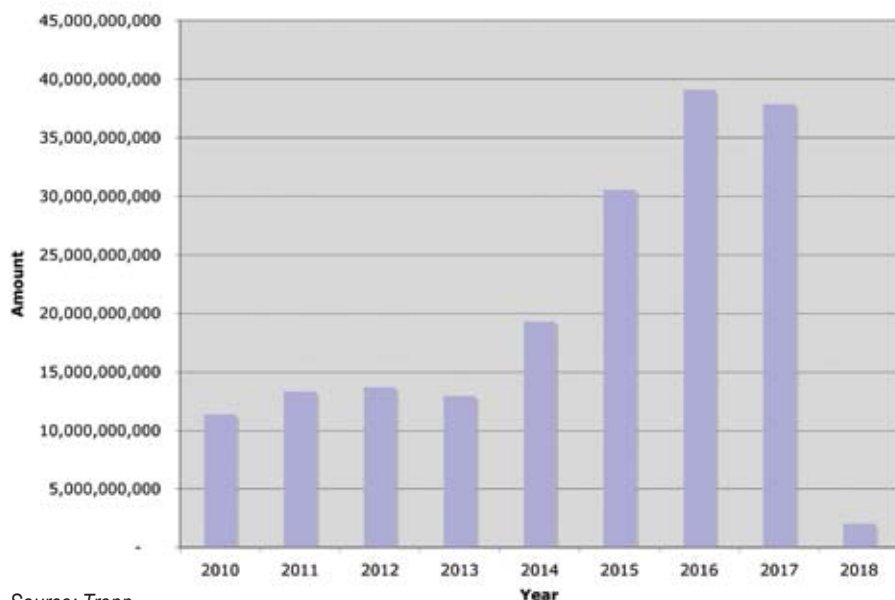
Goulston & Storrs attorneys Christine Lynch and Jim Wallack concentrate their practice on distressed situations, particularly in the retail industry. The two represent landlords, troubled tenants, asset-based lenders and liquidators. The two have worked on a lot of rent relief cases. They advise tenants on what they need to do to stay out of a bankruptcy or liquidation proceeding. In some cases, that means presenting the retailer’s case to multiple landlords. For landlord clients, they help to analyze retailers’ cases to see if rent relief is warranted by advising the type of information the landlord should request and assist them in the review of the information. For large clients with many stores, the firm often recommends real estate services firms who can design rent relief programs or strategies for the entire portfolio.

“The fact that so many landlords have been willing to grant rent relief has enabled some retailers and restaurants to stay out of chapter proceedings,” says Lynch.

“The reality is that the track record of companies going into bankruptcy that come out successfully is abysmally low,” says Wallack. “Most retailer bankruptcies end up in liquidation these days. There is an incentive for both sides — landlord and retailer — to work together because a liquidation benefits neither side.”

The company has worked with Gordon

Maturing Retail Loans



Source: Trepp

Brothers, the retail liquidation firm, on the disposition of assets for Finlay Jewelers, Sportsman’s Warehouse and Boscov’s, among other retailers. It works with Gordon Brothers to secure the rights to liquidate inventories, and it works with the company’s real estate disposition arm, DJM Asset Management, to secure the rights to liquidate real estate holdings and leases.

Some retailers, say attorneys, are enjoying this market. They are happy to be in the driver’s seat during dealmaking, without feeling too guilty.

“There are some successful tenants with the staying power to weather this storm who are using the current economic environment in an opportunistic fashion to enhance the economics of the deal they have with their landlords,” says Rabinowitz.

“There are a lot of savvy tenants that have a year or 2 less on their leases who are approaching renewals in a time when their stores are doing well,” adds Schear. “A tenant with some staying power has a wonderful opportunity for an early renewal.”

At top centers, though, owners are still holding their own.

“Many would think that a tenant doing a new deal would have the upper hand when negotiating with the landlord,” says Rabinowitz. “But in more successful centers, the landlords have been protective of their assets and the smarter ones are looking at the center long term. They want

to make a deal, but they don’t want to give the store away.”

BREAKING POINT

For some retail property owners, the breaking point comes when tenants can’t be found and financing comes due. This has most notably been seen among recently built mixed-use and lifestyle centers, where landlords are struggling with tenant allowances and the tenant pool is scarce. It also takes place in grocery-anchored centers, power centers and troubled regional malls where fundamentals are shaky.

“For those landlords who bought or refinanced in the heady market between 2002 and 2007, they can’t afford to give much more as they are under immense pressure to hold on to prevent further rental revenue erosion,” says Silver.

Others, who are facing leasing challenges, simply don’t have enough cash to offer tenant allowances required by in-demand retailers.

“Some developers could make money if they had money to build out tenant spaces,” says Schear. “It is hard to put in a restaurant when neither the landlord nor the tenant has the cash to build out a space. That distressed space can lead to having a distressed asset.”

Whatever the case, when to draw the line has been a decision faced by a number of retail owners over the past year.

“The owner, at some point, will decide that rather than committing additional monies to a property where, ultimately,

they will not be able to improve the results, it will be better to stop the bleeding and give the property to the lender,” says Schear.

WORKING OUT

At some point after the owner defaults on its loan, a retail center is generally placed in special servicing by the lender. Many lenders are choosing not to foreclose [see also articles in this issue on capital availability and investment and management] as their balance sheets can’t afford to hold all the real estate in arrears. Attorneys are also asked to do loan workouts on properties.

“We are seeing a lot more properties enter receivership than we’ve ever seen before,” says Steve Pepper, a workout attorney with Arnall Golden Gregory. “Particularly in the permanent loan market where CMBS lenders don’t want to own the asset, but they don’t want the borrower or its manager running it. They are filing motions to put receivership in place.”

Receivership shields the lender from being the owner and keeps the borrower on the hook for the mortgage, taxes and insurance premiums.

“Clients are asking how to get their lender’s attention,” says Silver. “They want to know if they have to miss payments to get their loan assigned to a special servicer. They want to know what sorts of loan workouts I’m seeing and what they can expect on their loan.”

For financing or refinancing loans today, attorneys say a lot depends on the state that the property is in. Tom Janos, partner with Chicago-based Levenfeld Pearlstein, estimates that between 10 and 20 percent of distressed properties are newer projects with lease-up issues.

“If your property is ground-up new development, but has no tenants, you are in a world of hurt today,” says Janos. “There are very few lending sources who will take you out of your construction loan. If there’s no cashflow or tenant interest or demand, you are left restructuring with your construction lender. Chances are, he’s not going to be very cooperative. The bank is not built to handle that kind of loan long-term.”

In the case of a property where the developer has an otherwise healthy balance sheet, the borrower will be asked to rebalance the loan so that there is an equity stake of at least 50 percent, says Janos.

“If you have a \$1 million loan, you may

have to cut that in half to get to a loan-to-value ratio that the bank can live with," he says. "They will give you an extension as long as you are current on interest. You'll also have to prove your ability to pay for leasing commissions and tenant improvements when the tenants do surface. It is a dark picture for a new project."

Properties that are 60 to 70 percent leased aren't in the clear either. If the developer is exiting construction financing, there will still be some hurdles to jump. The missing equity will have to be replaced. As well, there will be funds required for lease-up. If permanent financing isn't available, the construction lender may want as high as 80 percent of the loan's value before it grants an extension.

"Someone has to pay down that loan, and that will be the sweet spot," says Janos.

"If you have enough money to pay down that loan, you will probably get a longer term extension. If you just go to the bank asking for more time, it is going to be a tough workout to manage because the lenders don't have a lot of wiggle room to make it happen."

What about centers that are leased up and performing well, but are leveraged for a short term at 75 to 80 percent? They are a problem too, thanks to their lower values. For a \$10 million center that has a \$7.5 million existing loan facing refinancing, that may mean the owner is now only able to borrow \$6.5 million. Again, the borrower must bridge that \$1 million gap.

"In most cases, the lenders are saying 'if you bridge that gap, we'll refinance your loan,'" says Janos.

Most of the debt that was originally

financed at 5- to 10-year terms between 2004 and 2007, has not yet matured.

"That class of real estate is going to appear to do okay right now because we're not seeing debt maturities for the next 18 months," says Janos. "When those debt maturities start to come with lenders only offering \$6 when they were offering \$7, we could have a crisis in retail."

The stumbling block for retail owners needing to refinance properties today is the lack of capital availability for large loans.

"There really isn't a lot of incentive for banks to loan on commercial real estate now," says Pepper. "Banks can borrow from the Fed at less than 1 percent and buy bonds that are paying 4 to 4.5 percent; they can take no risk. Where is your incentive to invest in real estate?" **SCB**

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