

**Strafford**

*presents*

# **Commercial Lease Restructurings and Workouts**

## **Negotiation Strategies for Landlords and Tenants in Troubled Leases**

**A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Yolanda Rodriguez, Co-General Counsel, **O'Neill Properties Group**, King of Prussia, Pa

Richard R. Spore, III, Member, **Bass Berry & Sims**, Memphis, Tenn.

Gregory G. Gosfield, Partner, **Klehr Harrison**, Philadelphia

**Wednesday, September 22, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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Please refer to the dial in/ log in instructions emailed to registrants.

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# Commercial Lease Restructurings and Workouts- Strafford CLE Webinar

9-22-10

## Current Market Trends

Yolanda Rodriguez, Esq.

O'Neill Properties Group, L.P.

(610) 992-5885

[yrodriguez@oneillproperties.com](mailto:yrodriguez@oneillproperties.com)

# Marketing dynamics provide the backdrop to every lease restructuring/workout

- While negotiations for lease restructurings/workouts are tenant, landlord, and building-specific, market dynamics dictate:
  - The relative leverage of each party
  - The range of potential outcomes
- Counsel can enhance value provided to clients by considering market dynamics when formulating lease restructuring/workout negotiating strategies

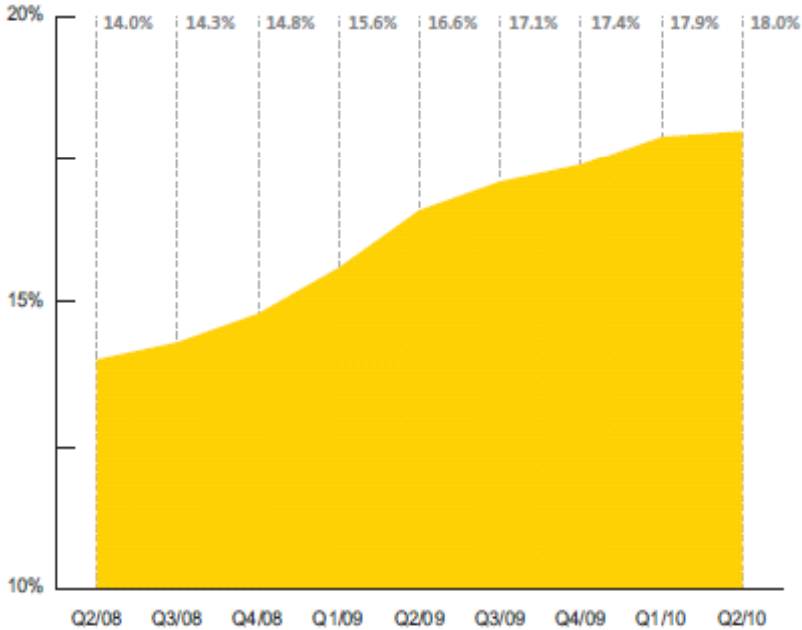
# Key Market Factors in Lease Restructurings and Workouts

	<b>Landlord</b>	<b>Tenant</b>
<b>Vacancy Rate</b>	If I cause this tenant to leave, how long will it take me to find a new tenant?	Is there a glut of alternative space in my market?
<b>Net Rents</b>	How does this tenant's current net rent compare to current net rents for new tenants in my market?	How does my current net rent compare to alternatives in the market?
<b>Other Common Concessions</b>	What other concessions would replacement tenants demand?	What other concessions would my landlord have to offer replacement tenants?
<b>Timing Impacts</b>	How do I expect market dynamics for my project to change in the future?	How do I expect market dynamics for this project and my business to change in the future?
<b>Lender and Investor Influence</b>	How are lenders and investors influencing decisions in this market?	How are lenders and investors influencing decisions in this market?

# Vacancy Rates- Office and Industrial

## U.S. Office Vacancy Rate

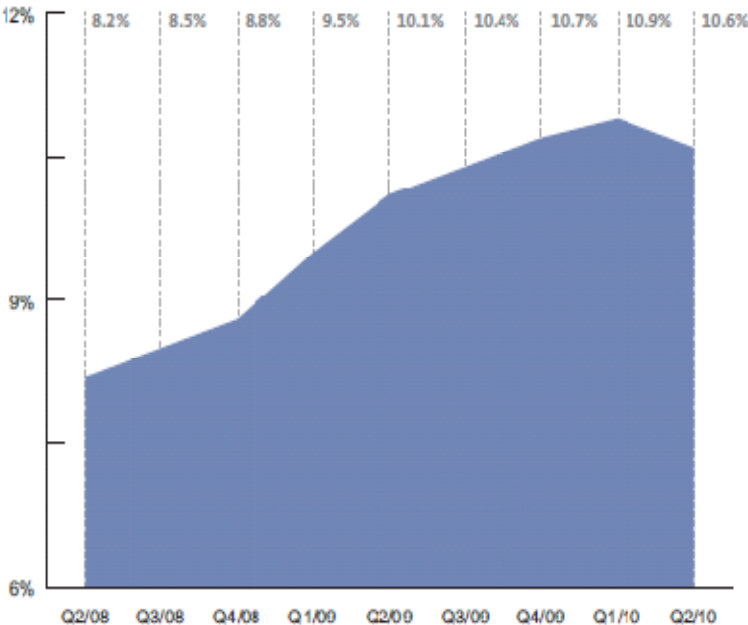
US OFFICE VACANCY RATE\*



\* All classes of space

## U.S. Industrial Vacancy Rate

US INDUSTRIAL VACANCY RATE\*



\* All product types

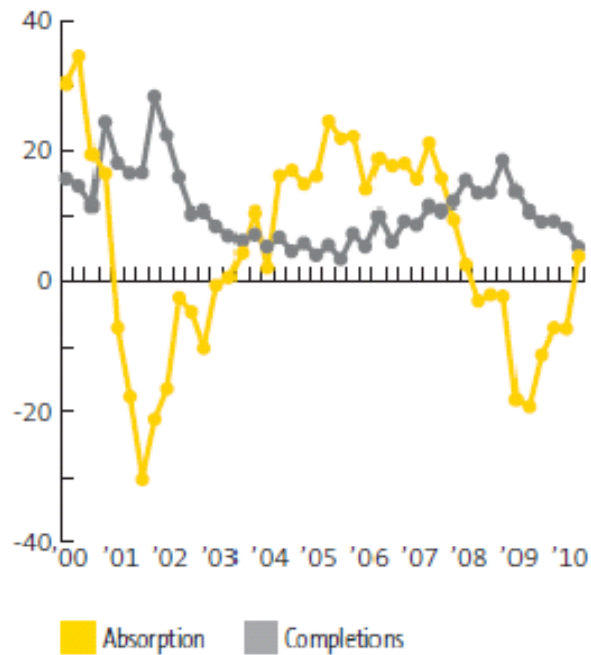
Have we seen the bottom, or will we see a "double dip"?

Source: Grubb & Ellis

# Absorptions and Completions and Sublease Space- Office

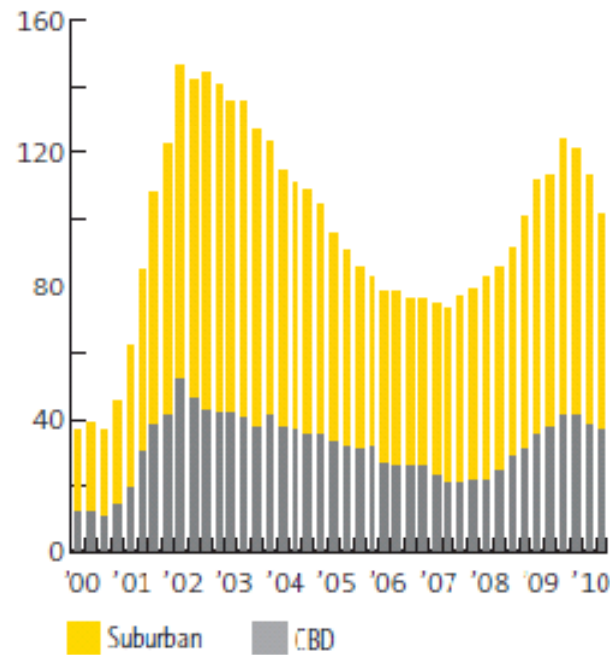
## Absorption and Completions

**Absorption and Completions**  
in Millions of Square Feet



## Available Sublease Space

**Available Sublease Space**  
in Millions of Square Feet



- Record-low completion rates show the stagnancy in the markets
- Gains in absorption and declines in sublease space may signal hope
- Individual markets vary tremendously, e.g. New York City CBD vacancy of 9.70% vs. San Jose-Silicon Valley vacancy of 28.9%

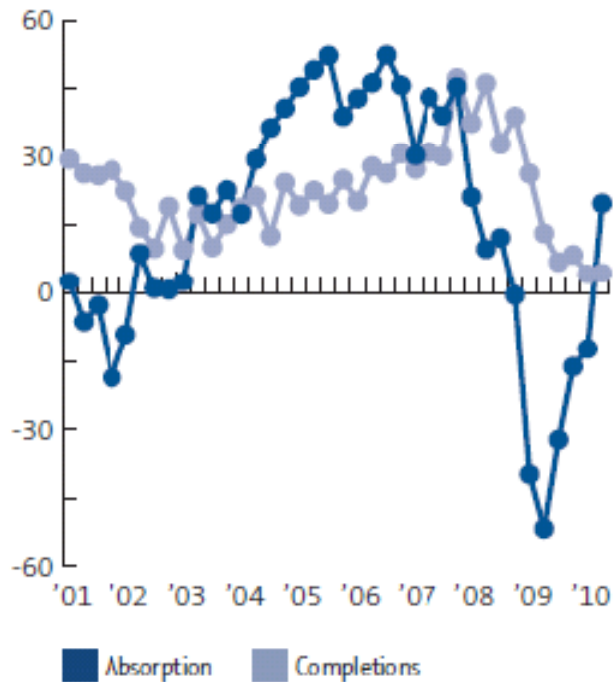
Source: Grubb & Ellis



# Absorptions and Completions and Space Under Construction- Industrial

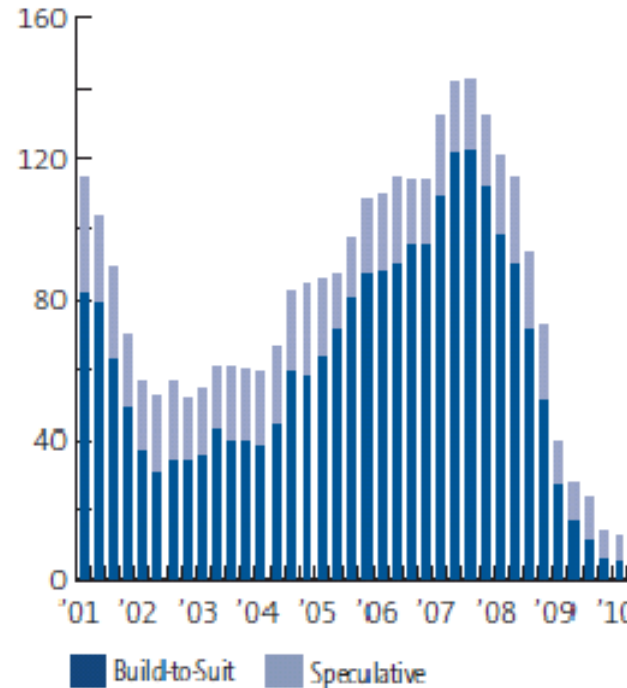
## Absorption and Completions

**Absorption and Completions**  
in Millions of Square Feet



## Space Under Construction

**Space Under Construction**  
in Millions of Square Feet



- Absorptions in Q2 2010 were 12.1 million s.f. of warehouse distribution product, 7.2 million s.f. of general industrial, 244 thousand s.f. of R&D flex, and 308 thousand s.f. of incubator space
- Build-to-suit and speculative construction were equally impacted

Source: Grubb & Ellis

# Retail Vacancy Rate and Completion vs. Absorption

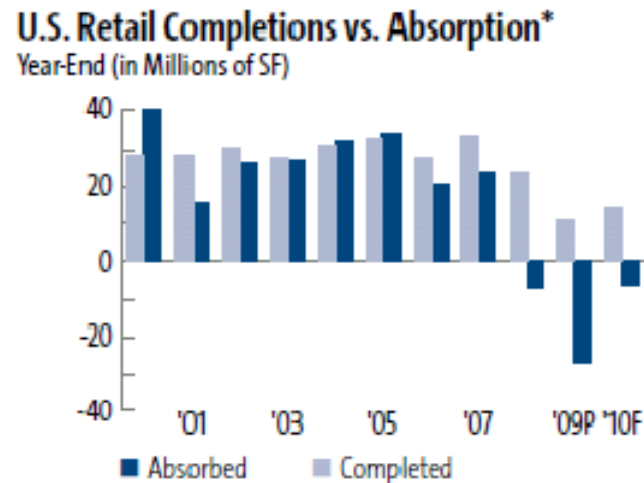
## U.S. Retail Vacancy Rate



\*Neighborhood and community centers  
Source: Reis, Grubb & Ellis

Source: Reis, Grubb & Ellis

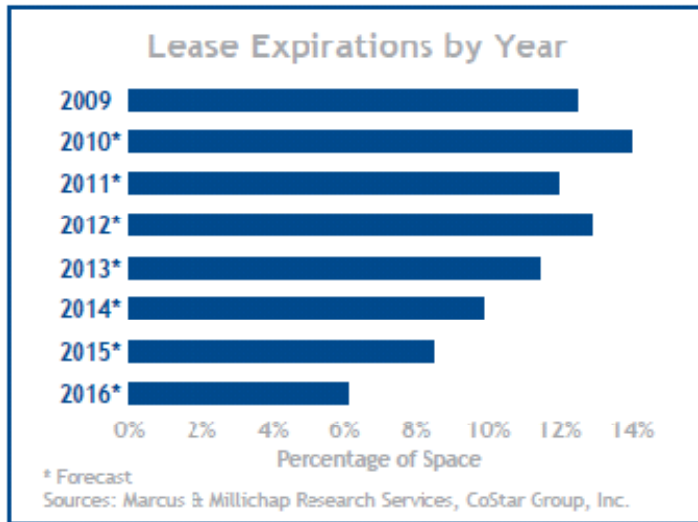
## U.S. Retail Completion vs. Absorption



\*Neighborhood and community centers  
Source: Reis, Grubb & Ellis

- Completions are at the lowest rate in 30 years
- Vacancies are still on the rise
- Grocery-anchored neighborhood centers and fortress malls have significantly outperformed neighborhood and community centers and regional malls

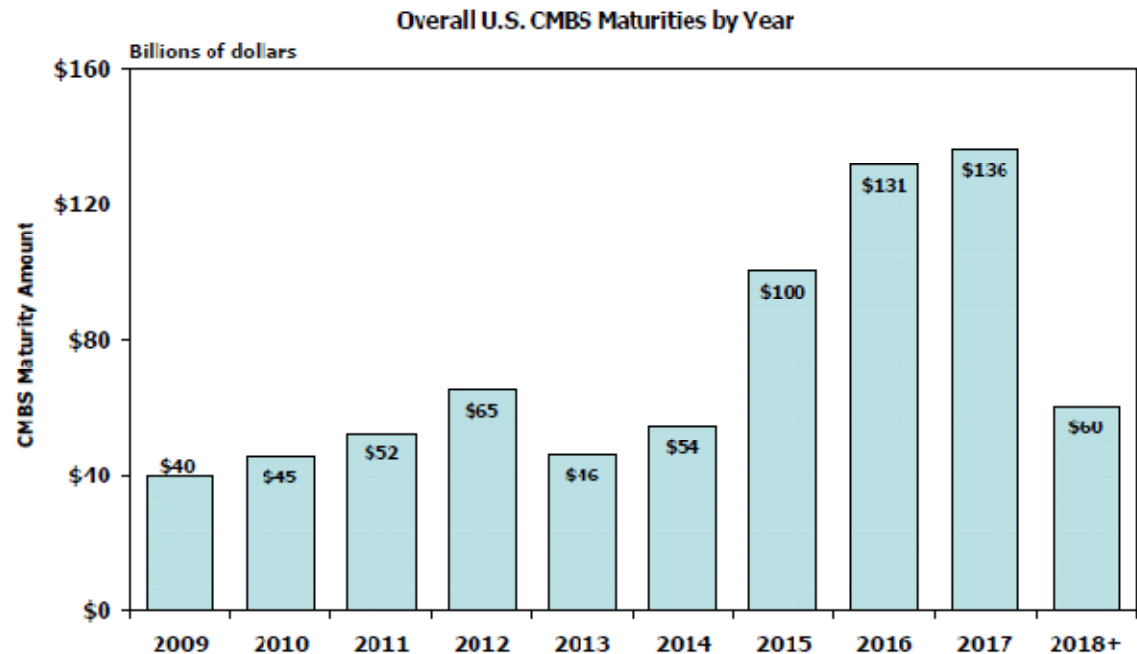
# Future Market Pressure from Lease Expirations and Debt Maturities



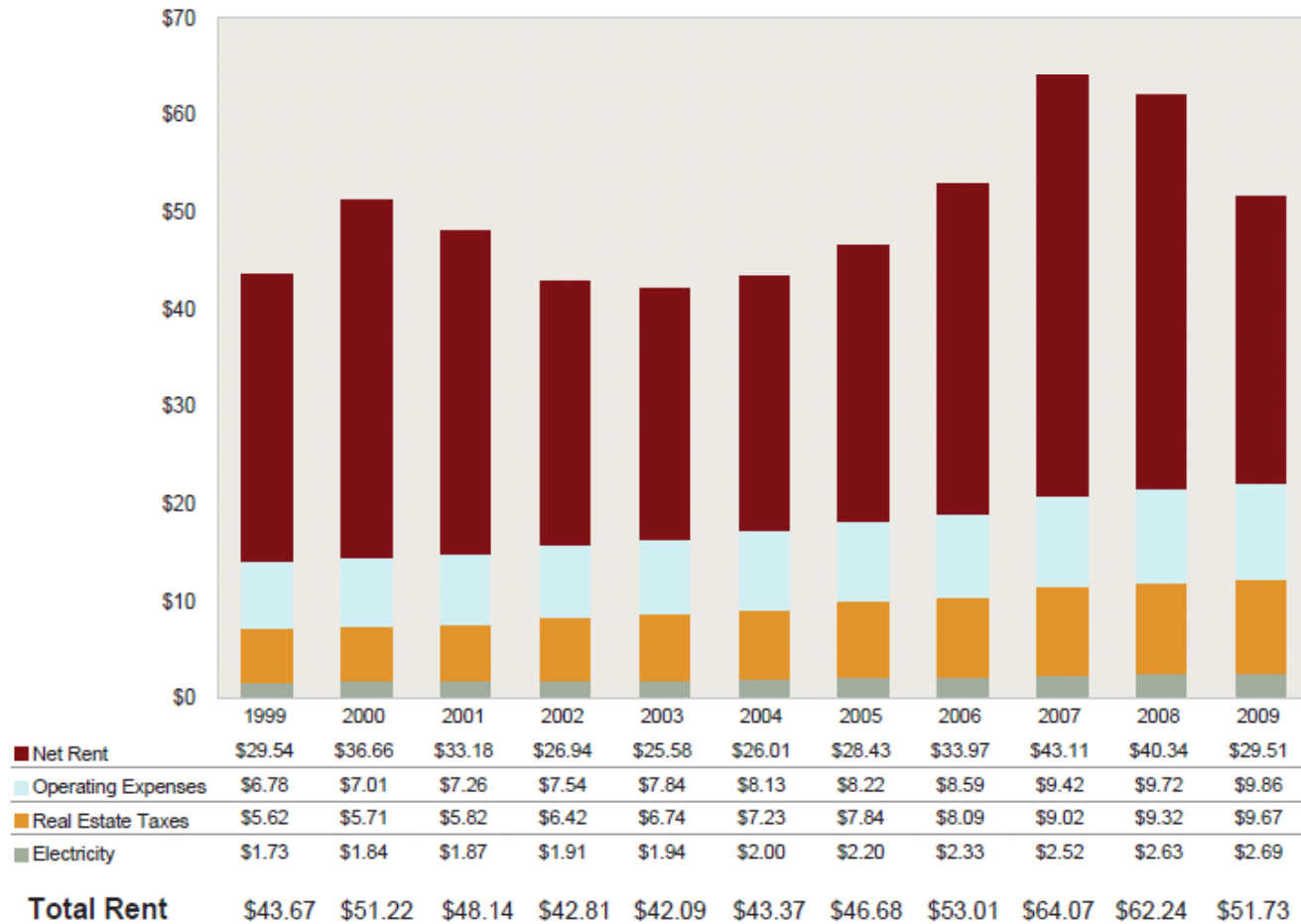
Some analysts fear the markets will not recover fast enough to make up for new vacancies and loan maturities.

*Note: Lease Expirations by Year show expected office lease expirations only.*

*Source: Marcus & Millichap Research Services, Costar Group, Inc., Goldman Sachs and Trepp*



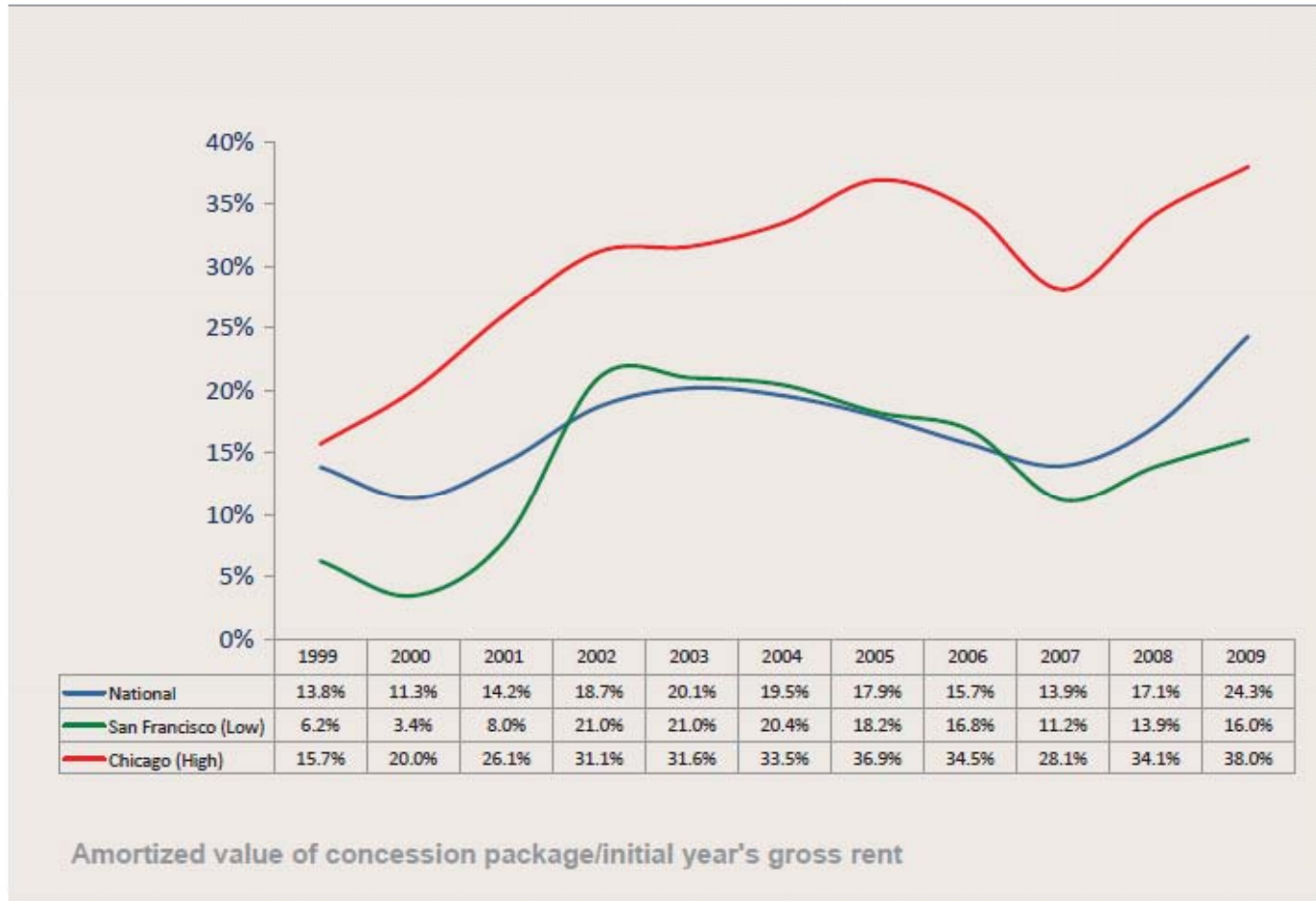
# Total Rent Components- Office



- Average gross rent fell by 16.7% in 2009
- The critical factor was the sharp drop in net rent by 26.9%

Source: Studley Effective Rent Index 2010

# Value of Amortized Gross Concessions- Office

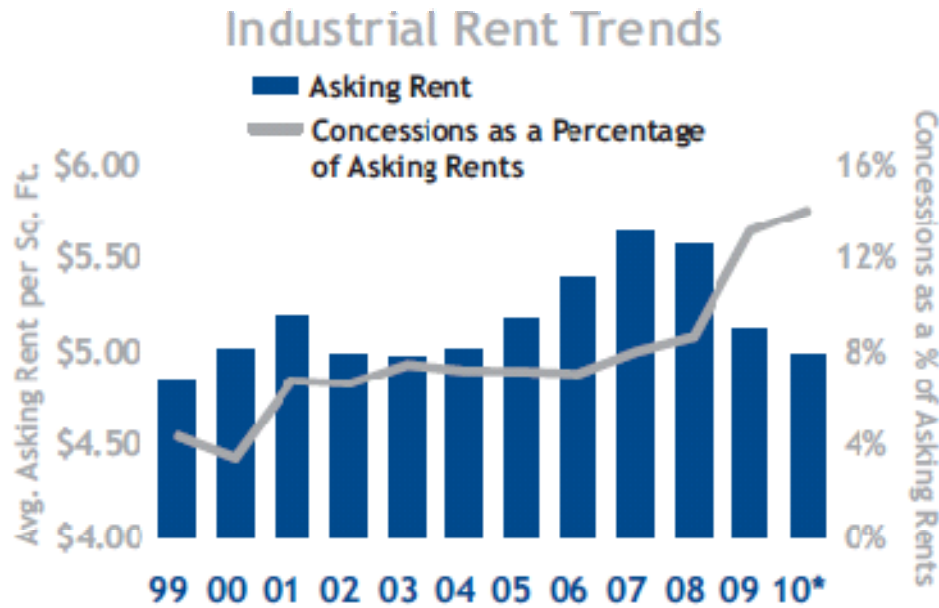


- In 2009, the average value of concession packages spiked by 26.6% from \$71.94 psf to \$91.10 psf
- Landlords facing a lack of funding for tenant improvement dollars have been forced to offer extended free rent periods

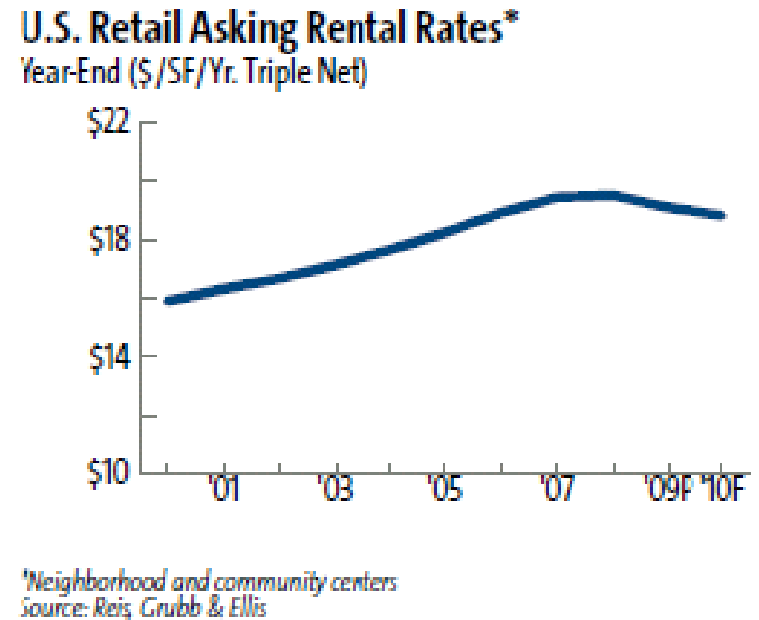
Source: Studley Effective Rent Index 2010

# Rent Trends- Industrial and Retail

## Industrial Rent Trends



## U.S. Retail Asking Rental Rates

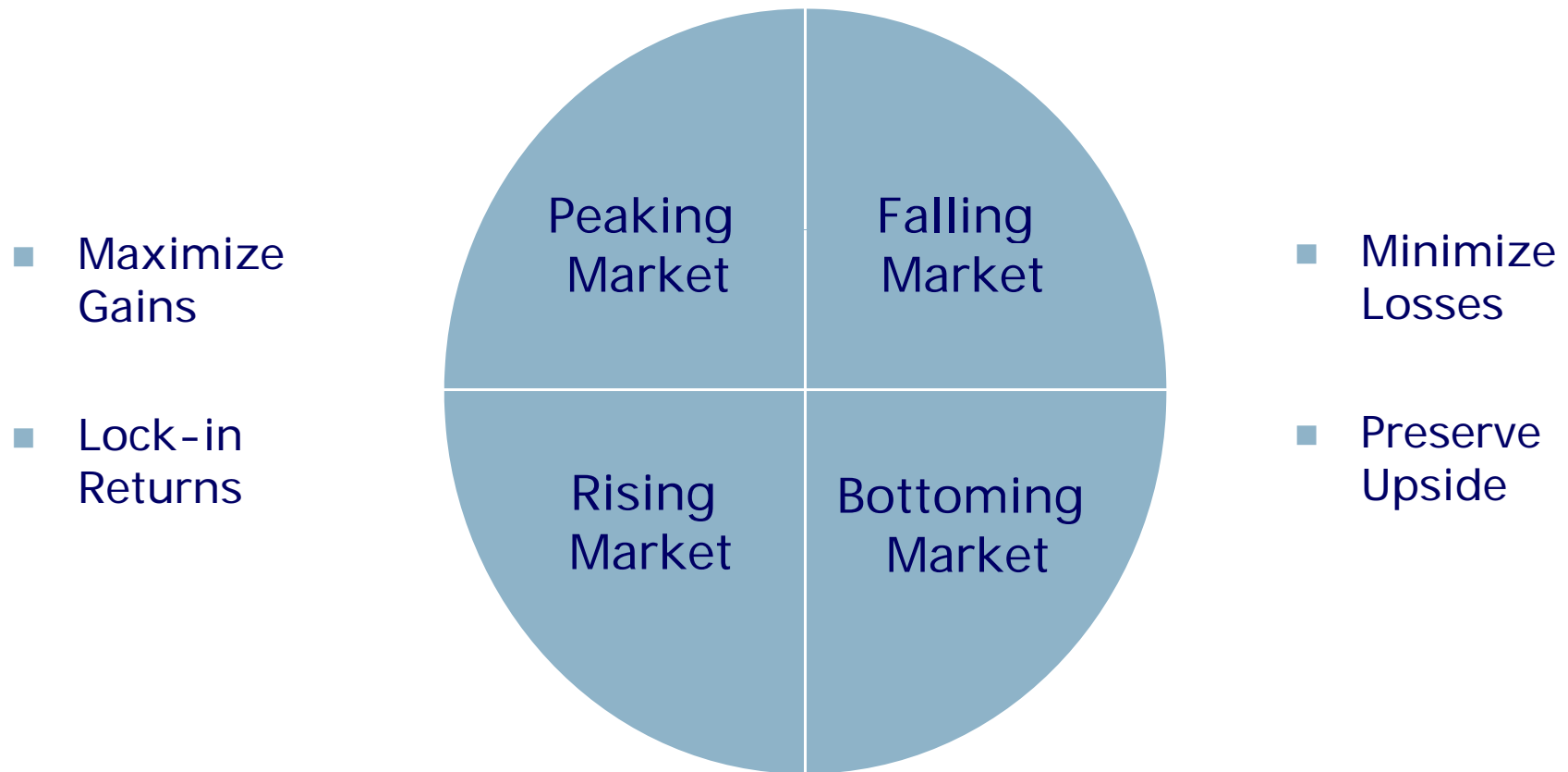


Source: Marcus & Millichap; Reis; Grubb & Ellis

# Other Concessions

- Expense Caps
  - Shift to base year deals from expense stop deals in office
  - Pre-negotiated caps on operating expenses in retail and occasionally industrial
- Cancellation options/Short terms with multiple renewals
- Offset rights
- Signage rights
- Turnkey vs. allowance deals
- Retail percentage rate deals

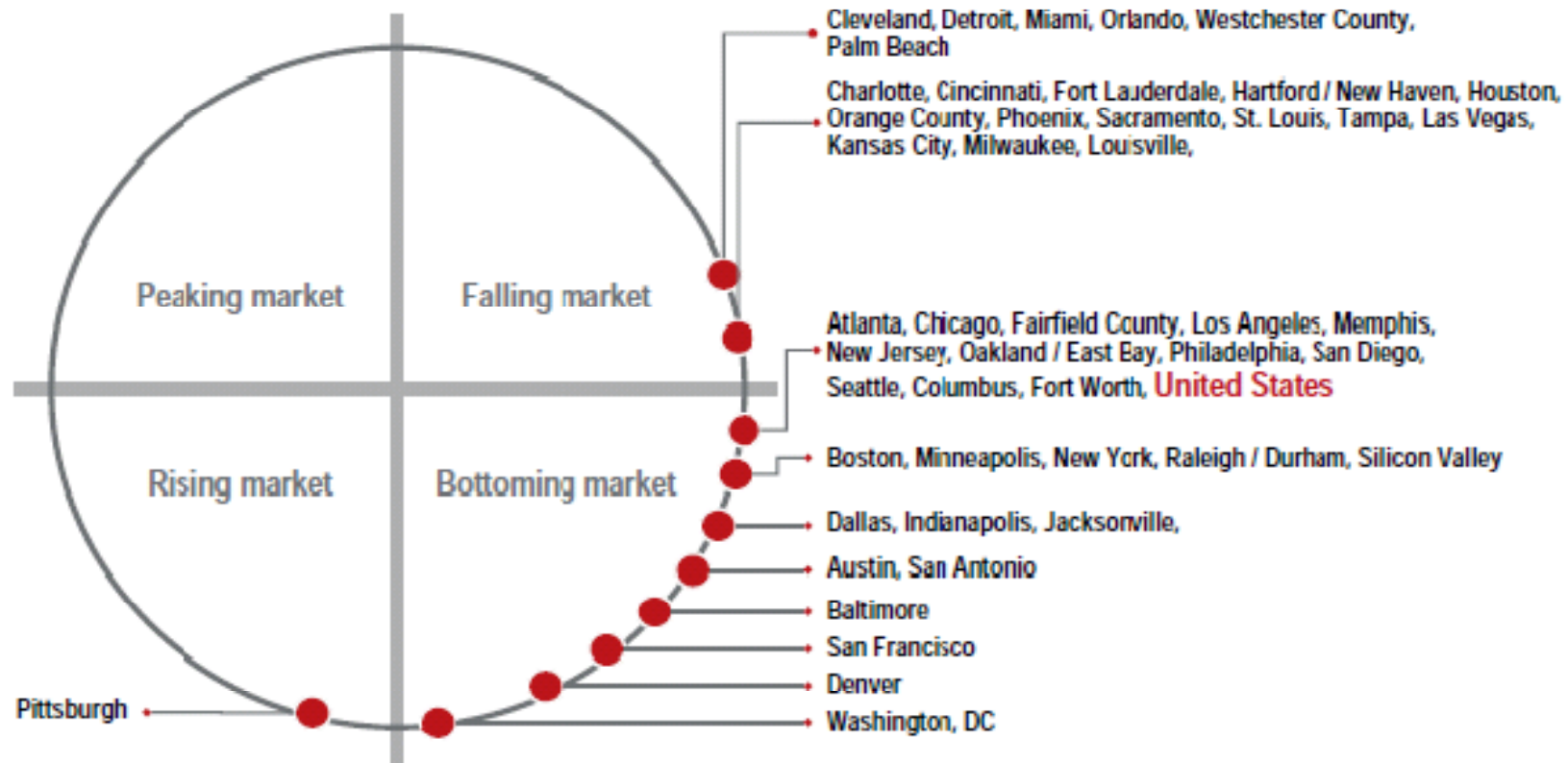
# The Rental Market "Clock"



Source: Jones Lang LaSalle



# Example: United States Office Clock Q2 2010



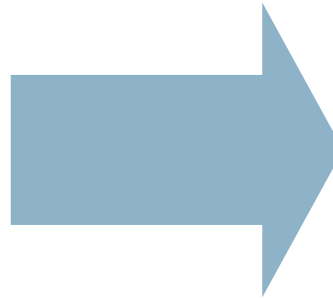
Source: Jones Lang LaSalle

# Lender and Investor Influence

- Availability to finance new deals and upfront concessions
  - Example: Steve & Barry's
- Likelihood of lender flexibility
  - Example: CMBS loans vs. portfolio loans, loans acquired from troubled banks
- If landlord is likely to market building for sale, investor perception of deal
  - Example: Medical vs. retail uses; single vs. multi-tenant assets

# Heightened Importance of Subordination Non-Disturbance and Attornment Agreements

- Tenants want to confirm:
  - Lenders agree to deal terms, even in the event of landlord loan default
  - The prospects for future property management/operations
- Lenders are more carefully examining:
  - Commitments to build-outs, allowances, and vertical construction
  - Long term prospects of the deal vs. the initial investment
  - Creditworthiness of tenants



Strategize  
lender  
involvement in  
the context of  
the overall deal

# Conclusions and Recommendations

- Lawyers should consider market dynamics to effectively service their clients in lease restructurings/workouts
- Clients and brokers can provide the required background
- Please note that submarket and product type intrinsics vary widely
- Questions/Comments

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# Lease Work-out Strategies: Rehabilitating the Tenant

Richard Spore  
Bass, Berry & Sims PLC  
(901) 543-5902  
rspore@bassberry.com

## Rehabilitation vs. Removal

- Distinguish between a tenant that is already in default vs. a tenant that is headed for trouble but still performing its lease obligations.
- The fundamental question:
  - Is the tenant worth more alive than dead?
  - Is an impaired tenant better than no tenant?

## Factors to Consider

- Tenant's financial condition, operating ability and long term viability. How was the tenant doing before the crisis? If the landlord provides the tenant some accommodation, is the landlord delaying the inevitable (and, if so, is there any advantage to landlord to doing that)?
- Tenant's history at the property and credibility.
- Overall financial, operating and marketing impact on the property of the tenant's demise. How bad will a dark space be? How will other tenants react to favorable/unfavorable treatment of this tenant (and is there a need for a confidentiality provision in any agreement)? Co-tenancy issues if this tenant goes dark/terminates its lease?

## Factors to Consider

- Impact of unamortized tenant improvement/leasing commission expenditures.
- Existence/absence of tenant credit enhancements like lease guarantee/letter of credit.
- Issues/concerns with landlord's lender and loan. Can the landlord terminate/modify the lease without lender consent?
- Prospects for reletting.



# Principles for Minimizing Landlord's Risk and Down-Side

- Landlord should not make uncompensated concessions.
  - Consider eliminating existing tenant “goodies” like building signage, exclusive use, co-tenancy/kick-out provisions, renewal or other options or free rent.
  - Consider adding additional credit enhancements like additional security deposit, new guaranty or a letter of credit.

# Principles for Minimizing Landlord's Risk and Down-Side

- Landlord should not concede more than is necessary.
  - Obtain current financial information on the tenant and updated tenant projections.
  - What concessions are tenant's owners, vendors and other creditors being asked to make?
  - Is the tenant in default under other material obligations (e.g., bank loans) and, if so, what are the implications of those other default(s) for landlord?
- Landlord should understand its bankruptcy risk and take it into account in structuring any lease work-out. Landlord should not do a deal in reliance upon something that it will probably have to give back in a bankruptcy context (but landlord should not refuse a concession just because it may be a preference).

# Principles for Minimizing Landlord's Risk and Down-Side

- A modification agreement typically modifies the underlying lease terms so that the tenant can avoid being in default, subject to certain conditions and concessions by tenant.
- With a forbearance agreement, the lease typically is not modified, and the tenant remains in default, but the landlord agrees not to pursue its remedies in connection with that default if the tenant performs certain agreements and satisfies certain conditions.
- Identify all defaults and reserve all rights, except as expressly agreed

# Issues to Consider in the Lease Modification or Forbearance Agreement

- Eliminate/waive notice requirements for any future defaults.
- Identify and rectify any “glitches” or problems with the original lease.
- If applicable, stipulate that landlord’s pending FED/eviction action will not be dismissed but will remain outstanding unless/until tenant meets certain conditions.

# Issues to Consider in the Lease Modification or Forbearance Agreement

- Identify any concessions by landlord and tenant, including any new credit enhancements. Condition all of landlord's obligations on the proper and timely performance by tenant of its obligations.
- Include financial reporting by tenant, even if it's currently a public company (that can change if the company is delisted).

# Issues to Consider in the Lease Modification or Forbearance Agreement

- Have tenant sign interest bearing promissory note for any past due or deferred amounts (including free rent that will be due if there's a new default; deferred rent; past due rent; unamortized TI and commissions; and any other sums owed by tenant). Note may include forgiveness feature if tenant satisfies certain agreed upon conditions.
- Include exclusive venue/jurisdiction/governing law/attorneys fee provisions, including any disputes relating to guarantors (and have guarantor execute agreement).

# Issues to Consider in the Lease Modification or Forbearance Agreement

- Have tenant release landlord from any liability relating to events occurring prior to the date of the agreement.
- Consider adding a confidentiality agreement.
- Consider requiring tenant to pay landlord's attorneys fees in connection with the workout.
- Add a condition for lender or other 3rd party approvals, if applicable.

# Lease Exit Strategies

Gregory G. Gosfield, Esquire

KLEHR | HARRISON | HARVEY | BRANZBURG LLP

1835 Market Street • Philadelphia, PA 19103

Tel: 215.569-4164 • Fax: 215.568.6603 • [ggosfield@klehr.com](mailto:ggosfield@klehr.com)



# Exit Options: Background

- Nonconsensual: Bankruptcy is primary touchstone ; eviction is secondary
  - Tenant Bankruptcy
  - Landlord Bankruptcy
- Nonconsensual: Eviction is secondary touchstone
- Guarantor Liability/Security Deposit

# Exit Options: Background

- Consensual:
  - Sublease/Mitigate
  - Assignment/Withdrawal
  - Termination

# Non-Consensual Exit: Tenant Bankruptcy

- Pre-Bankruptcy Lease Modification for Termination or Recapture
  - Executory contract
  - Better to shorten term with options to renew
  - Advances landlord termination fee as loan secured by personalty and leasehold
  - If termination is rejected, loan is due
  - Cash is tenant's estate and stayed from collection
  - Letter of credit is outside tenant's estate

# Non-Consensual Exit: Tenant Bankruptcy

- Rejection Generally
  - 120 days to decide plus 90 more days for “cause”
    - Landlord unsecured claim for damages greater of
      - 1 year’s rent
      - 15%, not to exceed 3 years rent for remaining term

# Non-Consensual Exit: Tenant Bankruptcy

- Landlord Damages
  - Is landlord worse off with limited recovery,  
or
  - Better with unencumbered asset outside of  
the estate

# Non-Consensual Exit: Tenant Bankruptcy

- Assignment and Designation
  - Lease anti-assignment clause unenforceable
  - Lease recapture unenforceable
  - Tenant power to monetize a valuable leasehold



# Non-Consensual Exit: Tenant Bankruptcy

- Assumption Generally
  - Cure existing defaults
  - Provide adequate assurance of future performance

# Non-Consensual Exit: Tenant Bankruptcy

- Shopping Center Adequate Assurance
  - Assure source for base rent
  - Assure percentage rent
  - Subject to real estate covenant restrictions
  - Maintain tenant mix



# Non-Consensual Exit: Landlord Bankruptcy

- Rejection Generally
  - No further obligation to tenant
  - Landlord breach of lease

# Non-Consensual Exit: Landlord Bankruptcy

- Tenant Right of Continued Possession or Termination
  - Tenant may terminate or
  - Tenant may retain possession
  - Tenant rights “in or appurtenant” to real property of use, quiet enjoyment, assignment/ subletting
  - Off-set rent against landlord breached performance

# Non-Consensual Exit: Landlord Bankruptcy

- Realty Provision Compared to Contract Provision
  - Covenants independent or dependent
  - Mitigation/acceleration
  - Anticipatory breach

# Non-Consensual Exit: The Sublease in Bankruptcy

- Subtenant Risks
  - Rejection of prime lease can divest sublease
  - Subtenant – recognition by landlord/new lease
    - Contractual right to exercise tenant's rejection and indemnify tenant

# Non-Consensual Exit: The Sublease in Bankruptcy

- Bankrupt Tenant Powers
  - Assumes prime lease
  - Rejects sublease
  - Subtenant retains subleasehold and sets off against its rent

# Consensual Exit: Termination Agreements

- Landlord Advantages
  - Eliminate chronic drama
  - Stop hemorrhaging (legal) expenses
  - Prevent fear of bankruptcy
  - Reposition space

# Consensual Exit: Termination Agreements

- Tenant Advantages
  - Skip continuing expense
  - Secure strategic shedding of location
  - Avoid imminent call for upgrades
  - Eliminate festering disputes



# Consensual Exit: Termination Agreements

- Posture and Protocol – Pre negotiation Agreement
  - Single representation
  - No change of position
  - Confidentiality of settlement negotiations
  - Admission/no admission of default
  - Come current/escrow rent



# Consensual Exit: Termination Agreements

- Consideration – who pays whom
- Diligence – what claims by contract, statute or tort
- Inspection – condition of surrendered space, improvements, equipment (who gets it)

# Consensual Exit: Termination Agreements

- Covenants– pay; turnover; cooperate
- Representations and Warranties
  - no undisclosed liabilities;
  - power and validity;
  - no third party claims;
  - no violations of law

# Consensual Exit: Termination Agreements

- Release of Claims /Snapback for conditions subsequent
  - mutual;
  - floor/ceiling;
  - pre-transfer/post-transfer

# Consensual Exit: Termination Agreements

- Indemnity, hold harmless, protect and defend against third party claim;
- Waiver of defenses

# Consensual Exit: Termination Agreements

- Transfer of Property and form of Transfer
  - Surrender
  - Assign
  - Consents
- Survival of Obligations or Releases - known or unknown conditions

# Consensual Exit: Termination Agreements

- Holdover – consent to judgment and eviction
  - penalty rent
  - extinguish releases
  - reinstate guaranties

# Consensual Exit: Termination Agreements

- Conditions to Surrender –
  - date certain;
  - material conditions;
  - third party (lender, co-tenancy) approval;
  - substitute tenants.



# Consensual Exit: Termination Agreements

- Surrender Condition of Property – -
  - broom clean;
  - fixtures;
  - environmental;
  - water;
  - MOB;
  - title.



# Consensual Exit

## Assignment of Sublease

- Extinguish options: extension, scale up, scale down
- Extinguish or soften exclusives
- Fee/Profit-Sharing
- Tighten covenants: “kick-out” for financial ratio or performance
- Consent and stipulation for eviction
- Tenant further investment in improvements
- No further tenant transfer
- Landlord relocation right
- Landlord redevelopment and termination rights

# Consensual Exit: Assignment

- Assignor
  - like guarantor, unreleased
  - No right to mitigate
  - No further ownership liability
  - No duty to assignee

# Consensual Exit: Assignment

- Assignee
  - No refashioning lease
  - Loss of options – extension, expansion, contraction, termination

# Consensual Exit: Sublease

- Sublandlord
  - Remains in title
  - Right to mitigate and terminate sublease

# Consensual Exit: Sublease

- Subtenant
  - Sublandlord bankruptcy/default risk
  - No privity with prime landlord or its mortgagee
  - Non-disturbance

# Assignments & Subleases: Pro Con Summary

	Subletting of Premises		Assignment of Lease	
	Pro	Con	Pro	Con
<b>DEAL ISSUES</b>				
<b>PRIVITY OF ESTATE</b>	Transferee has no duty to Prime Landlord	Transferee has no recognition from right of Prime Landlord, no rights as to: <ul style="list-style-type: none"> <li>• Quiet enjoyment</li> <li>• Wrongful eviction</li> <li>• Remedies of setoff</li> <li>• Possession upon landlord rejection of lease</li> </ul>	Landlord has direct duty to Transferee	Transferee has direct duty to Landlord
<b>PRIVITY OF CONTRACT</b>	Transferee has no direct duty to Prime Landlord	Transferee has no direct right of audit contests, policing of rent payments to Prime Landlord	Transferee has direct right of audit, contest, invoice copies	Transferee has direct duty to Prime Landlord
<b>BUFFERS</b>	Sublandlord buffers Subtenant from Prime Landlord	Sublandlord relies on Subtenant to fulfill Prime Lease obligations	Transferor free from direct lease performance and its administrative chores	Transferor is distanced from ability to police lease performance while liable for failure of lease performance
<b>PRIME LANDLORD</b>	Buffers Prime Landlord from Subtenant (not underwritten by Prime Landlord)	Prime Landlord and Subtenant have no direct control over each other	Prime Landlord has Transferee as new responsible party, plus Transferor	Transferee may not be as attractive as original Transferor; Prime Landlord may have chosen someone else if allowed
<b>LIABILITY OF TRANSFEROR UPON DEFAULT BY TRANSFEE</b>	Transferor rights to mitigate loss by repossession, re-entry or acceleration	Transferor remains liable to prime landlord	Transferor paid in advance for value of site	Remains liable for tenant obligation unless released (novation)  No structural reversionary rights for mitigation, repossession or re-entry may be deemed to be sublease
<b>PRIME LANDLORD RISK UPON TRANSFEROR BANKRUPTCY</b>		Bankruptcy of Transferor can divest/reject sublease	Bankruptcy of Transferor does not affect lease.	

# Assignments & Subleases: Pro Con Summary - Continued

	Subletting of Premises		Assignment of Lease	
	Pro	Con	Pro	Con
<b><u>DRAFTING ISSUES</u></b>				
<b>NOTICE AND CURE</b>	Notice and cure should be less than original lease		Transferor should have separate covenant by Transferee to limit notice and cure to less than original lease and allow Transferor final performance	
<b>REMEDIES</b>	Property right to accelerate, re-enter, and recover.	Transferor may have duty of mitigation of Transferee's damages	Notwithstanding Transferor has no reversionary interest. Contractually assert right to accelerate, re-enter, and recover	Could recharacterize assignment as a sublease
<b>RETAINED PROPERTY AT SURRENDER</b>	Distinguish Transferor's property from Transferee's		Distinguish Transferor's property from Transferee's or create total assignment and applicable consideration	
<b>INCLUDE OR EXCLUDE PRIME LEASE TERMS</b>	Consent, notice and cure, set off, termination, audit contest	Termination for destruction or loss of services may not easily import		No easy way to modify Transferor rights, no easy way to monitor against Transferee's default