

Morgan Lewis

Leasing Issues in a Distressed Market



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A Commercial Broker's Perspective

ISSUES FOR CONSIDERATION

- Business Considerations
 - Business Plan (e.g., short- and long-term objectives)
 - Headcount Implications
- Physical Considerations
 - Building
 - *Condition of Facilities (e.g., image, need for capital improvements)*
 - *Mechanical Systems (e.g., repairs, capital improvements)*
 - Occupancy
 - *Percentage of the Building Occupied by Tenants*
 - *Space Utilization (e.g., density, underutilized)*
 - *Contribution to Productivity (e.g., workflow, adjacencies)*

A Commercial Broker's Perspective

ISSUES FOR CONSIDERATION

- Financial Viability of the Building
 - Rent Roll
 - Distribution of Lease Expirations
 - Rights and Options of Master Leases (e.g., first offer/refusal, renewal)
 - Solvency of Tenant Base
 - Landlord's Break-Even Rent

A Commercial Broker's Perspective

ISSUES FOR CONSIDERATION

- Financial Viability from a Capital Standpoint
 - Landlord Capital Stack (e.g., first mortgage, mezzanine loan, JV, equity)
 - *Sources: Municipal Records, Rating Agencies, Bloomberg, TREPP, Prospectus of Securitization, etc.*
 - Ownership Structure (e.g., REIT, limited partnership)
 - Financial Position
 - Cash Reserves (i.e., upfront capital for performance of lease terms)
 - Shortfall (i.e., is the landlord writing a check to cover annual expenses?)
 - Lender Approval (e.g., economic terms, SNDA)

A Commercial Broker's Perspective

ISSUES FOR CONSIDERATION

- Market Dynamics
 - Supply vs. Demand
 - Assessment of Market Deal Terms
 - Concession Packages
 - Economic Incentives

A Commercial Broker's Perspective

LEASE EXPIRATION IN THE NEXT 24 MONTHS

- Blend & Extend (Early Renegotiation)
 - Achieve rent relief and right size for a long-term commitment at prevailing market rates
- Lease Buyout (Early Termination)
 - Weigh impact of sublease write-down vs. one-time buyout penalty
- Hidden Value in Lease Options
 - Assess value of the forfeiture of rights and options for immediate relief
- Lease vs. Own
 - “Cash rich” companies can leverage a depressed sales market to purchase and occupy real estate to be monetized as the market recovers through a straight sale or sale/leaseback

A Commercial Broker's Perspective

LEASE CONSIDERATIONS

- SNDAs
 - Agreement from the landlord's mortgage lenders and ground lessors
- Tenant Improvements
 - Demand funds be placed in escrow or in a letter of credit
- Self-Help Rights
 - Upon Landlord default Tenant reserves the right to hire vendors to perform services at the landlord's expense
- Right to Offset
 - Tenant reserves the right to adjust rental expense to capture the value of landlord default
- Subleasing
 - Negotiate the right to stay in the space with the building landlord if the sublandlord defaults
- Lease Flexibility (e.g., expansion, contraction)
 - Right of First Offer (ROFO), Right of First Refusal (ROFR), cancellation rights for a portion of the premises

A Commercial Broker's Perspective

LEASE EXPIRATION BEYOND 24 MONTHS

- Leverage Position to Bargain for Better
 - Contingent upon the portion of the building occupied, tenant has an opportunity to renegotiate advantageous lease terms and conditions
- Assess the Value of Lease Options
 - Utilize rights or options as bargaining chips for more advantageous lease terms and conditions
- Short-Term Rent Relief
 - Leverage your tenancy to negotiate for a short-term percentage reduction in rent
- Reduce Ancillary Charges
 - Leverage market precedent to reduce fees associated with overtime services
- Secure Higher Standard of Maintenance
 - Leverage market conditions to enhance maintenance services

A Commercial Broker's Perspective

PORTFOLIO OPPORTUNITIES

- Cost Savings Opportunities
 - Dispose of Surplus Space
 - Consolidate/Co-locate
 - Maximize Space Utilization
 - Shed Underperforming Locations
 - Establish New and Consistent Space Standards
 - Reduce Operating Expenses (e.g., vendor count, energy management, bulk purchasing, SLAs)
 - Mark-to-Market Analyses
 - Evaluate Lower-Cost Labor Markets
 - Lease Audits (e.g., operating expenses, real estate taxes, overtime charges)

Tenant Leverage Issues

Subordination Non-Disturbance and Attornment Agreement

- *Non-Disturbance – Tenant’s possession shall not be disturbed and the Lease continues in full force and effect unless Tenant is in default beyond any applicable grace and cure periods under the Lease.*
- *Lender’s Standard Positions: Lender/Successor Landlord not liable for or bound by:*
 - (i) any act or omission of any prior landlord under the Lease;
 - (ii) any rent paid more than one month in advance;
 - (iii) any amendment, modification, waiver, renewal or extension that is not approved by Lender;
 - (iv) any reduction in rent unless made with Lender’s prior consent;
 - (v) any reduction of the term of the Lease or any termination, cancellation or surrender of the Lease;
 - (vi) any credits, offsets, claims, counterclaims or defenses that Tenant may have that arose prior to the date of the foreclosure or liable for any damages that Tenant may suffer as a result of any breach by any party other than lender/successor landlord; or
 - (vii) any obligation to make improvements to the property, including the leased space, to make any payment or give any credit or allowance to Tenant provided for in the Lease.
- *Tenant should try to add that Lender/Successor/Landlord is only liable or bound by the above provisions if they are in the Lease.*
 - Lender insists on additional time to cure default (over and above) notice and cure period for Landlord. Tenant’s optimal result, but difficult to get: Lender’s cure period runs concurrently with Landlord’s.

Tenant Leverage Issues

Failure of Service

- *What Services?*
 - Optimal position for Tenant is all services
- *Classic Fight: Services provided by Landlord or all services regardless of who provides.*
- *Who should bear the risk of utility explosion where Tenant has a direct meter?*
- *Rent Abatement – After how long?*
 - Tenant wants the shortest period of time possible.
- *Termination of Lease – After how long?*
 - Tenant wants the shortest period of time possible.
- *Lender's Position – Lenders detest abatement of rent and termination of lease provisions.*

Tenant Leverage Issues

Repairs

- *Optimal for Tenant:*
 - Landlord responsible at its own cost and expense for all repairs.
- *Self-Help*
- *Optimal for Tenant:*
 - If Landlord fails to make repairs within a reasonable time or within _____ days of request, Tenant makes repairs and gets reimbursed promptly; if not Tenant gets to offset rent.
- *Typically, Landlord requires Tenant to give two notices and two cure periods. Landlord also reserves the right to object to Landlord's payment of such invoice because such action was unnecessary or charges are excessive.*
- *Lender's Position:*
 - Lenders detest self-help and offset rights.

Tenant Leverage Issues

Casualty Damage

- *Optimal Position:*
 - Landlord to use proceeds to rebuild if it can rebuild within shortest period of time; otherwise, Tenant can terminate.
 - Landlord will counter that Lender needs proceeds if Lender wants to apply them to debt.
- *Lender's Position:*
 - Lender wants the right to do what it wants with the proceeds, including apply them to debt.
- *Tenant-Friendly Compromise:*
 - Lender holds and disburses proceeds which are used pursuant to the Lease provisions (and Lease provisions say proceeds are to be used for rebuilding).
- *Landlord must rebuild/restore the building within one - hundred eighty (180) days in event of casualty; otherwise, Tenant has right to terminate lease.*

Tenant Leverage Issues

Negotiating Lender Issues with the Landlord

- *Tenant's Position :*
 - Lender is not a party to the Lease or Lease negotiations and Tenant is not a party to the mortgage/deed of trust.
 - Addressing the Lender is Landlord's issue.
- *Result :*
 - Tenant leverage with Lender; otherwise, negotiating against itself.
 - If Tenant successfully negotiates an extremely tenant-friendly position with Landlord, Tenant can compromise with Lender and, in turn, ideally position itself.

Tenant Leverage Issues

National Lease

- *National Lenders*
- *Regional Lenders*
- *All or nothing strategy is a mistake*
 - 60% rule

BANKRUPTCY OF A LANDLORD

- This is a very rare event, especially for owners of malls and/or shopping centers.
- Little case law creates uncertainty

Query: Does the bankruptcy filing prohibit commercial tenants from terminating their leases as a result of the landlord's insolvency and/or bankruptcy filing?

Answer: Section 365 of the Bankruptcy Code renders unenforceable any "ipso facto" clauses that are triggered by insolvency, appointment of a receiver or a trustee, or a bankruptcy filing.

- *Consequently, tenants cannot terminate leases for these reasons.*

BANKRUPTCY OF A LANDLORD

Landlord Nonperformance

Query: Can tenant terminate lease for landlord's nonperformance of its lease obligations (other than those covered by "ipso facto" clauses)?

Answer: Maybe.

- *The automatic stay prevents any creditor from taking any action against the debtor or its assets and property.*
- *Terminating the lease may be viewed as an action that causes harm to property of the bankruptcy estate.*
- *Best practice: Make a motion and seek court approval.*

BANKRUPTCY OF A LANDLORD

Phases of Landlord Bankruptcy

1. *Filing and "first day orders"*
2. *Stabilization period*
 - DIP loan is obtained to fund the chapter 11 case and debtor sells some non-core assets
3. *Negotiate exit strategy and propose a plan of reorganization, including:*
 - new capital and debt structure
 - business plan
 - classification and treatment of creditors
 - post-bankruptcy funding
 - other issues

BANKRUPTCY OF A LANDLORD

Assignment and Rejection of Leases

Assignment

- Section 365 of the Code gives debtor broad power to assign leases despite any consent or "anti-assignment" provisions in the lease.
- Note: It is unclear whether the so-called "shopping center" protections in section 365 will apply where the landlord is in bankruptcy.
- Landlord must "cure" defaults as a condition to assignment.
 - Will REAs, radius, exclusivity and other provisions that protect tenants also be assumed and assigned?

BANKRUPTCY OF A LANDLORD

Assignment and Rejection of Leases (continued)

Rejection

- Bankruptcy Code allows debtor to reject (i.e. breach) a lease, thus terminating landlord's obligation to perform in the future.
- Where a lessor is the debtor, section 365(h) gives the non-debtor lessee extensive rights including the option, in its sole discretion, to either
 - (i) treat the lease as terminated and "walk away" or
 - (ii) remain in possession for the balance plus renewal terms (and to continue to enjoy the protections of any radius, exclusivity, location, use, mix and balance provisions)
 - » The tenant may offset any damages from the landlord's nonperformance against the rent obligations but must waive any affirmative claim against the debtor's estate.

Questions?

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