

THREE THINGS TO CONSIDER TO PROTECT YOUR COMPANY AND YOUR MONEY:
Real Estate Lease Strategic Planning in the Current Economy

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As anyone involved in commercial real estate knows, landlords and tenants are having a challenging time in the current economy. For retail tenants, sales have been either down or without the consistent upward trends to show that the economy is back on track. Landlords, faced with rent concessions, vacancy, and lower rental rates, are having difficulty meeting both current debt obligations and new refinancing requirements. The simple reality is that consumers do not have the same cash in their pockets that they had even three years ago. This reality is causing a domino effect from the consumer, to the retailer, to its landlord, and to the landlord's lender (and then, arguably, back to the consumer).

Current Economy Requires Strategic Planning. A real estate lease is one of the biggest financial obligations of any company. Companies often myopically focus only on rental rates and landlord incentive packages and failing to conduct a strategic analysis of a prospective lease agreement to confirm that the lease is aligned with its corporate business plan and strategic objectives.

Below are a set of ideas - suggestions based on my work experience and not an exhaustive or hard-and-fast set of rules - that might be considered in conjunction with a new lease agreement or an amendment to renew or extend an existing lease. Although these are best applied to 'new deals', it might be worthwhile to also review these ideas against existing signed leases as well.

First Thing to Consider: Reducing Your Costs. The most obvious cost item in a lease is the monthly basic rent, but a tenant may be able to manage its costs by scrutinizing other less obvious cost-related provisions. We start with the most obvious first:

Rent: The monthly base rent will be a product of a variety of factors, including, among other things, fair market value, length of term, and size of premises. A second form of rent – percentage rent – can be included, sometimes to a retail tenant's benefit. Percentage rent is rent calculated based on a fraction of a store's gross sales over and above a certain breakpoint. When it is used, landlords may be willing to lower the monthly base rent amount (the thinking being that what a landlord may lose in monthly rent, it likely will make up based on store sales). If a company is nervous about opening in a new geographic area or in a new location, it may be worthwhile to consider thinking through the base rent-percentage rent structure. If a tenant secures a lower month rent because of percentage rent and the store's sales then do not exceed the percentage rent breakpoint, this may be a cost-effective rental strategy for a tenant.

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Triple-Net Pass Throughs: Triple-net pass throughs, expenses that a landlord can charge to a tenant, can be broadly categorized as insurance, real estate taxes, and common area maintenance costs (CAM). Landlords generally resist negotiating their insurance provisions due to covenants under their loan agreements. However, real estate taxes and CAM are worth tenant scrutiny:

- a. Real estate tax pass throughs should not include real estate transfer taxes, which are those taxes arising from the landlord's conveyance of the property. Additionally, a tenant should receive the benefit of any real estate tax appeals, but its cost for such benefit should not exceed the amount of the reduction.
- b. CAM costs are those expenses arising from a landlord's operation of the center that are passed to its tenants. Tenants have a variety of means to manage these costs, including base year provisions (tenant pays only CAM amounts that are increases over and above CAM amounts in a certain base year) and caps on the amount CAM expenses can increase annually. The base year provision also can be used to manage real estate taxes.
- c. Although a landlord may want to pass through all CAM expenses to tenants, certain expense items can, and should, be excluded. These include, among other things, certain capital expenses, items benefitting some but not all tenants, legal fees, and accounting fees not related to the particular property. When representing retail tenants, approximately 25 items are on my list to push to exclude from CAM, and by negotiating these exclusions, tenant can help manage its expenses.
- d. A right to audit landlord's CAM calculations will help a tenant confirm that it is being charged accurately and fairly. In conjunction with this audit right, an enforcement mechanism – such as landlord being obligated for audit costs in the event there is a discrepancy of more than 2% - can be enough to encourage a landlord into keeping its books in proper order.

Gross Sales: Just as specific items can be excluded from CAM costs, specific items also can be excluded from gross sales. By excluding certain items, this will reduce the gross sales figure and, ultimately, any percentage rent that is calculated on this figure. Additionally, it should be noted that retail landlords may require gross sales reporting even if no percentage rent is required. The purpose of this is to keep close watch on the tenant's financial health and to anticipate finance-related problems.

Co-Tenancy: Not all tenants can get a landlord to agree to a co-tenancy provision, but this still should be part of the tenant's discussion with its broker or landlord. A co-tenancy provision allows a tenant to pay a reduced amount of rent when certain conditions are not met either before the store opens or once the store is operating. Usually, the condition is that certain other stores, such as anchors, or a certain percentage of stores in the center have to be open for business. The reasoning is that a tenant is spending a lot of money for a particular site and center, and if that center is not operating as it should, then tenant should receive a

remedy. By negotiating this provision into a lease, a tenant will protect itself in case other stores close or fail to open due to the economy.

Tenant Improvements/Rent Abatement: It is worth noting that landlords, although they might be inclined to provide competitive tenant improvement allowances to lure tenants, may not have the available cash to provide this. Other options in lieu of an improvement allowance or landlord build-out agreement include adjustments to rent. A tenant may be able to negotiate a lower monthly rent or a temporary rent abatement, which may result in a better lease deal from a financial perspective. Tenants should be aware, however, of a landlord attempt to claw back their concessions in the form of overhead, supervisory, or other administrative fees during any tenant build-out.

Security Deposit: Landlords are increasingly asking for a letter of credit (LC) as a security deposit because certain case law has held them to be more landlord-favorable during a tenant bankruptcy. These courts have deemed the LC as a contract between landlord and the issuing bank and not a part of the bankrupt estate. A tenant first should try to negotiate out any type of security deposit. However, if this is not possible, the tenant should anticipate that a letter of credit might be required and should be aware that the LC probably will require additional time to negotiate. The negotiation will be between the landlord, tenant lawyers, and the issuing bank. If time is of the essence with respect to a lease negotiation, the tenant should begin the LC process as soon as it is known that one will be required. By simultaneously negotiating the lease and the LC, the tenant may be able to shorten the overall time to complete and finalize the lease and move forward to the construction and site opening phases.

Second Thing to Consider: Aligning Your Lease with Your Business Plan. A tenant needs to carefully review a prospective lease to make sure that its business strategy is reflected accurately within the agreement. Often, the lease will be a form that is used for all tenants at a certain center or for all tenants generally of the landlord. A conscientious tenant will analyze this form to make sure the lease is aligned with its business plan and will, among other things, review the following:

Alternate Term Length and Termination, Contraction, and Expansion Rights. Some tenants currently are being very cautious about the length of new lease terms. In a better economy, a tenant might not give much thought to signing a ten-year lease. However, some tenants who are concerned about the viability of their business or their success in a new market now may desire a shorter initial term with more renewal terms. In prior years, a lease could have a ten-year initial term and 2 five-year renewals. In today's market, that same deal might now have an initial three-year term and 5 three-year renewals. In this scenario, the tenant could get out of the lease deal if the business does not support the space but, at the same time, has reserved rights to the space if the business does well. Similarly, early termination, expansion, and contraction rights are devices that can be used during the lease term, itself. If business is slow, contracting the space or exercising an early termination right (both are often with a fee paid to landlord) might be a cost-effective way to reduce the lease obligation. Alternately, if business is better than expected, a right to expand into adjoining space is very useful for

those who initially conservatively leased a smaller space due to the uncertainty of the business.

Permitted Uses, Assignment, and Subleasing. Due to continuing economic uncertainty, it is worthwhile for tenants to review sublease or assignment provisions to make sure they provide maximum flexibility in case quick action is necessary. If a business fails or underperforms, a tenant may want to wind down operations at the site and quickly unload the lease obligation to a subtenant or assignee. In conjunction with this, a tenant should review the permitted use section of the lease (the lease provision stating the specific uses under which tenant is approved to operate). It is very important to make sure the permitted use definition is as all-encompassing as possible. For example, it is infinitely better to have a permitted use “for all retail uses” than a use only for “the sale of wicker furniture.” A broadly-worded permitted use clause will expand the audience of prospective subtenants and assignees that can operate within it, while a very narrow permitted use clause conversely may limit the size of the prospective subtenants that could use the space and might be interested in subletting. If tenant needs to rapidly end its operation at the site, a broad permitted use section is very helpful to secure during the lease negotiation as part of advanced preparation.

Delayed Delivery of Space and Holding Over. In a bad economy, two key money-related problems can arise in two specific lease provisions, the landlord premises delivery clause at the beginning of the lease term and the holdover provision at the end of the term, that merit some discussion. The landlord delivery clause will state when the premises are to be delivered and what tenant’s remedies are for late delivery. The holdover provision will provide landlord remedies in the event the tenant does not timely vacate by the end of the term. A variety of issues can arise on both the front and back of a lease that may trigger these provisions, including, among others: an existing tenant will not move out because it cannot find suitable new space or landlord does not have the wherewithal to complete its build-out or remove an existing tenant. Although it may not be intuitive for a lawyer to think of these on-the-ground realities, it is virtually certain that these types of issues are a major tenant concern, and they should be thought through as part of a lease analysis.

- a. In the event a tenant does not timely vacate and triggers the holdover provision, tenant should aim to keep the holdover provision to the smallest penalty as possible, such as holdover rent at 125% of base rent and no liability for consequential damages. If the landlord is adamant about including a more strict penalty for tenant’s holding over, one reasonable compromise to consider is a provision providing that tenant initially is only liable for holdover rent (ideally, at 125%), but in the event landlord has a new tenant ready to occupy the same space and tenant then does not vacate within 30 days of notice from landlord, tenant, at the expiration of the 30 days, could be liable for actual damages.
- b. It normally is critical for a tenant to have new premises delivered by landlord on time so that it can open for business as scheduled and begin to generate revenue as budgeted. Due to the importance of this, a tenant should include certain provisions to protect itself in case landlord does not timely deliver the premises. Consider providing in the lease that in the event landlord does not deliver the premises on the

agreed-upon delivery date, then tenant receives a credit of one day of rent abatement for each day of delay and two days of rent abatement for each day over thirty days of delay (this credit is in addition to pushing back the rent commencement date). Additionally, if landlord does not deliver the premises within approximately 90 days, then tenant has the right to terminate. An enforcement mechanism like this should motivate a landlord to resolve any issues that may delay delivery, which allows the tenant to open on time and to begin generating the budgeted revenue.

Address Potential Weaknesses in Defaults. The default section in a lease should be reviewed for the particular tenant to try to minimize any issues with respect to that specific tenant. The default section lists a set of items that will constitute a default if tenant does or fails to do what is stated. The default section should be reviewed because the prospective tenant may be more susceptible due to its individual circumstances. For example, a rapidly growing company that may have organizational challenges as part of its growing pains would probably be helped very much by having the default for late rent be triggered “five days after notice from landlord” and not “five days from when due”. It is important to confirm that the defaults are reviewed with respect to the individual tenant to avoid issues that may distract the tenant from its business objectives.

Third Thing to Consider: Anticipating Landlord Problems. If landlord appears to be having difficulties of its own (or if it is reasonable to think that it may), then it is important to insert some defensive provisions to protect tenant. Landlord difficulties might manifest themselves in a variety of ways – a decreased maintenance level in the center, delays in repairs or maintenance, or even rumors of possible landlord loan problems. If the landlord appears to having difficulty on its own, then these tenant protections may greatly help the tenant through such landlord difficulties. Some tenant defensive provisions include the following:

Self Help. A self help provision can be very valuable to a tenant because it provides a tenant with a right to act on behalf of a landlord in the event the landlord fails to do what it is required to do under the lease. For example, if landlord is required to keep the roof in a water-tight and leak free condition but fails to do so, then tenant would have the right to exercise self help, repair the roof, and offset the cost of doing so against future rent. A self-help provision will avoid a scenario in which a tenant is held hostage to the problems of a landlord when landlord fails to act. Self help also may help a tenant remedy the problem in a timely manner, avoid protracted negotiations with a non-acting landlord, and incur possible legal fees to enforce lease obligations. Ultimately, defensive provisions like this will allow a tenant to stay focused on its business and productivity.

Rent abatement. Not every landlord will agree to the preferred form of the rent abatement provision, but it is a very useful tenant right, so a sophisticated tenant will often push for this provision in its leases. A rent abatement provision simply provides tenant with an automatic rent abatement in the event the landlord fails to provide, or do, what it is obligated to do under the lease and the issue continues for 48 consecutive hours. If the issue continues for 30 consecutive days, then tenant has the right to terminate the lease. For example, if landlord is obligated to provide utility service and the service is interrupted for 48 hours, then rent automatically abates (i.e. it abates without tenant having to do anything or provide any

notice). Although a landlord will want to soften this language, it is a very good provision to have for a tenant because the mere threat of the rent abatement usually is enough to motivate a landlord to fulfill its lease obligations.

SNDA. Most tenants have uncertainty as to exactly what a Subordination, Non-Disturbance, and Attornment Agreement (SNDA) is - probably because of its lengthy name - but it is very useful in the event a landlord is having trouble meeting its debt obligations. An SNDA Agreement is three things one agreement: (1) Tenant agrees to subordinate its leasehold interest to the interest of landlord's lender, (2) landlord's lender agrees that, so long as tenant fulfills its obligations under the lease, tenant's leasehold interest will not be disturbed, and (3) tenant agrees that, in the event the landlord's lender steps into the shoes of landlord through a landlord loan default, then tenant will recognize lender as the new landlord. This agreement helps to provide certainty in the event a landlord is unable to meet its debt obligation and landlord's lender exercises its default remedies. A well-represented tenant will typically either ask for a SNDA agreement during the negotiation process or have the lease state that a landlord will obtain one upon tenant's request. An agreement like this should provide comfort to a tenant during landlord financial problems and will enable a tenant to maintain its focus on its business and not be distracted by lease issues.

Conclusion. A lease agreement generally is a tricky document to negotiate even in the most ordinary of circumstances. A lease requires the parties to negotiate binding terms in the present that will bind landlord and tenant for many years into the future. It requires the parties to be able both to think through and anticipate a variety of circumstances and scenarios that may arise in the future and then to address them now in the agreement. However, by using an experienced leasing attorney to help review and negotiate the document, one can begin to think through these complex issues and to anticipate the variables. This is particularly true for those new issues, some unforeseen, arising from the current economy. By taking into consideration the issues discussed above, a tenant will be able to more suitably protect itself under one of its biggest business obligations. Ideally, this analysis during the lease negotiation process will keep the company's focus off any problems associated with the lease and on its most important goal: the success of its business.