OFF BALANCE SHEET FINANCING, VIA REAL ESTATE "OPERATING" LEASES – SOON TO BE A THING OF THE PAST?

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On August 17, 2010, the Financial Accounting Standards Board ("FASB") released for public comment proposed changes to the generally accepted accounting practices ("GAAP") accounting standards for leases. Among other things, FASB decides various issues that determine the GAAP standards. The proposed new rules recognize that many leases are but alternative forms of financing. If and when adopted, the revisions to Accounting Standards Codification "Topic 840" will dramatically alter the balance sheet treatment of lease transactions.

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This article will first review the currently effective FASB standards concerning leasehold interests, particularly with regard to real estate leases. Next, the article will briefly recount certain criticisms of the present treatment, and the ten-year process towards establishing a “new” standard. Then, some of the computational aspects of the proposed changes will be examined. We will follow that with a short review of the public commentary received by FASB to date on the “Exposure Draft” proposed by the FASB and the International Accounting Standards Board (“IASB”). Finally, we will address certain loan covenants and certain other details that will need to be addressed in connection with the proposed change in lease accounting rules. Whether public comments result in revisions to the draft or not, the classical “off balance sheet” leasing transactions likely will soon be largely a thing of the past.

1. Current FASB Leasing Rules

Effective in November 1976, FASB issued Financial Accounting Standard 13 covering lease accounting. FAS13 has been amended at least 7 times. Numerous interpretative and technical bulletins have provided additional guidance. However, the general authority has remained in effect throughout 35 years. The latest version of the lease accounting rules and guidelines is codified in Accounting Standards Codification Topic 840 (“ASC 840”).

Most real estate lawyers, when pressed, can tell you that a lease is a “capital” lease if any of the following are true: (1) ownership is conveyed to the lessee at the end of the term; (2) the lessee has a “bargain” option to acquire the property; (3) the lease term equals or exceeds 75% of the property’s useful life; or (4) the present value of rents, using a discount factor of the lessee’s incremental borrowing rate, is 90% or more of the property’s fair market value at inception of the term. If a given lease is not a “capital” lease under any 1 or more of these 4 measures, then the lease is an “operating” lease.

A capital lease under ASC 840 generally is treated as if the lessee financed the purchase the leased property. In this instance, the lessee’s balance sheet will include the property as an asset. However denominated, the “rental” payments’ present value will treated as a liability. The payments on a capital lease are then allocated between the reduction of the liability and an interest expense component.

Unlike capital leases, an operating lease under current ASC 840 typically has no effect on the lessee’s balance sheet. The lessee records the lease payments, as they accrue, as rental expense.

2. Reasoning and Motivation For Change

With the basic rules currently under ASC 840, legal and accounting personnel were given a great deal of flexibility to structure any number of economic arrangements as operating leases. Under these guidelines, the applicable lease term is defined to include only the fixed non-cancelable term, together with certain renewal options, (such as “bargain” renewal options) which are “reasonably assured”. In addition, only the scheduled minimum rental payments over the lease term are considered (including fixed rental increases or decreases). Thus, the 75% and 90% tests of the capital lease standard were easily avoided and could be designed around.

In 1996 and 2000, reports from the accounting standards boards of the US, the UK, Canada, Australia, New Zealand and IASB outlined a “new approach” to lease accounting that their staffs were recommending. Then, in 2002, the Sarbanes-Oxley Act was passed, signaling a call for transparency in corporate affairs and more meaningful financial disclosure. Later in 2002, FASB and IASB entered into a Memorandum of Understanding to converge their rules to comparability and consistency. There is a self-imposed deadline of June 2011 to complete various projects under the Memorandum of Understanding.

On July 19, 2006, FASB and IASB announced a joint project to reconsider standards for lease accounting. The chairman of the IASB, Scotland's Sir David Tweedie, expressed the view that the current rules are "fundamentally broken". Tweedie is also credited with the thought that, during his life, he would hope to fly in an airplane that is shown on the balance sheet of the carrier flying him!

The recent release of the "Exposure Draft" in effect proposes an "update" to ASC 840. A public comment period is open through December 15, 2010. The Introduction and Invitation to Comment section notes that the capital/operating models have been criticized for failing to provide "faithful" representations of leasing transactions. The new approach is said to be one that "would ensure that assets and liabilities arising under the leases are recognized in the statement of financial position."

Under the proposed version of ASC 840 virtually every lease will be reflected on both the balance sheet of the landlord and the balance sheet of the tenant. Three additional measures will also have a significant effect, if the lease accounting standard as suggested is adopted. First, the lease term would be measured by the longest possible lease term that is "more likely than not" to occur, taking into account options to extend or to terminate. Second, an "expected outcome technique" will be used to determine variations in rent, including contingent rental based on consumer price indices and sales volume. Finally, measurements will be revised when changes in facts and circumstances indicate a significant change in assets or liabilities since the previous reporting period.

A June 22, 2010 *New York Times* article reported that the revised lease accounting standards would require public companies to move approximately $1.3 trillion of off-balance sheet items onto their balance sheets. When private companies using GAAP accounting are also considered, the total balance sheet effect of the change could be closer to $2 trillion.

The proposed rules would be effective with annual financial statements for periods beginning on or after a fixed date determined when the rule is implemented. There will not be a grandfather provision for existing "operating" leases.

3. Tenant Accounting Under The Proposed Standards

The proposed standards eliminate the distinction between capital leases and operating leases for tenants and replace it with a "right to use" method that is similar to current accounting for capital leases. Under the proposed standards, on the commencement date of a lease, the tenant's balance sheet includes the right to use the underlying asset for the lease term as a right-to-use asset and the obligation to make lease payments as a liability. The value of the right-to-use asset equals the tenant's liability to make lease payments, reduced by the tenant's direct costs of acquiring or originating the lease (such as commissions, legal fees, and negotiating, preparing, and closing the lease).

The liability recorded to reflect the tenant's obligation to make lease payments is the present value of the lease payments over the lease term, determined on the basis of "expected outcome" as described below. The lease term represents the longest possible term that the tenant determines is more likely than not to occur after estimating the probability of each possible term and taking into account any options to extend or rights to terminate the lease.

The process for estimating the lease term can be illustrated with the following example, which is a paraphrase of Paragraph B17 of the Exposure Draft:

1. An entity enters into a lease that has a non-cancellable 10-year term, an option to renew for 5 years at the end of 10 years and an option to renew for an additional 5 years at the end of 15 years. The entity determines the probability for each term as follows:

   (a) 40% probability of 10-year term

   (b) 30% probability of 15-year term

   (c) 30% probability of 20-year term.

   The term will be at least 10 years, there is a 60% chance that the term will be at least 15 years (a 30% chance of a 15-year term and a 30% chance of a 20-year term), but only a 30% chance that the term will be 20 years. The lease term is 15 years, which is the longest possible term more likely than not to occur.

The "expected outcome" represents the present value of the lease payments over the lease term, which the tenant calculates using all relevant information as follows:

1. Identify each reasonably possible outcome under the lease, which could include extensions or terminations of the lease, changes in contingent rent, and payments under a residual value guarantee (a contract term requiring the tenant to pay the

landlord the difference between the anticipated residual value of the leased asset and the actual residual value of the leased asset at the end of the term);

2. Estimate the amount and timing of the cash flows for each reasonably possible outcome (including estimates of contingent rent payable, amounts payable under residual value guarantees, and expected term option penalties, but <u>not</u> including the exercise price of a purchase option under the lease);

3. Determine the present values of the cash flows for each reasonably possible outcome using the tenant's incremental borrowing rate (the rate the tenant would have to pay to borrow, over a similar term and with similar security, the funds necessary to purchase a similar asset), or the rate charged by the landlord if it can be readily determined of those cash flows; and

4. Estimate the probability of each outcome and calculate a weighted average present value of the cash flows under a reasonable number of outcomes based on the probability that each outcome will occur.

The tenant's income statement will reflect interest expense on the liability to make lease payments, amortization of the right-to-use asset, any changes in the liability to make lease payments resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees, and any impairment losses on a right-to-use asset.

The proposed standards provide that the tenant must amortize the right-to-use asset over the shorter of the lease term or the useful life of the underlying asset. The tenant's liability to make lease payments is amortized using the effective-interest method. Neither the liability to make lease payments nor the right-to-use asset will be reassessed unless the value is impaired or there is a significant change in the liability to make lease payments.

4. Landlord Accounting Under the Proposed Standards

The proposed standards create two separate approaches to lease accounting by landlords: the "performance obligation approach" and the "derecognition approach." The landlord determines which approach it must use at the date of inception of the lease. Once an approach is applied to a lease, it cannot be changed.

The landlord must use the performance obligation approach if, on the date of inception of the lease, the landlord retains exposure to significant rights and benefits associated with the underlying asset either (1) during the expected term of the lease or (2) after the expected term of the lease by having the expectation or ability to generate significant returns by re-leasing or selling the underlying asset. The landlord must use the derecognition approach if the landlord does not retain exposure to significant rights and benefits associated with the underlying asset.

<u>Exposure to Significant Rights and Benefits Associated with the Underlying Asset</u>

Under the proposed standards, a landlord must consider the following factors when assessing whether it retains exposure to significant risks or benefits associated with the underlying asset during or after the expected term of the current lease:

1. During the expected term of the lease:[†]

[†] Exposure Draft, Exhibit B, ¶ B22.

(a) significant contingent rentals during the lease term that are based on the use or performance of the underlying asset;

(b) options to extend or terminate the lease; and

(c) material non-distinct services provided under the current lease.

2. After the expected term of the lease:[‡]

(a) whether the duration of the lease term is not significant in relation to the remaining useful life of the underlying asset; and

(b) whether a significant change in the value of the underlying asset at the end of the lease term is expected. In making that assessment, the lessor shall consider:

(i) the present value of the underlying asset at the end of the lease term, and

(ii) the effect that any residual value guarantees (including those provided by an unrelated third party) may have on the lessor's exposure to risks or benefits.

<u>Performance Obligation Approach</u>

The landlord is required to use the performance obligation approach, which is similar to the current method of accounting for an operating lease, if the landlord retains exposure to

[‡] Exposure Draft, Exhibit B, ¶ B24.

significant rights and benefits associated with the underlying asset. With this approach, the landlord continues to carry and depreciate the leased asset on its balance sheet. On the date the lease commences, the landlord's balance sheet includes the right to receive lease payments as an asset and the landlord's obligation to allow the tenant to use the underlying asset for the lease term as a lease liability.

The value of the right to receive lease payments is determined using the present value of the lease payments over the lease term (the "expected outcome" determined in the same way as it is for tenants), reduced by the landlord's direct costs of acquiring or originating the lease (such as commissions, legal fees, evaluating the tenant's financial condition, securing the lease, and negotiating, preparing, and closing the lease). The lease term is determined in the same way for landlords as it is for tenants, and represents the longest possible term that the landlord determines is more likely than not to occur after estimating the probability of each possible term and taking into account any options to extend or rights to terminate the lease.

Under the performance obligation approach, the landlord's income statement will reflect interest income on the right to receive lease payments, lease income as the lease liability is satisfied, and any changes in the lease liability resulting from reassessment of the expected amount of contingent rentals and expected payments under term option penalties and residual value guarantees when the lessor satisfies that liability, and any impairment losses on the right to receive lease payments.

Neither the right to receive lease payments nor the lease liability will be reassessed unless the value is impaired or there is a significant change in the right to receive lease payments.

Derecognition Approach

The landlord is required to use the derecognition approach, which is similar to the current method of accounting for a capital lease, if the landlord does not retain exposure to significant rights and benefits associated with the underlying asset. Under the derecognition approach, the landlord is deemed to have transferred to the tenant, at the commencement of the lease, a portion of the economic benefits associated with the tenant's rights to the underlying leased asset. When this occurs, the landlord derecognizes the portion of the asset transferred to the tenant (meaning that the carrying value of the asset on the landlord's balance sheet is reduced), recognizes the present value of the right to receive lease payments from the tenant (the "expected outcome" determined in the same way as it is for tenants), which creates a lease receivable, and recognizes revenue and cost of sales. The amount derecognized by the landlord is equal to the carrying value of the underlying asset (the leased property) multiplied by the fair value of the right to receive lease payments divided by the fair value of the underlying asset. The remaining carrying value of the leased asset is allocated to a residual asset.

> For example, Landlord enters into a 10-year lease with Tenant for a building, and Landlord determines that it does not retain exposure to significant rights and benefits associated with the building. Landlord carries the building at a value of $85,000 on its books, the building's fair market value is $100,000, and the present value of Tenant's lease payments over the lease term is $92,661.
>
> On the date the lease commences, Landlord will derecognize $78,762 of the building's value ($85,000 carrying value x $92,661 present value of lease payments ÷ $100,000 fair value) and will have cost of sales of the same amount.

Landlord's balance sheet will include a lease receivable of $92,661 and a residual asset of $6,238 ($85,000 - $78,762). Landlord will have revenue of $92,661 and cost of sales of $78,762, so it will recognize profit of $13,899 ($92,661 revenue - $78,762 cost of sales) upon the commencement of the lease.

The right to receive lease payments is measured at amortized cost over the life of the lease using the interest method. Neither the right to receive lease payments nor the residual asset value will be reassessed unless the value is impaired or there is a significant change in the right to receive lease payments.

5. Early Feedback Based On Public Commentary

The August 17, 2010 Exposure Draft provides for public commentary through December 15, 2010. Apart from feedback made through correspondence to the FASB, there is also a protocol for e-mail suggestions and criticism, with postings to a website maintained by the International Financial Reporting Standards ("IFRS") Foundation.

As of October 12, 2010, there are 16 comment letters shown on the IFRS Foundation site, dated from August 19, 2010 through October 7, 2010. It can take up to 10 days for a comment letter to appear "live" on the website. Some common themes from the early commentary follow.

1. The treatment of short-term leases (defined as having a maximum possible term, inclusive of renewals or extensions, of 12 months or less) still can involve "bright line" determinations. As an extreme example, consider the use of an oil well drilling platform, at a cost of $500,000 a day. If the term is 1 year plus 1 day, the proposal would require capitalizing

the present value of the $180,500,000 in payments. If the term were 364 days, no capitalization would be mandated.

2. Several of the comments expressed that renewal options are not a guaranty of future expense, for the tenant, or income, from the landlord. It is a recurring theme that the parties to a lease usually cannot predict with any accuracy future renewals 15 or 20 years out.

3. Some parties are concerned that updated ASC 840 would make necessary the calculation of future rental factors such as forecasted CPI or sales results. One writer says that this exercise would be "at best, a wild guess".

4. It is said that the new provisions for altering "carrying amounts" of lease liabilities may promote widespread inconsistency in application, as well as exposure to significant penalties for "guessing wrong" during previous reporting periods.

5. In the case of routine equipment rentals and other transactions which are not material to the financial statement as a whole, questions have been raised about "phantom" liabilities and assets resulting in "ballooned" balance sheets.

6. In a number of cases, a company may find that it is mathematically in violation of loan covenants due to a change in accounting principles, without any change in true economic financial position. For loan agreements that have and will be in effect for a number of years, it is perceived that difficulty may be encountered in today's environment to negotiate corrective amendments, without acceding to some countervailing requests from the lender.

7. Certain of the parties providing public comment to date report that they serve clienteles consisting of principally small to medium sized companies. The general comment

from these practitioners is that the benefits from the new standard will likely outweigh the administrative and other costs. Some have suggested that revised ASC 840 deal with publicly traded companies differently from private businesses.

8. For mall landlords with multiple tenants, the proposed lessor accounting rules are said to be unnecessarily complex. For instance, in calculating lease receivables at any time, difficulties might be anticipated with such matters as co-tenancy provisions and "kick-out" clauses.

6. Some Potential Effects of The Proposed Changes

Several effects that may come out of the proposed changes are: (1) tenants may be inclined to negotiate shorter leases; (2) renewal and extension options may become less likely as a matter of course, as they make accounting more complicated and will require analysis of the effects that accounting for such options could have on the parties' financial statements; and (3) retail and office users who intend to occupy property for long periods of time may find it more favorable to own than to rent properties.

Users who borrow from financial institutions may feel a perceived impact on loan covenants concerning financial ratios and the like. The impact should be less significant when dealing with most sophisticated lenders, which already take into account the footnotes to financial statement and other information regarding current and future lease obligations, but it may take longer for the expectations of others to adjust to the new accounting regime. One significant result of the proposed changes is the likely increase in tenants' earnings before interest, taxes, depreciation, and amortization (EBITDA), as rent expense that is currently included when calculating EBITDA will be replaced with interest and amortization expenses that are not. The accounting changes would likely increase the administrative burden for public companies and privately held companies that report using GAAP as well.

PAYMENT OF "STUB RENT" IN COMMERCIAL TENANT BANKRUPTCY CASES

by Brian W. Hockett[1]

Upon the filing of a bankruptcy case by a tenant, one of the first issues to face landlords and debtors with respect to an unexpired lease of non-residential real property is the payment of postpetition rent.

The law requires tenant debtors to perform the obligations under their commercial real property lease pursuant to 11 USC § 365(d)(3), including the payment of rent due after the filing of the case. Section 365(d)(3) of the Bankruptcy Code imposes a duty on tenant-debtors with respect to unexpired leases of nonresidential real property. Specifically, this section provides that a bankruptcy trustee or chapter 11 debtor-in-possession "shall timely perform all obligations of the debtor . . . arising from and after the order for relief under any expired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding § 503(b)(1)."

Prior to the enactment of section 365(d)(3) in 1984, landlords had to rely on section 503(b)(1) of the Bankruptcy Code for payment of administrative postpetition rent and courts had to determine the benefit to the estate from the continued use and occupancy of the premises instead of simply looking to the rent stated in the lease. Typically, service providers and others doing business with the debtor postpetition are entitled to administrative expense treatment. Section 503(b)(1) of the Bankruptcy Code provides that allowed administrative expenses include "the actual, necessary costs and expenses of preserving the estate." Section 503(b)(1) requires that the creditor file a motion requesting allowance and payment of its administrative claim and

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the creditor bears the burden of establishing that its services provide a benefit to the estate. Section 503(b)(1) also does not specify when such claims would be paid. Unlike section 503(b)(1), section 365(d)(3) imposes an affirmative requirement on the chapter 11 debtor that is an exception to the usual rule that obligations arising post-filing meet the more stringent standards for payment of administrative expense claims set out in section 503(b)(1), and requires timely payment of the postpetition obligations as provided under the terms of an unexpired lease.

It is rare that a case will be filed on the day before a rent payment is due, so the question facing the parties is whether or not the debtor must pay the landlord a prorated amount for the period after the bankruptcy petition date until the first postpetition rent payment is due. The amount of rent corresponding to the period of occupancy of real property between the petition date and the first postpetition rental payment due date is often referred to as "stub rent." If the lease calls for the payment of rent on the first day of each month and the petition date falls on the fifth day of the month, the stub period would be from the fifth day of the month through the last day of the month. Must a debtor timely perform the obligation to pay rent for this "stub rent" period under section 365(d)(3)?

The bankruptcy courts have differed on their application of § 365(d)(3) with respect to stub rent. There are generally two approaches adopted by the courts in determining the application of the phrase "all obligations of the debtor . . . arising from and after the order for relief" from section 365(d)(3). The approach applied will largely depend on the circuit in which the debtor's bankruptcy case is pending.

Some courts have held that § 365(d)(3) requires a proration analysis under which the debtor is obligated to pay stub rent immediately under the requirements of § 365(d)(3) for the period of occupancy during the first partial month after the petition date. *See In re Handy Andy*

Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir. 1998) (proration of taxes between the prepetition period and postpetition period even though taxes were due postpetition); *In re Furr's Supermarkets, Inc.*, 283 B.R. 60 (10th Cir. BAP 2002); *Newman v. McCrory Corp. (In re McCrory Corp.)*, 210 B.R. 934, 939-40 (S.D.N.Y. 1997) (proration of real estate taxes); *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008) (proration of stub rent for first month after petition date); *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 67-70 (Bankr. S.D.N.Y. 2004) (holding that section 365(d)(3) is ambiguous and adopting a proration approach to determine the amount of obligations, rather than a billing date approach to final month's obligations upon rejection of lease); *In re All For a Dollar, Inc.*, 174 B.R. 358 (Bankr. D. Mass. 1994) (applying "proration" approach to tax obligations). Under the proration approach, the debtor in the example would be obligated to pay stub rent for the period from the fifth day of the month through the last day of the month.

Other courts have held that § 365(d)(3) requires a bright line test in which stub rent is not permitted. See *In re Goody's Family Clothing Inc.*, 610 F. 3d 812, 816-17 (3rd Cir. 2010); *HA-LO Industries v. CenterPoint Properties Trust*, 342 F.3d 794, 798-800 (7th Cir. 2003) (applying "billing date" approach to month during which lease is rejected); *CenterPoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205, 209-10 (3rd Cir. 2001) (holding that debtor was required to pay prepetition taxes that came due during the pre-rejection period); *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986, 989 (6th Cir. 2000) (holding that the debtor was liable for all of the rent for the month during which the lease was rejected because the due date for paying that month's rent preceded the rejection date); *In re Burival*, 406 B.R. 548 (B.A.P. 8th Cir. 2009). This is referred to as the "billing date" rule. The "billing date" rule requires the payment of obligations only that become due and payable upon or after the filing of the petition for bankruptcy. Under the billing date approach, the debtor in the aforementioned example would not have to make payment of the stub rent for the period from the fifth day of the month through the last day of the month. Instead, the first administrative expense payment required under 11 U.S.C. § 365(d)(3) would be the rental payment for the month following the bankruptcy filing date.

In the event that the debtor assumes a lease, the debtor must pay all past due rents for both the postpetition and prepetition period by operation of section 365(b)(1)(A), which conditions the assumption of an unexpired lease the cure of defaults. Under either approach to stub rent, upon assumption, not only the stub rent period must be paid, but the debtor must also pay for all prepetition rents and obligations. If, however, the debtor rejects a lease, pursuant to section 502(d), claims from the rejected unexpired lease will be treated as if they arose prior to the petition date as general unsecured claims. Courts following the billing date approach could render the "stub rent" a general unsecured claim under section 502(d) in the event the lease is ultimately rejected.

Just because a debtor is not required to make payment of postpetition rent for the stub rent period under the "billing date" approach, does not mean that the landlord cannot recover stub rent on a priority basis. Section 365(d)(3) may not be the exclusive basis for recovery of stub rent from a debtor on a priority basis. Where a debtor actually occupies a premises postpetition, landlords may be able to recover stub rent if they demonstrate that the premises provided an actual benefit to the estate and that the stub rent payment was necessary to preserve the value of the estate's assets under 11 U.S.C. § 502(b)(1). *See In re Goody's Family Clothing Inc.*, 610 F.3d 812 (3d Cir. 2010) In *Goody's*, the court determined that the occupancy of retail stores in various shopping centers by the debtor's liquidation agent benefited the estate where the debtor was able to obtain a 105% recovery from the store closing sales. *Id.* at 819. In that case, the landlords were entitled to reasonable stub rent as an actual and necessary expense for the benefit of the estate under section 502(b)(1) because the store closing sales were an integral part of the bankruptcy proceedings. *Id.* A landlord may be able to recover stub rent even in districts applying the billing date approach if the landlord can qualify for administrative expense treatment under section 503(b)(1) of the Bankruptcy Code.

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

By James P. Moorhead, Esq.[1]

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.

Façade Easements after the Whitehouse Hotel Decision
By Stuart Saft, Dewey & LeBoeuf

On August 5, 2010, the Fifth Circuit, in Whitehouse Hotel Limited Partnership v. Commissioner of Internal Revenue, 615 F. 3d 321 (5th Cir. 2010), vacated a decision by the Tax Court on valuation of a conservation easement and remanded the case back to the Tax Court to review and revise its valuation of the easement and to determine whether a penalty should have been assessed. This decision not only broadens the basis on which to appraise the value of a façade easement and limits when a penalty can be assessed, but it also precludes the IRS from discounting the value of easements of landmarked property, as some feared, they were intending to do.

In 1997 Whitehouse Hotel Limited Partnership ("Whitehouse") owned the Maison Blanche building ("Maison Blanche") and adjacent Kress building ("Kress") in New Orleans and built a 452 room Ritz Carlton Hotel, a 230 room Iberville Suites Hotel and a 75 room Maison Orleans Hotel. As part of this development Whitehouse conveyed an easement of the façade of the Maison Blanche building to the Preservation Alliance of New Orleans, which easement prohibited changes to the building's terra-cotta façade. Whitehouse obtained a "before and after" appraisal and took a deduction of $7.445 million, which the IRS rejected but allowed a $1.15 million deduction and assessed a gross misstatement penalty of 40%.

At the Tax Court, Whitehouse's appraiser valued the impact of the easement on both Maison Blanche and Kress buildings, used two appraisal methods (replacement cost and income) but did not use comparable sales, because there were no comparable sales to determine the highest and best use, concluded that the conservation easement reduced the number of rooms in a future luxury hotel by 60, and estimated the conservation easement value to be $10 million. Conversely, the IRS appraiser concluded there was no difference in the before and after values of the property he appraised: each was $10.3 million, and determined the value based on the impact only on the Maison Blanche building. Whitehouse, 615 F.3d at 327. The IRS appraiser took the position that the highest and best use of the Maison Blanche building was a mixed use, non-luxury hotel and retail complex, not a luxury hotel like the Ritz-Carlton. He also concluded that the easement did not limit the potential number of rooms. Id. In other words, he opined the easement had no effect on Whitehouse's rights to construct additional rooms on top of the Kress building and used the comparable sales method and disregarded the replacement cost and income valuation methods. [As discussed later the Fifth Circuit noted that the government's appraiser "rather extraordinarily, [he] assigned the easement a value of zero."] Id. The Tax Court rejected the replacement cost method, as inapplicable because there was no likelihood of replacing an historic building, disregarded the income method because there was no specific data on the future income from the hotel, but utilized the comparable sales method and made its own determination. The Tax Court found a before value of approximately $12.1 million and an after value of $10.3 million and permitted a deduction of $1.8 million.

The Fifth Circuit noted that, because the IRS conceded that the façade easement was a qualified gift, the only issue was valuation and, since the Tax Court determined that the comparable sales method was the appropriate method to determine value, the Fifth Circuit remanded the case for reevaluation. Whitehouse had argued that the highest and best use was as a Ritz Carlton, which is a luxury hotel, and not as a non-luxury hotel, which the Tax Court did not address. The Fifth Circuit indicated that the Tax Court should have included the effect of the easement on the Kress building because a hypothetical buyer would consider it in buying Maison Blanche. The Fifth Circuit noted that "regardless of the easement's not *burdening* the Kress building, it *affected* the fair market value of the Maison Blanche and Kress buildings. Accordingly, the Tax Court erred in not determining that effect." Whitehouse, 615 F.3d at 339. The Fifth Circuit held that "in making this valuation on remand, the tax court should, among other things, consider the experts' reports and valuation methods (including, *inter alia*, using non-local comparables) and their conclusions regarding highest and best use as a luxury or non-luxury hotel." Id. at 340.

As a result of the foregoing, the Tax Court must also review the appropriateness of the gross misstatement penalty in the review. With regard to the overvaluation penalty, the Fifth Circuit noted that whether the penalty should be assessed would depend on "whether Whitehouse met its burden of proof for reasonable cause. To demonstrate reasonable cause, a taxpayer "must show that he exercised ordinary business care and prudence….Given that Whitehouse offered proof that it relied on its accountants' and attorneys' opinions…a possible issue on remand is whether Whitehouse needed to prove more to show reasonable cause." Whitehouse, 615 F.3d at 342.

This decision is particularly interesting in light of something that was not raised in the case; the concern by preservationists that the IRS considers façade easements to have minimal value. On March 13, 2008, the Service issued a letter to the National Trust for Historic Preservation indicating that "the challenge for us in enforcing [Internal Revenue Code] section 170(h) is the proper valuation of façade easements….The value of a facade easement depends on the facts and circumstances pertaining to that easement. *Historic structures that are subject to existing local landmark or zoning laws that limit or restrict the owner's ability to change the appearance or use of the structure present additional problems of valuation….An easement is to be valued by considering, among other things, the specific restrictions imposed by the local landmark and zoning laws, the specific terms of the façade easement, and the interplay between them." [Emphasis added.]*

The problem is that the Treasury Regulations provide that if there is no substantial record of market place sales of comparable easements then the fair market value of the perpetual conservation easement is equal to the difference between the fair market value of the property before and after the granting of the restriction, which is referred to as the before and after valuation. Section 1.170A-14(h)(3)(ii) of the Treasury Regulations provides that if the "before and after" valuation is used, the fair market value of the property before the contribution must take into account not only the current use of the property but also an objective assessment of the likelihood that the property would be developed without the restriction, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use. See 26 CFR § 1.170A-

14(h)(3)(ii). As a result, there could be instances in which the grant of the conservation restriction may have no material effect on the value of the property.

A local Landmark Preservation Law, such as the one in effect in New Orleans, precludes alterations to the façade of a building designated as a landmark and, as a result, the IRS could have taken the position that a façade easement of a landmark building should provide the owner with little or no income tax deduction because the façade cannot be altered and therefore, the façade easement changes nothing. In that respect the most relevant aspect of the Whitehouse decision is the Fifth Circuit's statement that "rather extraordinarily, [the appraiser] assigned the easement a value of zero," which dicta by the Fifth Circuit appears to negate the concern raised by the March 13, 2008 letter.