

RETAIL PERSPECTIVES

CLIENT ALERT

APRIL 16, 2009

NEGOTIATING STRATEGIES FOR LANDLORDS: HANDLING RENT MODIFICATIONS IN THE CURRENT ECONOMIC DOWNTURN

An ever-growing number of retail tenants are requesting rent relief as a result of today's challenging economic landscape. While no landlord wants to grant rent concessions, reduced rent from an operating tenant is generally preferable to no rental stream and a dark space. Based on our experience in drafting and negotiating documents that reduce rent while protecting landlord's long-term interests, we offer the following strategies:

Review Tenant's Financial Statements. In considering a request for rent relief (assuming landlord is able to financially absorb the cash flow reduction), landlord's first step should be to request and review proof of the retailer's economic distress. This often takes the form of gross sales reports and/or financial statements. Many retail leases require tenant to provide periodic gross sales reports and other financial information, and even if the subject lease does not contain this requirement, landlord can request this information as a prerequisite to rent reduction consideration. Landlord should request gross sales reports and/or financial statements for the current period as well as for past periods. Landlords can also request financial information regarding tenant's other locations in order to provide a point of comparison. Any financial information received should be certified as an accurate accounting by tenant's accountant or another authorized representative. After analyzing tenant's gross sales reports and/or financial statements, landlord can better determine if tenant is in as dire financial straits as it may claim, as well as the amount and nature of rent relief that is most appropriate under the given circumstances.

Tenants in Default Are Not Entitled to Rent Relief. Any document granting a rent modification should be expressly conditioned on tenant not being in default. If tenant goes into default, the document should specify that the rent reduction automatically terminates, and that tenant must resume full payment of the original contract rent and immediately repay to landlord the total amount of unpaid rent tenant would have owed if rent relief had not been granted. Although some tenants may object to this provision, many believe that a tenant is not entitled to economic concessions from its landlord unless it upholds its end of the bargain by remaining in full compliance with the terms and provisions of the lease. Reinstatement of the contract rent and acceleration of unpaid but accrued rent at the contract rate is especially important because it provides landlord with an initial remedy to enforce against tenant before landlord turns to the remedies for tenant defaults under the original lease.

Include a Confidentiality Provision...With Teeth. A strongly-worded confidentiality provision is one of the most important provisions in a rent relief document. As many landlords know, word spreads quickly about rent reductions, and within very little time, landlords can be inundated with additional rent relief requests, sometimes from less-than-deserving tenants. A well-drafted confidentiality provision requires tenant, its employees, contractors and agents to keep the terms of the rent relief negotiation and agreement confidential, and sets forth indemnity obligations and a charge in connection with any violation of this covenant.

Think Short Term. Rent reductions should be viewed as a temporary concession to tenant, so rent modifications should only apply for a relatively short time. We suggest limiting the term of reduced rent to twenty-four months or less. The current downturn will come to an end eventually, and by establishing a relatively short term for rent relief, landlords can protect the long-term value of their property. Rent modification documents should provide that at the end of the reduced rent term, rates either re-set to the rents in the original lease, or will be re-negotiated by landlord and tenant based on the fair market rates at that time.

Review the Current Lease for Concessions from Tenant. Since landlord is giving up one of its most valuable rights—the right to rental rates locked-in during an up market—landlords have the leverage to negotiate for similarly high-value concessions from tenant. Accordingly, a thorough review of the existing lease and any amendments is an important step in any rent modification process. For example, landlords can request eliminating or modifying exclusive use, prohibited use and co-tenancy provisions.

(continued on back)

By eliminating (or at least watering down) these leasing restrictions, landlord gains important flexibility in leasing out its dark space. Landlords can also consider imposing operating covenants and recapture provisions (see discussions below), and/or adding a requirement that tenants submit regular gross sales reports—even for a non-percentage rent tenant. These reports can be a very important management tool that permit landlord to regularly monitor the health of tenant's business and the overall well-being of the center. In addition, some landlords are even requiring that tenants consult with landlord's marketing and merchandising consultants and implement such consultant's recommendations. Finally, if tenant secured its rental obligations with a letter of credit, Landlord should determine the strength of the issuing bank. As the FDIC has signaled that it may not honor letters of credit issued by banks that are in receivership, landlord should attempt to modify the existing letter of credit provision to the extent landlord has concerns about the viability of the issuing bank.

Add Estoppel and Release Language to Head Off Future Disputes. It is advisable to include estoppel and release language in rent relief documents in order to limit landlord's exposure to inchoate claims. A landlord can thereby protect the long-term value of its property despite the reduction in the current rent stream. Ideally, the language would be similar to the provisions of a typical estoppel certificate and would include a release of landlord from any claims up to the date the rent modification document is executed. Some tenants may balk at this concept (especially those with greater leverage), but there is an equitable argument in favor of inclusion. Consider a scenario where landlord grants tenant rent relief, and several years later tenant's business fails. It is easy to imagine this tenant unhappily searching for dollars to bolster its economic position, and then formulating a claim that landlord owed it money because of some act or omission at or prior to the time landlord reduced rent. Such a claim seems plainly unfair. Accordingly, inclusion of estoppel and release language in a rent reduction document seems like a reasonable request.

Include a Landlord Recapture Right. Another important concession to gain from tenants in a rent relief negotiation is the inclusion of a right for landlord to recapture the space from tenant for any reason during the rent reduction period, which, if exercised, can only be nullified by tenant's agreement to revert to payment of full rent under the original lease. While some tenants may initially find such a recapture right to be overly-aggressive, it actually represents a fair compromise between landlord's long-term interests and tenant's short-term needs. Consider the theory behind rent concessions: tenants need temporary rent relief based on the magnitude of the current economic downturn. However, neither party is entitled to a windfall when the economy improves. Since it is unlikely that a landlord would exercise its recapture right against a performing tenant now when times are difficult, tenant is protected from an unexpected lease termination in the near future. If rental rates during the period of rent reduction rebound, landlord retains the flexibility to recapture the space and re-lease it to a tenant who can pay the then-current market rate. If the original tenant can afford such higher rates, then it can nullify the recapture notice by agreeing to pay the higher rent. If it can not afford the higher rates, the lease simply terminates and the parties can go their separate ways.

Defer Rent, Don't Abate. Whenever possible, Landlord should avoid giving up the right to collect rent payments it bargained for under the original lease. Instead, we suggest that landlords structure rent relief as a deferral, instead of as an abatement or a waiver. As discussed above, the amount of deferred rent can also be used as an incentive against non-performance, so that if tenant violates any of the provisions of the lease, the portion of rent that is deferred accelerates and becomes immediately due. Landlords may also consider structuring deferred rent as a non-interest loan that is payable at the end of the lease term or at some other date in the future.

Tenants Must Be Open and Operating Continuously. To the extent the original lease does not include an operating covenant, rent relief should be conditioned on tenant's continuous operation. This provision is especially important (if not necessary) if rent relief takes the form of a percentage of gross sales in lieu of fixed rent.

Include a Right for Landlord to Show the Space. During any period of rent relief, landlord should be allowed to show the premises to other potential tenants. While the existing tenant may object, it seems fair to give landlord the ability to market the space to a prospective tenant who can pay full rent during the period in which tenant is enjoying a gratuitous rent reduction. This right provides landlord with the flexibility to take advantage of new players in the market, thereby preserving landlord's ability to put the space to its highest and best use.

For more information about this article, or to discuss any retail development or commercial leasing matters, please contact:

Gary Glick at 310.284.2256 or glick@coxcastle.com

Scott Grossfeld at 310.284.2247 or sgrossfeld@coxcastle.com

Bob Sykes at 949.260.4640 or rsykes@coxcastle.com

Scott Brooks at 415.262.5110 or sbrooks@coxcastle.com