

When Good Leases Go Bad: Workout Strategies for Landlords and Tenants

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With consumer confidence plunging and companies significantly reducing their workforces, the remainder of 2009 will likely bring a rise in troubled commercial retail and office leases. Office and retail tenants alike will find themselves burdened by leases with either too much space for the tenant's present needs or rental rates which drastically exceed current market rates. Either way, more and more tenants will begin contemplating lease restructuring in the upcoming year.

The simplest solution for a tenant needing to alleviate the burden of a lease it cannot afford or does not want is to find a subtenant. (Please see the related article on Subleasing Concerns.) However, in the current market, subleasing may not be feasible for most tenants due to a combination of an increased supply and a decreased demand for commercial space. Accordingly, tenants will turn to more creative alternatives to alleviate the burden of these leases. Prior to taking any action with respect to a particular lease, the initial question a tenant must ask is whether the tenant and its business are sustainable in the long run. The answer to this question not only dictates the tenant's strategy in approaching its landlord, but also the options available to it.

Strategies for a Non-Sustainable Tenant

If, after careful consideration, a tenant determines that its business is not sustainable, reorganization or even dissolution is likely inevitable. This tenant will probably first attempt to reorganize or dissolve its affairs on its own, which, among other things, will require negotiating the early termination of its commercial leases. If all else fails, this tenant will file for bankruptcy.

If the tenant knows its business is going to fail, its first course of action will likely be to approach its landlord about voluntarily terminating its lease. With the threat of bankruptcy looming, a landlord may be more inclined to discuss this option in order to avoid receiving little or no lease damages in a bankruptcy liquidation. A lease termination agreement generally provides for the early termination of a lease in exchange for a lump sum payment to the landlord equal to a few months' rent due under the lease plus any unamortized portion of tenant improvement and brokerage costs incurred in connection with the lease. Additionally, the parties may wish to address other issues in the lease termination agreement, such as what happens to any rent already past due, the security deposit, the condition of the premises upon surrender, and the removal of tenant improvements or furniture. A savvy tenant will also bargain for a general release of all claims and obligations under its lease (including California Civil Code Section 1542 language) as part of any lease termination agreement.

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A key obstacle a tenant may encounter in negotiating a lease termination agreement is its ability to make a termination payment. The termination payment is generally made at the time the lease terminates in one lump sum cash payment. In many instances, the security deposit held by the landlord can be used to offset the amount of the termination payment. However, if the tenant cannot make a lump sum cash payment even with the application of the security deposit, the parties may consider an installment payment arrangement. Nonetheless, a landlord will likely have concerns about such an arrangement given the uncertainty over the continued existence of the tenant and its ability to make those payments when they come due. The landlord might suggest that any such payment obligation be secured by a letter of credit or promissory note secured by additional collateral.

While the threat of bankruptcy may incent the landlord to reach an agreement for the early termination of a lease, this threat is somewhat of a double-edged sword. Landlords should be aware that if the tenant ends up filing for bankruptcy even after its initial restructuring or dissolution attempts, any termination agreement entered into within ninety days prior to the tenant filing for bankruptcy risks being treated as a preferential transaction under the U.S. Bankruptcy Code. As a result, a landlord could end up being bound by the termination agreement but having to return any payments made under the agreement within such ninety day period to the bankruptcy estate. Therefore, any lease termination agreement should state that it unwinds and the parties retain their existing remedies if the agreement is deemed a preference in bankruptcy court.

If a failing tenant is not successful in negotiating a lease termination agreement with its landlord, its only other option to rid itself of its lease may be through bankruptcy. If the tenant files for bankruptcy, the bankruptcy trustee, upon request therefor by tenant within 120 days after the bankruptcy petition (subject to extension for an additional 120 days) has the power to reject the lease, thus effectively forcing the landlord to accept termination. If the lease is rejected, Section 502(b)(6) of the U.S. Bankruptcy Code caps the amount of damages recoverable by the landlord to the greater of (a) twelve months rent or (b) fifteen percent of the rent for the remainder of the lease term, not to exceed three years. The amount of any security deposit or draws made on any letter of credit held by the landlord will be applied to offset these capped damages. However, even with the ability to draw on such security devices, the crude reality for a landlord is that it probably will not receive the full capped amount of damages, unless there are sufficient funds in the bankruptcy estate to pay all of the tenant's unsecured creditors.

Strategies for a Sustainable Tenant

If a tenant's business is sustainable in the long run and it simply suffers from a temporary decrease in profitability, the goal of both the landlord and the tenant should be to arrive at some compromise to ensure that the lease also remains sustainable. In this instance, bankruptcy is not an effective option and, in any event, the tenant will most likely want to keep the leased space with a few adjustments. Thus, the tenant's primary objective will be to reduce the financial burden of the lease by negotiating a temporary reduction in the rent in exchange for other concessions.

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One approach is to reduce the amount of space leased and/or relocate the premises to a less desirable or less improved location in the building. This is especially appealing to the landlord if it frees up the existing space to enable the landlord to have a full floor of space available to lease to a new tenant.

Another approach is to alter the amount of rent due under the lease, either by unconditionally reducing the rent per square foot, declaring a lease "holiday" for a discrete period of time or deferring a portion of the rent until later during the term of the lease. It is not uncommon for the parties to agree to extend the lease term in exchange for the rent reduction under the theory that by granting the rent reduction the landlord is creating a more viable tenant the landlord will want to lease to for a longer period of time. However, a landlord will want to condition any such rent modification on the tenant not defaulting in the future. Upon any future default, the tenant's previous higher rental obligations return.

Landlord's rental accommodations typically come at a price to the tenant, however. Landlords will typically look to strip the existing lease of: (i) existing economic features, such as undisbursed tenant improvement allowances or impending free rent or moving allowances; (ii) tenant options, such as early termination rights, expansion and/or extension options; and/or (iii) generally favorable provisions, such as representations and indemnities given to the tenant in a more generous leasing market. In addition (or in the alternative) to such provisions, landlords might ask for additional lease guaranties, increased security deposits (or a security deposit in the form of a letter of credit instead of cash) or introduce net worth, income flow or other financial tests to be met in order for the tenant to expand the premises or extend the lease, or possibly as a default allowing the landlord to terminate the lease if such financial test is not met by the tenant. More aggressive landlords might also ask for a stipulated judgment for possession of the premises, avoiding the eviction process in the event of a subsequent tenant default. Finally, sometimes a landlord will ask for - or a tenant will offer - warrants in the tenant's company at an attractive "strike price" under the theory that a landlord who grants a tenant rental concessions is much like an economic partner in the company who deserves a piece of the "up side" created by those concessions.

The foregoing overview is not an exhaustive list of all possible options available for dealing with troubled leases. It is merely meant to outline several ways to address leases involving too much space or above market rents. The best available option will of course vary based on individual circumstances. Landlords and tenants will want to thoroughly discuss their particular circumstances with their respective counsel to decide what the best overall approach and outcome in their specific scenario will be.

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