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THE NEXT LEVEL
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IDEAS TO HELP YOU TAKE YOUR BUSINESS TO THE NEXT LEVEL

Rules for Restructuring Leases Emphasize Openness

Financial transparency is advised when renegotiating terms

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Friends and lovers should have no secrets and, apparently, neither should landlords and tenants — at least not when it comes to renegotiating a lease.

Brokers, property managers and attorneys agree that both parties should be honest about their respective situations when a tenant asks a landlord for reduced rent or amended terms. They say the amount of space a company leases can influence the negotiations, but other factors are also important when a tenant and landlord get in bed together.

Michael Meyer, managing partner of the Los Angeles-area offices of law firm **DLA Piper**, said both tenants and landlords need to approach lease renegotiations with the understanding that both parties are sophisticated and neither side is likely to outsmart the other. Total transparency is key.

"No reasonable tenant can go to their landlord and say, 'The economy has crashed, rents are dropping, will you lower my rent?' any more than when rents are going up and the economy is booming that landlords can ask tenants to pay more," Meyer said.

For landlords, it all starts with an assessment of the tenant's financial situation, said Patrick Conn, president of property management at Los Angeles-based **Charles Dunn Co.** Conn said property managers are doing a lot of negotiating on behalf of building owners.

"Initiate these discussions with the landlord or the management company before you fall too far behind," he said. "It shows a good intent to try to work things out with the landlord."

Tenants should be prepared to provide tax returns and sales data, explain other efforts to cut expenses and share a business plan that shows how a restructured lease agreement will help the company return to profitability. That information helps weed out businesses that are simply looking to take advantage of the real estate downturn by requesting a rent reduction whether their profitability is dependent on it or not.

At the same time, the landlord needs to evaluate the viability of the tenant's space in terms of the rent it might garner in the current market, the amount of tenant improvements needed and brokerage commissions to re-lease the space.

When tenants are trying to restructure a lease of any significant size, Meyer said it's likely that the property owner's lender is going to be involved in negotiations.

The building owner must consider whether or not its lender must sign off on any agreements to modify lease terms, determine if the reduced rental income will impact the debt service coverage ratio for the property or trigger some other default.

"It's an involved process for both parties," Conn said. "There are a lot of things that need to be reviewed and understood before a landlord grants a lease renegotiation."

Advice for Tenants

Scott Ginsburg, executive vice president and tenant representative at **Jones Lang LaSalle** in San Diego, said office tenants must consid-



Scott Ginsburg of Jones Lang LaSalle in San Diego said there are many factors tenants should consider before they ask landlords to restructure their leases, including credit quality, square footage requirements, and gap between contract and market rent.

er the size of the gap between market rents and the tenant's contracted rent, the amount of time remaining on the current lease and whether or not the tenant needs to give back some excess space.

"The building must work for them for a longer term because the tenant must be willing to agree to a longer term to get lower rates," Ginsburg said. "If the tenant has 20,000 square feet and they want to give back 6,000 or 7,000, that's another way to cut costs radically. But if the tenant wants more space, they have more buying power."

If the tenant is a startup business, it's going to have a harder time getting a landlord to renegotiate than a more seasoned company with better credit.

And in addition to credit quality, the size of the tenant does matter, because a 5,000-square-foot tenant and a 100,000-square-foot tenant are likely to be treated much differently.

"Certainly, the most leverage you have is if you take up the whole building," Ginsburg said. "You're not going to have as much leverage if you're in 5,000 square feet, but if you're that size and you're in a building where you take up 10 percent of the building, that matters. And if that building has a lot of vacancy, it's important."

In the retail sector, Matt Holmes, principal of brokerage **Retail West Inc.** in San Francisco, said any lease that will reach the end of its term in the next three years should be examined.

"The reasonable position is to look at your sales and see how you're trending and make adjustments based on that," Holmes said. "What tenants have to offer landlords is more opportunity to have more stability right away by committing to leases early."

If tenants can commit to another five or 10 years in a space on top of the remaining term on an existing lease, that gives landlords more credibility with their lenders.

"Where the store is struggling such that the store is going to close without restructure, the landlord looks at do we want to help the tenant to keep them open and prevent a dark space that could hurt the other tenants and add other dark spaces," said Bill Sullivan, a partner in St. Charles, Ill.- and Roseville-based **Hundley Mullaney Spargo & Sullivan LLC**.

"The bigger the box, the less a landlord or a lender wants that tenant to leave. But there are lots of tenants that are smaller in size that are valuable to the landlord."

Lenders have become much more involved in lease negotiations this year. Often tenants work with their landlords first and then the agreement to restructure the lease must be reviewed and approved by the lender.

"Where lenders and landlords have an open and honest relationship it's easier," Sullivan said. "Where landlord and lender are cross with each other, it takes a little more time and the lender wants to talk to the tenant before an agreement is reached with the landlord."

Nadav Ravid, shareholder in the Los Angeles office of law firm **Buchalter Nemer**, said he does see a difference in how landlords approach the restructuring of lease agreements with small and large tenants, but that's not the only factor that determines whether or not a property owner will agree to rent relief.

"It doesn't necessarily come down to how much space you're taking, but it does come down to the likelihood that this tenant, if given this rent reduction, will be able to come back from the economic downturn,

Ravid said.

He said some landlords are under the impression that certain tenants, like mom-and-pop stores, are not going to make it through the downturn, so they should squeeze all of the rent they can out of them before they shut down. Other landlords want to work with even the smallest of tenants because if they help those small businesses make it through the recession then they might remain in place and even grow in the future.

Advice for Landlords

The bigger the tenant the more willing the landlord is to come to some kind of agreement, primarily because of re-leasing costs, tenant improvements and commissions, but also because there's additional pressure to work something out if lenders require building owners to have a percentage of the property leased, said Conn.

Working in a landlord's favor is the fact that it's easier for a smaller tenant to relocate than a larger one. It might seem that a larger tenant has more leverage to renegotiate lease terms, but they might not be able to move to another building as easily or as quickly as a smaller tenant.

Brian Ffrench, senior vice president and branch manager for **Studley** in San Diego, said a lot of the tenants that his firm is working with all over the country are trying to control all of their operating expenses now, including leasing costs, even if that means moving to a new building.

"If they can avoid the move costs and the intangibles that come from moving, they'll do it," Ffrench said. "Although landlords in certain markets are getting so aggressive with incentives, sometimes it's hard for them to say no to a move."

That's why, Jones Lang LaSalle's Ginsburg said, it's important for landlords to focus on customer service and treat existing tenants with the same care as prospective new tenants.

"My first advice to any landlords getting these inquiries is never respond to a mass e-mail or form letter," Holmes said. "If somebody doesn't have the courtesy to pick up the phone and talk to you, then don't even consider it."

Holmes said he has seen retail chains doing mass mailings to all of their landlords in attempts to get their rents reduced, but those letters don't always go to the right person. He has gotten letters on accident as if he was the owner of a shopping center.

"If somebody wants to get on the phone and express what's going on with their business with the market and offers you something in return, then you should think about it," Holmes said.

He said shopping center owners who agree to restructure existing leases should force tenants to sign a percentage rent clause, in which tenants pay a certain percentage of the store's sales in rent, so the landlord can track the tenant's performance. Also, tenants should know what kind of obligations landlords have to meet leasing requirements under the terms of their loans.

"If we're all going to get in the same bed, we just may as well understand what we're all doing," Holmes said.

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