

LEGISLATIVE NEWS

Potential Damages as a Factor in a Lease Workout Analysis



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As most people know, the fallout from the economy is not just hitting residential real estate; the fallout is having great impact on the commercial real estate market as well. As a result of the economy, a number of tenants who entered into long term leases at market rates some time ago find themselves now with rents far above market. Some of these tenants find themselves in a position to need a workout with the landlord in order to survive.

Unfortunately, there are others that are attempting to take advantage of the economy and request workouts solely because they can.

When approached by a tenant with a request for a lease workout, the property manager and landlord must consider a multitude of factors. In addition to considering whether the landlord is in a position to do a workout, the value of the tenant to the landlord's overall property, the effect the workout may have with regards to landlord's loan documents and all the various workout options, the landlord must conduct a risk benefit analysis and consider what they may recover if they refuse to participate in the workout and the tenant defaults.

THE LAW

The California Legislature drafted legislation in an attempt to clearly set forth what damages would be available to a landlord in the event of a default by a commercial tenant. Those damages are set for forth in California Civil Code §1951.2.

California Civil Code Section 1951.2

a) Except as otherwise provided in Section 1951.4, if a lessee of real property breaches the lease and abandons the property before the end of the term or if his right to possession is terminated by the lessor because of a breach of the lease, the lease terminates. Upon such termination, the lessor may recover from the lessee:

(1) The worth at the time of award of the unpaid rent which had been earned at the time of termination;

(2) The worth at the time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss that the lessee proves could have been reasonably avoided;

(3) Subject to subdivision (c), the worth at the time of award of the amount by which the unpaid

rent for the balance of the term after the time of award exceeds the amount of such rental loss that the lessee proves could be reasonably avoided; and

(4) Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessee's failure to perform his obligations under the lease or which in the ordinary course of things would be likely to result therefrom.

b) The "worth at the time of award" of the amounts referred to in paragraphs (1) and (2) of subdivision (a) is computed by allowing interest at such lawful rate as may be specified in the lease or, if no such rate is specified in the lease, at the legal rate. The worth at the time of award of the amount referred to in paragraph (3) of subdivision (a) is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus 1 percent.

c) The lessor may recover damages under paragraph (3) of subdivision (a) only if:

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(1) The lease provides that the damages he may recover include the worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of award, or for any shorter period of time specified in the lease, exceeds the amount of such rental loss for the same period that the lessee proves could be reasonably avoided; or

(2) The lessor re-let the property prior to the time of award and proves that in re-letting the property he acted reasonably and in a good-faith effort to mitigate the damages, but the recovery of damages under this paragraph is subject to any limitations specified in the lease.

d) Efforts by the lessor to mitigate the damages caused by the lessee's breach of the lease do not waive the lessor's right to recover damages under this section.

e) Nothing in this section affects the right of the lessor under a lease of real property to indemnification for liability arising prior to the termination of the lease for personal injuries or property damage where the lease provides for such indemnification.

WHAT IT MEANS

In plain language, §1951.2 states that a landlord receives all that is owed and all that would be due under the lease minus whatever the tenant can show would be received by the landlord using reasonable efforts to re-let the space.

The Legislature, in drafting and preparing California Civil Code Section 1951.2 tried to set forth the formula for damages in order to assist the parties in determining their respective positions. Unfortunately, it seems clear that they did not contemplate the type of commercial real estate market that we are experiencing today when they drafted the formula.

THE ANALYSIS

In today's market, determining what might be awarded, or what the tenant might be able to prove, by trying to decipher the amount that could have been received through reasonable efforts to re-let is extremely difficult to ascertain. In conducting the analysis it is advisable to seek the assistance of a commercial real estate agent or broker in the same area as the property. This person has the best information that can assist in determining the anticipated time to re-let and the prevailing rental rates for like properties in the area.

A hypothetical analysis, under Civil Code §1951.2, consider a landlord with a lease with terms at \$2.00 per square foot and two years remaining on the lease. The landlord must determine not just how long it will take to re-let the premises, but also at what price. If the analysis determines it will take six months to re-let the premises, but the market

rate is now \$1.50 per square foot, the damages are \$2.00 per square foot for the six months it is empty and then \$.50 per square foot for the remaining one and one half years of the lease. Keep in mind under Civil Code §1951.2 there is also a discounting based on present value, which will reduce the net figure.

CONCLUSION

Again, there are a multitude of factors to consider in the analysis of a requested lease workout. First, whether a workout is even necessary. In other words, does the tenant have the financial need or are they simply taking advantage of the economy. Second, what type of workout will be acceptable. As part of the analysis, the potential damages that could be recovered by the landlord if they are unable or unwilling to reach a satisfactory workout is an important element. Factoring in collectability and the cost of re-letting the premises will place the landlord in a much better position to determine economically, what is a reasonable and acceptable lease workout.

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