

# NEWSLETTER ARTICLE

COMMERCIAL REAL ESTATE WORKING PAPER SERIES

## **PRESERVING THE COMMERCIAL TENANT: THROUGH THE LEASE WORKOUT**

by

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### **INTRODUCTION**

As property owners and property managers are faced with these requests from tenants, they struggle to balance all of the interests involved and hope to come to a resolution that is workable for both the landlord and the tenant. Unfortunately, in today's difficult economic times, there are not only large numbers of people and companies that are in desperate need of help in order to survive, there are also those that are seeking to take advantage of the economic times. That is, in addition to the companies seeking lease modifications or workouts due to financial need, there are those that are seeking lease workouts or modifications simply to improve their bottom line and increase their profits.

### **STEP ONE: DETERMINE IF LEASE MODIFICATION IS A POSSIBILITY**

It is extremely important for any property owner or property manager to develop a system or standard procedure to handle these requests from the tenants. Our law firm has handled a number of these matters for clients, as well as a large number of loan workouts, which are handled very similarly. The first step we take is to consider the very important issues related to the landlord. For instance, what impact may a lease

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modification have on a landlord's loan documents? Would it even be allowed? Would it require lender approval? Further, what impact would it have on other tenants or leases within the center or property? Are there restrictions in the tenant's lease or other leases?

These and others are all extremely important factors that must be analyzed to determine whether or not a lease workout is even a possibility, and if so, what types of workout or modification alternative are available. Before ever commencing any negotiation with a tenant, a landlord or property manager should prepare, if they have not already done so, a lease summary/abstract. The abstract should contain: (1) default provisions, (2) remedy provisions, (3) application of security deposit provision, (4) assignment and subletting provision, (5) any rights of first refusal, (6) lease termination provisions, (7) reduction/expansion provisions, (8) opening and operating covenants, (9) co-tenancy provisions, (10) co-tenancy/operating requirements of other leases, and (11) other critical provisions contained therein, which may impact the type of modification that can be offered or entered into.

The last thing a property owner wants to do is enter into a lease modification with a tenant that puts them in default with another tenant or tenants, or the lender, and subjects them to damages; or default under the lender's loan provisions.

## **STEP TWO: SEND WORKOUT NEGOTIATION LETTER**

After analyzing these factors and considering the lease provisions to determine what types of remedies may be available, and if it is determined that a lease workout or modification is a possibility, a workout negotiation letter should be sent to the tenant before any negotiations are commenced. The workout negotiation letter should include an acknowledgement and waiver, tenant estoppel certificate, a confidentiality provision, and a recitation as to the reasons for forbearance or workout as it was explained by the tenant.

Although it may be difficult to obtain money from a tenant in trouble, some property owners may want to consider requesting a fee to cover the expenses associated with a lease modification. Prior to making such a request, the property owner should review Civil Code Section 1950.8 and consider all factors set forth in that section to make sure they do not run afoul of the law regarding "key money".

The reason for the workout negotiation letter is first and foremost, to make clear that the property owner is not waiving any rights or remedies that they may have and are only agreeing to enter into a negotiation for possible resolution. Further, because the property owner now has some additional bargaining power, it may allow them to obtain waivers of any potential defaults that they may have had in the past and provides them with an acknowledgement that there has been either a breach or a default under the lease by the tenant. If a lease workout or modification is not eventually completed, and the landlord is required to commence with litigation, the workout negotiation letter may be used as an admission, which will be extremely compelling evidence against the tenant.

The workout negotiation letter will also contain a request for extensive financial information from the tenant, including:

1. Profit and loss statements (annual for the last two years and monthlies for the last six months);
2. Balance sheet;
3. Tax returns;
4. Information on other leases;
5. Personal financial information on any guarantors;
6. Credit check;
7. Inventory levels and supply sources;
8. Two years of that particular store's sales;
9. Any comprehensive recovery plan of the tenant.

### **STEP THREE: ANALYZE POTENTIAL ALTERNATIVES AND COMMENCE NEGOTIATIONS**

Once financial information is obtained, the next step is to coordinate and conduct a discussion with the property owner, and/or property manager, and a commercial real estate broker or agent in that particular area. The discussions should be aimed at dealing with the terms of the tenant's request. Again, these discussions should cover the ability of the landlord to modify the lease, including considering any affect a lease modification may have on the landlord's loan documents and whether there is a need for consent. If there is a modification, the ability of the property owner to meet debt service should also be considered. Market conditions should also be discussed in order to properly evaluate what an appropriate modifications and what the landlord may be facing if a modification or workout is not completed, i.e. the potential that the landlord may end up with an empty space.

Obviously a consideration in the discussions should be what remedies are available if there is no workout and the tenant defaults. California Civil Code Section 1951.2 sets forth damages that may be recovered from a tenant. California Civil Code Section 1951.4 provides for remedies if the tenant breaches but the landlord chooses to continue the lease.

The landlord should also consider these discussions and the negotiations as an opportunity to potentially recapture provisions of the lease originally conceded to the tenant during the original negotiations. Provisions that should be considered are:

1. Adding termination or relocation provisions;
2. Extending the term of the lease;
3. Eliminating or reducing scope of exclusive use protections and first refusal or first offer rights that may affect landlord's ability to backfill space;
4. Eliminating co-tenancy clauses;
5. Imposing new requirements on the tenant to regularly provide landlord with financial information; and/or
6. Regaining signage rights that can be used to induce replacement tenants

As the landlord and tenant commence with the negotiation process, the landlord should keep in mind that there are a variety of alternative restructures or modifications that are available. A tenant may be focused strictly on rent reduction or buyout. However, it may be in landlord's and tenant's best interest to consider all other possibilities, including a rent deferral, an extension of the term, reduction of CAM expenses, converting to percentage rent only or reducing the percentage of rent, a forbearance or forgiveness of past rent, and attempting to reduce landlord's expenses, such as deferring non-critical maintenance which can reduce CAM expenses for the tenant.

In addition to the above monetary alternatives, a landlord should consider and discuss non-monetary restructuring, which can include changing or expanding the tenant's permitted use, subdividing or reducing the space used by tenant, or trying to hold events or do things at the center which may bring more foot traffic and more customers to the tenant's space. The important thing is to keep an open mind, be creative, and consider different possibilities which may result in a tenant that is better able to perform and may not result in as significant a monetary loss to the landlord.

#### **STEP FOUR: DOCUMENT AGREEMENT**

Finally, after all of the considerations and negotiations, assuming a lease workout or modification is reached, a written agreement is executed. With regard to the final agreement, there are a number of alternatives available. In our office, we have prepared the document as a forbearance agreement, which may be more beneficial to the landlord than a lease amendment. A lease agreement has ramifications on loan documents and other potential contractual relationships, a forbearance agreement may not.

#### **CONCLUSION**

As we are all trying to survive and get through these difficult economic times, it is important to work with people, companies, and tenants in order to maintain these important relationships. A major component of maintaining those relationships may call for lease workouts or modifications that allow a tenant to survive. However, it is important for property managers, property owners and others that are involved in

commercial real estate to develop a process and procedure to handle requests for lease workouts or modifications so that there is uniformity and some predictability in the process.

The commercial lease workout process should begin with the determination as to whether a workout or modification is even a possibility, and if so, a determination as to whether or not the tenant is in actual need or is simply attempting to take advantage of the times. Once that is determined, the focus should be on considering all options available, being creative, and coming up with a resolution that is suitable for both the tenant and the landlord that does not negatively impact or expose the landlord to liability. Ultimately, if we all work together, we will all get through these difficult times and come out on the other side with stronger relationships going forward.

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