



David Morris, CCIM, SIOR
Senior Vice President
(314) 719-2050

A Tenant's Guide to Lease Restructuring

David Morris, CCIM, SIOR
Senior Vice President, Brokerage Services

Restructuring a lease during the lease term is not, in and of itself, a new concept. It has been practiced for many years, during a variety of economic conditions—the Great Depression of the 1930s; the explosive growth in the 1980s; and the recession of the 1990s. Whenever a disparity exists between market and existing rents, as well as when a decline in property values occurs, lease restructuring is an option. In stable, balanced real estate markets, where supply of space approximates demand, lease restructuring typically occurs to:

1. Accommodate a tenant's need to expand or contract.
2. Permit longer amortization of additional tenant improvements.
3. Deal with issues created by mergers and acquisitions for more (or less) space.
4. Address Chapter 11-related issues.

However, in a “down” or recessionary market, tenants may seek to restructure their leases to lower their occupancy costs. Tough economic times for professional organizations, as well as corporate downsizing and restructuring, put great pressure on firms to reduce all expenses, occupancy costs among them. Lowering the rent is one way to do it. For landlords, losing tenants to competitors having lower rental rates creates a double hit—lost revenues coupled with the need to invest new capital for re-leasing and retrofit costs (tenant improvements and commissions) associated with the vacated space. Hence, landlords recognize (sometimes reluctantly) the benefits of lease restructuring as it relates to tenant retention. In the past, lease restructuring has typically involved only landlords and tenants. However, with a decline in real estate values, lenders become involved. As reduced rents adversely impact the cash flow available to service debt, hereby lowering debt service coverage below traditional underwriting standards, lenders closely scrutinize lease-restructuring proposals.

Furthermore, many of those same lenders face the prospect of having to foreclose on the properties due to inadequate funds to service debt or fund re-leasing vacant space. Lease restructuring increases in popularity during a prolonged economic downturn and/or when an oversupply of space occurs in the marketplace. Tenants, landlords, and lenders have

a stake in this process. Properly handled and structured, all parties to a lease—landlord, tenant, and the lender—benefit, even if the resulting benefits merely minimize losses instead of actually making money.

The Tenant's Perspective

Tenants typically seek to restructure their lease for a variety of reasons. Leases can be restructured to:

1. Lower the rent on the space occupied.
2. Reduce the amount of space occupied.
3. Extend the lease term on more favorable conditions.
4. Induce the landlord to make additional improvements.
5. Obtain greater flexibility for future expansion or contraction.
6. Defer rent to lower expenses during difficult economic conditions.

While these reasons can be raised on a case-by-case basis, it is recommended that a more comprehensive approach be taken to deal with as many issues as possible. By taking a comprehensive approach, the tenant can typically get more of what he or she needs than by proceeding on a piecemeal basis.

Furthermore, the landlord's lender will not want to keep addressing issues raised by one tenant over time. It is better to focus on all issues needing to be addressed at one time.

In seeking to restructure his or her lease, a tenant is wise to remember that the new restructured lease has to work for all parties, or it will not work for anyone. For example, too aggressive a deal could result in the landlord's going bankrupt resulting in an unwelcome change in ownership, or services may be cut if the rental stream is not large enough to support appropriate maintenance. Furthermore, unless the tenant is in a commanding negotiating position (lease to expire soon, imminent Chapter 11), some concessions will undoubtedly occur anyway (extended lease term, higher "back-end" rent, etc.). Tenants should also understand what they are "giving up" when restructuring the lease. For example, extending the term in a declining building does not make any sense. Extending the term during a soft market may preclude taking an even better financial deal in the near future. Additional improvements in a dated facility may ultimately "wed" the tenant (with more money invested) to a marginal property. Waiving or delaying an expansion or renewal option may seem like a good idea in the present, but may prove disastrous in three years. These considerations must be addressed carefully and soberly, preferably

with a real estate professional schooled in the intricacies of the market, the tenant's building, and lease-related issues. Finally, remember that the tenant need not be in a financially precarious situation to seek to restructure a lease. On the contrary, many tenants seeking to restructure leases are fiscally sound and profitable. Restructuring is just another form of exercising sound business judgment.

The Landlord's Perspective

It is extremely unusual for a lease restructuring to result in the tenant's paying a greater rent or occupying substantially more space. Consequently, landlords usually have more of an "avoidance" perspective toward lease restructuring. Landlords seek to avoid:

1. Loss of a tenant through relocation.
2. Loss of a tenant through bankruptcy.
3. Costly tenant improvements.
4. Loss of cash flow, albeit diminished cash flow.
5. Sub-par occupancy levels for financing issues.
6. Loss of equity due to foreclosure.

Most of those conditions deal with situations indicating a bad or deteriorating ownership situation. Consequently, the owner may be a reluctant or irritated participant in the process. This needs to be dealt with, as the restructuring decision or methodology should be rational, not emotional. Sophisticated landlords and/or developers understand what happens in an unbalanced marketplace. They realize that the values of existing properties decline. They know that buildings are charging less rent than originally projected. They understand that properties recycled through the system (via foreclosure and resale) have less debt and therefore need less rent. They may not like it, but they understand it. Therefore, with few exceptions, landlords should be participants (willing or otherwise) in the restructuring process.

On occasion, an effectively restructured lease may be the only way for the landlord to hold onto that real estate. This may be a crucial goal as the loss of the real estate means not only a loss of equity, but possible tax-recapture problems as well. Therefore, a lease restructuring should

be viewed by landlords as a form of “root canal” therapy . . . “it may be painful now but you’ll feel a lot better in the future.” From the landlord’s perspective, restructured leases foster tenant retention, preclude defaulting on mortgages, maintain a property’s cash flow, and enhance a property’s image. However, there have been times when willing landlords have been precluded from restructuring leases by mortgage holders and other assorted lenders.

The Lender’s Perspective

When deciding to permit a lease restructuring, a lender is, in essence, deciding whether (and how much) to write down the loan. Some of the questions in a lender’s mind include:

1. Will the reduced cash flow and lowered debt service coverage address the problem?
2. Can the landlord pay the difference if no change is made to the loan?
3. What is the condition of the market? Are rents turning up or staying flat?
4. Would we be better served taking back the property?
5. How much cash will be needed in the restructuring?
6. How and when will the additional money be repaid?

These are difficult questions, and the answers may be totally unrelated to the real estate itself. For example, problems in the lender’s portfolio may encourage him to facilitate the lease (and possible loan) restructuring. A lender with a conservative, mid-west philosophy may refuse to accept the proposed lease restructuring on general principles (“You said you’d pay this back, now pay it back!”). One thing is quite certain—unless a building’s ownership is prepared to make up shortfalls created by restructured leases featuring lowered rent, the lender must be involved in the decision-making.

The Lawyer’s Perspective

Lawyers typically participate in the lease restructuring process on behalf of their clients. And while the parties’ counsels clearly bring different perspectives to the process, certain fundamental questions almost always need to be answered. These questions include:

1. Should the restructured agreement be written in an amendment, restatement of lease, or completely new lease document?
2. Are there any opportunities for improving language (from the client's perspective) to reflect current practices and/or trends?
3. How can renegotiating previously negotiated lease clauses be accomplished, avoided, or at least minimized?
4. How can the landlord and tenant deal with new clauses demanded by the lender (e.g. environmental hazards, ADA, etc.)?

While the business terms may be attractive, properly drafted and carefully considered lease provisions ultimately decide how good a deal is actually negotiated. This is particularly true as it relates to pass-throughs, rent escalations, caps on increases, etc. Therefore, as with new leases, lawyers play critical roles in drafting the restructured agreement.

The Restructuring Process

No one usually wakes up one day and says, "I need to restructure my lease." It takes understanding the business and real estate issues and following a structured process using certain steps. These steps, taken from the perspective of the tenant, are usually as follows:

1. Understanding the Tenant's Own Position.

By carefully analyzing the lease document, a tenant will learn his (or her) financial and non-financial exposure in the lease. From a dollar point of view, such items as base rent pass throughs, escalations, and scheduled increases need to be quantified for the balance of the lease term. Non-financial considerations (e.g. renewal options, expansion options, and cancellation options) must be determined as well.

2. Understanding the Market.

After the tenant understands his or her exposure, he or she must learn where the market is with regard to rents, fit out allowances, options, available space, concessions, etc. This knowledge enables the tenant to establish goals and to understand the conditions under which the landlord is operating (especially if there is less than two years left on the lease).

3. Compare and Analyze the Tenant's Current Position to the Market.

Where does the tenant stand vis-à-vis the marketplace? This is the threshold question a tenant must answer before developing a plan for restructuring a lease. The range of alternatives available to the tenant and the position taken by the landlord will be based on this comparison.

4. Analyze the Landlord's Position.

Once the tenant knows where he or she stands in the marketplace, it becomes necessary to learn as much as possible about the landlord's position, both corporately and with regard to the building. For example, is the building over-leveraged? Is the owner personally guaranteeing any of the debt? Who is the lender, and what are they like to deal with? What is the value of the building in the marketplace compared to other buildings? How much space is vacant, or becoming vacant, during the next 12, 24, or 36 months? Answers to these questions help the tenant understand the extent to which a restructuring may be possible.

5. Evaluate the Landlord's Exposure.

After the tenant assesses his or her own long-term financial exposure, he or she must decide what the landlord's exposure will be. Specifically, how much vacancy exists? What would be the cost of refitting and re-leasing the space if the tenant moved out? Does the owner have the money to make new deals, at lower rents, with interior construction? What is the potential cost of losing his tenancy? Will the building be lost via foreclosure? Are there issues of loss of equity, tax recapture, and technical defaults for other properties?

Not every answer to every question can be easily obtained. However, the more information the tenant knows, the more effective he or she will be in restructuring the lease.

6. Develop and Submit the Offer.

After performing the above "due diligence," the tenant should prepare and submit a proposal for a restructured lease that addresses the tenant's issues, reflects current market conditions, and addresses the landlord's concerns. For example, a proposal that effectively forces the property into foreclosure is a non-starter if the tenant wants to stay and likes the level of services rendered. A proposal that requires substantial outlay of new dollars when none are known to exist will go nowhere fast. While the

tenant's leverage is based on a variety of factors (e.g., remaining lease term, financial stability, etc.), the bottom line is that most restructuring situations require the cooperation and participation of the landlord. In developing the offer, the tenant needs to remember the non-economic aspects of the deal. Such issues as expansion, contraction, cancellation, and renewal should be carefully thought out and included in the submittal.

7. Negotiate the Offer.

After submitting the proposal, the next phase is negotiating the best deal, understanding that the landlord, and ultimately his lender or shareholders, must see economic sense in the outcome. Of lesser concern to the landlord and lender will be issues relating to expansion and renewal. These issues are typically more meaningful to the tenant.

8. Obtaining Lender Approval.

Once the tenant and landlord have agreed upon the restructured lease, the lender typically needs to approve it. (In certain situations, usually with large tenants, the lender is involved from the beginning). This approval is by no means a sure thing, as lenders sometimes believe that it is in their interest to take back the building, write down the loan, and operate it themselves. In this manner, they take their lumps immediately ("First Loss is Best Loss"), minimize risk of a tenant going bankrupt on a restructured lease (no "throwing good money after bad"), and position themselves to get the appreciation when the market comes back. As lender approval is by no means automatic, the tenant should try to learn as much about the lender and its lending philosophy and priorities as possible in developing the initial proposal.

Reversing the Process

The process articulated above assumes that the tenant is suggesting the restructuring of the lease. It should be clearly understood that this process works in reverse. The landlord can, for any number of reasons, initiate the proposal for restructuring the lease.