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Lease Leverage

How can creditworthy tenants maximize their bargaining advantage?

by Steven D. Sallen and Kasturi Bagchi

Many property owners continue to be weakened by the languishing commercial real estate market. Falling rental values, declining occupancy rates, and maturing loans with no readily available replacement financing all are affecting landlords' bottom lines and eroding their equity.

For tenants, however, this creates an opportunity, especially for those that are fiscally stable and have short lease terms remaining or other circumstances that make viable a threat to vacate. These tenants are in a position to use their leverage to renegotiate their existing leases. Here are some negotiating points that tenants should consider — and to which landlords must be prepared to respond.

Quid pro Quo

Tenants who demand lower rental rates should be prepared to offer something of value in return. Most landlords cannot afford to reduce their rental income with no quid pro quo. They have mortgages to pay, and their lenders are unlikely to offer concessions in this climate.

Tenants have several options to propose to landlords in return for rent concessions, including offering to extend their lease terms. It will be far easier for a landlord to justify a rental reduction in the short term if the contracted rental stream continues beyond its original term. Another option is timed rent escalations, perhaps even returning to pre-concession levels.

Operating expenses is another area for negotiation. Many landlords may want or need the added certainty that operating expenses will not increase; therefore,



changing a gross lease to a triple net lease — which assigns to tenants responsibility for operating costs — may give a landlord confidence that it won't be damaged on the back end by operating expense inflation.

Tenants also can offer a personal or affiliate guaranty, sometimes known as a good-guy guaranty, which ensures rent payment if the tenant defaults and fails to immediately yield possession of the leased premises.

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Landlord Finances

Tenant improvements usually are a part of new leases or lease amendments, but in today's economy, tenants may wonder if the landlord can afford to pay for promised improvements. In such instances, tenants may need to examine a landlord's financial statements. In the old economy, such financial analysis always was downstream and almost never upstream to the landlord. But a landlord may be a mere shell for a limited liability company whose only asset is the building. Add to that the likelihood that the building's equity is probably eroded, and tenants may have little recourse if the landlord cannot perform a TI build-out.

Depending on the bargaining strength of the parties, a tenant may demand certain protections. For example, the landlord could commit TI dollars in advance by depositing funds in escrow, or obtain a letter of credit naming the tenant as the beneficiary. However, a letter of credit or escrow may be considered part of a debtor's estate and could be seized if the landlord files for bankruptcy.

Another option is to establish a right of offset against rent if the landlord fails to complete the improvements. Parties also could agree to a reduced rent upfront and make the tenant responsible for the improvements. In such cases, landlords must make sure tenants do not take advantage of the rental reduction and do nothing to better the space.

A landlord's failing financial strength also may lead to deterioration in building and common area maintenance. Tenants concerned about a landlord's ability to maintain and make timely repairs may want a self-help right to maintain and offset costs against rent to cover the incurred expenses. Tenants also may need to consider what levels of building maintenance and other services will be continued if the building winds up in foreclosure and/or receivership.

Default Issues

Tenants should confirm if the landlord has a mortgage and if there is a current or potential likelihood of mortgage default. If yes, tenants should review lease terms to determine if a nondisturbance agreement in favor of the tenant is in place or can be obtained from the lender. A nondisturbance agreement assures that the lease stays in place (so

long as no default exists) even if the lender forecloses its mortgage. Lenders typically are receptive to such agreements because they help ensure that the tenant will pay rent directly to the mortgagee after a loan default. Tenants also should ask the lender to provide a duplicate notice of mortgage default, and, in certain cases, such as a single-tenant building, a right to make direct payments to the mortgagee, with a corresponding credit against the rent.

Typical loan documents prohibit landlords from amending leases (especially for a rental concession) or entering into new leases without a lender's consent. Thus, in assessing leverage, tenants should determine ahead of time how many parties will be sitting at the bargaining table and be aware that dealing with lenders on these issues can take time, patience, and sometimes money.

Tenants negotiating new leases or amendments to existing leases for single-tenant buildings might ask for an option to purchase the leased premises. However, lenders often

consider such options as an impediment to their foreclosure rights. Therefore, lenders may withhold their consent to purchase options within a lease without additional provisions. Often the option specifically must provide that it cannot be exercised against a successor landlord such as a lender after foreclosure or, at a minimum, that the purchase price must pay off the mortgage in full.

As with any negotiation, leverage points can be anticipated by being prepared. Tenants — as well as landlords — should plan a strategy for success in advance, indentifying all the players involved and the potential obstacles. In today's climate both parties must be creative, and above all, make the deal a win-win for all concerned.

Steven D. Sallen is president and CEO of Maddin Hauser, a business law firm in Southfield, Mich. **Kasturi Bagchi** is contributing editor of *Real e-State*, where a version of this article was originally published. Contact them at sds@maddinhauser.com and kxb@maddinhauser.com.