

Hot Topic

The Distressed Landlord Problem: Strategies for Tenants in Today's Lease Market

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Vacancy rates are rising, rents are falling, the market is flooded with cheap sublease space. Most real estate professionals believe the next 6-12 months will be an ideal time for tenants to lock in favorable long-term rental rates. But beware: a tenant that fails to protect itself from its landlord's financial problems may lose the benefit of its terrific deal. What should a tenant do to manage the risks that come with having a financially shaky landlord?



Recognition Agreement (Subleases)

Some of the most favorable deals available today are sublease opportunities. In midtown Manhattan, for example, financial services firms have dumped massive amounts of space on the market, at fire sale prices. But a sublease rests on the foundation of the prime lease, and if the prime lease is terminated, then the sublease disappears with it. From the subtenant's point of view, the situation is analogous to a tenant demanding an SNDA when leasing from a shaky landlord; in both cases, the space user needs the party at the top of the chain to agree that the failure of a party in the middle of the chain will not result in termination of the occupant at the bottom of the chain. In the sublease context, this agreement is called a "recognition agreement." The landlord agrees to "recognize" the subtenant's occupancy rights in the event of a termination of the prime lease. The terms of this recognition are negotiable and depend entirely upon the relative bargaining power of the parties and the dynamics of the building and market: in some cases, the subtenant succeeds in getting the landlord to recognize the favorable sublease terms; in other cases, the subtenant's occupancy rights are protected but it must pay the higher prime lease rental rate; in yet other cases, the parties will agree to a fair market value determination.

SNDA

A subordination, non-disturbance and attornment agreement is a three-way agreement among the landlord, the tenant and the landlord's lender. In the absence of an SNDA, the foreclosure of a mortgage in most jurisdictions would wipe out leases that are subordinate to the mortgage – i.e., leases that were signed after the mortgage was put

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into place. The SNDA overrides that principal of real property law, with the lender agreeing to honor the lease and the tenant agreeing to accept the lender as its landlord in the event of foreclosure. Without an SNDA, a tenant that signs a great deal in a down market could see that great deal disappear following a foreclosure -- leaving it subject to renegotiation of deal terms or even eviction. In the current climate, an SNDA is a must-have in most situations.

Protecting Tenant Allowances and Buildout Promises

A significant component of most leases is the landlord's promise to perform certain construction obligations in the space, or to reimburse a tenant, via a tenant allowance, for the costs of the tenant's own construction in the space. The rent is calculated to include a recovery by the landlord of these costs and so, in the end, it is the tenant that bears the actual burden of the cost. What happens when a landlord fails to perform the work or write the check? Must the tenant continue to pay rent,

despite the landlord's failures? In general, yes, as most leases require rent to be paid no matter what (a principal known as the "independent covenants" rule). This conundrum applies to other landlord failures as well: snowplowing, HVAC maintenance, cleaning. As management fails, the tenants often sit, watch, complain – and pay rent. If the lender takes over, there is an outside chance that the SNDA will require the lender to perform the landlord's construction and tenant allowance obligations – but it is much more often the case that the SNDA states expressly that the lender is not responsible for these things.

There are several avenues the tenant can consider to protect this aspect of the deal from a landlord's financial weakness. First is the "drop dead" clause, which allows the tenant to walk away from a lease if the space has not been built and delivered by an agreed upon outside date. Additionally, the tenant should seek self-help and offset rights. Self-help and offset rights enable a tenant to perform construction and other work itself if the landlord fails to do so, and deduct from the rent the costs of performing that work. Similarly, if the landlord fails to pay the tenant allowance, the offset right allows the tenant to deduct the allowance amount from the rent. From a cash flow standpoint, this may not be an ideal solution – an expense the tenant expected to pay on an amortized basis over the course of the lease term suddenly becomes a year 1 expense – but the tenant at least ends up with, for the most part, the benefit of its bargain and the ability to operate.

Lease Amendments

One way of avoiding the problems of landlord distress is to avoid landlords in distress: sign leases only in blue-chip locations with blue-chip landlords that are not over-leveraged. But many tenants find themselves already bound by long-term leases in buildings owned by distressed landlords, and these tenants do not have the luxury of shopping for stability. Their leases may have been negotiated in a landlord-favorable market when strong SNDAs and self-help and offset rights were not available. Perhaps it is time to expand or extend or otherwise restructure the lease. Is it too

late to gain some protection? No. At this point the tenant should push for an SNDA that will protect both the existing lease and the amendment – but there are often complicating factors. First, when a lender and a borrower are engaged in a high-pressure loan workout dance, tenants and lease restructurings tend to be put on hold. Lenders are trying to get their arms around an asset they may soon own and landlords are struggling to fend off disaster.

Landlord Bankruptcy

If a landlord files for bankruptcy, it can affirm or reject the lease. If it affirms, life goes on. If it rejects, the tenant has two options: (a) treat the lease as terminated, in which event the tenant must move out or negotiate a new deal with the subsequent or reorganized owner; or (b) retain its rights under the lease. The latter case is tricky, depending on the scenario. The landlord no longer has any lease obligations, and so it is up to the tenant to manage the property, provide its own services and so forth (in exchange for which the Bankruptcy Code allows the tenant to deduct these costs from the rent, even if the lease does not contain self-help or offset rights).

Given the fact that the tenant must fend for itself under this scenario, an election to continue in occupancy is usually feasible only in single-tenant, triple-net lease situations. In most other circumstances, the landlord's rejection of the lease results in a tenant moving or entering into a new lease with the subsequent or reorganized owner, and usually on less favorable terms (after all, the landlord would not have chosen to reject a landlord-favorable lease). For these reasons, most prospective tenants will steer clear of a building that is a likely bankruptcy candidate, no matter how enticing the proposed economics.

Sublandlord Bankruptcy

In bankruptcy, a tenant has the right to affirm or reject a lease. If affirmed, the lease goes on and so does the sublease. If rejected, the sublease dies with the prime lease. Unless the subtenant has negotiated a recognition agreement with the building owner, it is left without occupancy rights.



Sublease Security Deposits

A party concerned about the solvency of its sublandlord should not prepay rent or give the sublandlord a cash security deposit, as the bankruptcy of the sublandlord will leave the subtenant an unsecured creditor with respect to the amounts paid. Instead, the security deposit should be in the form of a letter of credit which can be drawn only in the event of a sublease default.

There are few places to hide in times of widespread distress, and a tenant seeking 100% security today will find itself paralyzed unless it selects the bluest of blue-chip landlords in the bluest of blue-chip buildings – and even then, there is no guaranty that the blue-chip landlord will not some day sell to an

over-leveraged disaster waiting to happen. It is an irony of today's market that the forces creating opportunities for tenants can be so powerful that they push landlord weakness beyond the point at which a tenant can exploit those opportunities. The most successful tenants will find a balance that allows them to both take advantage of the opportunities and also sleep at night. In most cases, some combination of the strategies outlined above – along with a little luck – will do the trick.

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