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THE TENANT'S ADVANTAGE

As Landlords Continue to Struggle, Tenants Encouraged to Protect their Rights

A Guide to Addressing Commercial Loan Defaults, Delinquency, and Landlord Liquidity

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While the financing of commercial real estate has received much attention this past year, most of the focus has been on the impact on banks and property owners. But what about the implications for tenants and end users of commercial real estate who have an opportunity to leverage their negotiating strength as landlords continue to struggle?

The contributing factors that led to the CRE credit crisis are obvious. CRE investment markets exploded with record years leading up to the recession. During this period, property values climbed, and lending practices loosened. Approximately half the tenants in the Bay Area are in institutional grade buildings that were sold or refinanced during this time, and many of the loans securing these properties were highly leveraged.

As the recession deepened, landlords were forced to lower rental rates and increase concessions. Today's rents cannot accommodate many of the debt structures placed on buildings over the past few years. Many CRE loans are at risk of delinquency, and many are set to expire in the next couple of years. Normally, these loans would simply be refinanced. However, while credit markets have improved, many experts are wondering how these buildings can secure new loans given the current loan-servicing abilities of the properties and the availability of loans.

This issue is also critical to tenants and end users. There are specific steps companies can take if they are in the middle of their lease: evaluating upcoming lease expirations, or negotiating lease agreements. Companies should look at ways to minimize their risk in existing leases and in new lease transactions over the coming years.

First, consider which of the following three scenarios best matches your situation:

Scenario #1: Tenants Completing a Lease in the Next 3 Years

Today is a great time to evaluate your lease portfolio and negotiate lease transactions since there has been only modest absorption of vacant space, even as the economy slowly improves. While end users

remain cautious and sensitive to increasing operating costs, they should recognize that the CRE lending crisis has put an unusual twist on the leasing market: In the past, landlords thoroughly vetted their tenants to analyze the risk involved in lease transactions. Tenant risk is still a factor, but tenants now need to do more investigation of their landlord to evaluate risk.

You should evaluate your current and potential landlord in terms of the following:

- Who are they? What type of landlord/ownership?
- When did they acquire the building?
- What type of debt is on the building? Who is the lender? What type of lender? What is their role in transaction approval?
- What capital improvements have been made? When were they made? How were they financed?
- What are the building operating expenses? What is the likelihood of the landlord cutting back on expenses?
- When was the last tax assessment of the building? Has the property value declined since the acquisition? Is the landlord challenging the most recent tax assessment?
- What is the current vacancy and projected rollover in the building? How does the landlord vacancy and churn look over the coming years?
- Has the landlord completed any lease transactions recently? Is the landlord negotiating with anyone else right now?

Negotiate the lease terms to reflect the risks of the current market:

- What is your right of self-help and offset of rent in the event of landlord default of payment of tenant improvement allowances and failure to maintain the building? What specific terms are included?
- What is in your non-disturbance clause? How protected are you?

Scenario #2: Tenants in Buildings at Risk for Default, Delinquency, and Landlord Liquidity Issues

Tenants in "at risk" buildings need to know specific details in their lease agreement. Your lease may have been negotiated with certain protections against this type of event. Even so, every lease is different, and not all of them offer adequate protection. Tenants should learn and understand the default process and the roles of each party. Tenants should also record a "Request for Notice of Default" so that they will receive notice of the initiation of any foreclosure proceedings against the landlord.

If a property goes into foreclosure, a tenant's rights are dependent on two things: the "priority" of the lease compared to the loan in foreclosure, and what the lease says about that priority.

If the lease is signed, and the tenant records a memorandum of the lease in the real property records or takes possession of the property before any loan is placed on the property, then the lease has priority over the loan.

However, most leases provide that the tenant "subordinates" its interest in the property to the lender's lien on the property, subject to a proviso that the lender, if it forecloses on the property, will not evict the tenant.

If the lease does not have priority over the loan, or if the tenant subordinates its lease to the loan, then a foreclosing lender has the right to evict the tenant. The tenant can avoid eviction by entering into a Subordination, Non-Disturbance, and Attornment Agreement (SNDA) with the lender, which typically provides that the lender recognizes the tenant's occupancy rights as long as the tenant is not in default under its lease. The wording of the SNDA agreement is very important, as is the clause in the lease that typically calls for the tenant to enter into an SNDA with any current or future lender. A tenant should never enter into a lease that provides for subordination without corresponding non-disturbance language.

To protect your interests, take the following measures:

Review your lease.

- What is your right of self-help and rent offset in the event of landlord default in payment of tenant improvement allowances or failure to maintain the building?
- What is in your non-disturbance clause?
- What is your right of offset?

Identify concessions or benefits that haven't been realized or might be challenged by a new landlord.

- Do you have any unfunded tenant improvements? Who will fund them if the building goes into foreclosure? What is the process to release these funds?
- Do you have fixed-rate renewal options? What is the process for your renewal option?
- Do you have back-loaded free rent during or at the end of your lease term?

Evaluate your building.

- Are capital improvements needed? Will they be needed in the immediate future?
- How responsive is building management?
- Have you noticed any change in the day-to-day operation of the building?

Learn and understand the foreclosure process.

- What are the steps in the foreclosure process?
- Who are the people involved in a foreclosure process? What is their role?

Seek advice to clear up any questionable items or issues.

Scenario #3: Tenants Who Think Their Building Is Not at Risk

A lesson from this recession is to not assume companies or institutions are safe. Your current landlord might appear to be in a safe position, but it is prudent to investigate any potential risk. Although the investment markets are still slow, your building may sell to a new landlord. Given the risk, it is appropriate to do a thorough review and evaluation of your lease portfolio. If you are planning to renew at your current location, you can improve upon the non-economic terms in your lease.

How do you know if you're in an at-risk building? You should know when the building was acquired, at what cost, and what type of debt is on the building. Be cautious if your building was acquired and financed in the past few years. Next, look at who/what type of owner and who/what type of lender are involved in your building. This information might give some clues to the likelihood of certain outcomes in the event of debt or liquidity issues.

What does the reality of commercial loan defaults mean to the leasing market? The obvious impact is a continuing trend of declining property values. Many properties will be acquired by new owners at a lower cost. The new landlords will be able to offer more competitive lease transactions than landlords who acquired building at a higher basis. This will help sustain today's competitive leasing environment and provide significant concessions for tenants.

Pretend and Extend

One challenge for tenants is that many banks have been approaching their troubled assets with a "pretend and extend" strategy. Despite landlords' inability to pay the debt service, many lenders are not pushing buildings through the foreclosure process. This is likely because banks are not in a position to own/manage the buildings and the investment market to sell these assets if depressed. In addition, the sale of these distressed buildings would involve major bank write-downs on the loans securing these buildings. These potential losses present significant danger to our economic recovery.

The impact of the pretend and extend approach on leasing is many owners/lenders are slow to respond and make decisions. Many of them seem to be waiting for a market recovery that has been very slow without the required job growth. These owners/lenders are hesitant or unwilling to do deals because of the economics involved in a "market deal." The income from a deal today will not correspond with the debt service that was placed on the building a few years ago. A "market deal" would be an acknowledgement by the owner/lender that the debt service on the building is unsustainable.

CresaPartners is an international corporate real estate advisory firm that exclusively represents tenants and specializes in the delivery of fully integrated real estate services, including: Transaction Management, Project Management, Relocation Planning and Management, Strategic Planning, Workforce and Location Planning, Subleases and Dispositions, Lease Administration, Capital Markets, Sustainability, Supply Chain and Facilities Management. With more than 50 offices, CresaPartners is the largest tenant representation firm in North America. Internationally, CresaPartners covers more than 125 locations in 35 countries. For more information, visit www.cresapartners.com or contact Craig Zodikoff and Tyler Kellogg at 415.394.1020.

Founded in San Francisco in 1978, Sideman & Bancroft LLP specializes in real estate and business transactions, tax litigation, estate planning, family law, civil litigation, and intellectual property transactions and litigation. For more information, visit www.sideman.com or contact James Janz at 415.392.1960.