

Let Troubled Tenant Contract Its Space, But Don't Get Burned

Many office and shopping center tenants hit hard by the economy are discovering that they don't want, and can no longer afford, to occupy all of their leased space, says F. Alison Dodds, an attorney at the Chicago law firm of Shaheen, Lundberg, Callahan & Orr. Increasingly, they're asking owners to let them give back—that is, contract—part of their space and pay a lower rent in return. Obviously, the tenant can benefit from this contraction. But you, too, can benefit from the concession, as long as you take the right steps to maximize your benefits and not get burned.

Why Allow Contraction?

A tenant may prefer to contract its space rather than sublet or assign it, because market conditions would force it to sublet or assign that space at a loss, says Marilyn Lissner, a broker with Cushman & Wakefield in Chicago. Even if the tenant could break even, many tenants don't want to stay on the hook for all of their space.

At the same time, letting the tenant contract can be a better alternative for you than forcing the tenant to stick with all its space. If you hold the tenant to its lease, the tenant may choose to pick up and leave. You'll have to try to chase the tenant down to get the unpaid rent. Or the tenant's high rent burden might force it into bankruptcy—and you'll get only a fraction of the unpaid rent you're owed.

Take Steps to Avoid Getting Burned

Whatever agreement you reach with the tenant, make sure it works to your advantage and that you don't get burned by letting the tenant contract.

Get concessions from tenant. Use this opportunity to take back concessions you may have granted to get the tenant to sign the original lease. Or, make the tenant extend its lease or increase the square footage rent on the contracted space.

Charge tenant a fee for contraction. Your agreement with the tenant will probably take the form of a lease

amendment (see box, p. 2). Charge the tenant, in the lease amendment, for any costs you incurred in re-renting the contracted space and for any transaction costs you didn't get back on that space.

Put protections into lease amendment. Make sure you put protections into the lease amendment. Otherwise, you may find yourself with a tenant that's holding over in the space it promised to give up or with a lease guarantee that's no longer in effect.

Update existing lease to reflect contraction in space. You'll also need to update your existing lease to reflect the contraction in space. Lease clauses on parking, floor plans, and percentage rent are just a few examples of where you may have to change the language.

Get Concessions from Tenant

Try to remove any concessions you were originally forced to give in the lease. Carefully review your lease for such concessions. Here are some take-backs to consider:

Cancel or amend tenant's options. When you first lured a big tenant, you may have been forced to give it various options—for example, an option to expand, cancel, or renew at below market rent, or a right of first refusal. Now, you're in the driver's seat. So try to get rid of some of those options or make the terms better for yourself, suggests Marc L. Ripp, vice president and associate general counsel of Bellemead Development Corporation in New Jersey.

How will a tenant respond? Lissner says that tenants realize you're giving them a big concession by letting them contract. So, they'll be flexible in return. Neil T. Neumark, a partner at the Chicago law firm of Schwartz, Cooper, Greenberger & Krauss, says he's been able to cancel several options successfully when negotiating space contractions. For example, he usually gets the tenant to agree to give up its expansion option. And, he amended a renewal option at below-market rent so that it became a renewal option at fair market rent.

Dodds points out that owners often give concessions to attract a big tenant. But if your tenant is no longer big after downsizing, your rationale for the concession is gone. So, you've got every right now to try to take back the concession. For example, Dodds successfully renegotiated to remove a once-big tenant's option to buy in return for letting it contract its space.

Take back any ongoing concessions. Say you gave a tenant a concession that lasts throughout the lease term—such as a break in operating or common area maintenance (CAM) expenses, or an exclusive. Again, if you gave this concession to attract the once-big tenant, take it back, says Dodds.

Exclusives are another concession to consider with shopping center tenants. If you gave a tenant an exclusive, is that exclusive still financially prudent after the contraction? For example, at one time the tenant may have been large enough to handle the exclusive demand in the center. But, now that the tenant is smaller, it may not be able to manage the exclusive. So the exclusive may no longer be economically feasible, says Ripp.

Both Dodds and Lissner find that tenants will usually be flexible in giving up these concessions in return for a contraction.

Make tenant extend the lease. Consider extending the lease term in return for the contraction, suggests Dodds. Although you'll be extending the lease at a lower rent, you'll get stability in return through a longer, guaranteed, rent stream. Dodds says that this concession will be especially valuable to you if the lease is ending soon—you'll avoid the imminent risk and cost of finding a new tenant for the space. Tenants usually think this concession is reasonable, says Dodds. Neumark says he frequently can get this concession from the tenant.

Relocate tenant. If your tenant is occupying prime space, Neumark suggests trying to move the tenant into a vacant "dog space"—that's space with a bad view or in a less desirable area of the building. You may not want a smaller tenant in your prime space, and it may be to your advantage to lease the bigger chunk of prime space. Neumark has negotiated relocations several times. But he warns

that how a tenant reacts to a proposed relocation depends on its desperation level and the quality of the dog space.

You could also give yourself the right to relocate a tenant at a later date. A relocation option may have been impractical with a big tenant, but may be useful in the future with that now-smaller tenant, says Mark Senn, a partner at the Denver law firm of Senn Lewis Visciano & Strahle.

Increase square-footage rent. Some tenants want to contract because they no longer need all the space—not because of financial problems. If that's the case, you may want to try to raise the rent per square foot on the space, suggests Ripp.

Suppose your tenant was renting a 100,000 square-foot space with rent at \$20 per square foot—that's \$2,000,000. If the tenant gives back 25,000 square feet, why not try to raise the rent to \$25 per square foot? With the increase, the new rent will be \$1,875,000, instead of \$1,500,000. The tenant gets a break with lower rent, says Ripp. But the total rent is higher than it would have been with a standard pro rata reduction.

This strategy may be especially appropriate where the rent "steps up," says Senn. That's where, for example, the rent on a five-year lease is set to go from \$10 per square foot during the first year of the lease to \$12 during the second year, and so on, until it reaches \$18 during the fifth year. The "effective rent" over the five-year period will be \$14 per square foot ($\$10 + 12 + 14 + 16 + 18 = 70 \div 5 = \14). By accepting the contraction, you'll lose the full benefit of the higher rent in the final years. So you'll lower your "effective rent," says Senn.

Senn also suggests that you get the tenant to pay the original CAM or operating expenses—not the prorated reduced amount—until you re-let the space you've taken back. You shouldn't have to pay these costs on the space the tenant gave up in addition to eating the lost rent, says Senn.

But, Neumark warns, a tenant typically asks for a contraction when it's in dire straits. In that scenario, you couldn't raise the rent. In fact, you could be forced to lower the rent per square foot in addition to contracting the space—something Neumark says he's often had to do.

► Use Lease Amendment for Tenant Contraction

If you let the tenant contract its space, write the agreement in an *amendment* to the original lease, says attorney Marc Ripp at Bellemead Development Corporation in New Jersey. There's no reason to draft a new lease—that would be "overlawyering," he says. Chicago attorney Neil T. Neumark agrees, adding that you could run into trouble preparing a new lease. If the original lease was heavily negotiated or if you've changed your lease form, you may make an inadvertent change when preparing the new lease. But there's less chance of doing that when you only prepare an amendment.

Charge Tenant a Fee for the Contraction

Taking back part of the tenant's space can be expensive. To re-let the space, you may need to erect partitions or doors, install bathrooms, and so on. These kinds of improvements could trigger compliance requirements with the Americans with Disabilities Act, which might further jack up your costs. Plus, you haven't gotten back all of your original transaction expenditures because the tenant's not paying the total rent you expected.

Try to get the tenant to make up for all these costs, suggests Susan Fowler McNally, an attorney at the Santa Monica, California, law firm of Gilchrist & Rutter. To do

this, McNally suggests making the contraction contingent upon the tenant paying a surrender fee.

A surrender fee should reimburse you for all your unreimbursed transaction costs allocable to the space the tenant is giving up—the “surrender space.” McNally calls these costs “landlord’s lease costs.” Make sure your lease defines exactly what these costs are. While subject to negotiation with the tenant, typically these costs include free rent, takeover obligations, tenant improvement allowance, and brokerage commission. You may even want to charge the tenant interest on these costs because that’s money you spent on the tenant, which could have earned interest in your pocket.

You’ll also want the fee to include all of the costs you’ll incur in order to re-let the surrender space. These are what McNally calls “surrender space alteration costs.” Again, make sure your surrender fee provision in the lease says exactly what these costs are. Typically, though, they may include any alteration costs you’ll pay in order to make the contracted space marketable—such as partition walls or bathrooms. She recommends the following language:

Model Language:

a. Surrender Fee. In order for such surrender of the Surrender Space to be effective, Tenant shall pay to Landlord the “Surrender Fee,” which shall be an amount of money equal to the sum of:

1. The unamortized amount of Landlord’s Lease Costs (defined below) allocable to the Surrender Space as of the Actual Surrender Date, with Landlord’s Lease Costs over the term of the Lease

straight-line amortized from the Commencement Date at a per annum interest rate equal to _____ percent (___%); and

2. Surrender Space Alteration Costs (defined below).

b. Definitions.

1. “Landlord’s Lease Costs” are defined as the sum of [insert all applicable lease costs].
2. “Surrender Space Alteration Costs” are defined as the sum of [insert all costs associated with re-letting the Surrender Space].

A tenant, especially one with money problems, may not be able to pay these costs. If that’s the case, McNally suggests that you negotiate with the tenant—make it pay only a portion of these costs or pay the surrender fee in installments over a period of time. Or, you can amortize the total costs over the new lease term and increase the new rent accordingly, Dodds says.

Include Safeguards in Lease Amendment

If you give in to the tenant’s contraction request, make sure you don’t get burned in the process. Take the proper precautions, and make sure they’re carefully laid out in your lease amendment.

Charge tenant extra for not giving up space on time. Make sure the tenant gets out of the space on time. Otherwise, you might have problems re-letting or making the necessary alterations. Ripp suggests including a lease provision that requires the tenant to give you the space it’s giving up by a certain date (referred to as the “requested

► Questions to Answer Before Agreeing to Tenant Contraction

Here are several issues to consider before deciding whether or not to agree to the contraction:

Is Keeping the Tenant Worth Making the Concession?

Most tenants want to give back their space for economic reasons—they can’t afford the rent and additional costs associated with a large space, says Chicago broker Marilyn Lissner. If that’s the case, you’ll need to decide whether a potentially viable tenant paying less rent is better than a potentially bankrupt tenant, says Chicago attorney F. Alison Dodds.

Don’t just accept the tenant’s cries of poverty, adds Neil T. Neumark, a partner at the Chicago law firm of Schwartz, Cooper, Greenberger & Krauss. Verify that the tenant’s financial picture is really as gloomy as it says it is before you agree to take back the space. To do this, he recommends reviewing the tenant’s financial statements.

Some tenants are financially secure, but want to downsize for other reasons, says Lissner. For example, some need to downsize as their companies become technologically advanced—they don’t require the same office space because employees now work out of their homes at computers installed with modems and faxes. Or, they want to contract because they plan to expand to a second location. If your tenant fits into this mold, ask yourself whether it’s big enough, and whether your rental market is bleak enough, to make this concession worthwhile, says Dodds.

Can You Get a Marketable Space?

Make sure that you’ll be taking back a rentable portion of space, warns Neumark. The returned space should be not only a rentable size, but also a marketable configuration, he says.

Can You Get Lender Approval?

Many mortgage loans are contingent upon the lender’s approval of the lease and any lease amendments, says Neumark. Your lender may have a problem with the contraction because you’ll be collecting less rent for reduced space. So, check your loan documents and, if necessary, get your lender’s approval *before* you agree to the contraction, warns Neumark.

Is Your Tenant’s Rent Current?

Don’t consider granting your tenant’s request to contract until the tenant pays any back rent, including all late charges, says Ripp. He adds that a tenant that can’t bring itself current may not merit a contraction. But, if you still decide to go along with the contraction, Neumark recommends that you first make the tenant sign a promissory note in which it agrees to repay all the back rent under a fixed payment plan—plus interest.

surrender date”). To deter the tenant from delaying, treat the tenant as a holdover tenant and charge it extra for the surrender space until the date it actually leaves the space (the “actual surrender date”).

Ripp even increases the standard holdover amount in his lease—say it’s 200 percent of the rent, he raises it to 250 percent—if the tenant doesn’t move out of the surrender space in time. Ripp recommends including the following language in your amendment:

Model Language:

The “Requested Surrender Date” shall be _____. The earliest date on or after the Requested Surrender Date when Tenant has delivered to Landlord the Surrender Space in the physical condition and state of repair required under Article ____ hereof is hereinafter called the “Actual Surrender Date.” If the Actual Surrender Date occurs after the Requested Surrender Date, then Tenant shall be deemed a holdover tenant for the Surrender Space and shall be liable to Landlord under Article ____ of the Lease as if the Requested Surrender Date were the Termination Date. Notwithstanding anything contained to the contrary in Article ____ of the Lease, Landlord and Tenant agree that with regard to the Surrender Space only, the two hundred percent (200%) referred to in Article ____ of the Lease shall be deemed increased to two hundred fifty percent (250%).

Ripp says that generally a tenant won’t approach you with a contraction request unless it’s prepared to leave the space. But, if a tenant balks at the increase in holdover rent, you can negotiate it down.

Don’t cut rent until you get back your space.

Another way to stop the tenant from remaining in the space after the agreed-upon contraction date is to reduce the tenant’s rent only after the tenant moves out. To do this, Ripp suggests having the reduced rent go into effect only on the actual surrender date—not before that date.

Get guarantor’s reaffirmation. If the lease has a guarantor, the guaranty will technically stay in full force after a lease amendment that doesn’t increase the guarantor’s liability. But, courts will generally look for any excuse to let the guarantor off the hook, Dodds warns. So, place a reaffirmation of the guarantor’s lease obligations on the same page as the tenant’s signature at the end of the lease amendment, she recommends. Make sure the guarantor signs this reaffirmation.

A guarantor should have no problem with this reaffirmation because its liability is actually being reduced. But it may want to lower the guaranty cap in relation to the reduced rent. If the original guaranty was capped off at an amount lower than the full rent, don’t reduce the amount, warns Ripp. You deserve the additional security—especially if your tenant has money troubles.

Also, if you didn’t require a guarantor under the original lease, Neumark recommends that you get one now.

To have the guarantor reaffirm its obligations, Dodds suggests placing the following reaffirmation at the end of the amendment, after the tenant’s signature:

Model Language:

REAFFIRMATION OF PERSONAL GUARANTY

The undersigned, _____ (“Guarantor”), hereby reaffirms his (her) obligations under the Guaranty consisting of ____ () pages, which is attached to the Lease as Exhibit ____, acknowledging that he (she) has read the foregoing Amendment.

Dated: _____

[Insert guarantor’s signature block, including a space for current address]

Make sure there are no liens. The tenant may have installed decorations or other fixtures—ceiling fans, for example—which it plans to leave behind in the surrender space. Make sure that anything you take back with the surrender space has been paid for and will belong only to you. If there are liens or other claims, warns Stuart D. Byron, a partner at the New York City law firm of Tenzer, Greenblatt, Fallon & Kaplan, you could inherit them. You can order a lien search against the tenant to verify that no liens or other claims exist. Byron also recommends that the amendment include a statement by the tenant that it’s the sole owner of any items remaining in the surrender space. He suggests the following language:

Model Language:

Tenant hereby covenants that nothing has been, or will be, done or suffered by Tenant whereby the Lease or the estate of the Tenant in and to said Surrender Space or any part thereof, or said alterations, decorations, installations, additions and improvements in and to said Surrender Space or any part thereof, have been, or will be encumbered in any way whatever; that Tenant has, and will have, good right to surrender the same, and that no one other than Tenant has acquired, or will acquire, through or under Tenant any right, title or interest in and to the Lease or any term and estate thereby granted in and to all or any part of the space covered by the Lease or in or to said alterations, decorations, installations, additions and improvements in and to said Surrender Space or any part thereof.

► Consider Phased Contraction

If your tenant wants to return a large chunk of space, you may have problems re-letting it all at once. Until you re-let, you’ll be stuck with a huge “dark” space.

So, consider making the tenant give back the space in manageable portions over time, suggests Dodds. You can do this by requiring the tenant to give back one floor or half of a floor at a time at reasonable intervals—say, every six months. Dodds says that most big tenants won’t have a problem with doing this. It will make the shrinking process smoother and more gradual for the tenant as well as for you.

Keep tenant on the hook for outstanding costs. You may not have yet charged the tenant for all of its operating expenses on the surrender space. Don't let the tenant out of paying these costs just because your billing falls after the surrender date, says Byron. Make the tenant acknowledge that it's still responsible for paying these costs by including the following language in the amendment:

Model Language:

Nothing herein contained shall be deemed to constitute a release or discharge of Tenant with respect to any obligation or liability incurred under the Lease and outstanding and unsatisfied on the Surrender Date.

Update Lease Provisions

You may need to change a number of lease provisions to reflect the contraction. Go through your lease carefully, and put the appropriate changes into the lease amendment. Here are a few lease provisions to check:

Parking. Many leases give tenants parking spaces based on how much space they lease. Now that the tenant's space is smaller, you should decrease the number of its parking spaces.

Unusable options. The contraction may make some tenant options moot, says Senn. For example, you might have given the tenant an option to expand or a right of first refusal on the space next-door. But after the contraction, that space will no longer be next-door. To avoid confusion,

have the lease amendment state that the tenant gave up these options.

Security deposit. The tenant might argue that its security deposit should be lowered as a result of the lower rent. Don't automatically agree to this, says Dodds. If the tenant is financially unsound, you should probably hold a bigger security deposit. So, the current security deposit may be reasonable. If the tenant objects, Ripp recommends that you offer to base the security deposit on the new monthly rent; but, increase the number of months—say, from two months to three months.

Floor plan and square footage. Don't forget to annex a new floor plan to the amendment, which shows the smaller space—or the new space if you've relocated the tenant. Also, put the new smaller square footage of the space in the lease amendment.

Rent and operating or CAM expenses. Both the rent and any prorated expenses, such as CAM or operating expenses, will be lower as a result of the tenant's decreased square footage. Make sure you change these numbers as needed in the lease amendment, warns Dodds.

Signage. Your tenant may have been so big that the building was named after it. But if the tenant's stature and presence are sufficiently diminished, you should change the name of the building, says Dodds. ▲