TOUGH TIMES TEACH TENANTS TOUGH LESSONS

By Joshua Stein

As the booming real estate years fade into memory and the development and lending communities struggle with the aftermath of over-building, over-lending and under-capitalization, tenants are learning some important, and often costly, lessons.

Commonly accepted "boilerplate" lease provisions from those days when space was at a premium and tenants were the underdogs, now are creating more problems than they are solving. Today, however, tenants hold most of the cards. By understanding the consequences of past mistakes, they can add protection in new leases that will better serve their interests in the future.

Build-Out Contributions

Landlord contributions to build-outs represent one area of potential trouble for tenants. For example, in 1990 a major manufacturing company negotiated a lease for 100,000 square feet of headquarters space in a suburban office park. After long and difficult negotiations, the company was able to convince its new landlord to agree to reimburse most of the extra cost of building out its space: nearly $20 a square foot or about $2 million.

The company, National Widget Manufacturing, started the build-out on time and finished ahead of schedule and under budget. It was a great outcome in every way, except for one thing — by the time National Widget was ready to collect the landlord's contribution, the landlord was in bankruptcy and decided not to honor the company's lease. Although National Widget maintained some limited rights against the landlord's estate, these didn't include the right to be paid the promised $2 million reimbursement.

Sophisticated tenants have always known that they need to obtain a "nondisturbance" agreement from their landlord's lender. Today's real estate depression has emphasized not only the importance of that document, but also its potential pitfalls.

In theory, a nondisturbance agreement requires the foreclosing lender to honor the tenant's lease, but it also contains a laundry list of exceptions, conditions, limitations and restrictions that can cost tenants money. For example, American Target Distributors believed its nondisturbance agreement would protect its interests when the lender foreclosed on the landlord. However, although the company had to continue paying the rent required by its lease, American Target lost its right to be paid the negotiated build-out contribution.

Companies negotiating new leases in the 1990s — a time when rent-paying tenants are the only true source of value — have the strength they need to protect themselves against these mistakes. They can insist upon lease provisions that allow them to avoid losses and surprises if things don't turn out quite as well as expected for the landlord.

National Widget could have saved $2 million by insisting on an absolute right to offset against its rent if the landlord failed to pay the promised build-out contribution. American Target Distributors could have demanded the same right or insisted that the nondisturbance agreement specifically protect its right to be reimbursed for its build-out costs.

Even if a tenant negotiates the world's greatest nondisturbance agreement, though, this will not be the end of its concerns.

In a decade when bank failures have become everyday news and the federal government has suddenly realized the magnitude and endless variety of all the risks it assumed in issuing deposit insurance, a tenant also has to think about the possibility that both the landlord and its lender will become insolvent.

In this case, the tenant can lose not only its right against the landlord, but also many or all benefits under the nondisturbance agreement.

Again, careful planning and aggressive negotiation can solve problems in advance. Rather than accept a "subordinate" lease position and a collection of promises from

the lender, the tenant can insist on having its lease be "superior" to the mortgage — so that a foreclosure under the mortgage could never affect the lease.

Although traditionally this concept has been unthinkable to lenders and their regulators, they may have to accept it if they want to fill the empty buildings they own, or may soon own, with rent-paying tenants.

Once it has negotiated a lease with a strong nondisturbance agreement and moved into the space, the tenant must watch for signs of financial stress on the landlord's part and be prepared to respond quickly to any problems that arise.

Even the most aggressively negotiated nondisturbance agreements usually will protect the lender from claims that tenants might make because the landlord mismanaged the building before foreclosure. Therefore, the tenant needs to move fast if the landlord doesn't live up to the lease or fails to provide services. As the final sign of trouble, the tenant may receive a notice to pay rent directly to the lender or to a designated third party. At that point, the tenant usually can assume the landlord has missed at least two or three interest payments and will soon lose the building or be in bankruptcy. If the tenant doesn't carefully review its lease, its nondisturbance agreement, and any related documents, it may find that it has to pay the same rent twice — once to the landlord, once to the lender. Tenants also have been known to take advantage of the uncertainty this situation creates and not pay rent to anyone. Even if the landlord isn't yet in trouble with its loan, a half-empty building can create unexpected pressures for some tenants.

Operating Expenses

The operating expenses clause often found in office leases can contain hidden problems. For example, General Consultants Ltd. (GC), a once-growing consulting company, was one of the first to sign a lease in "Central City Tower," a hypothetical office building in a major city, at a time when landlords were king and rents were rising by the month. GC took about 10 percent of the space in the new building and, as part of its rent package, agreed to pay $15 a square foot as "base rent" plus an appropriate share of the landlord's operating expenses and real estate taxes.

Today, GC has learned the importance of the denominator in any fraction. The allocation clause in its lease defines GC's share of operating expenses and taxes as the company's square footage divided by the total occupied square footage in the building. With the structure only 40 percent leased, this language means that, rather than paying the 10 percent the company had expected, GC now must reimburse 25 percent of the landlord's operating expenses and taxes.

This could have been prevented. Tenants negotiating new leases in the current market can avoid the same problem by insisting that their share of operating expenses and taxes reflect only their portion of leasable space, whether or not the rest of the building is occupied. This nuance didn't matter much when office occupancy never fell below 90 percent, but it certainly does today.

Renewal Options

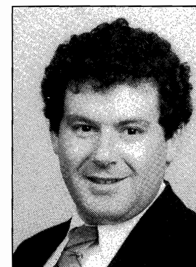
Similarly, when rents only went up and never came down, tenants willingly signed leases with "fair market value" extension options that included a "ratchet" clause. These clauses mean that rental rates during the option period can never be less than they were during the last year of the initial lease term. The proposition sounded reasonable enough, although irrelevant because everyone knew rents never went down.

Today, rents have gone down, and tenants are learning that the ratchet clause in a renewal option can make their option worthless.

If the tenant exercises its renewal option, it loses the benefit of today's lower rents. So, rather than renew, the tenant must renegotiate its lease. Undoubtedly, landlords will figure out how to extract a new rent that is above current market value — but not so far above it that the tenant moves out, leaving behind all the expensive custom build-outs it installed in the late 1980s.

In negotiating a "fair market value" extension option today, tenants should insist that this really means fair market value, without any artificial floor that protects the landlord but not the tenant.

These are but a few of the traps and pitfalls that the current real estate recession has created for tenants. Any company negotiating a new lease today should take advantage of the tough lessons learned from the past. By addressing these issues now, when tenants have the upper hand, they can negotiate deals that will protect their short- and long-term interests.



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