Exit And Restructuring Strategies For Retail Deals (With Form)

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It's not always possible to address every contingency, so build in some flexibility.

ENTERING INTO a retail deal, regardless of whether it involves a lease, ground lease, or pad sale, takes optimism. Each party enters into a new venture that it fully expects will be a mutual success. Unfortunately, the success of a retail enterprise relies in large part on the discretionary income of often fickle customers. The hottest concept one year may be old news the next season. Thus, the positive expectations that abound at the front end of a retail deal must be tempered with a certain degree of skepticism. Both sides need to craft exit tools, if the retail operation does not succeed. This article will address options for restructuring or, if need be, exiting a retail relationship. The discussion will focus primarily on leasing, but will also touch on arrangements in which a retailer owns a pad that is part of a larger development.

FRONT END PROTECTIONS • The logical time to structure exit strategies occurs during initial negotiations. Generally, a landlord's lease form contains all the bells and whistles the landlord needs to enforce the lease, but the tenant must expressly insist on provisions protecting its downside. Correspondingly, many national retailers have form leases and reciprocal easements agreements (REAs) that protect their interests, but do not offer the landlord or owner of the development viable options if the retailer experiences a downturn. The next section of this article discusses several common front end protections the parties may discuss.

Co-tenancy

A sophisticated tenant will look for assurances that the landlord will lease and operate the center as represented, both as a condition to the tenant opening for business and to the tenant paying fixed rent throughout the lease term. The tenant will want a requisite number of the proposed anchor tenants, which are the main draw to the center, to open. The tenant will also want the balance of the center to thrive, with a minimum percentage of the small tenants open to coax customers to stay and shop. If the center does not satisfy either of these tests, the tenant will initially want relief on its rent, and eventually the right to terminate the lease.

Co-tenancy provisions pose a significant risk for the landlord. The landlord cannot guarantee that any given tenant will remain in business. Even if a lease requires the tenant to remain open and operate for business, as a practical matter, courts have routinely refused to grant landlords the remedy of specific performance for such an obligation, on the grounds that the court cannot reasonably monitor an ongoing business operation. Co-tenancy provisions can have a domino effect, in which one store closing may trigger rent concessions or termination rights in a number of other leases. Thus, a wise landlord will negotiate for time to resolve a co-tenancy violation before tenant remedies come into play. The landlord will also want to tie the tenant's remedies to damages the tenant has actually suffered because of the co-tenancy violation. For instance, there may be a co-tenancy violation in the center that does not materially impair the tenant's sales. If the lease gives the tenant the unfettered right to pay reduced rent, the tenant may happily operate for years paying a fraction of its normal rent. This devalues the center and impairs the landlord's ability to refinance or sell it. Further, if the tenant has an ongoing termination right because of a co-tenancy violation, no lender or purchaser will allow any credit for that lease in valuing the center. Therefore, all co-tenancy remedies need to expire at some point. Either the tenant must terminate the lease or go back to full rent. A common structure for a co-tenancy provision would therefore look something like the following:

1. Landlord has X months after notice from the tenant to remedy the violation (the "Cure Period");

2. If the violation is not remedied within the Cure Period, the tenant thereafter pays percentage rent in lieu of fixed rent (and expense pass-throughs);

3. If the co-tenancy violation continues for X months (the "Cure Deadline"), the tenant thereafter has the right to terminate the lease upon X months' notice to the landlord;

4. If the tenant ceases doing business in the center at any time prior to the Cure Deadline, the tenant's remedies go away and full rent resumes;

5. If the co-tenancy violation continues for X months (the "Tenant Remedy Deadline"), the tenant must either terminate the lease or waive its termination right and return to full rent.

Gross Sales Thresholds

Sometimes a tenant will have doubts as to whether a location will generate enough sales to justify long-term operation. In that instance, the tenant may ask the landlord for a right to terminate the lease if its gross sales do not exceed a certain threshold. This presents several issues for the landlord. First, the landlord will need the tenant to commit to operate in the center long enough to attempt to grow a customer base. Second, underwriters will value the lease as if the termination right will be exercised. Last, the landlord may find itself out of pocket for leasing commissions, tenant improvement allowances and legal costs if the tenant terminates the lease. The landlord can protect against loss of expenses by providing that the termination option can only be exercised if the tenant reimburses the landlord for unamortized costs associated with the lease. A smart landlord will also ask for advance notice of termination, in order for it to have time to find another tenant. The landlord must also tie a termination option based on gross sales to a continuous operations clause. If the tenant goes dark, its sale will obviously drop, so the termination option needs to be contingent upon the tenant operating its business at full capacity. Thus, a termination right based on gross sales will often have the following features:

1. The tenant must operate for business at least X years, fully staffed, stocked, and fixtured (the "Test Period");

2. The tenant must report its gross sales to the landlord promptly during the Test Period;

3. The tenant must give the landlord at least X months' prior notice of its election to terminate the lease;

4. The tenant must elect to terminate the lease within X days following the Test Period or the termination option is waived;

5. The tenant must pay the landlord's costs associated with the lease, amortized over the initial lease term (at the time the Tenant exercises the termination option).

Pre-negotiated Termination Options

If a tenant has a high level of insecurity on the front end, it may ask for a simple termination option after an initial operating period, regardless of its gross sales. In such a case, aside from gross sales reporting, the landlord will have the same concerns as for a termination option based on gross sales, and the option will include items 3, 4, and 5 in the discussion of gross sales, above.

Landlord Solvency Concerns

Most discussions of exit strategies focus on problem tenants, but, especially in the current environment in which lenders are taking back properties, a tenant who is making a significant investment in its space will want assurances that the lender will not terminate the lease if it forecloses on the center. Generally speaking a lender will consent to a non-disturbance agreement at the outset of a lease, if the tenant likewise agrees to recognize (and attorn to) the lender as its landlord following a foreclosure. However, the tenant will not want to pay a foreclosing lender rent if the tenant has not received allowances the landlord has promised. At minimum, a tenant should ask for an offset right in its lease, allowing it to recover unpaid allowances before it must pay rent. If the allowance is significant and the tenant cannot or does not want to recoup its costs from the rent over time, the tenant may want the lender to agree to fund any unpaid allowances if it forecloses. This may present a significant issue for the lender, because it is one thing for the lender to receive reduced cash flow from the property, and something else entirely for the lender to invest additional sums after foreclosure. The resolution in this instance will likely be for the lender to require the landlord/borrower to escrow sufficient money to fund the improvement allowance as a condition of the lender approving the lease. These issues should all be sorted out in a subordination, non-disturbance and attornment agreement between the lender and the tenant, which may have the following provisions:

1. Lender agrees not to disturb the tenant's possession of the premises as long as the tenant is not in default;

2. Tenant agrees to attorn to the lender after foreclosure;

3. Lender agrees the tenant will have offset rights for unpaid allowances.

4. After foreclosure the lender will fund any unpaid allowance (if and only if the landlord escrows the allowance with the lender pursuant to a separate agreement).

The tenant may want additional protections from the landlord that allowances will be paid in a timely fashion, even if the lender does not take over the property. Possible forms of collateral include a parent guaranty, if the landlord is a single asset subsidiary, or a letter of credit. The tenant may also require that the landlord fund a build-out allowance aggressively, posting payment with the tenant before work is done so that the tenant need never come out of pocket for construction costs. Of course, this last option has its down side from the landlord's perspective, because if the tenant does not manage construction well or does not apply the money as anticipated, the landlord could find itself out of pocket for an allowance to a tenant that never opens in the center. Placing the allowance in escrow with a third party, such as a title company, may provide a compromise.

OPTIONS AFTER THE RETAILER IS IN TROUBLE • Although a party may try to craft exit options on the front end of the deal, this may not be feasible for a number of reasons. First, an early termination right may prevent a landlord from using a lease to finance construction. A 10-year lease with a termination right after three years constitutes a three-year lease in the mind of a lender. Further, a retailer simply may not have enough bargaining power to obtain a termination right. Anchor tenant deals are often break even for landlords and developers, who make most of their money on the small shop spaces. The unfortunate truth is that the small operator, who can least afford a downturn, often gets few or no exit rights at the time it executes its lease or buys its parcel. Small operators gain their leverage when the other side perceives that the business has a strong likelihood of failing if the parties do not restructure the deal.

When a tenant's business starts to struggle, the tenant must address whether its exit strategy consists of paying what is necessary to terminate the lease, or whether it can recast the economic terms of the lease so it can survive until the lease expires. Often a solvent national tenant that has successful stores elsewhere is worse off in negotiating an exit with the landlord than a "mom and pop" store than has no other assets. For a national chain, the landlord may insist on a check, while for a single store operator, the landlord may accept a more creative solution. Only then should the parties move forward.

Every restructure should begin with an assessment of not only the economics of the deal, but also what may be missing. As a preliminary matter, any party that is considering granting a concession should require the other party to deliver an estoppel certifying that it has no claims, offset rights or defenses to performance. If a guaranty exists, the guarantor should also confirm that the guaranty remains in effect without defenses. If there are other gaps in documentation, such as missing exhibits or commencement agreements, these should be plugged as well.

Sales, Subleasing, And Assignment Issues

Finding another party to take over the space, by sale, assignment, or sublease, presents the most obvious means of reducing the retailer's exposure. The average landlord lease form will permit some type of subleasing with landlord consent, and the laws of many states require landlords to act reasonably in granting such consent. Most REAs do not prohibit the transfer of the retailer's fee interest.

However, the retailer will need to examine the documents, not only for the provisions that expressly deal with sale, assignment, and subleasing, but also for more subtle ways a landlord or center operator can obstruct a transfer of the space. For instance, a narrow permitted use clause can block a new operation. The original retailer's business may have failed because of an unsuitable location. In this instance, another, similar use will not make the location a success. Thus, a restrictive uses clause may preclude any realistic exit opportunity for the retailer. Further, provisions that require the retailer to operate under a particular tradename will preclude transfer of the space unless the tenant has sold its business. Lastly, provisions giving the landlord or center operator control over exterior signage and alterations to the space may also obstruct a potential change in use.

What A Replacement Retailer May Need

Aside from the control provisions discussed above, other factors may make a site unappealing to a replacement retailer. For instance, a lease may provide that renewal options are personal to the initial tenant. This may make the lease unmarketable to a new tenant that needs a certain minimum guaranteed term to amortize its front end costs in taking over the location. Other provisions may require the tenant to submit financial statements and gross sales reports to the landlord on a regular basis, which may not jibe with the new tenant's accounting practices. Finally, if the new tenant intends to invest in significant improvements, it may need the lender to commit that the new tenant will not be disturbed in the event the lender forecloses on the shopping center. Similarly, if the new user is a subtenant, it may need the landlord to commit to continue the subtenant's occupancy of the premises if the original tenant defaults under the prime lease. If a new retailer is taking over a pad site, it may want assurances from the center operator as to what sums it must contribute under the REA and whether payments are current.

What The Landlord Needs

When a tenant requests landlord approval for a lease transfer, the landlord should review the lease to determine whether the tenant must provide documentation regarding the proposed user and whether there are time limits for the landlord's review. If the lease does not specify what information the tenant must supply, at minimum the landlord should request the name, address, and organizational documents for the proposed subtenant (such as a certificate of good standing from the state where it is organized), certified financial information for the new tenant and its principals, and a copy of the proposed sublease or assignment document. Other landlord concerns include the following:

1. Is the new tenant of a character or reputation or engaged in a business consistent with the shopping center?

2. Would the new use result in a reduction of gross sales or customer traffic?

3. Is the new user a government agency or instrumentality that might cause additional regulatory compliance issues or that would not be consistent with a high end center?

4. Would the use result in significant increases in the use of the parking areas or common areas by employees or visitors?

5. Is the use consistent with landlord's desired tenant mix?

6. Does the new operator have enough experience to ensure the success of the new operation?

7. Would the new use cause a violation of another lease or give another tenant the right to cancel its lease?

8. Has the new user negotiated with the landlord to lease other vacant space in the shopping center?

Not every proposed tenant will produce a positive set of responses to the above, but a landlord may feel stuck in a situation in which continuing a monthly rent source is the only "win." If the new tenant is not ideal, the landlord might consider improving its position under the lease. For any sacrifice that a landlord makes, it should consider renegotiating provisions such as co-tenancy requirements, exclusives, purchase options, expansion options, rights of first refusal, and other restrictions on leasing to potential tenants. A tenant might be willing to sacrifice these items in exchange for the reducing its economic exposure on the lease.

Rent Concessions: Reduced Fixed Rent

Many tenants in distress will come to the landlord and ask for a simple rent reduction. In assessing such a request, the landlord will need to consider a number of factors, which include the following:

1. How long will the concession last?

2. Will the tenant be obligated to repay it through higher rent later in the lease?

3. What if the tenant defaults, should the concession end?

4. Can the landlord recover the concession if the tenant defaults? (This may be difficult if the tenant bankrupts, but it may be possible to secure this duty with a guaranty from another party.)

5. Can the landlord lease the space for higher rent? (If so, the landlord may want a termination option if it finds another tenant at some point.)

6. Is the reduction personal to the tenant or would an assignee or subtenant have the benefit? (At minimum, the tenant should not be able to sublease the premises for more than the reduced rent without the profit first going to repay the concession to the landlord.)

Percentage Rent

If a retailer cannot find another user, it may be more economical for the retailer to shutter its space than to operate its business at that location. As discussed earlier, this can create problems for a landlord that has co-tenancy requirements in other leases. If the landlord faces the possibility that another tenant will terminate its lease or pay reduced rent because of low occupancy in the center, a distressed tenant may be able to convince the landlord that a rent concession provides a viable means of keeping not only the tenant, but also the center, afloat. Percentage rent, based on the gross sales from the location, often provides a good alternative either in combination with a reduction in fixed rent or in lieu of fixed rent entirely. Of course, the landlord should connect any agreement to accept percentage rent in lieu of fixed rent to an operating covenant. If the tenant were to close its business, the fixed rent must resume.

Lease Buyout

If the tenant is not strapped for cash, but its business suffers at a particular location, the tenant may be able to offer the landlord a lease buyout. The actual dollar figure will depend on a number of factors, including how long it will take the landlord to find another tenant, the cost of retrofitting the space for a new tenant, brokerage commissions, and how much time remains on the lease. Generally speaking, the later the buyout occurs in the lease term, the lower it will be, since the landlord will have recovered most of its front end lease costs through receipt of rent.

Giving The Landlord A "Hunting License"

If all else fails, one simple way of encouraging the landlord to relet the premises is to give the landlord a "hunting license," that allows the landlord to terminate the lease in the event it finds another tenant to take the space. The hunting license provides the landlord assurance that, if it spends the time and effort to relet the premises, the original tenant will not hold the space hostage for concessions later on. (See the form at the end of this article.

DO NOT FORGET THE LENDER • Parties often forget that the lender usually has the biggest economic investment in a retail center. In most workout discussions, determining whether the lender must approve the deal comes only as an afterthought. The landlord will want to ensure that any deal its strikes with the tenant will not imperil its position with its lender. For instance, the landlord cannot agree to a rent concession that would put it in default of a covenant relating to the debt service coverage or requiring lender consent for lease modifications. Further, the lender might extract concessions for approving a lease restructure. The lender might require the landlord to post reserves for debt service, tenant improvements, and leasing commissions. Such reserves can impair the landlord's cash flow well beyond any rent concession requested by the tenant. Also, if the property is a phased development, a construction lender might refuse to release funds for construction of later phases when existing phases are not meeting pro forma projections. Thus, at the outset of any workout discussion, the landlord should read its loan documents and visit with its lender.

CONCERNS WHEN THE RETAILER OWNS ITS PAD • Retail centers often combine property owned and leased by a developer and outparcels or pads owned by the retailer. Usually such arrangements include an REA that requires each party to perform certain obligations. The retailer will often contribute some amount toward the overall maintenance of the parking and other common areas serving the center. If either the retailer or the landlord gets into financial difficulty, the overall quality of the center may decline. Thus, a well-written REA will protect against this eventuality by giving the parties self-help rights to perform obligations and collect the sums expended from a non-performing party. Often, this will include the right to lien the property of the non-performing party for unpaid sums. An exceptionally strong retailer or developer might even require that this lien primes the lien of any lender on the non-performing party's parcel, so that the lender will ensure its borrower pays these sums.

The operator of the center might also worry that a derelict outparcel will impair the rest of the center. Thus, in addition to having the right to maintain that parcel if the retailer fails to do so, the center operator may want the option to repurchase the retailer's parcel if it closes its business. The calculation of the purchase price will have a number of permutations, including whether the retailer has constructed improvements, how long it has had to amortize the cost and whether the improvements have any residual market value.

CONCLUSION • Retail restructurings have become commonplace. The threshold question for any retail deal is what happens if things do not go as planned. Ideally, the parties should address these concerns when they enter into the deal. However, the parties may still have options for restructuring that make sense if the deal gets into trouble down the road. In any event, to formulate the best solution, each party needs to understand the concerns and drivers for the other side. If the parties can salvage the deal, or at least provide a temporary respite until things turn around, they both will benefit.

APPENDIX
Termination Option

THIS OPTION AGREEMENT is made as of the _____ day of _________, 20___, by and between ___ ___________________, a _____________________ (the "Landlord") and ____________________, a ___________________________ (the "Tenant").

W I T N E S S E T H:

WHEREAS, by that certain lease agreement dated ________________________________ (the "Lease"), Landlord leased to Tenant certain premises known as ________________________ (the "Premises"); and

WHEREAS, Tenant desires to terminate its Lease, and Landlord has agreed to do so if Landlord locates a replacement tenant for the Premises upon terms and conditions acceptable to Landlord; and

WHEREAS, the parties have agreed that in the event Landlord negotiates a lease of the Premises with a replacement tenant, Landlord shall have the right to terminate the Lease;

NOW, THEREFORE, in consideration of One Dollar ($1.00) and the premises and the mutual covenants herein contained, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

1. In the event Landlord negotiates a lease of the Premises with a replacement tenant upon terms and conditions satisfactory to Landlord in its sole discretion (the "New Lease"), Landlord shall have the right to terminate this Lease effective as of the commencement date of the New Lease (the "Termination Date"). If Landlord makes such election, Tenant agrees that it shall surrender possession of the Premises to Landlord in the condition required under the Lease, effective as of the Termination Date.

2. In consideration for Landlord's agreement to terminate the Lease as provided herein, within ten (10) days following receipt of the Termination Notice; Tenant shall pay Landlord (the "Termination Fee"):

a. A fee in the amount of ________ and No/100 Dollars ($________);

b. All rent and additional rent that would otherwise have come due under the Lease for ________ following the Termination Date;

c. All commissions paid by Landlord in connection with the New Lease;

d. All attorneys' fees incurred by Landlord in connection with this Agreement and any new lease.

Further, Tenant shall pay all Minimum Rent and Additional Rent when due under the Lease through the Termination Date.

3. If Landlord terminates the Lease pursuant to this Agreement, and Tenant fails to pay the Termination Fee as and when required by this Agreement, the provisions of the Lease governing monetary defaults shall be applicable, and Landlord shall be entitled to all remedies to which it may be entitled at law, in equity, and under the Lease for such default. In no event shall Tenant be entitled to regain possession of the Premises after the Termination Date. Tenant acknowledges that Landlord has entered or will enter into a lease of the Premises to another tenant contingent upon Tenant's execution of and performance under this Agreement. Tenant shall indemnify and hold Landlord harmless from and against any and all loss, liability, damages, claims and expenses, including but not limited to reasonable attorneys' fees, that Landlord may suffer on account of Tenant's breach of this Agreement.

4. Landlord hereby agrees that, if Landlord exercises its termination right, Tenant shall be released from all obligations and liabilities of the Tenant to be performed under the Lease from and after the Termination Date, excluding (a) the obligation to pay the Termination Fee; (b) any indemnity obligations of Tenant under the Lease; and (c) any other obligations that expressly survive the termination or expiration of the Lease.

5. Tenant hereby agrees that, if Landlord exercises its termination right, Landlord shall be and is hereby released from all obligations, duties, and liabilities of Landlord to be performed under the Lease from and after the Termination Date.

6. Nothing herein shall be deemed to obligate Landlord to enter into a lease with a replacement tenant, nor to use efforts to lease the Premises before leasing other vacant space in the building in which the Premises are located, and Landlord shall have no liability whatsoever to Tenant if Landlord, in its sole discretion, elects not to enter into such lease.

7. Tenant hereby certifies to Landlord the following:

a. The Lease is in full force and effect, has not been modified, amended, or supplemented in any way except as may be set forth above. The Lease constitutes the entire agreement between Landlord and Tenant. No other agreement exists between Tenant and any other party with respect to leasing, possession or ownership of the Premises;

b. Tenant has not assigned the Lease, sublet all or any portion of the Premises or otherwise transferred or pledged any interest in the Lease or the Premises;

c. Landlord has complied with all terms, conditions and provisions of the Lease to be complied with by Landlord and no event has occurred and no circumstance exists that would, with the passage of time or the giving of notice, or both, constitute a default by Landlord under the Lease. There is no existing basis for Tenant to cancel the Lease or to exercise any other remedy available to it by virtue of a default by Landlord;

d. There are no charges, liens, defenses, offsets, claims or credits known or asserted by Tenant against the payment of rent or other charges, or the performance of Tenant's obligations under the Lease.

8. This Agreement shall be binding upon and inure to the benefit of the parties hereto, their successors and assigns.

IN WITNESS WHEREOF, the parties have executed this Termination Option as of the day and year first above written.

LANDLORD:

____

By:___________________________

Title:_________________________

TENANT:

____

By:___________________________

Title:_________________________

ACKNOWLEDGEMENT OF GUARANTOR

The undersigned Guarantor hereby approves the foregoing instrument. The undersigned acknowledges and agrees that: (a) its lease guaranty dated ______________ (the "Guaranty") remains in full force and effect, without any defense to the performance of Guarantor's obligations thereunder; and (b) payment of the Termination Fee is part of the guaranteed obligations under the Guaranty.

GUARANTOR:

____

By:___________________________

Title:_________________________