

Mining Silver From a Gray Real Estate Market: Hidden Value in Leases

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As part of senior management, general counsel are being asked to pare their own budgets and help eliminate non-essential business activities and assets across their companies. Real estate assets and obligations can be an unexpected source of hidden value. Mining that value requires the skills of in-house, and sometimes outside, counsel in reviewing existing agreements, negotiating and documenting modifications, a process that also proves the value of the legal department as a cost-saving, rather than cost, center. Leases, purchase agreements and mortgage arrangements all provide areas of opportunity. This article examines key opportunities that lease reviews can uncover.

Whether the company is a landlord or tenant, the company's counsel may well find areas of opportunity in the intricate provisions of its leases. Some areas for focus:

COST-SHARING PROVISIONS – Many leases contain complex cost allocations between landlord and tenant, which are frequently misconstrued by property managers. A careful review of these clauses will often yield savings to one party or the other (but usually the tenant). There are auditors who perform such reviews, often on a contingency basis, but lawyers are preferable—the provisions require careful analysis and, if handled too brusquely, such audits can permanently damage the landlord/tenant relationship. Some shared costs, such as property taxes, decline with the value of the property, and many leases give both landlord and tenant the right to appeal the assessment, thereby lowering the costs of both. A landlord or tenant (particularly a ground tenant) with the right to depreciate its investment may benefit from having its depreciation schedules reviewed by a cost-segregation specialist. Bear in mind that as we enter a heavier tax regime, it may make sense to defer any savings discovered to future years, when the depreciation benefit can offset higher taxes.

OPTIONS, ROLLOVERS, RENEWALS – Depressed markets give tenants substantial bargaining power over renewals. A resourceful tenant will perform diligence on the landlord's financing and balance sheet, to determine if the landlord is particularly vulnerable and motivated to provide favorable terms. Examination of title to the property and the court dockets may reveal that the landlord used short-term financing approaching maturity or is in default on its loans. Evidence of long-term leases from credit worthy tenants enhance a landlord's ability to obtain refinancing in the current market. This dynamic, plus diminished market demand, will give a renewing tenant significant bargaining power. However, the landlord will frequently require an extension of seven years or more as a condition of granting its best terms. A renewing tenant should beware rent provisions tied to inflation as we enter a period of expected increases in the cost of living. A careful lawyer should also make sure that any renewal or modification complies the terms of the financing documents governing the property, including mortgage documents, such as loan agreements, mortgages, estoppel certificates and nondisturbance agreements. If the lender is entitled to consent to any renewal or modification of the lease, landlord and tenant want to obtain such consent so that the lender is bound. Many observers anticipate that the abundance of "short money" loans and the weakened market will lead to an increase in commercial mortgage defaults over the coming 12 to 18 months. A tenant in such a property may prefer to go elsewhere, even foregoing an aggressive set of terms from the landlord, to avoid the difficulties any building suffers during foreclosure.

COVENANTS – Review the covenants governing the landlord's and tenant's obligations to perform, to see if they are being met. Some, such as those requiring the tenant to continuously operate, or to do so only if surrounding tenants do so, may give one party or another leverage under the lease. Examine whether the applicable covenants are enforceable in the relevant jurisdiction.

PURCHASE OPTIONS – Purchase options tied to fair market value may give tenants a fleeting right to acquire their premises at historically low prices. Even if tenants lack the necessary capital reserves to pay cash, they may be able to obtain favorable, even nonrecourse financing, if their balance sheet is strong. Consider regional and community banks as lenders for purchase transactions as they have substantial capital and take particular pride in lending in their communities.

SALE/LEASEBACKS – Some companies may want to sell their facilities and take back a long-term lease, to realize needed operating capital and gain the deduction that rental payments provide. Needless to say, great care must be taken to evaluate the tax effects of a sale, sale/ leaseback or 1031 exchange.

BANKRUPTCY – Recent changes to the Bankruptcy Code require that parties to executory contracts, such as leases, act with greater decisiveness and alacrity to preserve their rights. Evaluate the solvency of the other party in any modification of a company's real estate obligations. Also, landlords should use renewals to gain enhanced security from tenants. For instance, letters of credit may provide superior collateral to cash deposits and even guaranties in the event of a tenant default, provided the issuing bank remains creditworthy.

In summary, a careful review of a company's leases can yield opportunities for savings that counsel are particularly able to identify, enhancing the company's bottom line and the importance of in-house counsel. One caveat: don't put off lease reviews. The sooner the negotiation begins, the

better able landlord and tenant are to reach a mutually agreeable solution.