

# To Fish or Cut Bait?



## Steps for Evaluating Whether to Provide a Distressed Tenant with Rent Concessions Needed to Weather the Economic Downturn



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**W**ith revenues decreasing and operating expenses as costly as ever, many businesses are having great difficulty remaining solvent and viable during this economic downturn. Rent and related tenancy costs often constitute a significant portion of a business's operating expenses. As a result, it is becoming increasingly common for tenants to approach their landlords with the proverbial hat-in-hand asking for rent concessions to help them weather the downturn. A tenant's request for rent concessions places a landlord in the unenviable position of determining whether to strictly enforce the rent terms under the

lease, risking the failure of the tenant's business and a resulting vacancy, or to provide the rental concession and take the financial hit for the loss in revenue. If your tenant is fishing for a rent concession, should you fish or cut bait?

### *Step #1:*

#### **Evaluate Your Re-Leasing Options for Space in the Current Market.**

Your primary consideration as a

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landlord should be whether you can sustain the costs associated with re-leasing the space or carrying a tenant vacancy if the tenant's business fails. First, determine whether there is active market for the space or whether you are instead likely to have a long-standing vacancy. If the rental space is marketable, you need to perform a careful analysis of the lease terms for comparable rental to determine the effective rent per square foot, factoring in tenant improvement allowances, free-rent periods, build-out periods and other customary tenant concessions. Do not forget that initial costs will likely include brokerage commissions for re-leasing the space. Should you ultimately discover that a re-lease under market terms will generate no more revenue than the adjusted rent with the tenant's requested concessions, then your decision to provide the concessions will be markedly easier. Conversely, if the market for similar rental space is strong and the market rent and terms similar or more advantageous to those in your current lease, you may be better refusing to grant the concessions.

## Step #2:

### Assess the Financial Condition of the Tenant

You must take care to protect yourself against two types of tenants: (1) the unsalvageable tenant whose business is likely to fail with or with-

out the rent concession, and (2) the opportunistic tenant who is taking advantage of the downturn to renegotiate the terms of its lease. Rent may only be a small portion of the tenant's cost of doing business. Perform the necessary due diligence by obtaining complete and accurate financial statements from the tenant. Based on your review of the financials, you can better determine if the tenant is a lost cause or whether a properly structured concession will enable the tenant's business to remain viable.

## Step #3:

### Assess Your Ability to Grant a Concession

Since owners and landlords are not immune to this economic down-cycle, you must determine whether you have the financial ability to grant these concessions or to absorb the releasing costs of the alternatives. It would be advisable to consult your lender, and to seek their approval or to seek some corresponding accommodation on the lender's part. Many loans impose restrictions on modifying leases without first securing lender approval. There are even circumstances when ignoring these provisions can trigger personal liability. All of these considerations become especially important if the overall debt service coverage is marginal or insufficient. In considering the type and

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duration of any concessions you should consider the potential impact of a reduced rental rate, or a vacancy, on a later refinancing.

## Step #4:

### Know Your Rights under the Lease

You should review your rights under the lease in the event of tenant's default in payment of its rent, abandonment of the premises or filing of a bankruptcy petition. In addition to standard remedies such as lease termination or a claim for damages, you may have additional protection in the form of a security deposit, letter of credit or lease guaranty. The security deposit and letter credit, however, may not be in amounts sufficient to cover the costs of re-leasing the property, and the automatic stay in the tenant's bankruptcy will render the security deposit inaccessible and may have the same effect on the letter of credit. A guaranty of payment and performance under the lease secured by a creditworthy party is the best form of protection against a failing tenant; although in many cases,



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If you decide that it makes financial sense to grant some concession, then you must make sure that you structure the concession thoughtfully, allowing an opportunity to recoup initial losses in the future.

the guarantor's largest asset is its interest in the tenant's business: so if the business goes under, so does the guarantor's credit and your ability to collect.

## Step #5:

### The Decision - Weighing Your Options

Taking into account the above considerations, you can reach a well-reasoned determination on whether to (i) grant the rent concessions to help sustain a salvageable tenant and avoid a costly default or bankruptcy; or (ii) enforce the lease to cut your losses now with a tenant that is beyond saving, or who is simply being opportunistic and looking to cash-in on the economic downturn.

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you must make sure that you structure the concession thoughtfully, allowing an opportunity to recoup initial losses in the future. Rather than strictly abating rent for a period or reducing the rent by a certain percentage to meet the tenant's needs, you can instead defer the rent, allowing sufficient time for the tenant to weather the downturn, while ultimately providing for a catch-up in rent once the tenant's business improves. You may want to include an interest component in the deferred rent to provide yourself with a reasonable

return. Since every circumstance is different, you must take into account the particularities of the property and the tenant in deciding--when your tenant comes to you fishing for a rent concession--whether to fish or cut bait.

**o&c**

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