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# **Fundamentals of Commercial Leasing in a Depressed Economy**

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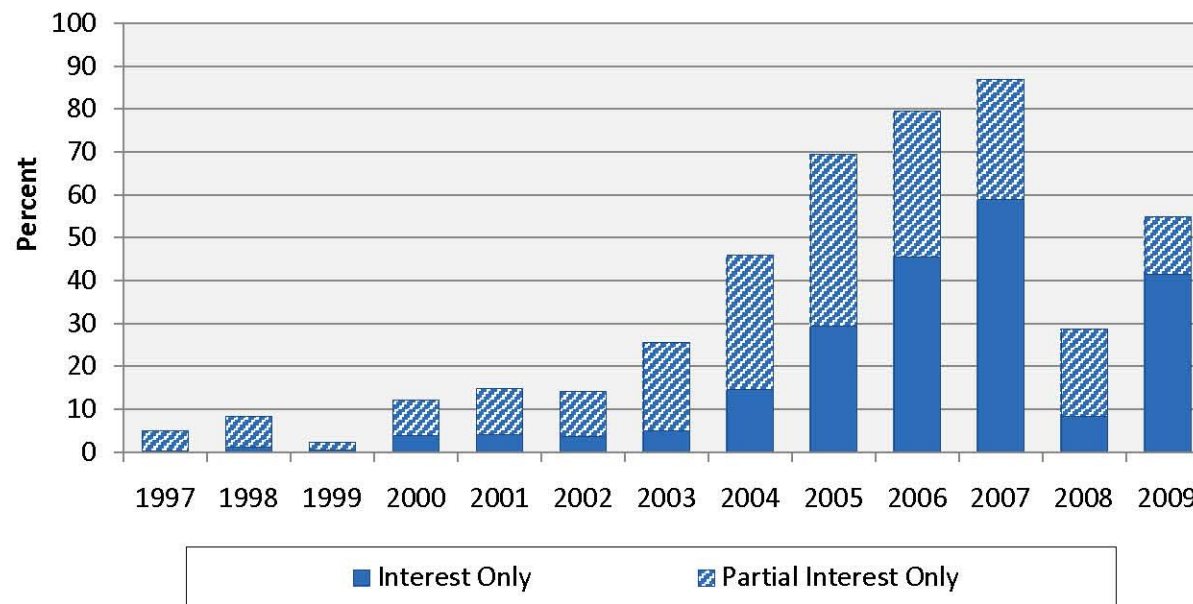


# **Erosion of the Commercial Real Estate Market Since 2007**

- Between 2010 and 2014, around \$1.4 trillion of commercial loans will reach maturity.
- Nearly 50% of these loans are currently "under water".
- Values have fallen more than 40% since the beginning of 2007.
- Bank losses alone could range as high as \$200-\$300 billion for 2011 and beyond.

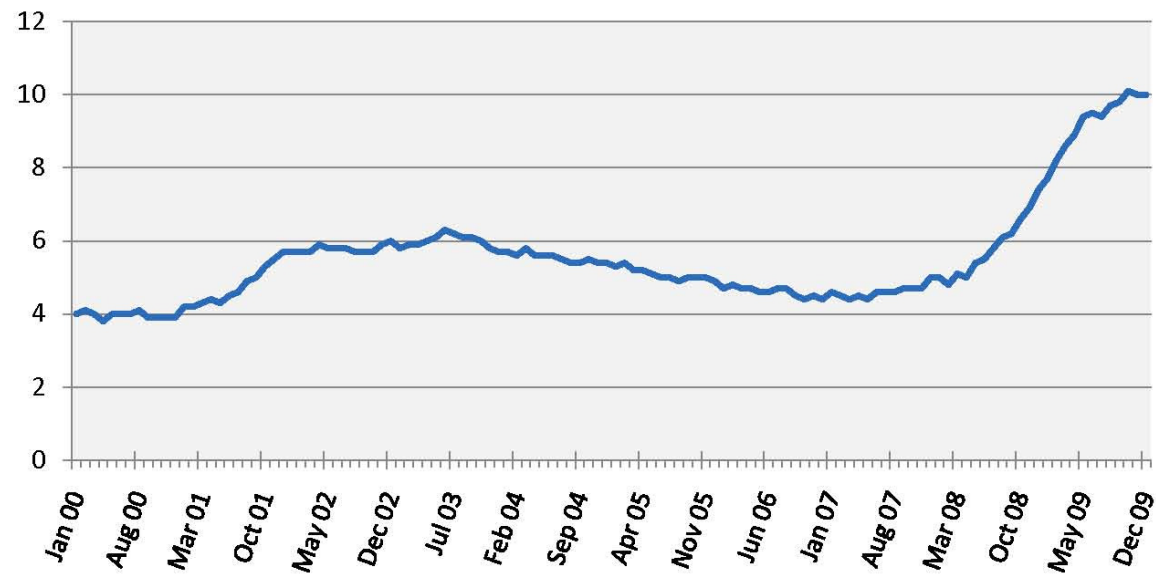
# Problematic Underwriting of CMBS Loans

- Lax underwriting standards were evident in CMBS transactions from 2005-2007.
- Loans were originated based on overly aggressive rental or cash flow projections.
- Interest-only loans amounted to only 6% to 9% in the CMBS market in the late 1990s. These loans were the majority in 2005-2007.



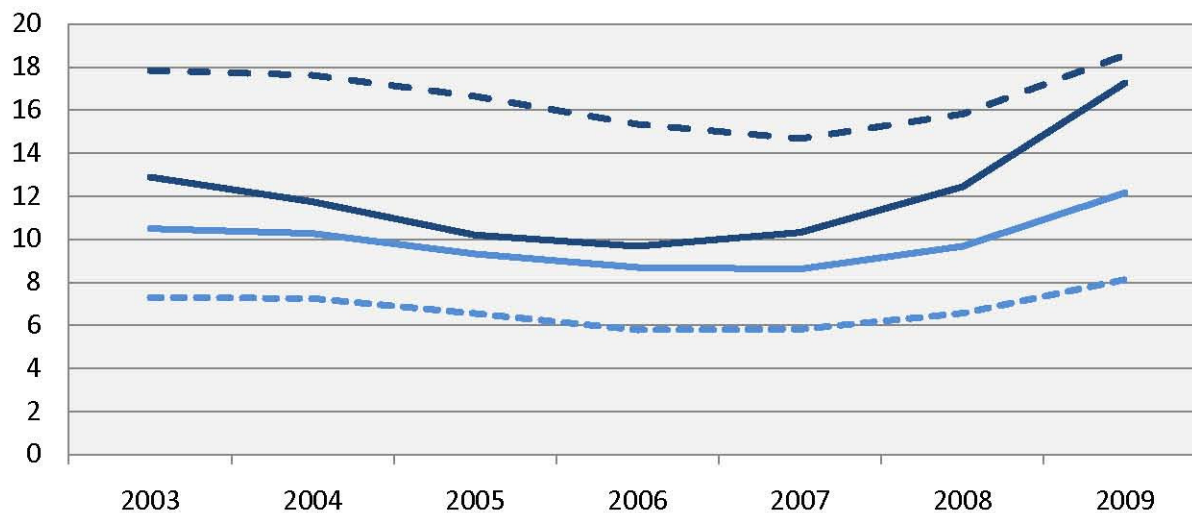
# Deteriorating Market Fundamentals

- Unemployment figures have risen to levels not seen in decades.



# Commercial Vacancies

- Vacancies rates are reflected by property type.



Office  
Retail  
Industrial  
Multi-Family

# Some Lease Default Alternatives

## Should the Landlord Keep the Tenant in the Premises?

- Some rent will continue (with luck).
- Retail premises will remain occupied, avoiding co-tenancy issues.
- The landlord will probably have to make rent or other accommodations.

## Is Rent Acceleration an Option?

- What does “acceleration” mean in your state? Is mitigation required?
- This right to either type of “acceleration” must be granted in the lease.
- The states that permit rent acceleration, without a mitigation factor, may restrict the landlord’s right to re-enter the space if it exercises this remedy.

# Various Default Scenarios

## Re-Entry Without Lease Termination:

- Not enforceable in some states except in abandonment.
- This right must be granted in the lease.
- Rent is generally payable only as it comes due.
- The landlord will probably be obliged to mitigate its damages, though the lease can provide that the landlord is not obligated to lease if other space is available, or to lease for another use.
- The landlord's obligation to mitigate conflicts with the principle that the lease remains in effect. Mitigation attempts may lead to termination.
- California requires that the lease permit the tenant to sublease or assign the space, subject to reasonable standards, if the landlord wishes to re-enter and continue to collect rent.

## Lease Termination:

- Traditional law requires that this right be granted in the lease.
- The landlord's termination of the lease may cut off its right to continue to collect rent.
- If the termination is in a circumstance in which the landlord is permitted to continue to collect rent (for example, abandonment), the landlord may be obligated to mitigate its damages.
- Courts have difficulty awarding damages for loss of future rents, unless the lease provides for liquidated damages.



## Dark Space in Retail Leases

- "Dark Space" occurs as more tenants consolidate, go out of business or default on leases.
- Landlord co-tenancy violations may permit in-line tenants and anchors to "bust" their lease or "operating covenant" respectively.
- In healthy economic climates, use restrictions will prevent "dark space" from being occupied by non-traditional users.
- In the current economy, tenants and landlords are working together to modify use restrictions in favor of non-traditional retail users.





# What Happens If Your Landlord Files Bankruptcy

- In the commercial property field, there is a tendency to contemplate that the tenant, not the landlord, will file bankruptcy.
- Landlord's bankruptcy is addressed by Section 365(h)(1)(A).
- Under Section 365(h)(1)(A)(i), the lessee may treat the lease as terminated in certain events.
- The lessee may instead retain its rights in a lease, if the lease has commenced, "to the extent that such rights are enforceable under applicable nonbankruptcy law".



# Percentage Rent Only Leases

- Some retail tenants are negotiating short term leases, with percentage rent only, and no breakpoint.
- The upside for the tenant is that rent is tied to actual sales.
- The upside for the landlord is that rent increases with sales.



# Rent Relief To Keep A Tenant

- Secure tangible benefits, as a consideration for restructuring the relationship.
- Eliminate tenant-favorable provisions - kick-out clauses, right of 1st refusals, co-tenancy protection.
- Negotiate new landlord-friendly clauses - tax refunds, right to relocate, right to terminate.
- Make relief personal, and unavailable to successors and assigns

# Rent "Holidays" To Induce New Leases

- Will the tenant occupy, for a period, free of charge, or will operating expenses and taxes be paid?
- Will the foregone rental ever be repaid, i. e. amortized for recovery upon default?
- Require security deposits or lease guaranties, even if they "burn off".
- Provide for commissions to be paid in installments, so that the brokers share the risk.

# Tenant Allowance (TA) For Tenant Improvements (TI)

- One of the most significant current “new lease” issues from the tenant perspective is whether the agreed tenant allowance funds will be available to reimburse the tenant. Alternate forms of tenant assurance include the following:
  - SNDA-Lender’s are reluctant to agree to continue to fund TA if the landlord/borrower defaults on the mortgage.
  - Letter of Credit-Costly for landlord
  - Cash Escrow-Costly for landlord
  - Front Load (tenant gets more TA funded before construction starts instead of making draws as work progresses)
  - Deep rent concessions (including free rent) for specified period during initial lease term permitting tenant to control and fund TI





## **Drive-Thrus; New Opportunity in a Weak Economy**

- End caps of struggling shopping centers become low-cost alternatives for fast-food and other drive-thru operators.
- Less costly than building a free-standing store.
- The corner location is good exposure.
- Popeyes Chicken and Biscuits uses end caps to train new franchisees.
- End cap players include Panera Bread, Applebee's, Quiznos, Pizza Hut, Subway, Taco Bell, McDonald's and Jamba Juice.



## **A Philly Boutique, Financed In An Innovative Fashion**

- A boutique opened at 1700 Sansom, in Philadelphia, PA, late last August.
- About 80% of the products carried are made in Philadelphia.
- Seamstresses and tailors make up a workforce that created 20 jobs locally.
- The Philadelphia Industrial Development Corp. lent assistance to financing. PIDC and a local bank each invested 45%. The remaining 10% is equity.
- A separate grant from Philadelphia Workforce Development enabled an 8 week training program for new employees.



# Real Estate Trends in the Medical Marketplace

- The 1990s saw a decentralization of services, such as ambulatory surgery centers, imaging centers and medical office buildings.
- In some instances, medical facilities have occupied vacant retail space.
- The medically related commercial real estate market has been relatively resilient during the general slump.
- With the recently passed federal legislation, there will be an increased population served.
- An effect of the changes will likely be a reversal of the trend to suburban locations.
- The differential in reimbursement, which has been a factor in the proliferation of ASCs and imaging centers, will be reduced, to the benefit of acute care hospitals.





# The Popularity of the Ethnic Mall

- As early as the late 1980s there were in Los Angeles, Miami and Newark malls specializing in sub-cultural tastes and frequented by the corresponding ethnic groups.
- An 80,000 square foot Asian market was described in *The Christian Science Monitor* last August as having 10% increases in sales for the last 2 years.
- Fort Worth Town Center is now a 1.1 million square foot Latino mall, with 150 retailers. In 2005, this aging 1960s structure was only 10% occupied.
- Many ethnic malls are doing well. Factors cited include customer loyalty, cultural attitudes about savings and the growing population of these demographics.
- The typical ethnic mall focuses on a narrow, underserved group of shoppers.



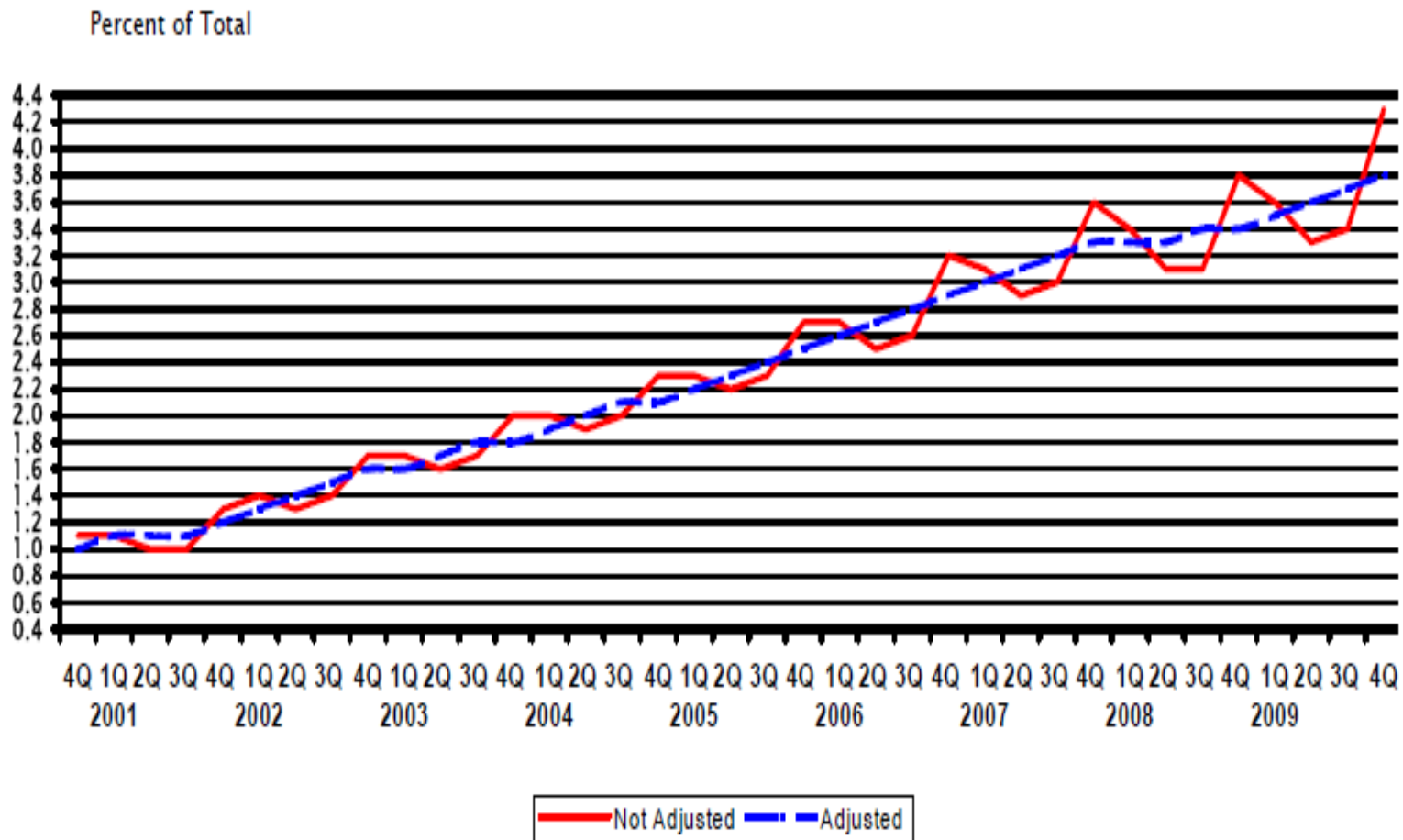
## **A November, 2009 Ribbon Cutting**

- Millenia Crossing, a 90,000 square foot retail center, opened in November, 2009, with an occupancy rate of 74%.
- The property was anchored by Nordstrom Rack, a popular store at which prices are discounted 50-60%. Heavy traffic is expected.
- The Nordstrom Rack outlet was only its second location in the state of Florida.
- Millenia Crossing was 1 of the few retail projects completed and opened in the Orlando market in 2009.

# Estimated Quarterly U.S. Retail E-Commerce Sales as a Percent of Total Quarterly Retail Sales:

4th Quarter 2000 – 4th Quarter 2009

Source:





# Online Retail Sales Set a Single-Day Record

- Tuesday, December 15, 2009, was the first day ever to top the \$900 million mark, according to ComScore, having estimated e-retail sales of \$913 million.
- For the 5 days ended December 18, 2009, 45% of web retail sales included free shipping, up from 38% during a similar period in 2008.
- Free shipping can be used by e-commerce retailers to encourage higher spending. During the week ended December 6, 2009, for example, the average order involving free shipping was \$134, while orders for which the customer paid shipping averaged \$103.