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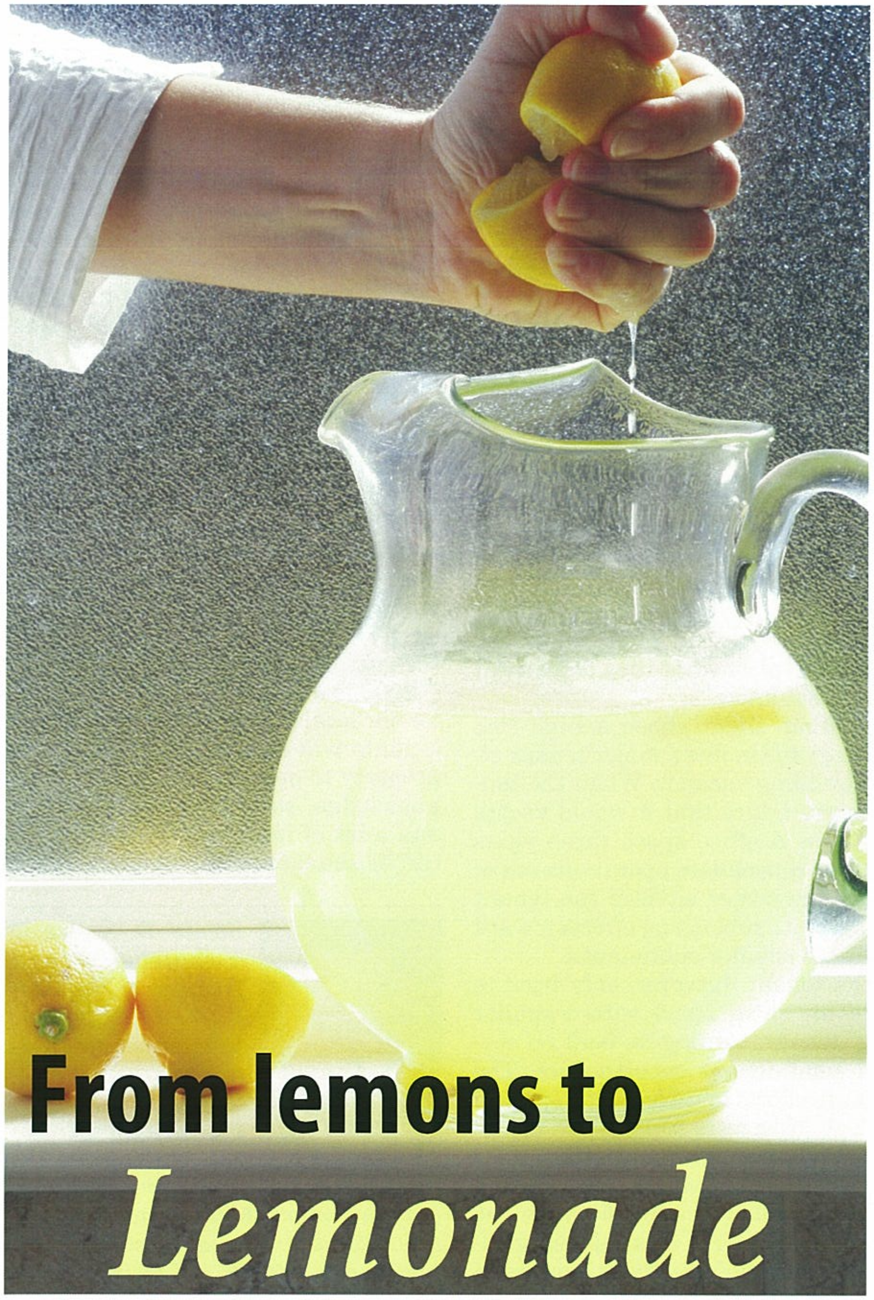

From lemons to *Lemonade*

Successful management of lease termination negotiations can lead to new opportunities for commercial property owners

By Steven D. Sallen

"It's been a wild ride this year in retail real estate."

So began a compendium of major retail real estate news stories from 2007 posted on the CoStar Group's Web site. Reading through it, I was struck by two apparent trends:

- On the mall-owner side, there seemed to be dozens of major mergers, portfolio acquisitions and joint venture deals made by some of the country's largest retail real estate owners and developers.
- On the tenant/retailer side of things, however, major and familiar store and restaurant chains closed thousands of stores and in some cases closed up business altogether. This national outlook of store closings refutes the idea that Michigan is "ground zero" for this kind of thing.

Being a bit of a wordsmith, I also was struck by some of the euphemisms used to describe these major store closings and related transactions (emphasis added on all):

- "Foot Locker Closing 250 Stores, Exploring *Strategic Alternatives*."
- "DJM [a prominent store liquidation firm] announced the successful completion of the Discovery Store *disposition project* in November …"
- "CompUSA … finally gave up via an *acquisition by liquidation* …"

My own experience in 2007 included store-closing and lease-buyout negotiations with some of the tenants and lease "disposition" firms mentioned by CoStar.

While every store closing presents its own unique challenges to the property owner, if handled properly (and with a little luck) they can also present *new opportunities* for the commercial property owner.

For example, in one case we successfully negotiated a significant lump-sum lease buyout payment that was almost four times greater than the store liquidation firm's opening offer; then within four months, the shopping center owner found a new tenant to take over the space at a lease rate that was only slightly less than the original tenant had been paying.

The economics for the owner turned out to be the proverbial "home run," as the lease buyout payment far exceeded the sum of the cost to carry the space for the months between store closing and new tenant leasing, plus the rental difference over the term of the new lease.

Lease buyout negotiations are best handled from a position of power, and, in the case of retail store closings, knowledge is power to the property owner. To manage a successful lease termination negotiation, accurate information is key. Answers to these and other questions are crucial to success:

- Is the tenant closing all of its stores, or just some of them?
- Who is handling the store liquidation (or disposition) process for the tenant, and what is their track-record or *raison d'étre*?
- What is the tenant's (or any lease guarantor's) general financial condition?
- What is the market value of the remaining lease term, and what are the short- and long-term prospects for the tenant to sublease or for the owner to lease the space?
- What are the owner's mortgagee's rights in regards to any lease termination, and must they give their approval?
- Is a tenant bankruptcy pending, threatened or otherwise a possibility?

Conveniently, much of the information a shopping center owner needs to make informed decisions and negotiate from a position of strength is available on the Internet, especially where the tenant is a nationally branded name.

For example, publicly traded companies file SEC documents; these may explain the scope and purpose behind closing a block of stores, while also laying out the company's (or its parent's) overall financial condition and going-forward plan.

Information about specific tenants may also be available on "the street." Contact brokers, appraisers, other clients or lawyers who might be cooperative in providing information that they know about specific stores. Also, ask the tenant or the disposition firm handling the store liquidation; after all, if they want to amicably terminate the lease with the owner, some level of cooperative sharing of information is expected.

Of course, beware of voluntarily divulged information, especially from lease disposition firms. They will tell you what they want you to know, but not necessarily what they don't want you to not know.

Another client chose a high-risk strategy to resolve a major tenant office building vacancy. When the tenant gave notice that it would vacate its Class A office space three years early to consolidate operations out of state, the owner advised the tenant to direct its subleasing efforts toward multiple smaller subtenants.

The tenant, however, only tried to refill the entire space with a similar "big" tenant, turning its back on several small-tenant opportunities. The tenant's efforts to sublease the space to a single user were fruitless, as the local market was saturated with similar large blocks of premium office space.

The owner worried that, with the tenant in control of subleasing efforts, when the lease term expired in three years, it would get back possession of the space, still vacant, just months before maturity of its mortgage. But the owner understood that the key to re-leasing the space would be to divide up the space into smaller tenant units, and to seek out multiple smaller users.

Confident of his prospects for re-leasing smaller units, the building owner formed a new limited liability company and negotiated a favorable sublease with the tenant; an affiliated company sublease was required due to loan document prohibitions against compromising any lease.

Now, the owner, through its affiliated entity, is actively sub-subleasing incremental spaces to smaller — and more lucrative — tenants. The goal is to be 100 percent occupied by loan maturity, and then to sell or refinance the building.

Will this high stakes gamble payoff? Only time will tell, but early sub-subleasing efforts have been promising, and generating leasing activity where the tenant had virtually no success with its efforts to sublease the entire space.

2008 is likely to be much like 2007 for our local real estate market. More tenants will be looking to give back property to owners. But with a little knowledge, some creative planning and a bit of luck, even these lemons can be squeezed into lemonade.

Steven D. Sallen is a shareholder and member of the Executive Management Committee at Maddin, Hauser, Wartell, Roth and Heller, PC. He concentrates his practice in the areas of real estate law, environmental law and corporate law. Contact him at sds@maddinhauser.com or (248) 355-5200.