Taking the Stress Out of Distressed Property

by Thomas S. Smith

After a decade of solid performance for the real estate market, REIT investment and other commercial real estate opportunities are greater than ever. Retail sales at shopping centers increased by $109 billion in 1999, up 7.6 percent over the year before, and accounted for 52 percent of the nation's overall retail sales according to a white paper issued by the International Council of Shopping Centers.[1] Despite the good news, there has been a substantial increase in the amount of surplus retail space or "distressed" properties that cost landlords and tenants a great deal of money. Real estate attorneys and other professionals are working to address this problem by helping retailers with surplus property reduce their cost of operating through a variety of strategies, including subletting at reduced rates. To understand how these strategies work, it is useful to look at the factors that contribute to the creation of distressed property in the first place.

DISTRESSED PROPERTY RESULT OF THREE PRIMARY FACTORS

A retailer may be highly successful with its primary business of selling "widgets," but still have various stores that fail. Three main factors impact the value and health of commercial property: size, location, and condition, any of which may change significantly over time. In the early half of the 20th century, people tended to live in the town where they worked, often establishing retail stores on the first floor of a building and apartments or town homes on the upper floors. Thus, shoppers were able to walk quickly from their place of work to the local hardware store and then to the local bakery or grocery store, which were often located within the same block. Moreover, the majority of retail shops were family-owned and often specialized in a particular trade, product,

ABOUT THE AUTHOR

Thomas S. Smith, Esq., *is a partner in the real estate and finance department of Preston Gates & Ellis LLP in Portland, Oregon. Prior to joining the law firm, Smith was vice president and general counsel of Pacific Realty Associates (PacTrust) and Property Development Associates.* [redacted]

or service. These shoppers went to the bakery to get bread, the grocer to buy milk, and the butcher to buy meat. As a result, most stores required minimal space to sell their wares, with the average commercial property size in the 1930s and 40s ranging from 500 to 20,000 square feet.

At the end of World War II, however, with a booming economy and rapid growth of the automobile industry, more prosperous workers began fleeing to the suburbs. Because it no longer made sense for commuters to drive from one store to the next only to pick up a few items, retailers began stocking a wider range of products, resulting in an increased demand for space. Grocery stores, for example, grew in size in direct proportion to the amount of goods stocked, growing to 25,000 square feet in the 50s and to 35,000 square feet in the late 60s. With the advent of community and neighborhood shopping centers in the late 60s and 70s, grocery operations expanded so shoppers could buy everything from garden hoses and shoe polish to freshly-baked rolls and a gallon of milk. As a result, retail grocery stores grew as large as 50,000 square feet.

As customer demand for department stores and shopping centers grew, many retailers abandoned their original properties in favor of larger spaces or those spaces located in or adjacent to malls, business parks, or other locations that offered increased traffic. While stores such as Wal-Mart, Big K, Costco and other suburban mega retailers are clearly here to stay, the last decade has also seen a revitalization of urban centers, especially in the inner city where public-private partnerships such as the Harlem USA project in New York City are developing chain retail and entertainment complexes funneling jobs and money back into lower-income neighborhoods.[2] As a result, so-called distressed properties may be found in almost any area of the country, with small, older strip centers being abandoned for newer, bigger ones down the block or even across the street.

While some companies are able to sell off their original storefronts, many of these surplus properties are subject to long-term leases of up to 60 years with all of the accompanying economic obligations. Meanwhile, these properties grow out-dated and deteriorate due to lack of use. Many retailers are reluctant to renovate or make repairs since such action will result in even greater economic detriment. Retailers, large and small, fall prey to this problem. According to a recent article in *Shopping Centers Today*, Wal-Mart has an inventory of 30 million square feet of excess space.[3] Due to

At the end of World War II, however, with a booming economy and rapid growth of the automobile industry, more prosperous workers began fleeing to the suburbs. Because it no longer made sense for commuters to drive from one store to the next only to pick up a few items, retailers began stocking a wider range of products, resulting in an increased demand for space.

increased national competition, surplus or distressed property seems especially prominent among supermarket chains and drugstores that have had to replace older, smaller stores with larger, more up-to-date ones or follow demographic changes and move to larger population centers.

FINDING A SOLUTION

Is there a realistic solution for distressed properties? While selling these properties may be an option if the real property is owned in fee, it may not be realistic where a retailer leases the property. Although some landlords may be willing to allow a buy-out or other termination of the lease, most recognize that large national credit chain stores such as K-Mart or CVS Pharmacy make great tenants and landlords are often unwilling to cancel the lease because they are left to fill a vacancy, often with a less stable tenant. As a result, more and more retailers with surplus properties are becoming landlords themselves, subleasing at a reduced rent or assigning their interest in the lease for a small fee to contain or reduce losses.

STOP THE BLEEDING

A good example is one of the author's commercial real estate clients, a large national supermarket chain, which for the purposes of this article will be referred to as ABC Corporation ("ABC"). In the mid-80s, another company he represented was asked to help ABC with its surplus properties. ABC had more than 1,200 surplus properties in about 36 states. Some, including an 80,000 square foot unit in a Chicago suburb had been closed due to shifting demographics. Here, the neighborhood no longer generated sufficient retail traffic to support the costs of operation. Another ABC property in a suburb of Washington, DC, was in an ideal location (in

fact, ABC decided to build a larger, newer store right across the street), but the building was too small and the underlying property insufficient to support a larger "on-site" replacement. As is always the case, each of ABC's surplus properties was unique in its location, condition, size, and reason for no longer being useful for its original intended purpose.

At the end of the day, ABC was carrying this surplus property portfolio on its books at an approximate $200 million negative value. Clearly, the first priority was to "stop the bleeding" by reducing the amount of ongoing fixed costs. One solution was for ABC to find tenants and subtenants to take over ABC's position in these surplus properties so that ABC could begin to recoup its losses. The challenge was finding the right tenants and subtenants, that, on the one hand, would not be incompatible with ABC's own business and at the same time sold products or services that would succeed at that particular location.

ABC's approach varied from location to location . In some cases, ABC sought tenants and subtenants such as startups or nonprofit organizations with reduced financial resources, that would entertain occupancy of properties that were less than first-class retail locations in exchange for lower rents or other economic incentives. In other locations, ABC was willing to subdivide the building into shop space to accommodate local merchants. In yet others, ABC was only willing to lease to first-class national credit retailers.

Keep in mind that these tenants and subtenants were often in the same boat as ABC, in that time was an enemy to the bottom line. Any small retail business will have a finite time because of economic necessity within which to open its business. For example, ABC entered into negotiations with an entrepreneur who sold handmade items imported from outside the U.S. His brother acquired these items in Central Asia and was prepared to ship them to the U.S. for the entrepreneur to sell, but he had to move the shipment quickly to pay the salaries of the craftsmen who made these items. The entrepreneur therefore had to quickly find a space that he could afford and one that would attract sufficient retail traffic to support his family. ABC offered part of a distressed property to the entrepreneur at a reduced rental rate provided that he took occupancy right away. Both the entrepreneur and ABC were economically motivated to consummate the transaction quickly and with professionals on both sides of the transaction who understood the nature of distressed property, a favorable result was achieved for both parties.

As you can see, the foregoing is an example of a true win-win situation for the leasing entity that was able to reduce its negative value and the tenant who was able to rent space at reduced rates, open his business quickly, and realize immediate income.

A second challenge for ABC was to reduce the day-to-day costs incurred in operating these properties. The first step for ABC was to get its arms around the various aspects of its economic obligations at each property. For example, many properties had been assessed for tax purposes as operating retail stores, and now that they were no longer fully useful for that purpose; challenging the tax assessments, where appropriate, resulted in many tax reductions. Controlling day-to-day operating expenses, such as making sure that lighting systems were shut down or placed on timers and heating systems were properly taken offline reduced monthly utility expenses. Increasing security activities reduced vandalism costs. While all measures cost money initially, these investments paid handsome dividends in the long run by reducing out-of-pocket costs while ABC sought a replacement occupant.

Because the first priority of ABC was to stop the bleeding, ABC quickly realized that leasing or subleasing these properties, even at reduced retail rates combined with prudent property management strategies, contributed to the reduction of the negative $200 million value of its surplus property portfolio.

WHAT LANDLORDS SHOULD LOOK FOR

While any entity seeking to lease distressed or surplus property is driven by the need to improve profitability (or at least the reduction of a negative value) as its primary goal, the prospective landlord must still maintain some control of the lease and how the property will be used. Below are some strategies that any prospective retailer/landlord should use when leasing or subleasing its distressed or surplus properties:

- Make sure the prospective tenant understands that the premises are being offered as is, with no representations or warranties as to the condition of the building. Smart landlords will make basic up-front repairs, such as those related to the roof or operating systems and correct defects that are reported within the first 30 to 60 days of the term because those types of repairs will be vital for the

tenant/subtenant to run its business safely and effectively (and therefore ensure that rent will be paid regularly). Depending on the tenant's/subtenant's financial resources, the landlord may be able to amortize over the term of the lease the cost of any repairs made in excess of a predetermined or negotiated amount.

- Insist that the lease be "triple net" pure and simple; the tenant/subtenant must pay all taxes, insurance and common area maintenance charges incurred during the term; otherwise, the landlord will have to charge more base rent.
- Negotiate carefully the provisions governing the condition of premises at the end of the term. If the tenant/subtenant chooses to alter the premises in any way, it may jeopardize the lease that the landlord has with its master landlord.
- Be flexible with base rent—remember this may be the only tenant/subtenant available for this particular distressed property. Keeping the lights and heat on and the taxes paid, even if the rent is at a reduced rate, may be advantageous until the market turns and a better tenant/subtenant can be found.
- Require that the potential tenant/subtenant use your lease form and make sure you have developed a form that can be negotiated quickly. While many lease forms are relatively even-handed in terms of information provided and agreements struck, the document should favor the landlord's position on matters such as triple net expenses, default, condition of premises, alterations, and assignment/subletting. The landlord's lease form should not be a very hard sell to the potential tenant/subtenant, because most will recognize the trade off of a reduced rent, and the landlord's need for ease of administration. Both parties should want to consummate the transition quickly and using the landlord's form may help to speed up the process.

WHAT TENANTS/SUBTENANTS SHOULD LOOK FOR

As stated earlier, prospective tenants/subtenants with limited financial resources may be able to gain access to quality property at a fraction of the price they would otherwise have to pay for similar property. Because many of ABC's distressed properties were under long-term leases, ABC might have leased property for only $5 a square foot back in 1960, whereas a similar property leased today might bring $15 a square foot. Because ABC's main focus was to reduce its losses, ABC often offered to sublease the properties to smaller tenants/subtenants at a lower than market rent, especially if several smaller tenants/subtenants could be brought in all at once to share a space that might have been too large for a single tenant/subtenant.

An experienced attorney and other experienced real estate professionals can help companies review their distressed property situation in terms of the company's overall business plan and goals and provide advice concerning appropriate alternative economic strategies for each particular property.

Just because a tenant/subtenant has limited economic resources, it does not mean it should immediately take the landlord up on the first deal offered. Tenants/subtenants need to be sure that the reasons the retailer/landlord vacated the property will not negatively impact the tenant's/subtenant's ability to succeed in the property.

If the landlord has vacated the property simply because it has outgrown the space, and not due to its poor retail location or the physical condition of the property, chances are that this property may present an exceptional retail opportunity. The tenant/subtenant should carefully evaluate how the location of the property might impact the products or services the tenant/subtenant offers. For example, a prospective tenant/subtenant that is a nonprofit organization working with a particular clientele may be benefited by an inner-city location because its business will be located in the heart of the community it serves. Personal service providers such as dentists or accountants might also prefer a retail site in a community or strip center location rather than a busy downtown commercial area, because their patients will not have to worry about competing for scarce parking spaces.

Prospective tenants/subtenants should also be sure to conduct a full physical inspection of the premises and surrounding area. Distressed buildings are often in disrepair and the tenant/subtenant may use that fact as a negotiating tool with the landlord. For example, a tenant/subtenant may offer to repair a leaking roof in exchange for a further rent reduction or may request that the landlord pay for a new roof in exchange and allow the landlord to amortize the cost of the roof over the term of the lease. Subtenants of ABC successfully used these arrangements in various ABC sites.

The tenant/subtenant should stay firm on keeping the rent low and should only agree to pay percentage rent when a reduction in base rent or other economic incentive is included. Remember that the property is a significant current expense to the landlord and any amelioration of that expense is a true benefit to the retailer's/lessor's bottom line. The tenant/subtenant may have additional leverage where the distressed property is particularly difficult and the tenant/subtenant is the only real prospect.

NEGOTIATING THE SPECIFICS

Other issues will arise during the course of negotiations and while it is not within the scope of this article to specifically address each provision of a lease/sublease, prospective tenants/subtenants and landlords should develop strategies for each provision before entering into negotiations. The "Use" clause is a good example of the kinds of matters that may arise in this surplus property context.

The use of its surplus properties was one of the biggest challenges for ABC. Using a property in the Washington, DC, area as an example, ABC knew it had to find a tenant/subtenant that could afford and use a large building space, and who would not be put off by the building's older appearance. Because of the favorable retail location of this building, seeking a nonprofit group or even a large discounter was not appropriate. ABC was confident that a better-established national retail tenant who could see the potential of the space would be attracted to the property. As the prospective landlord, ABC needed to think about what sort of control was necessary based on adjoining tenancies, local zoning and market conditions. ABC would not agree to a clause that would permit "any lawful retail use," as such a clause might encourage a further subletting by the tenant at greater rent, depriving ABC of the real property's value. ABC recognized that leasing the few very good properties at market or above-market rents is necessary to offset the other negative value portfolio properties. Additionally, such a clause could raise public relations issues for ABC if the subtenant's business, while legal, did not fit into the character of the shopping center or neighborhood in which it is located. For example, consider the risk to ABC if a family-friendly drugstore sublet to a tenant who operated an adult bookstore or gambling establishment. While both ventures may be legal, ABC believed that these types of uses would certainly compromise the image and community standing of ABC.

Other use issues that ABC had to address included granting of exclusive rights and operating covenants. ABC avoided granting broad exclusive rights out of fear of "handcuffing" ABC's rights when leasing adjoining premises. Carefully crafted and narrowly drawn exclusivity clauses were often acceptable to both parties. ABC often tried to obtain an operating covenant, but recognizing that these are difficult properties to lease, never forced the issue if the tenant opposed it. Tenants/subtenants were often willing to grant ABC the right to recapture the property and terminate the tenant's/subtenant's possession if the tenant/subtenant went "dark" for some extended period (i.e., more than 90-180 days).

In the case of the Washington, DC, property, ABC negotiated a subtenant arrangement with a major bath and linen store that saw the retail potential of the large space and agreed to make necessary renovations to the building and to hike rent. ABC also focused on other specific areas of its leasehold relationships in distressed properties including operations, maintenance and repair of the building and common areas, and assignment and subletting rights.

CONCLUSION

While many entities may feel initially a little uneasy about playing the role of landlord, especially if they are concerned that it may divert them from their "real" business, many retailers, especially larger chains, clearly have begun to realize the benefits of various exit strategies including subleasing their distressed property. While it may take some time to identify and attract the right occupants for its surplus properties, in the long term, companies can significantly reduce the drain on corporate resources that these portfolios often cause. An experienced attorney and other experienced real estate professionals can help companies review their distressed property situation in terms of the company's overall business plan and goals and provide advice concerning appropriate alternative economic strategies for each particular property. The end result may be the identification and realization of substantial value in these properties and the proverbial conversion of a sow's ear into a silk purse. RE125

NOTES

1. Casey, Dougal M., "A 1999 U.S. Retail Sales, Mall Sales and Department Store Sales Review," International Council of Shopping Centers, www.icsc.org/rsrch/wp/99storesales review.html.
2. Warson, Al. "Harlem USA Project Sparks Retail Renaissance," *Shopping Centers Today*, September 1, 1999.
3. Hazel, Debra. "Tenants Become Landlords: Wal-Mart, Others Face Surplus-Space Boom," *Shopping Centers Today*, November 1, 2000.