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Landlords Negotiate Now For Repayment Later

Tenants likely to see upfront fee, longer lease term or higher rates in exchange for reduced rents or giving back space
Tenants likely to see upfront fee, longer lease term or higher rates in the future in exchange for reduced rents or giving back space

By MANDY JACKSON

CREJ Staff Writer

Landlords may be reducing rents and agreeing to take back space, but they're not doing it at no cost to tenants.

With the exception of companies that file for bankruptcy, tenants will pay in the long run for short-term savings when landlords help them return to or maintain profitability. In the meantime, the best outcomes for both parties occur when both sides understand the perspective of the party on the other side of the negotiating table.

"Oddly enough, tenants in a poor financial position have a better chance of restructuring the lease," said Michael Meyer, managing partner of the Los Angeles-area offices of **DLA Piper**.

If a landlord believes a tenant will file for bankruptcy without reduced rent for a period of time, they are more likely to renegotiate lease terms rather than allowing the tenant to slip into bankruptcy and turning the landlord into a creditor in a long line of other creditors seeking payments.

Meyer is working on a number of lease renegotiations, even with strong tenants. They want to reduce their short-term costs, but they know going into it that they're trading dollars - saving money now that will be repaid later in the lease term.

Some tenants even are paying a substantial upfront fee to get out of all or part of a lease.

Neurocrine Biosciences Inc. announced on Oct. 1 that it negotiated an amended lease agreement with its landlord, San Diego-based **Veralliance Properties**, to vacate a 70,000-square-foot building at its headquarters in San Diego.

Veralliance bought the two-building, 220,804-square-foot Neurocrine campus in partnership with **Prudential Real Estate Investors** for \$109 million at the beginning of 2008 in a sale-leaseback agreement. Neurocrine signed a 12-year lease at that time.

"We worked with our landlord in a collaborative manner to reduce our leasing obligation and to allow them to directly market the property, while at the same time minimizing the cash flow impact to Neurocrine," said Timothy P. Coughlin, vice president and chief financial officer of the biopharmaceutical company.

Under the lease amendment, Neurocrine will pay Veralliance a \$4 million fee to vacate one of the two buildings at its campus in Del Mar Heights early. The company also agreed to make certain rent payments and rent differential payments.

"This is a significant first step in reducing our fixed real estate cost structure, reducing our overall obligation by approximately \$27 million," Coughlin said.

Tenant Distinctions

Hans Lapping, transactional shareholder at **Miller Star Regalia** in Walnut Creek, said most lenders are not pushing back against rent reductions if landlords can maintain their loan covenants and the rental income can support their debt service.

"Where we have a tenant making a one-time cash payment, the lenders have been fairly aggressive in making sure that cash payment is delivered to the landlord to pay down the loans," Lapping said. "They aren't allowing the landlords to keep the cash payments in most instances."

He said many of Miller Star Regalia's tenant clients are Fortune 100 or 200 companies that already have disposed of most of their excess space. Usually, they pay a rental termination fee to get out of an underperforming space rather than renegotiate the lease.

"The more sophisticated the tenant, the more they understand there's a quid quo pro, but the short-term payment outweighs the long-term burden," Lapping said.

He said smaller tenants, especially in retail properties, often don't seem to understand that commercial properties are encumbered with debt and rent is the primary form of repayment because those tenants tend to approach landlords about lease renegotiations with an unrealistic goal in mind.

Landlords may be delaying the inevitable by reducing rents on a short-term basis because the tenant won't be able to pay back the deferred rent added to a later period in the lease term, but such a move might keep the space occupied until the market improves and it's easier to find a replacement tenant.

"If you have Microsoft as a tenant and the parent [company] is liable, you're going to act differently and negotiate differently. You're not concerned that the tenant is going to disappear and no one is going to be liable," said Bob Baradaran, chair of the real estate group at **Greenberg Glusker Fields Claman & Machtinger LLP** and partner in the firm's Los Angeles office.

If the tenant is an individual with no guarantor, the landlord may get no payment at all if the business files for bankruptcy, so it's probably best to negotiate revised lease terms.

But, Baradaran said, there are many variations between a sole proprietor and a major corporation from tenants that are not viable businesses but have cash on hand to viable businesses without access to credit.

A landlord might want to keep a tenant with reduced sales volume and limited access to credit to prevent a vacancy. The solution might be a rent reduction for three months to a year, with the difference between the old and new lease rate added to rental rates in 2011 or 2012 within the existing five- or 10-year lease. Another tenant with slow sales that does have access to credit might not get the same leniency, though there are some exceptions.

"If you stick to your guns on one space where the [retail] tenant is a credit tenant, the tenant can shut down the store while paying rent because they make more money being closed and paying rent than being open and paying rent," Baradaran said. "That could have a ripple effect throughout the center."

A Limited Toolbag

Gerald Porter, chairman of Los Angeles tenant representation firm **CresaPartners**, said restructuring leases so that reduced rent is paid now in return for a higher rental rate later in the lease term usually is reserved for the most financially desperate tenants because such arrangements leaves them financing the current pain over a longer term.

"Many landlords can't withstand the loss of current cash flow and are incapable of offering any significant savings to their tenants," Porter said. "The upcoming loan maturity defaults in the market should offer tenants more opportunity as the successor ownership, in many cases, will have a lower cost basis in the building and will be motivated to retain their existing tenants by providing true rent reductions."

Greg Pyke, partner in San Diego at **Best, Best & Krieger LLP**, has seen some landlords ask for more than a longer lease term in exchange for reducing rent on a short-term basis, such as additional guaranties or prepayment of rent. Pyke has also seen landlords offer concessions in addition to reduced rent when tenants make a longer-term commitment.

In one lease renegotiation Pyke worked on, the landlord provided some basic tenant improvements and reconfiguration of the space to accommodate future growth in exchange for an extension of the lease.

"It was perceived by the tenant as my landlord's willing to invest in me," he said. "Unfortunately, the landlord has limited things in its toolbag to entice some tenants, but there is some give and take in most of these transactions."

Pyke has worked on fewer lease renegotiations during the past two or three months, but he said he's not sure if that represents a broad change in the local market.

"If the economic malaise continues at the same or similar pace and rolls into the first quarter of 2010, I would expect there to be another wave of these transactions toward the balance of 2010," Pyke said. "I've had discussions with three or four tenants who've said, 'We're going to wait and see. Things have gotten better in the past quarter or so. Let's see if the momentum continues into 2010 and if it doesn't we'll do something then.'"

- *E-mail MJackson@DailyJournal.com*

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