

How Do I get Out of My Lease

by Michael L. Cantor

The weak economy is prompting many businesses to ask whether or not it makes good business sense to get out early from their leases.

A weak economy causes shrinking business operations, resulting in reduced real estate demand in the office, industrial and retail sectors. Because most major real estate markets across the nation have been soft for more than two years, business clients face their own mounting operational challenges and additionally see landlords who face similar business challenges. Vacancy rates are up and, more significant to the tenant seeking a lease exit strategy, sublease market supply is high.

As corporate rightsizing continues, tenants ponder how nice it would be to be able to exit their leases. Exit strategy alternatives generally fall into one of three categories:

- early termination options,
- tenant friendly sublease/assignment/transfer rights or
- arms-length lease buyout negotiations.

Clients who look to exit their leases early must first consider several issues. First, if early termination options or tenant friendly sublease/assignment/transfer rights are available, which one makes the most economic sense? Second, if they do not exist, how should they pursue a negotiated lease buyout or sublease pursuit? Finally, what type of research and analysis is required to prepare for these decisions?

Early Termination Options

First, review your client's existing lease agreements to find the all-too-elusive Early Termination Clause, which is typically the best alternative. Hopefully, the client has a well-structured transaction that includes a formulaic approach to early termination penalties (i.e., liquidated damages). Review the lease carefully because these rights are often hidden in less than obvious provisions or in exhibits, addenda and side letters. Once you find the rights, review the language to determine if it is reasonable in present market conditions. If so, exercise it according to the requirements of the lease. How do you know if it is reasonable? Use the calculated penalty as a baseline for the decision analysis discussed later in this article.

Required Document – An Exercise Letter. The Exercise Letter needs to reference the lease, establish the effective date of the early termination, the penalty due, the circumstances of payment and the condition of the premises upon vacation.

Assignment/Sublease/Transfer

An alternative, though frequently less desirable, strategy is applying the Assignment/Sublease/Transfer provision. For example, a Fortune 1000 corporation may want to investigate transferring its obligations to another corporate division or related entity. Assuming this potential transferee has an equal or stronger credit rating, the provision may allow this type of transfer without being subject to a landlord's reasonable consent. In situations when a related entity transfer is not feasible, review the tenant-friendliness of the sublease and assignment language. It's likely the landlord will have some degree of approval, ranging from reasonable to arbitrary consent. Hopefully, there is a list of relevant exceptions that are subject to a landlord's consent.

Occasionally, a lucky tenant will have the opportunity to earn a profit through assignment or sublease or to secure a novation, releasing it of all further liability for the lease obligations. However, a sublease transaction is almost always a liability, including the complexity of a three-party transaction that recovers only pennies on the dollar and assumes some of the responsibilities of a landlord. Further, the client needs to select a real estate broker, without conflicts of interest such as the landlord's representative, and take on the risk of a "hit or miss" marketing process. This process is particularly challenging in today's market with its substantial supply of below-market rate sublease space.

Required Document – Sublease Agreement. The sublease agreement tends to be more complex than a prime lease because it is a three-party transaction. In particular, the tenant (assignor/sublessor) needs to be mindful of the following issues:

Retained Liability. In both sublease and assignment absent novation scenarios, the assignor/sublessor retains the primary liability and obligations under the Prime Lease. This means the sublessor must conduct adequate due diligence on prospective sublessees' financial condition, space usage and oper-

ational issues. The sublessor continues to be liable for any monetary and non-monetary defaults by the sublessee as well as other sustaining liability, such as environmental impairment.

Delegated Obligations. The sublessor needs to ensure the sublessee is obliged to comply with all of the applicable terms of the Prime Lease. On the other hand, the sublessor needs to exclude from its obligations some of the Prime Lessor's obligations related to property operations.

Prime Lessor's Consent. The process of consummating a sublease transaction can be particularly cumbersome because of the timing of the transaction. Because all negotiated transactions grow stale by the minute, the unmotivated prime lessor can put the deal in jeopardy. The sublessor should take this potential bottleneck into consideration and set the sublessee's expectations accordingly.

Required Document – Listing Agreement. Once a real estate broker is selected to market the property, a listing agreement must be negotiated to protect the tenant/sublessor's interests. You need to address issues such as the scope of services, term (given the tenant's finite control of the space), termination, rights after termination, standard of care and indemnities.

In circumstances where a sublease or assignment is not practical, the tenant can proceed with negotiated lease buyout discussions. Even when a sublease or assignment is feasible, a decision analysis should be conducted to determine which avenue is more desirable.

Lease Buyouts

A decision analysis is needed to evaluate the comparable pros and cons of a termination option (if it exists), a sublease/assignment and a negotiated lease buyout. Although it is often an expensive option, a negotiated lease buyout should always be considered. For instance, a lease buyout will relieve the tenant of further liability for its unoccupied space. Additionally, a tenant may get lucky because the landlord has a strong back-up plan. The landlord may need the tenant's space to incorporate into a larger transaction or may have plans to redevelop or re-image the site.

To fully evaluate a lease buyout, a market study is required that assesses both basic real estate market supply and demand and sublease supply and economics. As soon as you have a clear understanding of local market conditions, contact the landlord to discuss your client's plans and to determine the landlord's position. Regardless of market conditions, the landlord stands in a contractually strong position (absent arguments for landlord default). It is always best to have the market data and facts to support your position. The landlord may take a tough stance, given the lost revenues, dark space for a period of time and need for capital to fund lease-up costs for a replacement tenant.

Ultimately, the main issue to be resolved in a lease buyout is the penalty. The components of calculating a lease buyout penalty typically include:

- The balance of base rent through expiration;
- The balance of additional rent or triple net expenses to be recovered by landlord;
- The unamortized lease-up costs (leasing commissions, tenant improvements and concessions from the original lease negotiations) based on a negotiated discount rate,
- The value of the lease compared to current market conditions; and

- The remaining term of the lease and the projected downtime lease-up costs to secure a new tenant.

In strong economies, these types of negotiations often begin with the tenant paying 50 cents on the dollar. In soft economies, these negotiations quickly turn to the tenant paying closer to the total remaining rent obligation, including using a very low discount rate to calculate the present value given the current interest rate environment. While the value of the lease buyout is primarily based on market conditions as presented by both parties, it is strongly influenced by the landlord's financial situation and plans for the property. Unfortunately, the tenant doesn't know these factors until negotiations start. While an attorney is capable of assisting a client in structuring and documenting this type of transaction, a properly motivated real estate advisor (consultant or broker) plays an essential role by evaluating market conditions, uncovering landlord motivations, conducting comparative financial analysis and facilitating the negotiations.

Required Document – Lease Buyout

Agreement. The Lease Buyout Agreement needs to reference the lease and any amendments, and establish the effective date of the early termination, the

penalty due, circumstances of payment, the elimination of tenant's obligations, and the condition of the premises upon vacation.

Planning For The Future

We have looked at strategies for clients who may want to exit early from an existing lease. Going forward, however, you can help clients entering into new leases to be positioned for possible early exits. From a tenant's standpoint, all new leases should include Early Termination Options. At most, Early Termination Options need to contain definitive formulas and detailed processes to provide a quick resolution to future space issues. At the very least, the liquidated damages formula will serve as a baseline for future decisions and negotiations. ☐



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