Wednesday, October 23, 2019
3:30 PM – 4:45 PM

Seminar 4

(Br)Exit Strategies for Leases – Anticipation, Negotiation, Deal or No Deal – Avoiding an Impasse

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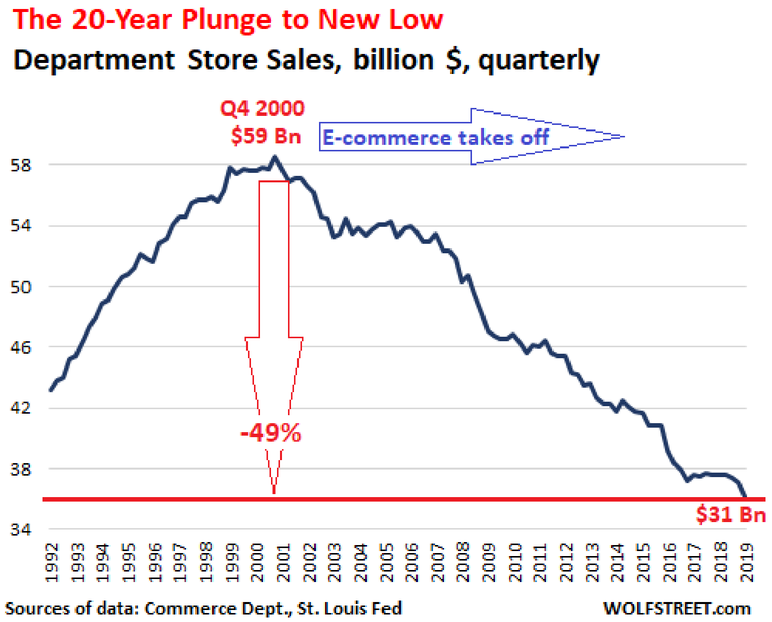
Introductions

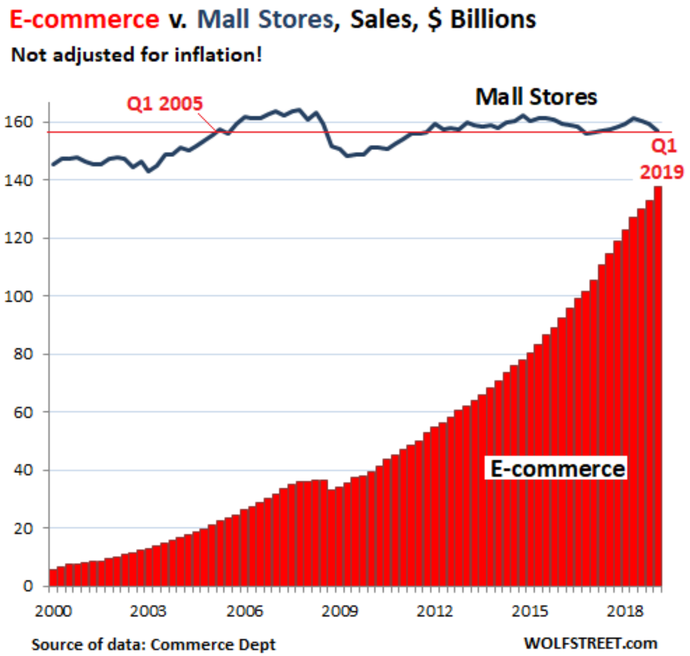
- David P. Vallas, Polsinelli PC, Chicago
  - David Vallas is Shareholder of Posinelli's and provides practical solutions to complex legal problems by understanding a client's business and its goals. As a Vice Chair of Polsinelli's Commercial Litigation practice and a Co-Chair of its Real Estate Litigation practice, David focuses his practice on resolving disputes in the real estate industry.
- Matthew Bordwin, Keen-Summit Capital Partners LLC, New York
  - Matt Bordwin is Principal and Managing Director of Keen-Summit Capital Partners. Matthew is responsible for all aspects of business development and execution. He focuses primarily on the development of new business, marketing and implementing strategic real estate plans for his clients. Those plans involve real estate analysis, real estate acquisitions and dispositions, lease modifications and terminations, and corporate finance and capital market services. Matthew has more the 22 years of real estate advisory and transactional experience, with particular expertise in workouts and restructurings, specializing in strategic planning, the sale of real estate assets and lease negotiations. He has represented financial, corporate and retail clients.
- John H. Lewis, Hartman Simons & Wood LLP, Atlanta
  - John Lewis has been practicing law for over thirty years and worked with a wide range of clients, from Fortune 50 businesses to non-profit institutions to individuals, in an equally wide range of transactions involving virtually all types of commercial real estate, including acquisition, disposition, development, finance, leasing and corporate transactions. His work in the retail field and in the representation of a nonprofit healthcare institution has also provided extensive involvement and expertise in urban and suburban mixed-use developments. John also has significant experience in the establishment and dissolution of joint ventures, the administration and dissolution of real estate investment trusts, loan workouts and foreclosures, the oversight of lender participation in borrower bankruptcy proceedings, and property administration and leasing, including retail, office, hotel, apartment and industrial sites. He has had the privilege to know, work with and learn from many fine colleagues, in small and mid-sized firms, and in-house at a major financial institution. He was a partner in two of the nation's largest law firms.

Reasons a Party Wants to Exit a Lease Other than Due to a Default or Express Right

- Corporate Cutbacks
  - STARBUCKS: Coffee chain cuts about 350 jobs, most at Seattle headquarters (~5% of non-restaurant workers)
- Disappointing Sales
- Changing Market (Amazon)
- Occupancy Costs Are Too High
- Landlord Wants To Reposition the Center

Source: “Markets: Starbucks Cuts 5% of Corporate Workers,” Bloomberg, November 13, 2018





Source: “E-commerce Crushes Mall Retailers One by One. Here’s the Data,” *Wolf Street*, May 18, 2019

Business Insider reported that retailers have announced closures for 6,400 stores thus far this year, already more than in all of 2018. Against this loss, 2,264 new stores are slated to open, the majority of which — Dollar Tree, Dollar General and Family Dollar—sell the cheapest of all merchandise.

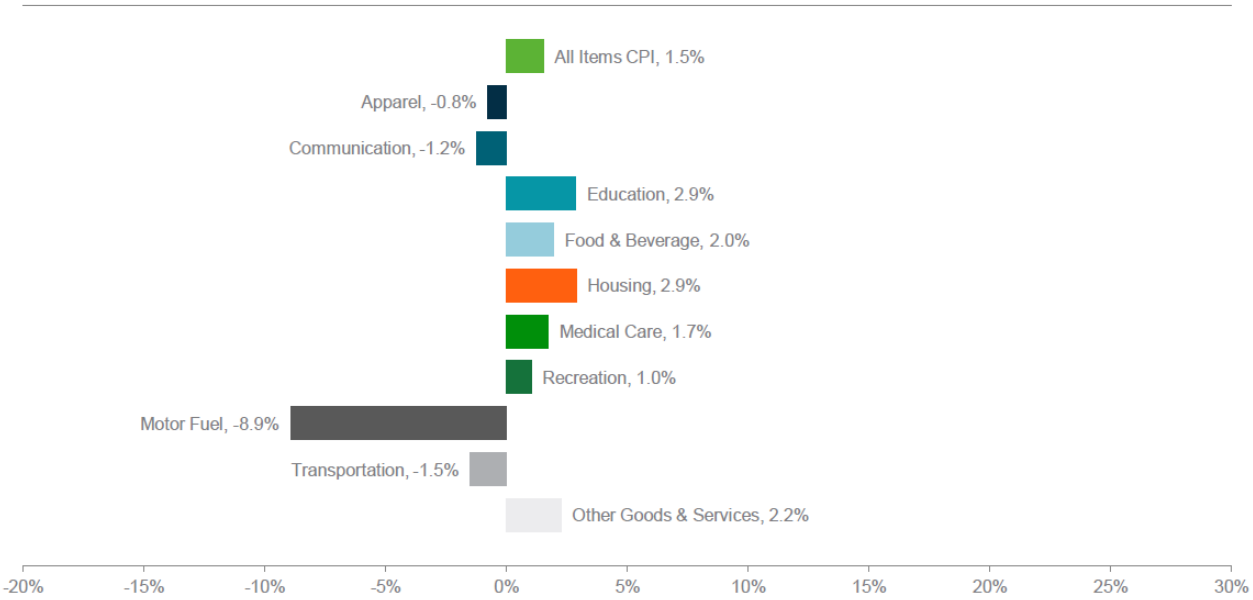
Projected Number of Retail Store Closings by 2026 if Online Retail Penetration Continues to Increase

Retailer with more than 50 locations scheduled to close in 2019

Payless ShoeSource	2,500
Gymboree	805
Dress Barn	650
Charlotte Russe	520
Family Dollar	390
Shopko	371
Fred’s	263
Chico's	250
Gap	230
Things Remembered	200+
Ascena Retail Group	200
LifeWay Christian Stores	170
Signet Jewelers, parent company of Jared: The Galleria of Jewelry and several other jewelry chains.	150
Starbucks	150
Pier 1 Imports	Up to 145
Performance Bicycle	102
Sears	70
Destination Maternity	Up to 67
Victoria's Secret Stores	53
Lowe's	51

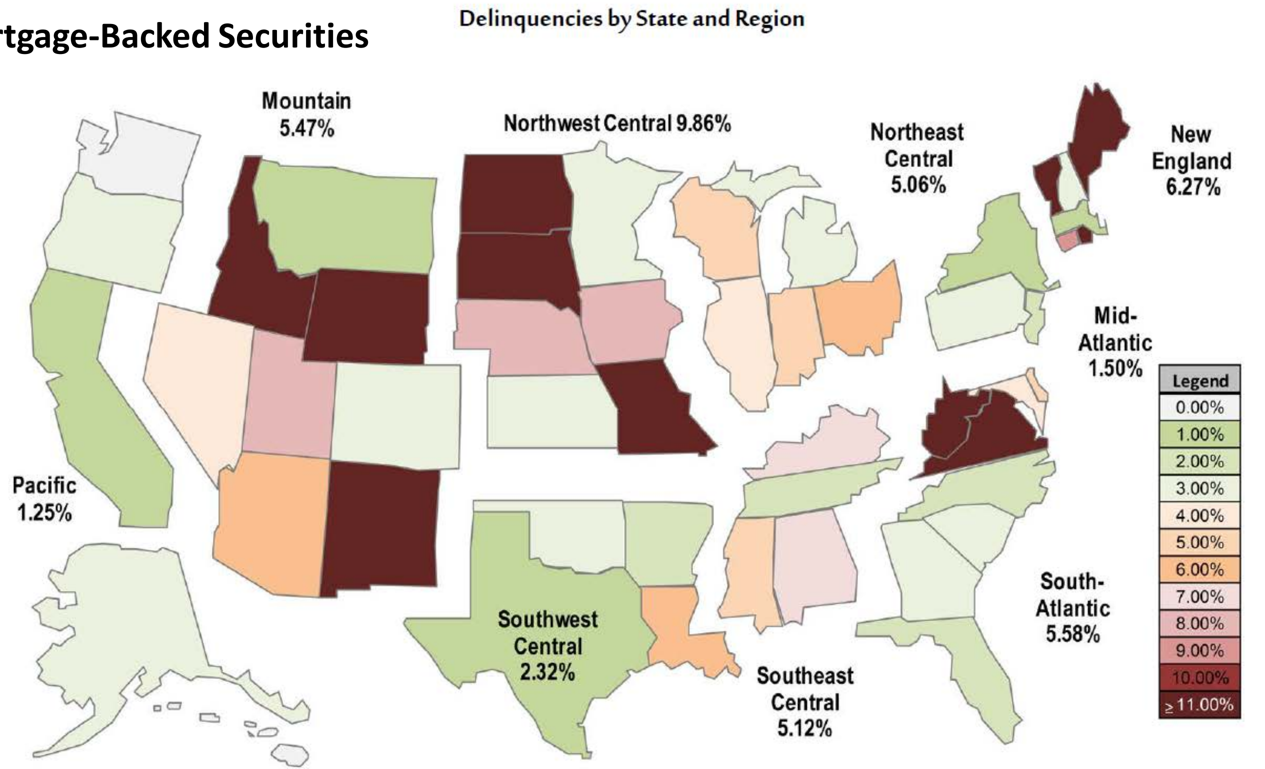
Source: American Bankruptcy Institute; “More than 7,000 stores are closing in 2019 as the retail apocalypse drags on — here's the full list,” *Business Insider*, May 21, 2019; “These Chains Have Announced a Ton of Store Closings in 2019,” *MoneyWise*, 5/27/2019

Consumer Price Index (CPI-U)
before seasonal adjustments base: 1982-1984 = 100



Please read and review the important information contained in the disclaimer on page two of this report
Source: US Bureau of Labor Statistics

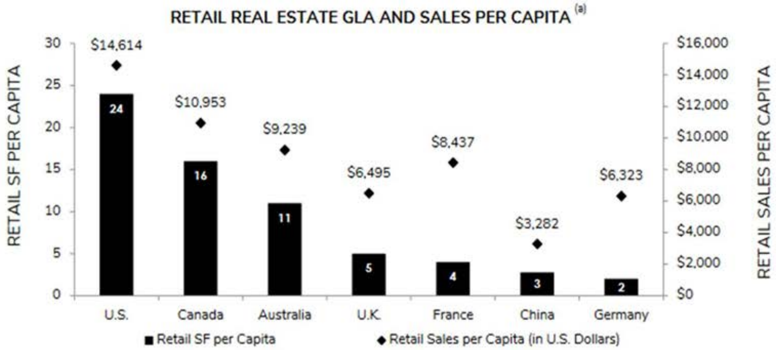
Commercial Mortgage-Backed Securities



Source: Trepp LLC

THE U.S. IS OVER RETAILED

U.S. has the highest GLA per capita by far among all developed countries



U.S. Regional Shopping Center Productivity

	Average Center Sales/SF [b]
At Current	$493
Assuming Reduction of GLA by 25%	$602

a) ICSC Country Fact Sheets.
b) At Current" is the average center sales per square foot data from Green Street Advisors, while "Assuming Reduction of GLA by 25%" removes 25% of lowest quality centers by productivity and redistributes sales to remaining centers.

Reasons a Party Wants to Exit a Lease Other than Due to a Default or Express Right (cont.)

- CHANGE OF CO-TENANCY (BANKRUPTCIES)
  - Anchor stores were the big draw bringing in foot traffic. Big box vacancies, decreased foot traffic and triggered co-tenancy agreements with their retailers that call for rent reductions if too many vacancies open up at a property.
  - Empty spaces are being filled with huge fitness clubs, rock-climbing gyms and on-site experiences, even if such businesses pay lower rents than the brand-name stores that closed or reduced their store size
  - Brands are shrinking their footprints, instead focus on flagship stores, especially ones in high-performing malls
- LANDLORD DESIRE TO REPLACE WITH "MORE DESIRABLE" TENANT
  - Beyond a need for a credit tenant are e-commerce resistant tenants with experiences: movie theaters, mini-golf, bowling, rock climbing walls, gyms/fitness centers, cooking classes (Whole Foods and Williams-Sonoma)

Source: "Duke acquires Macy's spot at Northgate Mall for hospital's largest off-campus clinic," *The Chronicle,* January 17, 2018; "Amazon Turns Shopping Malls Into Warehouses, Changing America's Community Landscape," *Forbes,* May 25, 2019; "ICSC RECon Attendees Feel Cautious Excitement About What Comes Next for Retail" *BISNOW*, May 22, 2019

Reasons a Party Wants to Exit a Lease Other than Due to a Default or Express Right (cont.)

- OCCUPANCY COSTS TOO HIGH
  - Landlords will have to adjust their expectations and rents will probably have to come down.
  - Vacancy is as high as it has ever been in top luxury submarkets like Chicago's North Michigan Avenue and Fifth Avenue in New York City.
- LANDLORD REPOSITIONING OF CENTER
  - Malls converting into warehouses to strengthen Amazon's supply chain and physical position
  - Duke recently purchased a 183,840 square-foot building in Northgate Mall that will become the largest Duke Health clinic off the main hospital campus. The two-story building—previously a Macy's department store that closed in early 2017—will house administrative offices and patient clinics for Duke Health. The project is expected to be completed by the beginning of 2020.
  - WeWork buys Lord & Taylor's iconic 5th Avenue flagship store for $850M for office space redevelopment.

Source: "Duke acquires Macy's spot at Northgate Mall for hospital's largest off-campus clinic," *The Chronicle,* January 17, 2018; "Amazon Turns Shopping Malls Into Warehouses, Changing America's Community Landscape," *Forbes,* May 25, 2019; "ICSC RECon Attendees Feel Cautious Excitement About What Comes Next for Retail" *BISNOW*, May 22, 2019

General considerations for the cost of an exist.

- TENANT'S INVESTMENTS IN THE SPACE
  - Tenant's work
  - Equipment and inventory
- LANDLORD'S INVESTMENTS IN THE SPACE
  - Landlord's Work
  - Tenant Allowance
- BROKERAGE COSTS
- DARK SPACES
  - Lost income stream

Using Rights under the Lease

- TERMINATION BY EXPRESS RIGHT
  - Unilateral Right Without Cause
  - Relocation of Premises
    - Landlords would like to keep their options open with a relocation of premises clause;
    - Landlords may want to relocate a retailer who are occupying space in an otherwise near vacant wing so that a landlord can execute plans for redevelopment;
    - However, landlords may rather see the tenant leave than pay tenant improvement costs to relocate into another part of the mall, particularly if the stability of the retailer is uncertain or the income doesn’t justify the cost

Using Rights under the Lease (cont.)

- SALES KICK-OUT
  - Gross sales and definition
  - Measurement period, including adjustment for periods of closure
  - Sales threshold
  - Recapture of tenant improvement expenses, leasing commissions, etc.

Tenant Defaults

- Failure to pay rent
  - Generally requires notice and right to cure
  - **Remedies:** Landlord may terminate the Lease or Tenant’s right to possession of the space.
- Failure to open and operate
  - Generally does not require notice or right to cure
  - Tenant may be liable for a fee for each day or hour that it fails to be open
  - **Remedies:** Landlord may terminate the Lease or Tenant’s right to possession of the space.
- Mechanics Liens
  - Generally requires notice or right to cure, including posing a bond
  - **Remedies:** Landlord may terminate the Lease or Tenant’s right to possession of the space, or discharge the lien and add the amount paid as “Additional Rent”
  - Bankruptcy or insolvency
    - Unenforceable default under the Bankruptcy Code

Landlord Remedies

- Terminating Possession
  - Landlord may collect past due rental.
  - The rental obligation continues so long as the lease provides for it.
  - Landlord may file successive actions for the unpaid rental as it accrues.
- Terminating the Lease
  - If Landlord does not seek to recover all of its damages – including the future rental – it risks waiving it.
  - In the event of default by a tenant, there are typically two types of remedy provisions that allow Landlord to recover future rent: worth at the time of the award or fair market value.

Worth at Time of the Award formula allows Landlord to the present value of:

+ Past due Rental

+ Future Rental, discounted to present value

+ Plus interest, discounted to present value

– Any amount Tenant proves could be avoided

+ Any other amount necessary to compensate Landlord.

Fair Market Value formula allows Landlord recover:

+ Past due Rental

+ Future Rental

– Fair Market Rental value of the premises through the end of the term

+ Any other amount necessary to compensate Landlord

Landlord Defaults

- Violation of Co-Tenancy or Exclusive Use
  - Generally requires notice and right to cure
  - Remedies: Reduced rent for some period or perhaps terminating the Lease
    - Landlord receives percentage of the tenant's gross sales
    - Generally, not affirmative recovery though.
  - Effect of exclusives and restrictions on lease negotiations
  - Willful landlord violation vs. violation by rogue tenant

Co-Tenancy Issues

- What does “similar” mean?
  - *RadioShack Corp. v. Azusa Pacific Univ.*, 2016 WL 3640370, B262107 (Ct. App. Cal. June 30, 2016): A fitness center was a “similar” tenant as Big Lots because the fitness center drove equal or better foot traffic to the shopping center and sold a small assortment of retail goods that were at least as good a quality as Big Lots’ merchandise.
  - *Shoe Show, Inc. v. One-Gateway Assocs., LLC*, No. 1:10CV13, 2015 WL 5674876, at *8 (M.D.N.C. Sept. 25, 2015) Co-tenancy requirement that a women’s apparel retailer be replaced with a “similar major retailer” was ambiguous and refused to find a violation as a matter of law where the retailer was replaced with a religious book store.
- How is occupancy calculated?
  - *Best Buy Stores, L.P. v. Manteca Lifestyle Center, LLC,* 859 F.Supp.2d 1138 (E.D. Cal. 2012): Finding that a co-tenancy provision ambiguous and that the ambiguities must be resolved through extrinsic evidence.
  - *Claire’s Boutiques, Inc. v. Brownsburg Station Partners LLC*, 997 N.E.2d 1093 (Ind. App. 2013): Occupancy was determined as the percentage of tenants, not the percentage of leased area

Operating Covenants

- Express/Implied
- Go-dark/recapture rights
  - A recapture clause permits a landlord to terminate the entire lease or a portion of it for the proposed assigned space. By giving control of occupancy to landlords, such clauses ensure that they receive all enhanced value of leased property.
  - Although any number of events can trigger a landlord's right to recapture property, they frequently are activated by a tenant requesting assignment of a lease.
- Opening covenants
- Landlord and Tenant positions and arguments
- Safeguards to consider and include
- Termination payments
- Remedies

Negotiated Exits

- LANDLORDS AND TENANTS ON THE SAME TEAM
  - Landlords taking store closure requests seriously
- NEGOTIATED LEASE TERMINATION AGREEMENT
  - Reasons
  - Monetary penalties
  - Method of termination; tying up loose ends
  - Contingencies and payments
- LEVERAGE OF TENANT VS LANDLORD

Midnight Run?

- *Simon v. Starbucks.* Notwithstanding the Continuous Operations Covenants, Starbucks publicly announced it was closing all of its Teavana stores, all in centers owned or managed by Simon.
  - The court enjoined the closures because:
    - Each of the Teavana leases contained a continuous operation provision and gave Simon the right to specific performance.
    - The balance of hardships also favored Simons because Starbucks was financially strong.
    - Each Teavana store was open and operating at the time of the injunction. While courts are generally reluctant to compel a party to act in a certain manner, courts are more likely to maintain the *status quo*, which in the *Simon* scenario meant keeping the Teavana stores open.

Midnight Run? (Cont.)

- *Bellevue Square, LLC v. Whole Foods Market Pacific Northwest, Inc.:* Notwithstanding the Continuous Operations Covenants, Whole Foods simply closed its store.
  - The court rejected an attempt to force Whole Foods to repen because enjoined the closures because:
    - The lease required the landlord to attempt to re-let the premises, such that the lease provided an adequate remedy.
    - The landlord could continue Whole Foods' lease and recover rent.
    - The court did not specifically address the fact that the Whole Foods store had already closed. Demonstrates the reluctance of courts to compel an already closed store to re-open.

Source:

Negotiating in Bankruptcy

- BANKRUPTCY CODE PROVIDES THE RIGHT TO REJECT A LEASE WITHIN 210 DAYS
  - First 120 Days Are Automatic, Additional 90 Days For Cause, Any Additional Time Requires The Consent Of The Landlord.
- FORCES LANDLORDS TO NEGOTIATING TABLE
  - In Enesco’s acquisition of Things Remembered, certain national landlord’s refused to participate in negotiations. With a portfolio of 400 locations and a requirement to only keep 50, Enesco began sending notices of all of the locations with each landlord that it would close. Negotiations opened up nearly immediately.
  - Mattress Firm: the largest mattress retailer in the U.S. closed hundreds of stores to restructure its business.
    - Mattress Firm gave many of its remaining landlords an ultimatum: significantly lower the rent or lose the location.
    - Other landlords were not given the opportunity to take lower rents. Houston-based Beeson Properties had two stores in its portfolio, both of which were shuttered without any communication from Mattress Firm.

Source: Enesco acquisition of Things Remembered case study, Keen-Summit Capital Partners LLC as real estate advisors; “Mattress Firm Issues Ultimatum to Landlords As Battle Over Bankruptcy Closures Begins” *Bisnow*, October 25, 2018

Negotiating in Bankruptcy (cont.)

- BANKRUPTCY MAY BE TOO LATE
- HOLISTIC APPROACH POSSIBLE (OPEN-KIMONO NEGOTIATING)
  - When a retailer requests rental relief due to financial difficulties, Landlords are not accepting a retailer's word for it and are requiring financials and an outline of the turnaround plan.

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