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Found Money! Creative Methods for Monetizing Underutilized Real Estate

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PART ONE

A shopping center is a major asset that has the potential to generate a large amount of income, but are landlords and tenants really getting the most out of their space? The traditional model of a landlord leasing existing premises to an individual tenant and that individual tenant selling its regular merchandise from the premises is not the only way to generate income in a shopping center. There are various creative ways for both landlords and tenants to monetize underutilized parcels and premises with minimal upfront costs. From food halls to performance stages, pop-ups to conservation easements, there is money to be made and every last square foot counts!

This paper will explore several ways to monetize physical space in a shopping center that is either underutilized or undervalued. It aims to provide a summary of different monetizing strategies and the legal implications that parties need to consider when implementing each strategy in a shopping center environment.

MONETIZING STRATEGIES

Pop-Ups

A popular way to monetize unrented space in a shopping center is to enter into a short-term leasing arrangement referred to as a "pop-up". Pop-up stores are temporary retail projects that allow new retailers to test the market and established retailers to generate additional sales or better define their brand. With the pop-up industry as a whole already valued at $50 billion in North America, this strategy can generate significant additional income for both landlords and their pop-up tenants.

Food Halls

Another strategy to monetize underutilized space in a shopping center is to assemble a food hall. A food hall is a collective dining area featuring several mini-restaurants offering quick-service meals. Food halls have been taking over the food scene, with world-renowned chefs coming together to service hungry shoppers in a communal space. A food hall can fill a shopping center "dead zone" and drive traffic to less frequented areas of the center. A food hall also gives restaurant tenants the opportunity to test out new recipes and offerings that have not yet made it on to their permanent menus.

Entertainment Uses

With the recent demise of a handful of retail giants and anchor tenants, some landlords are grappling with how to fill the large spaces that were left behind. Luckily for those landlords, there are an equal number of new players in the market looking to offer consumers experiences such as indoor skydiving, axe throwing and virtual reality gaming alongside their shopping. Entertainment tenants are no longer just movie theatres and bowling alleys. These new entertainment players can back-fill a major footprint of a shopping center and generate additional income for a landlord.

Performance Stages

Another use for large empty space in a shopping center is the creation of a performance stage (indoor or outdoor). Performance stages can be small and simple, with little additional technology, or full-blown concert-ready spaces. Whether such stages are being used by community groups, tenants or an Instagram celebrity, rental fees and ticket sales can offer a new source of income generated by an area of their shopping center that would otherwise remain underused.

Markets

Parties shouldn't simply think inside the box (or inside the shopping center) when thinking of ways to further monetize a shopping center. In addition to outdoor performance stages, a market, such as a farmer's market, set up in the parking lot or outdoor area of a shopping center can be a great way for existing tenants and other retailers to sell new and hand-crafted goods and food items to consumers that aren't looking to shop in a traditional shopping center. By creating these markets, retailers are able to reach a greater number of consumers and landlords able to generate income on a space that would otherwise not be profitable.

Easement and Operating Agreements

Another monetizing strategy for space outside the four walls of a shopping center is entering into an easement and operating agreement with other nearby landowners. An easement and operating agreement is an agreement between two or more landowners whereby the parties agree to share certain rights and obligations pertaining to their respective lands. One example is when two parcels in a shopping center are owned by two separate parties and the parties agree to share the rights and obligations related to the parking area that encompasses a portion of each parcel. By sharing certain rights and obligations (and potentially doing so for an additional fee), a landlord can monetize its outdoor land.

Conservation Easements

Similarly, a landlord can grant a conservation easement. In this scenario, a conservation easement is a device whereby a landowner relinquishes certain rights or opportunities in order to protect the conservation values of a portion of its land. A portion of the landlord's land is granted to an eligible conservation organization or government agency for a fee. The landlord retains title, and continues using the land subject to the restrictions in the easement. The restrictions are designed to protect a set of ecological, scenic and/or agricultural values which are catalogued and agreed upon at the outset. By granting a conservation easement, an environmentally conscious landlord can protect the environment while obtaining additional income.

LEGAL CONSIDERATIONS

The above-described creative uses, which, for the purposes of this paper will be referred to as "Monetizing Uses", create profit, drive traffic and offer guests a curated experience in a shopping center, but they also come with their own list of potential risks and pitfalls. Accordingly, landlords and tenants must address these risks, while still maintaining their ability to generate additional profit for the shopping center and deliver a first-class experience to their customers.

Governing Document

For many of Monetizing Uses, the first item that the parties involved will need to consider is the appropriate agreement to govern their relationship. For some of the Monetizing Uses, such as entering into an easement and operating agreement, it is clear what form of agreement will govern the parties, but for other, what governing document is best will depend on the strategy chosen and the interest of the parties.

The most common forms of agreements used to govern the above-described Monetizing Uses are a lease, a short-term lease, a license, or an occupancy agreement. The answer to the question of which document best suits the circumstances generally depends on three factors: the length of the term of the deal, the complexity of the business arrangement (including its rent structure), and the use to be carried out.

Lease

A lease transfers an interest in land to the tenant and confers on the tenant a right of exclusive occupation. Leases carry certain inherent rights and remedies, including certain statutory protections that are exercisable by landlords and tenants.

Short-Term Lease

A short-form of lease is an abbreviated form of lease that has been pared down to contain only essential terms. A short-term lease is usually created from the landlord's standard form, but is scrubbed to remove unnecessary provisions. For example, damage and destruction and subordination and attornment clauses are perceived as unnecessary in short-term arrangements, particularly where termination rights are available to a landlord.

License

Licenses are typically simple documents and therefore appropriate for uses of limited duration. There are at least three significant distinctions between a lease and a license: exclusive possession, revocability and transferability. A lease grants a tenant, for a defined period of time, exclusive possession and control of its premises without the interference by others, including the landlord. By contrast, a license grants the licensee inferior rights: a mere permission to use the land (which use may be to the exclusion of others, but the user's occupation is never to the exclusion of the licensor). It is important for licensees to understand that, typically, permission to use the land may be revoked at the will of the licensor upon reasonable notice. A license also cannot be transferred by the licensee, unless expressly otherwise specified in the license. This is because a license is a personal right. The benefit of the obligations can be transferred to a third party, but the entitlement to the rights cannot.

Occupancy Agreement

An occupancy agreement may be drafted as a form of month-to-month license. An agreement structured in this way allows the parties the flexibility to adjust the length of the term. (At the end of each month, the agreement can be extended for additional periods of time or amended to, for example, increase or decrease fees payable.)

<u>Rent or Fee Structure</u>

Since the objective of implementing a Monetizing Use in a shopping center is to generate income, it is important to consider how to structure the income generated by the Monetizing Use.

The parties may choose a net rent structure for the deal. Under this structure, the other party will be required to pay the landlord rent and any additional costs associated with that party's share of the Monetizing Use.

In situations where a landlord is able, with reasonable certainty, to quantify costs of operation, including amounts such as realty taxes, it may be more willing to enter into a gross deal or a deal with fixed rates for certain cost items. Short-term arrangements with commencement dates in the near term, such as pop-ups, are well suited to these types of financial structures.

By contrast, financial arrangements that are a function of sales generated from the premises can be very attractive to the other parties involved in a Monetizing Use. In a pure percentage rent structure, a party pays the landlord a percentage of the party's gross sales, generally after sales are generated. In these circumstances, the payment correlates directly to the success of the Monetizing Use, therefore, it is obvious that this scheme has the potential risk of leaving landlords high and dry if the Monetizing Use is unsuccessful.

Construction and Design

More than the average retail tenant, most of the Monetizing Uses described earlier in this paper require a number of design and construction considerations.

A landlord will want to review and approve all of the plans and specifications for any Monetizing Use before a fit-out of the premises and may have a standard construction exhibit that sets out tenant and landlord responsibilities during the fixturing period. The landlord will also want to ensure that the premises and external/internal signage is consistent/compatible with the existing design and structure of the shopping center so as to create cohesive space. Depending on the length of the tenancy and the level of sophistication of the tenant, a landlord may even consider constructing some or all leasehold improvements.

The parties will want to ensure that any construction related to the Monetizing Uses does not interfere with the rights of its existing tenants. Even after construction is complete, the parties need to be mindful of noise and vibration issues that can arise from Monetizing Uses (i.e. bowling balls hitting a floor in a family entertainment center located within a shopping center or music from a performance stage located within a shopping center).

If a Monetizing Use involves the serving of alcohol or having exclusive access to the premises (i.e. for ticket-holding customers only), the parties may also need to consider how consumers will enter the premises. The parties need to design barriers or limited entry points to ensure that minors and non-paying guests are unable to access the premises. Entertainment and gaming related uses and large capacity venues usually have very specific government-imposed exiting and access requirements, which must be addressed.

Further, if the tenant requires exclusive rooftop space for satellites, antennae and other transmission equipment, the landlord may consider requiring the tenant to enter into a license agreement with the landlord and pay an additional fee for this use.

Parking and No Builds

Parties will want to ensure that the Monetizing Uses do not conflict with any other tenant's parking ratio requirements or no-build areas. Landlords wishing to monetize their shopping center parking lot by creating a weekly farmer's market or setting up a temporary performance stage may be restricted from doing so based on its obligations to other tenants.

Parties do not only need to consider the parking ratios imposed by the leases with existing tenants at the shopping center, but also with the parking ratios imposed by the governing municipality. If a Monetizing Use limits the number of parking spaces to an amount less than the municipal requirements, such Monetizing Use will not legally be able to operate. Landlords will also need to study existing easement and operating agreements (or other similar shared facilities agreements) to ensure that they are not offside parking and access obligations in those agreements.

In addition, some of the Monetizing Uses will require significant parking for extended periods of time, which may also cause tension with existing tenants. Parties must ensure that the shopping center (and particularly its parking facilities) can handle any additional volume created by a Monetizing Use.

Use Clause and Existing Restrictive Covenants

Even when looking to monetize underutilized portions of their shopping centers, landlords will want to control the merchandise mix, as well as the character of their shopping center, which is primarily done by way of the use clause contained the agreement governing each Monetizing Use. These use clauses permit the landlord to assemble and co-ordinate complementary food or entertainment uses in order to attract and enhance traffic, offer a variety of cuisines and maximize customer experiences, while minimizing direct competition. When drafting these use clauses it is important to remember that many of the Monetizing Uses are particularly susceptible to market trends and demands. If a Monetizing Use is too tightly constrained by the use clause, the parties may be unable to adequately maneuver to respond to changes in the marketplace.

Parties must be particularly mindful of existing exclusive covenants and prohibited uses when curating Monetizing Uses. Generating additional income from underutilized portions of a shopping center is not beneficial for a landlord if that monetization creates tension and disputes between the landlord and existing tenants. Parties must determine what uses are restricted in the shopping center and determine whether those restrictions also apply outside of the shopping center.

Although some restrictive covenants may only apply within the four walls of a shopping center, it may not be advisable for a landlord to assemble a farmer's market in the parking lot directly in front of its grocery store anchor tenant. The cannibalization of sales would likely offset any benefit gained from the Monetizing Use and potentially have a detrimental effect on the landlord-tenant relationship.

Landlords will also need to study existing easement and operating agreements (or other similar shared facilities agreements) to ensure that they are not offside any exclusive or restrictive covenants, or prohibited uses contained in those agreements.

Permits, Approvals, Zoning and Municipal Requirements

Monetizing Uses typically acquire various permits and approvals to meet municipal requirements. Parties must consider whether there are any zoning issues, permitting timeframes or special permits needed for their intended Monetizing Use.

Parties should be aware of what the applicable shopping center is zoned for and confirm that any Monetizing Use is allowed within that zoning area.

A liquor license will be required for any Monetizing Use that involves the sale of alcohol. The parties must consider which type of license it requires based on its scope of service (i.e. will the tenant sell just beer and wine or will the tenant also sell liquor?). The parties may also be required to meet posting requirements whereby notice may be required to be posted at the premises for a period of time prior to a hearing or approval.

In addition to a liquor license, parties may be required to obtain and maintain various other permits and approvals, such as a license for games, assembly or valet parking (something that is discussed further below).

Insurance

All parties involved in any Monetizing Use should still be required to carry all standard forms of insurance, as well as any insurance unique to that Monetizing Use. For example, it may be appropriate to increase the limits of commercial general liability insurance for risky uses such as axe throwing/simulated skydiving, etc. In the case of establishments selling liquor, liquor liability insurance should be mandated.

Hours of Operation

Monetizing Uses may be more successful when they operate on a unique daily schedule that is outside of normal shopping center hours. Some Monetizing Uses, such as performance stages and cocktail lounges for example, can have their busiest hours far after the traditional retail tenants are closed.

Where the Monetizing Use is connected to an enclosed shopping center, the parties may want to address access issues, including which entrances and exits will remain unlocked for customers and whether common areas will remain lighted so customers and employees can safely exist the shopping center.

The parties may need to consider who will be required to contribute to any of the additional costs and expenses incurred by the landlord as a result of the unique operating hours of the Monetizing Use, including the cost of after-hours common area lighting and after-hours common area heating and cooling.

Security and Crowd Control

With extended hours of operation as well as some unique uses comes expanded security concerns. A landlord will want to ensure the safety and first-class operation of its shopping center. The landlord will need to consider the nature of the Monetizing Use and its hours of operation – will it be open late in the evening? Will it draw large crowds? Will there be a patio? Will there be loud music? Will there be alcohol served?

The parties may want to agree that the landlord is required to maintain proper illumination of the parking facilities and provide security for the shopping center past the operating hours of the Monetizing Use. In the alternative, the parties may want to consider hiring private security personnel to monitor the premises. The sale of alcoholic beverages and large crowds can lead to liability concerns the parties will want to have greater control over.

The parties will also have to consider fire code restrictions and how they will ensure that only a limited number of customers are present in the premises. The tenant may consider installing some form of tracking system, whether it be an old-school turnstile or a modern electronic tracking system.

Noise

The excitement of some of the Monetizing Uses can create a lot of noise. Excess noise may even emanate from the use itself. This may become an issue when one of the Monetizing Uses shares a wall with a traditional retail tenant that does not appreciate the noise created by their neighboring concept. This may even be an issue if the noise comes from outside of the shopping center, but can be heard from inside premises.

The parties may want to address this issue from the very beginning and install some form of noise attenuation in the premises (if applicable). The parties may also want to initially address who is responsible for any noise complaints made by other tenants in the shopping center.

Termination Rights

Parties involved in a Monetizing Use may default under the terms of their agreement due to a failure to obtain a myriad of the proper permissions. Likewise, the parties may fail to obtain, or adhere to, municipal by-laws or simply fail to secure relevant municipal or other governmental permits. Due to the inherent risk associated with some of the Monetizing Uses, parties should ensure they have the ability to move quickly to end the Monetizing Use in the face of a default or failure.

CONCLUDING THOUGHTS FOR PART ONE

The challenges facing shopping centers today are real and pervasive, but there are numerous creative ways for landlords and tenants to monetize unused space. With an open mind and some flexibility, parties are able to find hidden value in parcels and premises by creating exciting pop-ups, offering curated experiences and sharing their land. So long as the parties properly navigate the risks associated with these creative uses, landlords and tenants are able to increase both customer experience and their bottom lines.

PART TWO

Structuring Sale/Leasebacks for Retail Property Owners/ Ground Lessees

Introduction

Sale/leasebacks are an alternative to financing for retail property owners and ground lessees who want to take advantage of financing the entire cost of the development or value of their properties (or of a tenant's leasehold estate) at advantageous rates, without landlord markups. These transactions can be accomplished in a sale/leaseback for owned properties or a sale/subleaseback for ground leased properties (provided that the underlying lease meets the rating agency criteria for such transactions). The parties who can best benefit from these transactions are public or private investment grade company owner/operators (BBB+, Baa2, NAIC2 or better), because there is a market for their long-term, triple net leases. However, sale/leaseback transactions can also be used by non-credit tenants with solid financials (or that of a parent/guarantor). Moreover, sale/leasebacks can be used for single site or multi-site sale/leaseback portfolio transactions, so that national retailers can sell a portfolio of its properties rather than incur transaction costs for the sale/leaseback of each individual property. Finally, an existing single site lease can be converted to a credit tenant ground lease if the lease is amended to comply with rating agency standards – see the Appendix to these materials), so that in can be used in a sale/subleaseback.

Advantages

As set forth in the introduction there are a number of advantages to sale/leasebacks, including economic advantages, favorable accounting/tax/treatment, continued operational control of a property with minimal oversight by a landlord and with many properties being eligible for such transactions.

Economic Advantages.

One of the primary advantages of sale/leasebacks is the ability of a property owner or ground lessee to recoup cash from real estate for operations or expansion. As set forth above, the sale of the property frees up capital for or reduces financing obligations of the seller. Moreover, a seller should be able to exploit the spread between traditional lease rental rates and senior secured debt rates. That is, for credit tenants and entities, these transactions can be financed at senior secured debt rates, which are less than traditional lease rental rates (or traditional finance rates). Additionally, the seller can finance the cost of the improvements. Beyond that there can be economies of scale (e.g., one lease negotiation for multiple sites with one landlord), because it is not uncommon for national retail chains to structure multiple site sale/leaseback transactions. This cuts down on duplicative transaction costs and frees up even more money for an entity to expand or pay down debt. Finally, these transactions have very high loan/value ratio vs. asset based financing (can include 100% of cost). Unlike a loan, which generates anywhere from 50 to 75% of the value of a property, a sale/leaseback generates 100% of its value.

Accounting/Tax (Former Tax Treatment and for Some Tenants Until the End of 2019)

Another important advantage of sale/leasebacks is the accounting and tax treatment of such transactions. For non-public companies, until the end of 2019, this means the real estate would not be treated as an asset on a tenant's books. Accordingly, this avoids depreciation impact on a company's P&L and improves performance ratios (e.g., return on assets). Additionally, the leasehold obligation is not treated as indebtedness on the company's balance sheet (i.e., it is treated as an operating, not a capital, lease) and is considered a true lease for tax purposes. Because of this, a tenant is able to optimize its lease payment stream through the use of Section 467 IRC. All of this is codified in the accounting treatment- FASB Interpretation No. 46.

Accounting/Tax (Current – Pursuant to 2016 FASB-ASC 842)

For public companies with a fiscal year after December 15, 2018 (starting calendar year 2019) and for other companies with a fiscal year after December 15, 2019 (starting calendar year 2020), 2016 FASB-ASC 842 applies to sale/leaseback accounting and tax treatment. This presents a different analysis of what will be considered a capital versus an operating lease (including five criteria that have to be analyzed-- this analysis requires use of a sophisticated accounting firm). Assuming the sale doesn't permit the lessee to repurchase the property at the end of the term or have a less than fair market purchase option (among other criteria), the lease will be classified as an operating lease. Unless the resulting lease is classified as a capital lease, the buyer-lessee will defer immediate gain and will report it over the initial term. In such instance, the buyer/lessee will report the lease as an ROU (right of use) asset and indebtedness on its balance sheet (unlike current treatment for tax purposes). Parties have to be watchful as to whether or not this would affect debt covenants in financings. Accordingly, an entity making this determination should check their debt covenants carefully to make sure that these transactions do not violate them. For many public or private investment companies, this will lead to an analysis of ownership versus sale/leaseback for the impact on balance sheet, financial covenants and stock price. However, in the end, sale/leasebacks will still retain many of its current benefits (e.g., financing of the entire cost of acquisition and development at senior secured debt rates).

Operations/Control over the Real Estate

One important consideration for a property owner or ground lessee in deciding whether to enter into a sale/leaseback transaction is that such party will continue to control the property and its improvements. The landlord in a sale/leaseback transaction is generally passive. The resulting lease in a sale/leaseback transaction does not commonly contain any obligations for landlord (unless it owns adjacent property that has elements which are required to be maintained to serve the property being sold) and is a triple-net, bond type lease. The tenant controls the facility, with certain restrictions based on the requirements of operations in multi-tenanted properties, such as shopping centers, but the tenant is given more flexibility, due to the nature of its estate. One consideration to be aware of in a ground lease transaction is that the tenant should reserve the right to convey its leasehold interest in a sale/subleaseback transaction, to avoid later arguments with its ground landlord. As previously stated, the tenant in a sale/leaseback (or sale/subleaseback) has greater control over its property in operations than in a conventional space lease. Finally, any lease in a sale/subleaseback will generally be required to meet the following criteria: (i) assignment/subletting should be broadly permitted. Due to rating agency requirements, a ground lease that would qualify for a sale/subleaseback must allow broad assignment rights to allow the ultimate buyer/sublandlord an exit strategy if the seller/ground subtenant ultimately defaults; (ii) any lawful use should be permitted (subject to zoning and other laws and covenants, restrictions and exclusives, if any, for multitenant developments). An additional rating agency requirement is that the use of a ground lease property be as broad as possible, subject to exclusives, property mix and the like, to provide the buyer/sublandlord with flexibility if it has to find a new ground subtenant after a default; (iii) property structural and non-structural alterations and expansions should be under the tenant's control, to the greatest extent feasible, provided the value of the property in its improvements is not adversely affected. Sellers/tenants should pay careful attention to the ability to perform alterations and expansions that enhance the value of the properties, to reduce the discretion of the buyer/landlord or sublandlord to prevent it from improving its property; (iv) because the rental income stream is the primary consideration for a buyer/landlord in a sale/leaseback, tenants generally want to have the right to "go dark" (i.e., not have to continuously operate). Many retail tenants do not want to be is restricted from closing a location that is no longer economically viable, but the buyer/landlord needs to know that its rent will continue, despite any such closure. Additionally, in a ground lease situation, where the seller is a tenant, the seller/tenant should reserve the right for it to go dark without having the ground lease terminated or such failure to operate being deemed a default under the ground lease. This could severely affect the pricing of a sale/leaseback (or sale/subleaseback) and/or render the property unfinanceable. If a go-dark clause is agreed to by the tenant, its lender and the buyer, which allows the landlord to recapture the property after a tenant ceases operations on it (for reasons not due to force majeure, etc.), such provision should have long go-dark and re-opening periods (e.g., one year of failure to operate and 6 months to reopen after notice from landlord thereafter) and require the landlord to pay tenant the unamortized costs of tenant's improvements to the property; and (v) a seller/tenant should retain long-term control of its property via favorable renewal options. The leases used in these transactions generally are long-term leases with initial terms of 15-25 years and multiple renewal options. Such renewal options are very often at favorable rental rates, although there are sale/leaseback accounting issues that must be analyzed and adhered to so that the rent resets to a fair market rent after the improvements on the property exceed their useful life. This is one of the reasons a strong accounting firm should be engaged to analyze these transactions.

Properties Eligible for Sale/Leasebacks

As previously mentioned, fee owned and ground leased properties can be eligible for sale/leasebacks or sale/subleasebacks, subject to an analysis of the properties and the leasehold estates. However, companies should consult with their accountants, as well as their attorneys, to make sure that the tax treatment of such ownership structure will be advantageous to the seller/tenant.

Potential Concerns/Considerations

There are a number of potential concerns that must be addressed when considering whether to enter into a sale/sublease transaction, including the complexity of leases and the unfamiliarity of many practitioners with it, dealing with the completion of improvements for properties that are not operational by the date of the closing of the sale/leaseback, addressing potential casualty and condemnation issues (which is quite different than how such issues are dealt with in a more traditional lease or financing), and creating plans for the properties after the term of the sale/leaseback lease ends. These issues are discussed below.

Bond-type lease.

This form of lease is not as familiar to many practitioners, as more traditional space leases, and given the rating agency requirements for ground leases and some difficult accounting issues that are often embedded in these leases, they are difficult to negotiate, unless the attorneys on both sides have significant experience in handling them. The form of lease used in these transactions is often as much of a financial document as it is a lease, to comply with accounting rules for what are generally passive investor landlords.

Failure to Complete Construction.

In some instances in which the seller is a credit tenant with a large portfolio of properties, buyers and/or lenders will accept what is called a “rejectable offer”. This means that if the property improvements are not completed within a set timeframe, the credit tenant must substitute another completed property for it, usually identified in advance (or in a pool of eligible properties). In addition to traditional remedies, such as providing a guaranty of completion by a creditworthy entity or the posting of payment and performance bonds, it is not uncommon for the closing of a sale/leaseback to be delayed until construction is completed to avoid any risks attendant to incomplete construction (e.g. filing of liens, priority issues, etc.) and some large, retail chains only improve fully built (and operational) properties in their sale/leaseback transactions, to avoid these issues.

Casualty/Condemnation issues.

Casualty and condemnation issues often are key concerns for buyers, but most of leases in sale/leaseback transactions require the tenant to rebuild unless it is impossible or economically unfeasible to do so. In some instances, this also includes a rejectable offer concept to protect the interests of the lender and/or buyer. In a ground leased transaction involving a sale/subleaseback, careful attention must be paid to these issues in the original ground lease and one way to deal with this is to use the rating agency requirements as a template (see the Appendix hereto for such criteria).

Potential Upside to the Purchaser after the end of the Term (Reversionary Interests).

Although the term of a sale/leaseback lease is generally long (including the renewal options) which provides control of the property by the seller/tenant for a long period of time, the buyer ends up with a reversionary interest at the end of the term that it can market to third parties. Depending on the value of the property, at that time, it may be able to re-lease, sell or redevelop the property. This is attractive to some buyers who take a long-term view of their investment portfolios. Many buyers also look at this from the perspective of buyers of replacement properties in an IRC Section 1031 tax-free exchange, and view this as something to pass along to their heirs, who will have the right to sell or redevelop the properties at some far future date, with a stepped up basis.

Description of the Transaction

Sale/leaseback transactions are fairly complex and involve a multiplicity of parties (including sellers, buyers, investment bankers, mortgagees, certificates holders, rating agencies and accountants, in addition to attorneys), include a number of key documents that combine both sales and leases, financing and in many instances securities instruments (when the transaction is structured as a private placement or a 144A securities offering) and involve planning for the additional time needed to analyze the purchase of the property by the buyer, deal with the negotiation of a purchase contract, lease, financing and, in some cases, deal with the requirements of a securities offering.

Parties

As set forth above, there can be numerous parties to a sale/leaseback transaction. These include: (i) the company that wants to sell its property and lease it back, who will be both a seller and a lessee, (ii) a buyer, who will be both a purchaser and lessor, (iii) an investment banker which often guides these transactions and finds qualified buyer/lessors, especially when portfolio deals are involved, (iv) in many instances a trustee and possibly a debt certificate purchaser, (v) a rating agency, (vi) Qualified Institutional Investors for a 144A Offering, and (viii) an accounting firm. This also means that there can be multiple law firms involved in a transaction representing the various parties.

Documentation

These transactions involve a number of documents that can be expected in any sale or lease transaction (e.g., a purchase and sale agreement and lease), but also documents that may be out of the ordinary experience of many practitioners. Many of these transactions start off with the search for qualified bidders and an RFP (setting forth the proposed structure of the cash deal, finance deal, private placement or 144A Securities Offering) and once a qualified bidder is chosen, the negotiation of purchase and sale agreement, a form of lease (which generally and in best practice is attached to the purchase and sale agreement), a guarantee, if the tenant entity that will be entering into each lease is not the creditworthy parent, loan documents and the various closing documents involved. There also may be a review of any transfer taxes and other taxes that may be triggered by a sale or long term lease and analysis and structuring to minimize such taxes, to the extent feasible. However, practitioners should be aware that although many of these documents may be familiar to most of us, the terms of them are often significantly different than those normally negotiated, due to the difference in the parties' estates, the level of the tenant's control of the property, which can be tantamount to that of a fee owner during the term, in many ways, and the buyer/lessor's general desire to have no obligation with respect to the property, other than to collect the rent from the tenant, during the term. Accordingly, the documents can be difficult to negotiate, especially for buyers (and their attorneys) who have not negotiated these transactions before and have differing expectations as to their rights as landlords and owners.

Additional Issues to Consider When Dealing With Sale/Subleaseback of Ground Leased Properties.

There are a number of additional issues to be mindful of when structuring sale/subleasebacks of ground leased properties, including rating agency requirements, the impact of any potential default under the underlying ground lease on valuation, and the importance of leasehold mortgagee protections, among other issues that must be addressed. To improve the financeability of the resulting leases in these transactions, it is important that these leases hew to rating agency requirements, as much as possible. Failure to do so can result in lower yields and more difficulty in completing a transaction. As mentioned above, there is a discount in the valuation of ground leased properties, because of the potential for the ground lease to be terminated (and the diminishing value of the estate as the term progresses). This is generally dealt with in the leasehold mortgage section of the ground lease, as discussed below, and with the credit of the underlying tenant or guarantor, but it will still have an impact on a ground leased property's valuation. The credit of the seller/ground lessee is key to pricing and any impact on that credit or any issues regarding the property (e.g. ground lease rent resets, environmental issues, improperly drafted leasehold mortgage clauses and other impediments can affect the pricing of these properties.). Protecting the interests of a leasehold mortgagee is often one or more difficult parts of a ground lease negotiation, especially when a sale/subleaseback is contemplated. The sublandlord/buyer of the tenant's leasehold estate needs flexibility to finance its purchase of such estate and many landlords are not familiar with the requirements and restrictions required to separate the fee and reversionary estates necessary to provide such financing. Additionally, many fee lenders (or at least the people with whom the parties interface with at such lenders) do not initially understand the difference between a traditional lease and a financing lease with separate estates (and in which the tenant assumed the risks and cost of construction and is the owner of the improvements) that need to be protected for the benefit of a leasehold mortgagee and provide the tenant with a standard SNDA that allows the fee lender to be able to recover casualty proceeds and condemnation awards that rightfully belong to the tenant and/or the leasehold mortgagee (who have constructed the improvements at their own cost). Although these issues are generally, ultimately, resolved, it can take a fair amount of time to do so and often requires the parties to get access to the more sophisticated parties at a lender's or its counsel's office to resolve. Accordingly, this issue should be addressed upfront, and a form of acceptable SNDA should be attached to a ground lease to make it financeable.

<u>Process/Timing</u>

Given the complex nature of these transactions, parties should be aware of the additional time that will be necessary to draft and negotiate the documents, evaluate the property (or properties in a portfolio transaction), address any issues raised, identify financing sources and ultimately close; and not have unrealistic expectations of the time it will take to finalize a sale/leaseback. The following is a further exploration of these elements of a sale/leaseback transaction and their potential impact on its timing: (1) Document drafting and negotiation. Unless the parties have done many of these transactions, the documentation is fairly extensive and complex and will take some time to negotiate, especially if the properties are in multiple states; (2) Real Estate/Environmental Due Diligence. Because these transactions include the sale to a third party purchaser, and are often financed, commonly by use of securitized financing, complete due diligence should be conducted, despite the credit of the seller/tenant, and the timing of this process should be taken into account in planning for these transactions; (3) Identification and addressing of issues raised in due diligence. If issues are raised within the due diligence process, these issues must be addressed within the context of the parties respective risk tolerances in the transaction (and the timing of the resolution of issues); (4) Identification of, and negotiation with, financing sources. Because most of the transactions involve loans, loan documents must be negotiated and, although these loans are generally based on the credit of the tenant, as much as the value of the property, these loan documents are typically negotiated by the buyer. However, sellers have to be aware of the potential issues that may be raised by the lenders; (5) Timing of Securities Filings. If the transactions involve a securities offering, the timing of such offering must be taken into account; and (6) Closing. The closing will involve all the parties to the transaction so that they have to be carefully coordinated with such parties and the title company. Because of all of the above factors, these transactions often take a long time to plan, negotiate and complete.

<u>Post-Closing Issues</u>

Like any transaction, sale/leaseback transactions can include a number of post-closing issues, concerns and elements that must be addressed prior to the closing, to limit any later disputes, after the parties are no longer motivated by the desire to close. For the seller/tenant, if construction has not been completed by the closing, the parties need to agree about what, if any, security will be required to be provided to guaranty completion of the construction. As set forth above, guarantees of completion from the tenant or its parent, letters of credit, rejectable offers and payment and completion bonds are tools that are used to minimize the risks of construction and the failure to complete it. This should be negotiated well before the closing occurs and either set forth in the lease or in some other document that makes the parties' expectations and obligations clear. For a seller/tenant which has not completed a subdivision of its land by the closing (which is far from ideal), a mechanism should be set up to accomplish the sale of such excess property, post–closing (this can be difficult if the property is financed using securitized lending). Additionally, a seller/tenant should have the flexibility to make alterations or obtain zoning approvals or relief, if required post–closing, and a mechanism should be set up to deal with this, given the often lengthy lease terms involved in these transactions. On a more mundane level, the lease should address the payment of taxes, common area expenses and the like, as well as property maintenance, which are the tenant's obligations under the resulting triple net lease (although landlord may want proof of such payments and/or a self-help mechanism to protect their estates). From a buyer/landlord's perspective, other than payment mechanisms for rent (ACH payments, etc.) and monitoring of tax and CAM payments by tenants, there should be little need for administration in these triple net leases (many of the buyers of these estates are passive investors and want minimal property related obligations, post-closing). However, notwithstanding the passive nature of most of these investments, buyers/landlords should make sure that the transactions allow subsequent re-sale of their fee estates without penalties or obstacles from lenders (e.g. lockout periods for re-payment or an inability to transfer the property during a loan term without paying an excessive prepayment penalty).

CONCLUDING THOUGHTS FOR PART TWO

A sale/leaseback or sale/subleaseback transaction for national credit retailers is a fairly complex interplay between net leasing, securitized financing and conveyancing law (and in some instances securities law), but is an attractive alternative to traditional financing and allows retailers to draw down the entire values of their properties or leasehold estates and still retain control over such properties or estates. It is another monetizing strategy for retailers and should be considered by retailers with strong balance sheets.

Appendix with Rating Agency Criteria for Ground Leased Properties

The following are the criteria rating agencies consider when evaluating the financeability of ground leased properties:

A. Lease Recording. The ground lease or a memorandum thereof must be of record.

B. Financeability. The ground lease must permit tenant's leasehold interest to be mortgaged by the tenant.

C. Term of Lease. The term of the Ground Lease must be sufficiently in excess of the term of the leasehold mortgage facility. (S&P – 20 years; Duff & Phelps – 10 years; Fitch – 10 years; Moody's – 30 years). This is to preserve the value of the collateral during the full term of the loan and takes into account the possibility of later term defaults and the need to refinance the leasehold mortgage.

D. Ground Lease Assignable. The ground lease must permit assignments of the tenant's interest without consent of the landlord. Among other things, a sale at mortgage foreclosure would involve an assignment of the lease; and such assignment should not require landlord's consent.

E. Estoppel. A landlord's estoppel letter should confirm that as of the closing that the ground lease is in full force and effect, has not been modified and that there are no defaults under the lease.

F. Notice and Opportunity to Cure. The ground lease should provide that the leasehold mortgagee is to receive notice of and an opportunity to cure defaults under the lease. This affords the leasehold mortgagee the opportunity to cure defaults and keep its collateral in place.

G. New Lease. The ground lease must provide the leasehold mortgagee with the right to a new lease in the event the mortgaged lease is terminated, including by virtue of a rejection in a bankruptcy case.

H. Insurance/Condemnation Proceeds. The lease must call for proceeds to be applied to property restoration or to pay down the leasehold mortgage indebtedness.

I. Liens. The ground lease must be free of superior liens and encumbrances.