COMMERCIAL LEASE LAW INSIDER®

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The Practical, Plain-English Newsletter for Owners, Managers, Attorneys, and Other Real Estate Professionals

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Fed Supports Prudent CRE Loan Workouts

The Federal Reserve Board has adopted a policy statement supporting prudent commercial real estate (CRE) loan workouts. The policy statement, adopted by each of the financial regulators (including the Reserve's Board of Governors and FDIC), provides guidance for examiners and financial institutions that are working with CRE borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting properties.

The policy statement also details risk-management practices for these loan workouts. According to a Fed press release, a financial institution that implements a prudent loan workout arrangement after performing a comprehensive review of a borrower's financial condition won't be subject to criticism for engaging in the effort, even if the restructured loan has weaknesses that result in an adverse credit classification. A performing loan, including one restructured on reasonably modified terms, won't be subject to an adverse classification solely because the value of the underlying collateral declined.

FEATURE

Protect Yourself During FDIC Receivership of Bank Tenant

As an owner in the current recession, you probably thought that a tenant's bankruptcy due to the economic downturn would be the most difficult issue you would have to deal with. However, failing banks, unlike your other tenants, are not subject to the bankruptcy process under the Bankruptcy Code. Rather, they are subject to the FDIC receivership process—and, as the owner, so are you.

As the owner of property leased to a failed bank, you have fewer protections under FDIC receivership than under bankruptcy, which is why it is critical for you to understand the process of receivership and what you should do if you are facing—or heading toward—this difficult situation.

Understand FDIC Receivership

When a failing bank is subject to a cease-and-desist order from a government agency, one of the outcomes could be that the bank is taken

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DRAFTING TIPS

Limit Tenant's Right to Lease Audit

When looking to cut costs, one of the first things that tenants try to trim are their operating costs. If a tenant believes that it has overpaid for its share of the building's operating expenses, a lease audit is inevitable for you. Your first step in preparing for audits should be at the lease negotiations stage. Insist on lease provisions that limit your tenant's right to inspect your books and records so that the tenant doesn't have free reign over the process. While you don't want to fight your tenant's right to a lease audit—because you could be accused of cheating or sued for an accounting—you still have to protect yourself if errors are found.

Prohibit Contingency Fee-Based Auditors

One of the biggest points in a lease negotiation for the owner is prohibiting the tenant's use of a lease auditor who works on contingency

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FDIC Receivership (continued from p. 1)

over by the Federal Deposit Insurance Corporation (FDIC) as the receiver. Generally, the FDIC as receiver prearranges a sale of the whole bank or portions of it to another bank or to a buyer—but typically another bank. At that time, the parties enter into a purchase and assumption agreement, which establishes that the buyer is buying the failing bank, but not necessarily buying certain real property assets—in this case, the lease between you and the failing bank. The purchase and assumption agreement also gives the buyer a period of time to evaluate the lease and determine whether it wants to take or exclude it from its purchase of your failing bank tenant.

Regardless of whether the buyer immediately decides that it doesn't want the lease or later excludes it from its purchase of the bank, the FDIC as receiver has the power to repudiate—that is, terminate—the lease. Repudiation is much broader and stronger here than in bankruptcy; it means that the lease can be cancelled *unilaterally* by the FDIC.

Get Control over FDIC Receivership Situation

The FDIC receivership process may leave you feeling powerless over your own property. Even at the outset, you cannot be assured you will receive specific notice that the bank is for sale.

"There are some requirements when the FDIC takes over as receiver, but they are very loose, so the best practice is for the owner to monitor the health of its bank tenant," says Dana Schiffman, a partner at Allen Matkins Leck Gamble Mallory & Natsis LLP. Schiffman, whose practice encompasses shopping center development, expansion, and redevelopment. Schiffman points out that there are various ratings services and Internet resources available that describe the financial health of banks. This is an easy way for you to get a sense of whether your bank tenant might be a candidate for or is already subject to a cease-and-desist order—and might be in the process of ultimately failing and being taken over by the FDIC. The best thing that you can do is know that this is happening and plan for it.

➤ *FDIC Receivership: Owner Checklist*

- ❑ Be vigilant and aggressive about FDIC receivership, says Ted Fates, an associate at Matkins Leck Gamble Mallory & Natsis LLP. Don't assume that you are going to be notified of what is going on with your bank tenants. No one will explain the process to you, so be aggressive about getting information. "Half the battle is knowing what is going on so that you can react to it in the appropriate way," he advises.
- ❑ Be clear from your initial conversation with the FDIC to assert that the rent that is accruing from receivership to repudiation is an administrative claim. You want to make sure that your rent is getting paid, Fates emphasizes.
- ❑ Try to find out as early as possible whether the lease is going to be repudiated. You need as much time as possible to start looking for a new tenant.

What you may be able to recover after a bank tenant's failure and FDIC receivership depends on whether the lease has been repudiated. The FDIC may repudiate at the time that the receivership is put in place *or* within a reasonable time—roughly 90 days. For example, will you be paid for rent that has accrued between the receivership and the repudiation?

To understand what protections you will be afforded under an FDIC receivership and what you may be entitled to recover, contrast it with the bankruptcy process, which you probably already are familiar with, says Ted Fates, an associate at the San Diego office of Allen Matkins Leck Gamble Mallory & Natsis LLP.

Bankruptcy. In the bankruptcy process, a bankruptcy petition is filed with the court and notice goes out to all creditors. (There also is an online system where owners can easily find out if their tenants are bankrupt.) In bankruptcy, the lease may be rejected, which is a concept analogous to repudiation except that there is an ability to collect for the owner's future damages, such as the unpaid rent after the date of rejection. "It's a cap, but there is that ability to recover for damages to some extent," says Fates.

FDIC receivership. In FDIC receivership, access to information about what is going on is limited. You may not get an official notice in the mail that says that your bank tenant has failed and been taken over by the FDIC, says Fates. So you need to monitor it and check the FDIC's Web site for that information. You can check from week to week for banks that have been taken over.

If you find out that your bank tenant has been taken over by the FDIC, what will happen next? At this point, there are two scenarios: Your lease will be assumed and assigned to the acquiring bank, or, if the acquiring bank does not want to assume your lease with the failed bank, the lease will be repudiated by the FDIC.

You probably will have to wait—up to 90 days—while these decisions are made. During that time you can try to reach out to the acquiring bank to get more information on whether it plans to assume the lease. An owner equipped with the knowledge of what is going on might want to negotiate with the buyer during the period between the receivership and the repudiation or assumption decision, to restructure the lease, which might otherwise be repudiated. You can find out who the buyer is through the FDIC.

Be persistent in reaching the appropriate people at the buying bank if you believe that your space is not one that they are going to want. You need market information to determine whether this location is a strong or redundant one before you initiate these discussions, so you can offer appropriate lease restructuring incentives.

The buyer may reach out to you first if it is interested in restructuring, which may be good news for you because even in post-receivership you will have a solvent tenant and be able to deal with it in the normal course of events.

If Lease Is Repudiated

If your lease is repudiated and rent had accrued before the FDIC stepped in as receiver, you will have to get in line behind depositors to get paid. If funds are generated from the sale of the bank, depositors get paid first and creditors get paid second.

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MODEL AGREEMENT

Understand Purchase and Assumption Terms That Affect You

The following clause from a purchase and assumption agreement was provided by Dana Schiffman, a partner at Allen Matkins Leck Gamble Mallory & Natsis LLP. It is an example of one term that the FDIC and a potential buyer will agree to if the buyer decides to take over your lease.

PURCHASE AND ASSUMPTION
AGREEMENT WITH RESPECT TO BANK PREMISES

Option to Lease. The Receiver hereby grants to the Assuming Bank an exclusive option for the period of ninety (90) days commencing the day after Bank Closing to cause the Receiver to assign to the Assuming Bank any or all leases for leased Bank Premises, if any, which have been continuously occupied by the Assuming Bank from Bank Closing to the date it elects to accept an assignment of the leases with respect thereto to the extent such leases can be assigned*; provided that* the exercise of this option with respect to any lease must be as to all premises or other property subject to the lease. If an assignment cannot be made of any such leases, the Receiver may, in its discretion, enter into subleases with the Assuming Bank containing the same terms and conditions provided under such existing leases for such leased Bank Premises or other property. The Assuming Bank shall give notice to the Receiver within the option period of its election to accept or not to accept an assignment of any or all leases (or enter into subleases or new leases in lieu thereof).

FDIC Receivership

(continued from p. 3)

However, you can enforce payment of the rent that accrued *after* the FDIC receivership but *before* the repudiation. This is because the rent has accrued during a period of administrative priority, says Schiffman. If the lease is repudiated and terminates, the owner cannot collect future damages, such as rent through the end of the lease term. In comparison with bankruptcy, with the FDIC as receiver, there are no future damages to collect.

Although the FDIC has the discretion to determine what is and is not a priority claim, it generally does consider the rent between the receivership and repudiation as a priority and pays it, notes Fates, whereas payment of rent is absolutely required under the Bankruptcy Code.

When a tenant goes into bankruptcy, there is an automatic "stay" during which creditors cannot collect from the bankrupt tenant at all. Even sending a letter to the tenant demanding payment is considered a violation of the very broad automatic stay. In an FDIC receivership, there is no automatic stay, so the owner can continue to demand payment of the rent from the failed bank and take any steps it deems appropriate to enforce its lease. "Owners should not be hesitant to aggressively pursue their tenants for full rent after the FDIC receivership has begun," says Fates, "because they are not risking violation of a stay."

If Lease Is Assigned

If the buyer has determined that it will take over your lease with the failed bank, it still must deal with restrictions on transferability that are found in many commercial leases. Again, the FDIC acts as a trustee in this situation. As receiver, it has the complete power to transfer the leasehold without anyone's—even your—approval to the incoming bank.

In this situation you will have no control or input at all. That is an important distinction. In bankruptcy, sometimes the assumption is coupled with the new tenant sharing certain past defaults, but there is no such requirement with respect to assignment and assumption orchestrated by the FDIC, and you will have far less protection in this context.

FDIC Receivership Is Emerging Issue

As an owner in a recession that has very negatively affected commercial real estate, it's crucial that you try to understand what is happening with banks in the context of commercial real estate.

"It really has been a difficult time to make complete sense of the market dynamics," says Schiffman. He says that although the big national banks have achieved a degree of health and have gone through a stress test, many local or regional banks are under regulatory pressure behind the scenes that is building. For as many failures as there already have been, there will be a lot more, he predicts. Owners with failed bank tenants are realizing that the FDIC is now *their* owner essentially and that they are subject to this process—even though it is the tenant that has failed.

Insider Sources

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Search Our Web Site by Key Words: FDIC receivership; lease repudiation; lease assignment; bankruptcy

RECENT COURT RULINGS

➤ Tenant Was Not Constructively Evicted

Facts: A tenant operated her floral shop out of a shopping center under a three-year lease with the center's owner. After another owner bought the shopping center, the tenant agreed to extend her lease by five years. The lease extension agreement stated that the original lease would "remain in full force and effect" for the remainder of the lease.

Three years later, the tenant noticed water entering her shop. The shopping center manager couldn't determine the cause of the problem and hired a company to perform water extraction and drying services. Eventually, it was determined that a newly constructed concrete ramp built for another tenant in the alleyway behind the floral shop caused the flooding. Rainwater that flowed over the ramp's edge and under the door of the adjacent store was migrating into the floral shop. A piece of metal and a new door were installed and successfully diverted the water migration.

Over the following months, the tenant discovered several patches of mold in her store, which were

treated and sealed by the same company that handled the water extraction and drying services. New carpeting also was installed in the tenant's office, but she refused any additional mold remediation and subsequently permanently closed the shop.

The tenant sent a letter notifying the owner that she was immediately vacating her unit at the shopping center because it had become "uninhabitable" due to the flooding and resulting mold infestation. The owner sent a letter to the tenant stating that she was in default under the terms of the lease agreement for failure to pay certain annual billbacks for a previous year. She paid the billback charges two months later but refused to pay rent for the period of time when the water migration and mold affected her store up until she vacated the space.

The tenant sued the owner for breach of the lease and constructive eviction; the owner sued the tenant for breach of the lease. The trial court ruled in favor of the tenant and awarded $32,000 for economic damages and mental anguish and $40,000 for attorney's fees. The owner appealed.

Decision: The appeals court reversed the trial court's decision.

Reasoning: On appeal, the owner argued that it had not constructively evicted the tenant because under the lease it was not liable to the tenant for any injury or damage from the water. The lease provisions stated in part that "Owner shall not be liable to Tenant for any injury to person or damage to property caused by the Demised Premises or other portions of the Shopping Center becoming out of repair or by defect or failure of any structural element of the Demised Premises or of any equipment … backing up of drains, or by gas, water, steam, electricity, or oil leaking, escaping, or flowing into the Demised Premises." However, the owner was responsible under the provisions for damage resulting from its "willful failure" to make repairs required under the lease within a reasonable time after being notified of a problem.

The tenant argued that the provision applies only when the injury or damage is caused by the leased premises or other portions of the shopping center "becoming out of repair," and her damages award was not based on something that became out of repair.

The appeals court removed from the provision the language that was inapplicable to this case, so that it read: "Owner … shall not be liable to Tenant for any injury to person or damage to property caused … by … water … flowing into the Demised Premises." According to the appeals court, this language excused the owner from liability for the damage to the tenant's floral shop—including the mold—caused by the water migration, and therefore, the owner had not constructively evicted her. As a result, she no longer was entitled to damages.

The appeals court also ruled that the owner had not breached its lease with the tenant because it had not, as she alleged, constructively evicted her. The tenant had no other excuses for the nonpayment of rent. The appeals court ruled that the termination date was specified in the lease and, until that time, the tenant was required to pay monthly rent. A failure to do so would result in a default.

- Cove Terrace Associates, I, LTD., as successor in interest to CTE Shopping Centers I, Ltd. v. McGuire, October 2009

➤ Owner Not Allowed to Profit from Wrongdoing

Facts: An owner of a Miami, Fla., office building that was still under construction signed a 10-year lease with a tenant under which the tenant would move in 90 days after completion of the building. The lease was signed by one of the owner's employees and the tenant's president and vice president. However, there were no witnesses to any of the signatures. As the building neared completion, the owner repudiated—that is, rejected—the lease because the signatures had not been witnessed. The tenant sued the owner for "specific performance"—that is, a court order to compel it to carry out the lease—and for damages for fraud and breach of contract. The owner asked the trial court for a judgment without a trial in its favor on both claims.

The trial court granted the owner's request, ruling that specific performance of the lease was not appropriate and that the tenant was not entitled to damages. The tenant appealed.

Decision: The appeals court upheld the trial court's judgment without a trial in the owner's favor as to specific performance of the lease, and reversed it as to damages.

Reasoning: On appeal, the owner argued that to be valid under Florida statutes a lease for more than one year must be signed by the owner or his representative in the presence of two witnesses. The tenant maintained that the lease was valid even though the owner sent no witnesses on his behalf to the lease signing. It claimed that an exception to the two-witness rule

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Recent Court Rulings (continued from p. 5)

applied because the owner is a corporation. However, the tenant was incorrect; the owner is a limited liability company.

The appeals court agreed with the trial court that the lease was unenforceable because of the lack of witness signatures on it. It noted that in Florida a limited liability company leasing commercial real estate, like the owner in this case, must have two witnesses to a lease signing. Otherwise, the lease is not valid and binding upon the company.

According to the appeals court, the owner should not be stopped, or barred, from relying on the two-witness rule simply because it drafted the lease, failed to provide lines for its witness's signatures, and failed to have the witnesses attend the lease signing. "The bare failure of the owner to have his signature witnessed does not give rise to an estoppel, because for an estoppel to operate, the tenant must have changed its position in more than an insubstantial way," said the appeals court. The appeals court determined that that was not the case here, so it agreed with the trial court that specific performance was not appropriate.

However, the tenant was entitled to damages because the lease itself was valid according to its terms, but failed because it lacked the witness signatures required by state law. The appeals court noted that even if a lease otherwise complied with the law, a tenant still could pursue fraud and breach of contract claims if the lease was defective as a result of noncompliance with the two-witness requirement. The owner could have cured the deficiency at any time, but failed to do so, instead relying on the absence of witness signatures to disavow the contract. The appeals court concluded that an owner will not be allowed to profit from its own wrong.

- Skylake Insurance Agency, Inc. v. NMB Plaza, LLC, October 2009

Drafting Tips (continued from p. 1)

to perform the audit. These lease auditors get paid based on the amount of money they save for the tenant with the errors they find. Insist on a certified public accountant who is being paid on an hourly basis to do the audit. This is a major point that gets negotiated into lease audit provisions, says Rapkin, a shareholder at Akerman Senterfitt.

Another controversial issue is the threshold requirement for how much the owner should pay for the tenant's audit. For example, if the owner agrees to be responsible for reimbursing the tenant for the cost of the audit if its errors reach a certain amount, what will that amount be? How erroneous do the charges have to be to trigger the owner's obligation to pay? This is a critical number and one worth fighting for in the lease.

Usually, the owner and tenant agree on a percentage of the money, if any, that is owed to the tenant as a result of errors. Your best option is to negotiate provisions that make the tenant perform any audits at its "sole cost and expense." For an example of this type of provision that you can adapt, see our Model Lease Clause: Negotiate Owner-Favorable Lease Audit Provisions.

Imposing a limitation on how often the tenant can perform a lease audit and whether the tenant can exercise its right to audit if it is in default are two provisions that limit your exposure to unnecessary delving through your books and records.

The most important thing you can do not just for lease audit rights, but every other aspect of a commercial lease is to negotiate from *your* form lease. To start with, an audit right *won't* be in your form. Some tenants are unaware of how lease audits may help their bottom line. It's up to the tenant to bring up the lease audit point, says Rapkin, and offer language that it is comfortable with. But remember to include an operating expense provision with terms on how these expenses are paid monthly and how they are reconciled at the end of the year.

Include Crucial Resolution Provision

When negotiating lease audit provisions, Rapkin likes to have a final and binding resolution provision to handle disputes. Without this provision, a disagreement about the audit could spark a lawsuit. Rapkin's provision dictates what happens if there is a dispute: If the owner disagrees with the audit results, the owner and tenant refer the dispute to a mutually acceptable independent certified public accountant who will work with them to resolve the discrepancy, and render a final and binding decision. Our Model Lease Clause includes such language.

"This achieves finality without a lawsuit," says Rapkin.

Regardless of the length of the provision, it should include what happens as a result of an audit's findings: If there is an overpayment, the owner pays the tenant back; if there is an underpayment, the tenant pays the owner; and if there is a discrepancy and the owner disagrees with the audit, it is handled in an agreed-upon way. "But just to say 'once a year the tenant may look at the owner's books and records' is not enough," cautions Rapkin. This leaves open the issue of what happens if the tenant initiates an audit and finds errors.

Insider Source

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MODEL LEASE CLAUSE

Negotiate Owner-Favorable Lease Audit Provisions

The following lease audit provisions were drafted by Eric D. Rapkin, Esq., who has a full-service commercial real estate practice, including the leasing, financing, acquisition, and disposition of office buildings, shopping centers, hotels, and industrial properties for developers, retailers, and institutions. Show these provisions to your attorney before using them.

Note that the provisions here are very owner-friendly because the tenant alone must pay for the audit and may not use a contingency fee auditor.

TENANT LEASE AUDIT

During the Term or any extension thereof, but not more than [*insert #, e.g., 1*] time per year, and provided that no monetary default exists under this Lease beyond applicable notice and cure periods, Tenant, at its sole cost and expense shall have the right to cause Owner's books and records with respect to Operating Expenses to be audited by an independent certified public accountant (not to include a contingency fee auditor) of Tenant's choosing. Owner shall cause such books and records to be made available for such inspection during such normal business hours as are prescribed by Owner and at such location where Owner regularly keeps its books and records, upon [*insert #, e.g., 10*] business days' prior notification to Owner. (Prior to the audit commencing, upon Tenant's request, Owner will reasonably cooperate with Tenant in order to review the billing in question and the back-up documentation therefor, in order to explain any questions Tenant may have prior to Tenant conducting the audit.) Such audit shall be done in accordance with generally accepted accounting principles, consistently applied.

If, at the conclusion of such audit, Tenant's audit of such expenses for the preceding year indicates that Tenant made an overpayment to Owner for such preceding year, Owner shall credit such amount to Tenant's subsequent payments of Rent, or if the Lease has terminated, and no default exists under the Lease, remit the amount of such overpayment to Tenant within [*insert #, e.g., 30*] days after receipt of notice from Tenant of the amount of such overpayment. If, at the conclusion of such audit, such audit reveals an underpayment by Tenant, Tenant will remit the amount of such underpayment within [*insert #, e.g., 30*] days of Tenant becoming aware of such underpayment.

Should Owner disagree with the results of Tenant's audit, Owner and Tenant shall refer the matter to a mutually acceptable independent certified public accountant, who shall work in good faith with Owner and Tenant to resolve the discrepancy. The fees and costs of such independent accountant to which such dispute is referred shall be borne by the unsuccessful party and shall be shared pro rata to the extent each party is unsuccessful as determined by such independent certified public accountant, whose decision shall be final and binding.

With regard to Tenant's initial audit, Tenant, or its employees or agents, may not make any copies thereof, and such books and records and the results of any such audit are to be kept strictly confidential and are not to be made available or published to anyone, unless required by any applicable legal requirement or governmental authority.

Owner shall pay the cost of Tenant's initial audit if the total amount of Operating Expenses used for the calculation of pass-throughs for the year in question exceeded [*insert #, e.g., 10*] percent or more of the total amount of Operating Expenses that should properly have been used.

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