

ARTICLES

Five Lessons Learned by Landlords and Tenants from Past Recessions

By Larry L. Shosid – July 31, 2018

“Enjoy it while it lasts. It never does.” In today’s frothy economy and real estate market, it is easy to become caught up in the excitement of the development boom, high rental rates and great returns. Experts believe that this real estate cycle is more recession proof than in past times for numerous reasons: more stringent lending requirements, larger equity requirements, and lessons learned from prior downturns.

Developers, brokers, and landlords are eternal optimists by nature. There is a prevalent sentiment that things are great and will stay that way for the foreseeable future. However, real estate is cyclical and, while it is impossible to predict when the next recession will come, it is clear that our current expansion is nearing an end. According to Forbes, our current recovery is the second longest expansion since World War II. In July 2019, it will match the longest. A downturn could be triggered by adjustments in the stock market, interest rate increases, trade wars, foreign aggression, terrorism, and so on. It is impossible to predict or see it coming until it’s too late.

In the good times, it’s easy to chase the deal, and compromise the standards and principles that you follow in soft or depressed markets. But landlords and tenants still need to protect themselves in the good times, because at some point the good times become the not so good times, and eventually slip into a depressed market.

In good or bad times, landlords and tenants should focus their attention on the points below in their leases and do their best to protect themselves in each of these areas.

Security deposits and prepaid rent. Tenants with good credit very seldom pay security deposits and prepaid rent. However, these payments provide great protection for landlords, and owners should strive to obtain them. A compromise can be for the security deposit to be returned prior to lease expiration, perhaps after the tenant improvement allowance and broker commissions have been amortized. Tenants don’t like security deposits, but lease negotiations rarely fall apart because of the landlord insisting on one.

Personal and corporate guaranties. It’s common for tenants to form subsidiaries or affiliates to serve as the tenant under a new lease. Landlords should be careful to obtain a corporate guaranty from the holding company to ensure that it has the full credit of the enterprise standing behind the lease. For tenants that are closely held, it’s important to consider asking for a personal guaranty from the controlling owner. Personal guaranties are an enormous incentive for the tenant to make every effort to perform under the lease.

Real estate taxes. Tenants with excellent credit should make every effort not to pay the landlord for real estate taxes in monthly installments. Otherwise, you’re simply providing the landlord with an interest free loan. Tenants should pay their pro rata share of real

estate taxes either right before or right after they're due. There should also be a covenant by the landlord to timely pay in full all real property taxes, subject to the landlord's right to contest valuations without incurring penalties and interest.

Operating expenses. Operating expenses may be one of the first areas to experience issues if the landlord is having cash flow problems. Vendors are paid late or services are reduced, even in situations where the tenants are responsible for paying the operating expenses on a project. In order to protect against these issues, it's helpful to have an express covenant that the landlord will maintain the property at a certain level (e.g., specific class of buildings within the same submarket) and to pay all vendors in a timely manner. As a last resort, it is beneficial for tenants to have the self-help and cure rights discussed below.

Self help. Tenants want to be able to remedy a landlord's default if it is adversely affecting their use and enjoyment of the premises. As one might imagine, landlords are hesitant to allow tenants to take over any aspect of management and maintenance of the property. There are a number of safeguards to put in place to protect both sides, including providing the landlord with one of more written notices and the opportunity to cure, limiting the action that a tenant can take to the payment of monies (e.g., taxes, insurance and management company), and making the tenant obtain some type of court order if the landlord is contesting the action in good faith. A different question is whether the landlord will allow the tenant to offset its costs and expenses against rent. Landlords (and their lenders) are usually very hesitant to agree to allow offsets, but tenants with leverage can usually obtain some type of offset rights. Tenants should also receive interest and a management fee for any work performed on behalf of the landlord.

Subordination, nondisturbance, and attornment agreement (SNDA). Obtaining a commercially reasonable SNDA is the greatest single protection a tenant can obtain from the landlord and its lenders. It allows the tenant to stay in the premises with a direct, contractual relationship with the purchaser of the property in the event the landlord defaults under the loan and the building is sold at foreclosure. Unfortunately, smaller tenants usually don't have the leverage to obtain SNDAs. SNDAs have become complicated these days. Lenders want approval rights over lease amendments, cure rights and no responsibility for the acts of prior landlords. It's important to negotiate these provisions to appease the landlord without modifying the lease that the landlord and tenant negotiated in great detail.

Assignment. Landlords need to be careful about a tenant's right to assign or sublease the lease. The assignment provisions need to be clear that the assignor remains liable under the lease, and that the assignee must satisfy the same leasing requirements as if a new lease is being signed. These provisions give the landlord the opportunity to evaluate the new arrangement in advance and protect itself.

Cautious landlords and tenants don't run the risk of being Chicken Little. The sky will fall at some point. It's a matter of when. Not if. When the recession hits, the parties will be glad that they prepared themselves for depressed markets and adverse circumstances. The above protections, embodied in the lease, will protect the parties and serve to mitigate the tough times. We're marching toward the longest economic recovery in modern times, and it's inevitable that the good times won't last forever.

[Larry L. Shosid](#) is a partner with Bell Nunnally & Martin LLP in Dallas, Texas.