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### TRANSACTIONAL REAL ESTATE

# Sale-Leaseback Transactions



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Sale-leaseback transactions have long been a means for operating businesses to monetize their real estate holdings and reduce leverage. Sale-leaseback transactions may be of particular value to companies that are not in the business of owning real estate per se. The transaction allows the seller to convert equity in real property to cash immediately available for debt reduction or operations, while retaining possession and continued use of the property during the term of the lease.

Over the last several years, sale-leasebacks have been implemented with increasing frequency, perhaps driven in part by a proliferation of real estate investment trusts (REITs) and other institutional buyers seeking the stable returns these transactions provide, and in part by private equity buyers seeking an alternate means to finance the acquisition of the companies that occupy the real estate or, as part of the acquisition, to delever the company. The sale-leaseback market has grown robust, to the point that attractive deals are now available to tenants with weaker credit quality; in addition, tenants are able to command favorable non-economic terms.

Sale-leasebacks are attractive to operating companies for a number of reasons. A

sale-leaseback usually yields more proceeds than traditional mortgage financing. Lease payments are typically calculated to provide for a stated return on the purchase price over the term of the lease, plus agreed rent increases. The proceeds of the sale can, in some cases, exceed the fair market value of the real estate, provided that the buyer can underwrite the rental stream and residual value to support the price.<sup>1</sup> For a private equity firm looking to finance the acquisition of a company with significant owned real estate holdings, the sale-leaseback is a preferred financing tool, and may be particularly attractive for a business with poor credit that may have difficulty finding attractive debt financing.

Many companies only pursue sale-leasebacks if the lease will be classified as an “operating lease” under applicable accounting standards rather than a capital lease (i.e., a financing). With operating lease treatment, the seller’s fixed asset (i.e., the real estate) is replaced with a current asset (i.e., the cash proceeds from the sale), the rent payments will be treated as deductible operating expenses, and the property is not recorded as an asset on the books of the seller-lessee (and, consequently, the transaction is not treated as debt for the seller-lessee).

If the lease is classified as a capital lease, the property remains an asset on the lessee’s books and the lease obligations are treated as debt on the company’s balance sheet. Oper-

ating lease treatment is often beneficial to a lessee in meeting debt covenants under its corporate-level financing.<sup>2</sup>

### Disadvantages

The sale-leaseback does come with some disadvantages for the seller-lessee relative to owning the real estate with debt financing. The company loses both the residual value of the property and the benefits of appreciation and, more importantly, runs the risk that the property may not be available to it at the expiration of the lease term.<sup>3</sup> The company runs the risk of losing its core operating assets if it cannot comply with the lease terms. Perhaps the greatest drawback is the loss of operational flexibility that comes with the lease covenants designed to protect the buyer’s investment. The lease may place meaningful restrictions on use, alterations and transfers, and will impose obligations enforceable by the lessor for many aspects of the operations at the property. A corporate secured loan (a likely alternative to a sale-leaseback transaction) will impose covenants of a similar nature, but such covenants will typically be far less restrictive.

In particular, the lease may significantly compromise the ability of the company to transition out of uneconomic locations, and may impose restrictions on corporate-level transactions. The seller-lessee will want to preserve, to the greatest extent possible, the right to “go dark,” dispose of unprofitable or

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obsolete locations and enter into corporate level transactions—matters over which the seller-lessee has unfettered discretion when owning the property, but all of which are generally viewed by buyers with concern.

The lessee's desire for flexibility is complicated by a lessor's bankruptcy concerns in multi-property sale-leasebacks. Buyers will insist on the characterization of the lease as a "unitary" agreement demising multiple properties, as opposed to a lease severable with respect to each property (or groups of properties). The risk of the latter characterization in a bankruptcy of the seller-lessee would allow "cherry picking" of locations by the seller-lessee pursuant to the lease rejection right provided by 11 U.S.C. §365, leaving the lessor with only the less desirable properties and a diminished income stream. Lessors will generally prefer, even in a large portfolio transaction, to have a single lease, or at most a limited number of master leases involving multiple locations, in order to limit "cherry picking." Even with a single master lease, lessees have been successful in convincing a bankruptcy court to use its equitable powers to treat the lease as severable based on certain features of the lease.<sup>4</sup> Certain lease provisions on which the seller-lessee may insist in order to maintain operational flexibility (such as the right to terminate the lease with respect to individual properties in the event of a casualty or in the event that such properties are no longer useful in the conduct of the seller-lessee's business, or to renew the lease as to some properties but not others) can be regarded as inconsistent with the unitary lease characterization and present a recharacterization risk to the lessor.

### The Right to "Go Dark"

Particularly in the case of retail and restaurant properties, sale-leaseback leases frequently require that the tenant continuously operate in the leased space, with the specifics of such a requirement being subject to negotiation (and with portfolio transactions generally allowing more flexibility with respect to continuous operation covenants than single-property leases). Even where

the lessee has subleasing and/or substitution rights (as discussed below), it may be important for the lessee to have the right to shut down its operations (i.e., "go dark") if the economics of a particular location make it prudent to do so. While the lessee must continue to pay rent even if permitted to "go dark," the location may be operating at a significant loss even without taking rent into account, and there may be a variety of other business reasons dictating such closure.

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Lessors, on the other hand, generally take the view that a continuous operation covenant preserves the value of the building that serves as their collateral. Notwithstanding the covenant in the lease requiring maintenance and repair, lessors will argue that a lessee is more likely to maintain the property at the appropriate level if the lessee is operating at the property. In addition, lessors tend to perceive the risk of the tenant rejecting the lease in bankruptcy as diminished if the tenant is actually operating its business at the property.

The market has recently swung in the lessee's favor and the right to "go dark" has become more common. A middle ground is often reached, allowing a right to cease operations at a limited number of locations in a portfolio transaction and/or a right to cease operations for a specified period of time (generally to allow the lessee to cease operating while seeking an appropriate sublet), but not indefinitely. Lessors will be unable to provide this flexibility for properties that are subject to covenants to operate in favor of adjoin-

ing owners or ground lessors (in particular in the retail context, where reciprocal easement agreements for shopping centers may contain their own operating covenants). Continuous operating covenants in third-party agreements often provide for a reversion of title or a purchase option in the event the covenant is breached.

### Right to Sublease

The most feasible means for a lessee to free itself from an unwanted property is a broad right to sublease. Assignment is not a useful right to deal with specific locations in a sale-leaseback structured as a multi-property lease. A sublease, however, allows the company to shed an uneconomic property while ameliorating the economic loss involved.

Given that the lessee continues to remain liable to the lessor for all rental and other obligations under the lease in the event of a sublease, logic would dictate that the lessor should be flexible with sublet rights. However, lessors are often concerned about reputational issues that may accompany certain subtenants and also may be concerned that a "less substantial" subtenant is less likely to maintain the property to the proper standard and to otherwise comply with the lease.

In addition, as in the case of "going dark" provisions, if too many locations (or in a single-property transaction, significant portions of the property) are no longer used in the lessee's business, it may increase the risk of rejection by the lessee in a bankruptcy. Consequently, negotiations will often center on limiting the number of locations or the portion of a single property that may be sublet, and in some cases subtenants are required to satisfy certain financial and operational requirements.

From the lessee's perspective, it is important to negotiate a requirement that the landlord provide subtenant non-disturbance so that subtenants will be recognized as direct tenants by the landlord should the primary lease be terminated. Without non-disturbance protection, the universe of potential subtenants will be somewhat limited. Lessors understandably and strongly resist such a requirement, particularly if it

is not limited to sublessees and subtenants meeting standards satisfactory to the lessor. The lessor may argue, for example, that a sublease at a rent below the ratable lease rent for the applicable property should not be entitled to non-disturbance, although if a sublease is at market rent the lessor would be no better off were it to re-lease the property after termination of the lease.

Even where a lessor will agree to subtenant non-disturbance, it will often limit the number of subleases that are eligible for non-disturbance during the term, and also may provide non-disturbance only to subtenants of a certain credit quality.

Sublet rights may unwittingly be frustrated if the use clause of the lease is drafted too narrowly. From a lessee's standpoint, the use clause should allow any "legally permissible use," but lessors may seek to define permitted uses with more specificity, especially if the use figured prominently in the lessor's underwriting (in which case the use clause may take a more restrictive form, such as operation of a store under the company's existing and/or future trade names).

### Property Substitution Rights

In a portfolio transaction, a lessee may also eliminate a location that is no longer economically viable by exercising a property substitution right. Effectively, a substitution right allows the lessee to "swap" one or more new properties for one or more of the properties in a lease portfolio. This right is usually limited to no more than a specified number of substitutions during the term of the lease. Typically, the lessor has approval rights over the substitute property in accordance with its underwriting standards, and the value of the substitute property must be no less than the value of the existing property. The lessor will condition the substitution on approval from the fee lender, if applicable. Once the substitution is completed, the lessee can freely sell the substituted property.

### Partial Renewal

If the lease has an "all or nothing" renewal provision, the lessee would be forced to exercise the renewal rights with respect to all

leased properties, and thus take on the less desirable locations in order to maintain the better locations. Lessees frequently negotiate the right to renew the lease for fewer than all of the properties in the lease portfolio. This allows the lessee to dispose of undesired locations at the end of the initial term or any renewal term. Lessors are typically flexible with renewals, given that they usually underwrite the transaction based on the initial term. However, in many cases the lessee may be limited in the number of locations that may be excluded with respect to each renewal. The right to selectively renew is another feature that may be in conflict with the unitary lease analysis.

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### Sale of the Company

With sale-leasebacks frequently involving a substantial portion of a company's operating locations, it is imperative that a lessee negotiate the flexibility to enter into a sale, merger or other combination of the company so that the lessor does not have the ability to hold up a corporate-level transaction. The lessor usually takes comfort so long as the party who is the lessee under the lease at any given time has substantially all of the operating assets of the lessee that it underwrote. The permitted transfer provision should address (a) sale of all or substantially all of the lessee's assets, (b) sale of all or substantially all of the direct or indirect equity in the company, or (c) merger (of either the lessee or a direct or indirect parent) with a third-party entity.

The ability to consummate corporate-level transactions is fairly market-standard; where

lessors resist these provisions, it is usually over concerns that the transaction will result in a change in the capital structure of the lessee's enterprise that reduces the credit quality of the lessee. Lessors occasionally bargain for requirements that must be satisfied if the lessee is to undertake a corporate-level sale or merger, such as (a) a requirement that the senior management team of the successor lessee have substantial experience in operating the business, and/or (b) net worth, EBITDA or other financial tests.

One risk that lessors must consider is the lessee's ability to enter into transactions to strip assets from the lessee that do not involve transfer of the lease. An ongoing financial covenant from the lessee may adequately protect the lessor against such a risk. Absent any ongoing financial covenants of the lessee, though, the lessor may require that the lessee include the lease in any transaction involving the sale of a substantial portion of the lessee's other assets.

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1. A typical term structure for a lease is 20 years plus four (4) five-year extension terms, so the underwriting would be limited to the initial term rental stream. Note that the proceeds of the sale will likely trigger taxable gain (unlike a mortgage financing), though the company may have tax attributes that mitigate the impact.

2. The full accounting and tax implications of capital lease versus operating lease treatment are complex and beyond the scope of this article.

3. Purchase options of any kind run afoul of operating lease requirements, but many leases do contain "right of first offer" and/or "right of first refusal" provisions that are typically permissible under the applicable accounting standards. As a practical matter, especially for certain property types that are less adaptable to other users (such as industrial properties), the buyer will likely be more than willing to renew the lease or sell the property back to the user at the end of the term.

4. As a general matter, the issue in front of the bankruptcy court is whether the parties intended separate contracts even though they are contained together in one purportedly unitary agreement. Whether a "master lease" is severable is a fact-intensive inquiry in which provisions contained in the lease inform the intent of the parties. Among the factors considered by the bankruptcy court are as follows: whether (a) rent for the individual properties is apportionable under the lease; (b) the landlord has the right to sell the underlying property relating to any of the individual properties, resulting in severance of that property from the lease; (c) the tenant has substitution rights; (d) there is separate consideration for each of the properties; and (e) an extension of the lease term results in different expiration dates for different properties.