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EMPLOYMENT

Tips for Avoiding RIF Litigation

By Lynne C. Hermle

With the slowdown in the 2001 U.S. economy has come a tidal wave of employee layoffs. Emerging companies as well as established high-tech stars have announced widespread reductions in force (RIF). Of course, when contemplating a RIF, companies always should consult counsel who specialize in employment matters. The RIF process is laden with traps. There are steps that companies can take to help to avoid them.

Comply With WARN

The Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-2109 (WARN), which applies to enterprises that employ 100 or more employees, requires that employers give 60 days' notice of a plant closing or mass layoff. WARN provides that a covered employer cannot order a plant closing (defined as an employment loss at a site for 50 or more full-time employees during any 30-day period) or mass layoff (a RIF that results in employment loss at a site for one-third of the employees, equaling 50 or more people or at least 500 employees) without giving 60 days' notice to affected employees or their union representatives, as well as to state and governmental agencies. WARN will not apply in most situations in which a successor offers employment to the affected employees. See *Alter v. SCM Office Supplies Inc.*, 906 F. Supp. 1243, 1249 (N.D. Ind. 1995) (holding that employees who obtain jobs after

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REAL ESTATE

The Best Strategies for Extricating a Company From Its Long-Term Office Lease Obligations

By Joshua Stein

When a start-up company downsizes or shuts down, the office lease that it struggled mightily to obtain—perhaps only a year or two earlier—soon becomes its largest liability and its most painful burden. What can management do to extricate itself from long-term rent obligations? Understanding the best options and arming yourself with the information necessary to negotiate them will help you protect your company's interests.

Defaulting on the lease and forcing the owner to bring a potentially lengthy and expensive eviction proceeding is one option, but it means losing your security deposit and exposing your company to liability, expense and distraction that it might have been able to avoid. Moreover, if a meaningful personal guarantee is in place, defaulting probably isn't feasible. If a lease termination agreement or an assignment or sublet of the space is available, it probably will prove to be a better choice. Before you attempt to negotiate for one of these options with an owner, understand the owner's mindset, your legal rights and the potential pitfalls that may be involved.

Owner Motivations

Owners care primarily about economics. In the good times, they wanted to share in their tenants' good fortune—the "profits" tenants were reaping from subletting or assignments. For the same reasons, owners raised rents as much as they could, whenever they could. They were looking for windfalls, and finding plenty of them.

Now that the good times are gone, owners want reliable cash flow. They want to know that today's tenant will keep paying rent so the owner can keep servicing its debt.

Again because of economics, owners don't want to endure long fights with tenants in default. The last thing an owner wants is a drawn-out legal fight with a defaulted tenant that has no money. Any such delay probably

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will postpone the day when the owner can put another tenant into the space. It also probably takes rental income out of the owner's pocket.

Although the owner will want to free up the space as soon as possible, the owner also will want some prior notice before the tenant moves out, so that the owner has some time to find the next tenant.

Finally, from a tenant's perspective, weakness is strength. If a tenant is teetering financially, it probably will have more leverage than if it were an established industrial company with the financial resources to keep paying rent. If a tenant can persuade an owner that the tenant is near collapse, the owner probably will be far more accommodating than if the owner thinks the tenant has any financial strength.

Based on these owner motivations, the easiest, quickest and usually best solution is simply to persuade the owner that the "windfall" stage is over, return the space (after giving as much notice as possible) and go quietly into the night. The owner often will be willing to take back the space without much trouble. But beware: Some lease termination agreements are more favorable to tenants than others are.

Potential Pitfalls

When negotiating a lease termination agreement, here are some mine fields that a tenant should try to avoid:

Restoration. The lease may require the tenant to "restore" the space (that is, put it back the way it was when the tenant moved in). Ask the owner to waive any such requirements. Try to avoid any obligation to deliver the leased space in any condition other than "as is" on the date you move out.

Auctions. If the tenant plans to conduct an auction or other "going out of business" sale in the space, ask the owner to waive any lease language that might restrict such a sale.

Releases. When the tenant moves out, the parties should exchange general releases, including releases of any guaranties.

Lender Approval. The lease or a separate agreement may limit

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whether a tenant can negotiate a lease termination without consent from the owner's lender. In that case, try to obtain the required consent, particularly if you are paying the owner something for the lease termination.

Your Security Deposit

What about your security deposit? Chances are, any start-up company tenant negotiated its lease at a time when dozens of similar start ups were scrambling to rent the same space, and the start up needed to (and could) post a large security deposit just to "get the space."

In exchange for letting the tenant out of the lease, the owner will want the tenant to give up any claim to that security deposit. The problem with that approach, of course, is that it gives the tenant nothing more than it would get by simply defaulting on the lease and wasting everyone's time.

The likelihood that a tenant will be able to negotiate the return of its security deposit will improve to the extent that the tenant can offer the owner the following three benefits:

Notice. Give the owner reasonable notice before moving out.

Leasable Space. Make the space as attractive to the next user as possible. If making the place commercially feasible means demolishing and replacing walls and other finishes, the tenant will have a harder time getting its security deposit back. Unfortunately, because the tenant decided what to build in its space many months earlier, the ability to deliver this benefit probably will be out of the tenant's control. The tenant conceivably may be able to throw in its furniture, cabling and equipment to make the space more attractive to the next user.

A New Tenant. If possible, a tenant should offer the owner a new tenant ready to take the space. Typically, of course, start-up companies in shutdown mode are not in a position to do this. It may happen, for example, if some of the company's staff are forming a new company with new backers. Even a replacement tenant who is a credit risk may be attractive, or at least tolerable, to the owner—particularly for a smaller space.

Those are some possible "carrots" to persuade an owner to return part of the tenant's security deposit. The tenant also may have some "sticks" other than threatening to drag the owner through eviction proceedings.

See if your state has special rules about how owners must hold security deposits—such as requirements that they hold security deposits in a special trust account—and what happens if owners don't comply with those rules. If you can determine that your owner is not in compliance, this may entitle you to a refund of the security deposit. Faced with the possibility of such a claim, an owner might be more willing to make a deal.

If the tenant's cash security deposit exceeds a year's rent, the owner might face additional exposure, which the tenant can use for more leverage. If the tenant were to file bankruptcy, the owner's claim in the tenant's bankruptcy probably would be limited to a number lower than the security deposit, and the court might force the landlord to refund any excess.

If the owner and the tenant make a deal, though, and the tenant stays out of bankruptcy, then the tenant might agree to let the owner keep more of the security deposit than would the bankruptcy court.

If a large security deposit consists of a letter of credit (which is likely), it is not yet clear whether the owner faces the same potential risk. The underlying structure and logic of letters of credit should protect the owner. At least one recent case has suggested that it does. See *In re Farm Fresh Supermarkets of Maryland Inc.*, 257 B.R. 770 (D. Md. 2001).

Bankruptcy courts can be unpredictable, though. A bankruptcy judge might force the owner to refund to the tenant any amount drawn under a letter of credit in excess of the owner's claim against the tenant in bankruptcy. That remains to be seen. In the meantime, the uncertainty may give a tenant some leverage.

A strategic tenant also will want to review the precise words of the letter of credit and the lease provisions that govern it; understand exactly what the documents require the owner to do to obtain funds under the letter of credit; and consider whether there is any way the tenant can prevent the owner from making such a draw.

Usually, the tenant can't do much to prevent an owner from drawing. That's part of the whole point of a letter of credit. Some letters of credit are, however, written in a way that encourages the parties to try to work out a settlement before the owner draws.

That will be particularly likely if whoever arranged the letter of credit had the foresight to think about the rights and protections that might be needed if the lease ever went into default. In any such case, the tenant may want to bring its financial backers into the discussion. They may be the key to minimizing the tenant's loss.

If a tenant can negotiate any deal for the return of its security deposit (or letter of credit), the tenant should try to exchange its release documents for the refund check at the moment the tenant moves out and the owner accepts the space. Otherwise, the security deposit refund check probably will take forever to arrive. Don't give the owner an opportunity to find new ways to use up the security deposit.

Sublets and Assignments

If an owner refuses to negotiate a lease termination or return part of the security deposit, the tenant may need to consider subletting its space or assigning its lease. Any subletting or assignment has at least one major disadvantage: It leaves the tenant with a long-term liability for the remaining life of the lease.

If a tenant sublets, then the tenant remains directly obligated to pay rent, even if the subtenant decides not to pay in accordance with the sublease. If a tenant assigns, the tenant will be contingently liable under the lease, and obligated to pay rent if the lease purchaser decides not to do so. In either case, the tenant's exposure will continue until the lease has ended and the subtenant or lease purchaser has moved out.

If the lease ends, even on its scheduled expiration date, and a subtenant of a tiny fraction of the space has not moved out, the tenant may still owe rent—potentially at a penalty rate—for the entire space until the tiny subtenant decides to leave.

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A tenant therefore must make its own credit analysis about the lease purchaser or subtenant and be sure the tenant is willing to be responsible for that party's moving out.

Moreover, if a subtenant occupies part of the space, that occupancy will make it harder for the tenant to negotiate a simple lease termination later. The tenant usually won't be able to do anything that interferes with the subtenant's occupancy rights. But the owner might not want to accept the rest of the tenant's space (a partial floor, for example) subject to the subtenant's rights.

In any subletting or assignment transaction, the process and issues are more complex than for a simple lease termination, although some of the same themes and concerns arise.

Start by reading and understanding exactly what the lease says. Assignment and subletting clauses are often long, complex and poorly written. They often apply to some transactions and not to others, and establish time periods and notice requirements that are just not practical. They also may limit what a tenant can do to market the space.

In most states, the courts will interpret assignment and subletting restrictions narrowly; if the lease doesn't specifically restrict the transaction that the tenant wants to undertake, the courts probably will let the tenant go ahead without the owner's consent.

For example, a lease that says only that the tenant may not "assign" the lease usually would not prevent the tenant's sole shareholder from selling all of the tenant's stock. If the lease prohibits transfers of the stock of corporate tenant, but says nothing about transfer of membership interests in a limited liability company tenant, the tenant may be able to proceed without owner consent.

If the lease restricts some transactions but not others, the tenant may be able to structure its exit transaction in a way that avoids the need to deal with the owner. Usually, though, owners have learned from experience. The assignment and subletting restrictions in most modern leases apply to every possible transaction a tenant might want to undertake.

Even if the lease prohibits any lease transfer transaction without the owner's consent, the lease may also say that the owner shall "not unreasonably withhold its consent" to a proposed assignment or subletting. Unfortunately for tenants, though, such clauses were relatively rare in leases signed during the 1999-2000 owners' market and start-up boom because tenants didn't much care about lease negotiations and owners had so much leverage.

If the lease requires the owner to be "reasonable" about assignments or sublets, this can give a tenant meaningful leverage, because words like "reasonable" ultimately mean only whatever a court decides that they mean. Owners rarely want to spend months fighting over the meaning of such words. Therefore, they may be more inclined to go along with what the tenant wants or negotiate an early termination of the lease, as described herein.

Even if the lease does not require the owner to be reasonable about an assignment or subletting, today's owners may be more inclined to cooperate than they were in the past, because they may see less of an opportunity to squeeze the tenant and obtain a windfall. They may realize that a lease transfer may help them to achieve a better result than if the tenant were to stop paying rent.

Don't wait until a subtenant or lease purchaser is in place and then go and apply to the owner for consent in accordance with whatever process the lease requires. Raise the subject of an assignment or sublet with the owner as quickly as possible. This will give you and the owner maximum time and opportunity to make a deal, and perhaps make it easier for you to get the owner to agree to a simple surrender of the space.

Professional Help

Whether a tenant wants to negotiate a quick termination of the lease or an assignment or subletting transaction, as early as possible in the process, the tenant should engage counsel to help negotiate, structure and document the deal, taking into account the particular facts, lease language, state law and other circumstances of the tenant's situation. Counsel's first job should be to help define the relationship with any real estate broker or consultant that the tenant hires.

If a transaction consists of a quick exit without a termination payment from the tenant to the owner, the tenant often can get by without a broker or consultant. If, however, the tenant chooses, or is forced, to try to assign or sublet, the tenant probably can use a broker's or consultant's help to assess the market and make a deal.

Any such engagement should be in writing. The engagement letter should specify a definite period—long enough for the broker or consultant to do his or her job but not so long that the tenant will regret hiring the person if he or she can't do the job in a reasonable time.

If the tenant has already identified any likely lease purchasers or subtenants, the broker or consultant might accept a reduced commission—or no commission—on any transaction with one of those prospects, especially if it closes quickly. Such "exclusions" must be specified in the engagement letter.

Commission formulas for these engagements vary. Each formula creates its own set of incentives. In my experience, however, most brokers and consultants regard themselves as professionals. Instead of trying to squeeze the last possible commission dollar from a transaction based on whatever incentives their fee structure creates, they generally try to help clients to achieve their business goals.

Most brokers and consultants believe that, over the long term, this approach maximizes their reputation and future referrals. Of course, not every broker or consultant feels that way. Check references.

Intuitively you might expect that, whatever commission you negotiate, if you don't actually close a deal you won't have to pay a commission. That's often not correct. To avoid that risk, in the engagement letter try to say that you won't owe a commission unless you actually approve, sign and close a deal. Until then, you want the right to change your mind at any time.