

LEASE WORKOUTS

"IS THIS A MARRIAGE WORTH SAVING?"

**T. Andrew Dow
Winstead PC
1201 Elm Street, Suite 5400
Dallas, Texas 75270
(214) 745-5400**

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LEASE WORKOUTS

"Is This a Marriage Worth Saving?"

by

T. Andrew Dow

I. Introduction

The term "Lease Workout" is a broad phrase which encompasses a number of lease restructuring scenarios between a landlord and a tenant which may arise for a variety of reasons. In difficult economic times, it is inevitable that many landlords and tenants will be forced to revisit their lease agreements in order to restructure the obligations of the parties in a mutually beneficial fashion. Much like a marriage that isn't working out for a husband and wife, the parties to a troubled lease must resolve to either end the relationship or make an effort to change things in a way that makes each party desire to continue on. The extent of the restructure will depend upon a variety of factors, including (i) current market conditions, (ii) the financial health of each of the tenant, the landlord and the building of which the premises are a part, (iii) the effect the restructure will have on the landlord's debt and equity relationships and (iv) the effect the restructure will have on other tenants in the building.

Consider, for example, the following hypotheticals:

1. The signs of distress are self-evident – late or missed payments, creative excuses, conveniently avoided phone calls – all of which lead the landlord to one undeniable conclusion – its tenant is in trouble and its rental stream in jeopardy. The owner of the tenant has finally requested a meeting with the landlord to discuss its "lease situation." So what does the landlord do in response to this?

2. A tenant which executed a market rate lease three years ago now finds itself in a lease which is significantly above market. The tenant is doing fine financially, but knows that the landlord has provided concessions to

other tenants and wants to align its lease terms with the current market. The tenant has contacted the landlord to discuss a rent reduction or some other form of concession. The landlord has thus far resisted any such restructure, but the tenant is now threatening to leave the building if the landlord does not restructure its lease. How should the landlord respond?

Common sense would dictate that the landlord's response to each of the two tenants in the foregoing hypotheticals would be different. So, when should the landlord entertain a tenant's request for a restructure? Although the landlord is not legally obligated to modify the terms of the lease in either of the foregoing scenarios, a prudent landlord will consider some form of relief only when it is convinced that the tenant has a bona fide need and that it would cost less to grant such relief than suffer the consequences of the tenant's breach of the lease or the tenant's bankruptcy. Whether that is the case will depend largely upon (i) the factual circumstances of the tenant's ability to perform, (ii) the remedies available under the lease in the event the tenant fails to perform and (iii) the likelihood of recovery from the tenant should the landlord exercise its remedies under the lease. The reader of this article will find certain strategies which will assist him or her in helping make that determination.

To that end, this article will (i) address certain due diligence a tenant should undertake before requesting a lease restructure, (ii) address certain due diligence the landlord should conduct in evaluating a request by a tenant to restructure its lease, (iii) analyze certain factors the landlord should consider before developing a response to the tenant's request, (iv) describe certain tools available to landlords and tenants when the decision is made to restructure the lease, and (v) address the alternatives available

to landlords and tenants when a restructure or workout is not a viable alternative.

II. Tenant Due Diligence

Prior to approaching the landlord regarding a lease restructure, the tenant must conduct some due diligence in order to determine the tenant's bargaining power relative to the landlord and put the tenant in the best possible position to negotiate a successful workout. Such due diligence should include a thorough review of the lease and the creation of a business plan for survival in order to entice the landlord to grant the tenant's requested concessions.

A. Review the Lease – What are Landlord's Remedies if the Tenant Defaults?

- (i) First, the tenant should calculate the landlord's potential recovery for a default under the lease and under a bankruptcy scenario (where the landlord's recovery is capped by statute). This should provide the tenant a starting point for negotiations.
- (ii) Next, the tenant should ask the question: Does the landlord have recourse against a person or entity with substance (i.e. the tenant or a guarantor)? If not, the tenant gains leverage from a practical standpoint.

B. Create Your Best Case for Landlord Concessions

- (i) The tenant must show the landlord that the tenant has a bona fide need (and the tenant must be prepared to open its books to prove that claim). However, if the tenant oversells the need, the landlord may determine that it is a tenant not worth saving. Therefore, the tenant's request should include a business plan for survival.
- (ii) Bottom Line: The tenant's request must make the economic case for the landlord to grant the concessions being requested by the tenant (i.e., show the landlord

that it will fare better in a workout than a lease default or tenant bankruptcy).

III. Landlord Due Diligence

Upon receiving a request from tenant for lease concessions, the landlord must also conduct its own due diligence with respect to the tenant and its relative bargaining position. In that regard, the landlord should (i) review its lease to determine its leverage from a legal standpoint, (ii) require the tenant to provide detailed financial information and a business plan to determine the tenant's financial viability, (iii) review its loan documents and partnership documents to determine whether a proposed restructure requires the consent of any third parties, and (iv) prepare a list of issues the landlord would like to have addressed in any restructure.

A. Review the Lease – What are Landlord's Remedies if the Tenant Defaults?

A thorough review of the lease will tell the landlord what leverage it has, BUT the landlord's ability to collect a judgment is directly dependent on the tenant's ability to pay.

B. Are the Tenant's Threats Real?

- (i) The Landlord should insist on reviewing detailed financial information and a business plan of the tenant – no less than what a lender or investor would require because the landlord is, in effect, considering making an investment in the tenant.

If the tenant remains creditworthy, the landlord knows that its remedies have teeth and may choose either to enforce its remedies or restructure the lease in a way that makes economic sense to both parties. If the tenant is struggling but remains viable, the landlord may be willing to grant concessions to help the tenant get back on its feet. If the tenant is hopeless, then the landlord should cut bait, squeeze whatever termination fee it can out of the tenant and look for a new tenant. In such a case it is better for the landlord to get the space back with little

or no remuneration than wait for a tenant bankruptcy and still get little or nothing.

- (ii) Key Point: The landlord must understand what is driving the tenant's actions. Is it real need or simply greed?

C. What is the Landlord's Ability to Negotiate with the Tenant?

- (i) Does the landlord have constraints under its loan documents or partnership documents requiring another party (e.g., a lender or its partner) to consent? If so, then the landlord must bring its lender and/or equity partner into the negotiations.
- (ii) Would the proposed restructure affect the landlord's ability to service its debt? If so, then the landlord must factor this into the equation when determining its ability to agree to a restructure.
- (iii) Would the proposed restructure create issues under any other leases? The landlord also must consider whether the proposed restructure would violate any co-tenancy, exclusive use or other provisions of leases with other tenants.

D. Wish List – Is There Anything the Landlord Needs from the Tenant?

Simply put, if the landlord is being requested to give something up, it should get something from the tenant in return. For example, if the landlord needs the tenant's help on any issues that the landlord is dealing with at the time (such as a consent to an exclusive for another tenant or a waiver of a previously prohibited use), it should use this opportunity to address those issues. However, the landlord should be careful not to squeeze too much out of the tenant, leaving the tenant unable to perform or putting the tenant at a competitive disadvantage.

IV. Factors for Landlords to Consider

Once the tenant has made its request for a restructure of the lease and the landlord has

conducted its due diligence relating to such request, the landlord must then consider the potential costs/risks and benefits of entering into workout negotiations with the tenant.

A. Potential Costs/Risks to Landlord

The following list outlines some of the potential costs and/or risks to the landlord of restructuring the lease with the Tenant:

- (i) The obvious financial detriment to the landlord if the workout involves a reduction in rent.
- (ii) Lender/equity partner issues. What effect would the proposed workout have on the landlord's obligations under its loan documents and/or equity documents?
- (iii) Effect on other tenants. Is the landlord setting a precedent with the workout that may affect its relationship with its other tenants?
- (iv) Life support for a terminal tenant. Is the landlord just delaying the inevitable? If so, the landlord might be better off cutting its losses and moving on.

B. Potential Benefits to Landlord

On the other hand, the following list outlines the potential benefits to the landlord of restructuring the lease with the tenant.

- (i) The restructure probably allows landlord to keep some revenue stream (if not the full amount of rent due under the lease).
- (ii) The restructure keeps activity on site, which could help the landlord from a co-tenancy or insurance perspective.
- (iii) The restructure hopefully avoids bigger issues such as a tenant bankruptcy, eviction, and reletting costs (e.g. new tenant improvements, commissions, down time, and the like.).

C. Make the Call

After determining the tenant's future ability to perform and weighing the potential costs and benefits of entering into a workout with the tenant, the landlord must decide to either enter into workout negotiations or not.

V. "Let's Work it Out" – Potential Tools for Landlords and Tenants to Consider

Once the landlord has made the decision to work it out, there are various tools available to the landlord and the tenant to create a mutually acceptable agreement.

A. Rent Adjustments

The most obvious tool in any lease workout is an adjustment to the rent payable under the lease. A rent adjustment can take many forms, including the following:

- (i) rent deferral;
- (ii) rent reduction;
- (iii) rent forgiveness;
- (iv) temporary or permanent conversion to percentage rent (retail leases); or
- (v) anything else which would reduce tenant's expenses or increase tenant's revenues (such as a deferral of non-critical maintenance obligations or caps on operating expenses).

Often, prior to agreeing to any of the foregoing rent adjustments, a landlord will require that the tenant pay any delinquent rent and otherwise get current on any lease obligations for which the tenant has fallen behind. While rent adjustments often provide the most immediate and significant relief to tenants in distress, they also draw the biggest scrutiny from the landlord's lender or equity source. Therefore, the landlord should be absolutely certain that a reduction in rent is necessary.

In addition, if the rent adjustment involves a deferral or reduction for a limited period of time, with the tenant responsible for paying back such deferred or reduced amount at a later date, the landlord must ensure that any subsequent increase is consistent with the economic realities facing the tenant. In that regard, the landlord may need to consider an extended payback period and/or gradual increases in order to help nurse the tenant back to health.

B. Premises Adjustments

Another possible tool for a lease restructure involves an adjustment in the size of the premises, which can include any of the following:

- (i) a space reduction (either temporary or permanent);
- (ii) a space reduction accompanied by a right of first refusal and right of first offer to get the space back; or
- (iii) a space reduction accompanied by a relocation of the tenant (in which case, the landlord should not be responsible for typical relocation costs).

In connection with any restructure that allows the tenant to give space back to the landlord, the lease amendment should clearly spell out the condition of surrender of the Premises. Is the tenant required to remove certain modifications or is it giving the space back "as is"? See Section VI.A.(ii)(d).

C. Term Adjustments

A lease workout might also involve an adjustment to the term of the lease, which could be in the form of (i) an extension of the lease term (in conjunction with a rent or premises adjustment), (ii) a reduction of the lease term, thereby reducing tenant's overall lease exposure or (iii) a conversion of the lease to a month-to-month lease.

- (i) An extension of the lease term often provides the landlord its *quid pro quo*

for a workout involving either a rent reduction or premises reduction.

- (ii) A reduction of the lease term doesn't necessarily provide immediate relief to the tenant, but it does reduce the tenant's overall lease exposure.
- (iii) A conversion to month-to-month lease allows the landlord to continue to receive rent from the tenant for as long as possible, but provides an out for either party on one month's notice. The landlord may agree to this while it is looking for a better tenant, and the tenant may agree to this while determining its future viability or while attempting to wind up its operations prior to closing.

D. Use Adjustments

Another possibility in any lease workout involves an expansion of the permitted use, which might provide the tenant an alternative exit strategy. If the tenant is allowed to use the premises for a different purpose (such as reconcepting a restaurant or retail location), then it expands the potential assignees or sublessees that might be interested in the space.

E. Transfer Adjustments

The landlord might also agree to soften assignment or subletting restrictions, which also provides the tenant an alternative exit strategy. This is only an attractive option to the landlord if the tenant is solvent and it wants to keep the original tenant liable under the lease. Otherwise the landlord would typically prefer to terminate the current tenant and find its own replacement tenant.

F. Landlord Protections – Now, What Are You Going to Do For Me?

While a lease workout is generally intended to assist the tenant during a difficult time, the landlord may wish to use the opportunity to improve its position as well. This paragraph will highlight some of the more common landlord protections which are negotiated during a lease workout.

(i) Additional Security

Perhaps the most common demand of a landlord when considering a request for relief from the tenant is additional security for the tenant's obligations under the lease. This security can take the form of a lease guaranty from individual or parent company, a letter of credit posted by the tenant, or an enhanced landlord's lien (or the inclusion of one if previously waived). Of course, the landlord's success in obtaining this additional security is dependent upon the tenant's ability to provide it.

(ii) Confidentiality/Non-Disclosure Agreements

A second request often made by landlord's in connection with a work-out involves the execution of a confidentiality or a non-disclosure agreement by the tenant. Pursuant to such an agreement, the tenant agrees to keep the existence and the terms of the restructure confidential, and the landlord may agree to keep the tenant's proprietary financial information confidential. This is important to the landlord because the landlord may not want other tenants to know the existence or terms of the restructure. A breach of the confidentiality agreement should constitute a default under the lease.

(iii) Estoppel and Release

A prudent landlord will get an estoppel and release from the tenant as a condition to entering into negotiations with the tenant. The estoppel should include typical estoppel provisions such as no defaults, no outstanding TI allowances, no claims, condition of premises, etc. The release should include a release of all liabilities under the lease which occurred prior to the negotiations. If tenant is already in default, some landlords may also require the tenant to acknowledge its default, execute a stipulated judgment and/or

deliver a promissory note for past due amounts.

(iv) Landlord Costs

The landlord may require tenant to pay the landlord's costs associated with the workout, although this may not be realistic given the tenant's financial position.

(v) Removal of Special Tenant Privileges

The landlord may also use the opportunity to strip the tenant of certain rights which were previously granted, such as termination rights; exclusive or co-tenancy rights; expansion rights; or renewal options.

(vi) Recapture of Previously Deferred Rent

In certain circumstances, the tenant may be required to pay back the full amount or even premium rent if and when things get better.

(vii) Mixed Use Projects

The landlord may require tenant to provide discount coupons to landlord to help in leasing residential and/or office components.

(viii) Be Careful

In all cases, remember the goal is to provide the tenant some relief. If the landlord is too aggressive in requiring tenant concessions, it could guarantee the tenant's ultimate failure.

VI. "Its Not You, Its Me" – Tenant Calls It Quits

In some instances, the tenant determines that it is no longer economically viable to operate its business from the premises. In such a case, the tenant will typically attempt to either (i) terminate the lease (pursuant to a contractual right or mutual agreement with the landlord), or (ii) assign the lease or sublease its space to another tenant pursuant to the terms of the lease.

If both of those options fail, the tenant is left with the decision of whether to default under the lease and force the landlord to exercise its remedies.

A. Voluntary Termination

A voluntary termination of the lease can take the form of a unilateral termination by the tenant pursuant to a contractual right under the lease (such as, for example, failure to meet a gross sales threshold) or a mutual termination agreement between the landlord and the tenant. Often, the landlord and the tenant enter into a mutual termination agreement in order to clean up any lingering issues remaining under the lease. This allows the tenant to avoid the stigma of a default (which could become important in future financing representations), and allows the landlord to clear the space (both physically and legally) for a potential replacement tenant.

(i) Termination Fee

The main issue in connection with any voluntary termination is the amount, if any, of the termination fee to be paid by the tenant. If the tenant is terminating the lease pursuant to a contractual right to do so, the amount of the termination fee should have been already negotiated and contained in the lease. If, on the other hand, the landlord and tenant subsequently agrees to terminate the lease prior to its natural expiration date, the parties will need to address the issue of the termination fee in their termination negotiations. From the tenant's perspective, the tenant should not pay more than it would pay under a default or bankruptcy liquidation analysis. On the other hand, the landlord will want to ensure that the fee includes not only all or a portion of its lost rent, but also the unamortized cost of any commissions, tenant improvement allowances, legal fees and other costs incurred in connection with the lease.

Another issue regarding the termination fee is the timing of the payment. The landlord will desire to have the fee paid

upon notice of the termination or execution of the agreement, while the tenant will prefer to pay the fee upon the effective date of the termination (or even later).

(ii) Terms of Mutual Termination Agreement

In addition to addressing the termination fee, the mutual termination agreement should attempt to provide a clean break of liability between the landlord and tenant, clearly specifying which, if any, obligations under the lease will survive the termination. For example, will the tenant remain liable for environmental conditions created on the premises during the term of the lease? In addition, the termination agreement should provide a waiver and release of any claims or liabilities regarding the lease which are now and as of the date of the termination agreement. What, if any, claims are carved out of this mutual release as a matter to be negotiated between the parties. Finally, the mutual termination agreement should specify the condition of the premises to be returned to the landlord, clearly indicating which tenant alterations should be removed prior to the effective date of the termination. The landlord will want to inspect the premises and ensure that all tenant alterations are removed and that the tenant is returning the premises in the condition required under the lease.

B. Assignment and Subletting

The second option available to a tenant when it determines that the premises is no longer suitable for its purposes is to pursue an assignment of the lease or sublease of the premises to a third party. An assignment or subletting might become a viable option if the landlord and tenant are unable to agree upon the terms of a mutual termination or if the tenant's lease is at a below market rate and the tenant believes it can make a sublease at a higher rate, thereby profiting from the transaction.

Prior to marketing the premises for an assignment or sublease, the tenant should review the tenant's rights and obligations under the lease with regard to any such transfers, paying particular attention to the landlord consent standard under the lease and the tenant's obligation with respect to the payment of landlord's legal fees. The tenant should also be aware of the existence of a recapture right on part of the landlord in connection with any requests for an assignment of sublease, which could affect its ability to effectively market the premises.

In connection with any assignment or sublease, the tenant shall be responsible for the preparation of the actual transfer documents for landlord's review. This avoids unnecessary landlord liability for drafting and limits the landlord's legal fees in connection with the transfer. However, the tenant's documentation should be vetted by the landlord for accuracy and consistency with the primary lease. Some issues the landlord should consider include:

- (i) Is the tenant released from liability under the lease? What about existing lease guarantors?
- (ii) Is the tenant required to pay any portion of the excess rent received from the subleasing to the landlord?
- (iii) Does the lease give the landlord the right to collect rental directly from the assignee/sublessee?
- (iv) Is the landlord being asked (either direction or indirectly through the consent language) to execute a recognition/non-disturbance agreement with the subtenant?

In all cases, the landlord should expressly disclaim that its consent constitutes an approval of the business terms of the transfer.

In connection with its review of any assignment or sublease, the landlord should also confirm that the new use does not violate any

exclusives or prohibited use clauses affecting the property.¹

VII. "It's Not Me, It's You" – Landlord Calls it Quits

If the tenant is in default and the landlord determines through its due diligence that a lease workout is not a viable alternative, then the landlord will look to the lease to pursue its remedies. While certainly not an exhaustive discussion on the subject, this section highlights certain issues a landlord should consider when looking to enforce the default and remedies provisions under a typical lease.

A. FILE REVIEW IS CRITICAL

At the risk of stating the obvious, it is critical in any default situation to thoroughly review the file in understand the default and remedies provisions of the particular lease in question. All leases are slightly different and it is imperative that the landlord strictly follow the provisions of the lease (such as, for example, notice in cure obligations) prior to exercising its remedies under the lease. It is also important for the landlord to understand the statutory and common law which may preempt certain provisions of the lease.

B. Monetary vs. Non-Monetary Defaults

- (i) Failure to timely pay Rent is a "clean default", so long as notices are properly given.
- (ii) Courts abhor a forfeiture – termination or repossession for non-monetary defaults is risky.
- (iii) Abandonment/violation of continuous operations; violation of exclusive or prohibited uses; material refusal to maintain are possible defaults meriting termination or repossession, but proper

and multiple notices and opportunity to cure are key.

C. Notice and Cure

- (i) The landlord's attorney should not assume the landlord has given proper notice – confirm and resend notice of default and demands for cure as necessary.
- (ii) The landlord's attorney should confirm the most recent tenant address and ask about client correspondence files. Those correspondence files often reveal unfriendly surprises.
- (iii) If termination (as opposed to repossession) is intended, send separate notice of termination clearly setting forth the date. The termination date should be set to coincide with dates applicable under any subsequent lease for the space.

D. Landlord Remedies²

- (i) What are the landlord's rights?

The landlord's attorney should confirm that the landlord's express rights include termination of lease and/or right of repossession and reletting – THESE RIGHTS DO NOT NECESSARILY EXIST AT COMMON LAW AND ARE NOT INCLUDED WITHIN "ANY AND ALL REMEDIES AT LAW OR IN EQUITY."
- (ii) Lock Out/Required Notice and Rights of Re-Entry

Texas Property Code Section 93.002 sets the conditions upon which the landlord may lock a tenant out of its premises. Some case law suggests that

¹ For a comprehensive review of assignment and subletting considerations for landlords and tenants, see T. Andrew Dow, Assignment and Subletting-Balancing Landlord and Tenant Desires, State Bar of Texas: 25th Annual Advanced Real Estate Law Course (July 10-12, 2003).

² For a comprehensive review of available remedies under Texas law, see Bradley M. Gordon, Lease Remedies and Judicial Enforcement of Lease Obligations, State Bar of Texas: 25th Annual Advanced Real Estate Law Course (July 10-12, 2003).

this provision alone is not sufficient to allow repossession if the lease does not independently grant the landlord that right. It is important to note that the remedies for wrongful lockout can be harsh, allowing the tenant the right to a recover possession or terminate the lease and recover damages. Therefore, it is critical that the landlord take extra care in pursuing this remedy. As an aside, prior to locking out a tenant, the landlord should confirm the existence and priority of its landlord's lien. A waiver by the landlord of contractual and statutory liens could possibly result in a limitation on its right to lock the tenant out. The code does provide that the lease provisions control over statute with respect to the required content of a lock-out notice and conditions for tenant's re-entry; therefore, the landlord should confirm whether the lease addresses the topic and follow the lease requirement.

VIII. "It's Out of Our Hands" – Bankruptcy and Foreclosures

Although outside the scope of this paper, in certain cases the landlord and tenant lose control of their relationship and other parties (such as the bankruptcy court or the landlord's lender) control the fate of the lease. Clearly, if a tenant is in bankruptcy, the landlord should not hesitate to get bankruptcy counsel involved when attempting to enforce any remedies under the lease. In the case of a foreclosure whereby the landlord's lender (or some third party) becomes the new landlord under the lease, the tenant should refer to any subordination, non-disturbance and attornment agreement executed with the lender to determine its rights and obligations going forward. If no subordination, non-disturbance and attornment agreement was executed, then the tenant must determine whether its lease has been extinguished through the foreclosure process by operation of law.

IX. Conclusion

In conclusion, tough times call for creativity on the part of both parties to make a

troubled landlord/tenant relationship work. Experienced counsel can help their clients navigate these choppy waters. Often, the landlord's knee-jerk response to a tenant in distress is to impose the full force of the remedies available under the lease on the tenant. However, this may not be the best economic course of action for a landlord. Since landlords and tenants are principally motivated by their own economic self-interests and those interests are seemingly diametrically opposed, it would appear that a lease workout satisfying both parties is improbable. However, once the parties honestly evaluate their relative bargaining position (given both the facts and the relevant lease language), often an economic solution acceptable to both parties is attainable. Although tenants may attempt to take advantage of a depressed market by demanding certain concessions from a landlord, prudent landlords will only agree to such concessions if they believe it will cost more to lose the tenant than grant the concession. It is in those situations where a successful lease restructure can be accomplished. If not, then the relationship most likely will end either through (i) a negotiated termination, (ii) the exercise of the landlord's remedies under the lease or (iii) a tenant bankruptcy.