WHY MIXED-USE REAL ESTATE OWNERS SHOULD DETAIL ALL FACTORS CONTRIBUTING TO THEIR DISTRESS

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For owners of retail and mixed-use real estate facing distress, it is tempting to blame their economic woes solely on the COVID-19 pandemic. This explanation is attractive because it leaves them blameless, is seemingly self-evident, and does not compel them to justify their past actions or explain declines in revenue to their lenders, investors, or bankruptcy judges or creditors. The pandemic seems to serve almost as a hall pass, albeit a temporary one, excusing poor performance and supporting requests for forbearances, extensions, modifications, additional capital, or other concessions or relief.

Although blaming the pandemic might have superficial appeal, digging deeper and providing a more insightful explanation of both the factors influencing the environment and the circumstances that existed when COVID first hit, as well as the nuances and site-specific expenses that were created by the pandemic, could prove a better a long-term strategy when dealing with lien holders, equity, and other decision-makers and stakeholders. Providing a greater level of understanding and detail, and thereby painting a more complex picture, achieves several goals.

First, it allows owners and asset managers to demonstrate their core competencies and unique qualifications related to their specific real estate holdings. This sends a message that the current ownership and management are the most knowledgeable, well-informed, and best equipped to develop and implement a strategy to navigate the tumult and that any thought of taking possession of the property—or worse yet, initiating any adversarial foreclosure—or seeking the appointment of a trustee or receiver, without ownership buy-in, would be ill-advised when seeking to maximize and preserve the value of the asset.

Second, educating and providing transparency to lenders, investors, and bankruptcy stakeholders provide requisite knowledge that leads to confidence in a stable, predictable, and reliable outcome in an otherwise uncertain world. Affording this visibility sets some owners and asset managers apart from others, namely those that baldly blame everything on COVID with no further explanation other than a generalized hope that a property's economics will improve as the health of the world improves.

Owners and managers of retail real estate that have invested the time and have an in-depth understanding of their assets, however, are able to distinguish themselves as the borrowers, investment partners, and debtors that lenders, investors, and bankruptcy decision makers are more inclined to trust and to choose to work with and invest in over longer periods.

Life Before COVID-19

By the end of the first quarter of 2020, life for the owners and managers of retail developments across the country had changed abruptly and dramatically. But, that does not mean all changes to those properties only occurred in early 2020 and were only the result of the pandemic, or that such retail developments were entirely stable prior to COVID-19.

The contrary was true in many cases. Indeed, there is an entire portfolio of retail and mixed-use properties across the country that had 2020 and 2021 as target disposition dates under

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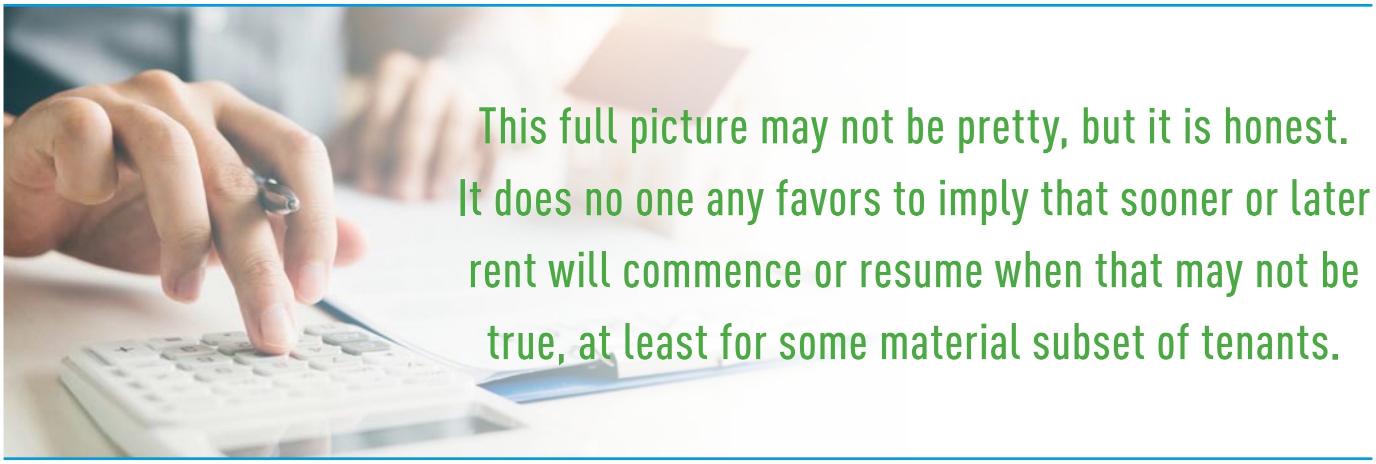

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long-term turnaround plans, which were first imagined in the wake of the recession that began in September 2008. Those plans were thrown into chaos by the pandemic on an entirely different level than retail centers whose owners and managers had no such exit strategies—and corresponding loan maturity dates—in place.

The shopping mall as it is known today did not even exist until the late 1950s, with the regional mall becoming the predominant format and reaching its peak in the mid-1980s.[1] Eventually, there were approximately 7,600 shopping centers, including enclosed malls and open-air strip malls, of which 3,000 were regional malls, by the mid-1980s.

This trend toward regional malls, however, led to a movement by big box retailers in the 1990s away from the mall concept to create their own "power centers," with fewer but larger tenants, each with its own dominant signage and storefront, parking field directly in front of its dedicated entrance(s), and large store footprint.[2] Then, however, came the internet, which impacted retail greatly at both malls and power centers, but big box retailers, with larger "pro rata shares" in power centers and merchandise, like appliances, which was harder to ship to consumers, were hit particularly hard.

With the advent of online shopping, two things had to occur for many retailers to survive—both the number and size of stores had to be right-sized. Theoretically, retail sales could remain flat even with fewer and smaller brick-and-mortar stores, so long as retailers pivoted to online sales to supplement the reduction of in-person shopping. As long as consumers kept shopping online, the problem was solved for retailers that right-sized their physical presence. But, what about the landlords that were left with excess vacant retail space?

At about the same time, the recession of 2008 began, and banks fell into crisis. As a result, owners of retail properties were getting squeezed at both ends. Tenants were not extending leases, were vacating spaces, and were missing gross sales thresholds to pay percentage rent, while lenders were not extending new debt and were showing little flexibility with borrowers who were having any sort of debt service or other loan issues. Additionally, already distressed retail properties that had been acquired by lenders in the years leading up to 2008 were now viewed as anchors on the books of those lenders.

Over the next several years, entrepreneurs started raising new, small REIT funds, and other equity that had been sitting on the sidelines began buying notes from lenders and investing in retail properties, creating a new generation of shopping center owners. These owners were looking at a whole new world of retail—one that included online retailing and a younger generation of consumers that shopped entirely differently than consumers of the past. These new owners bought these properties and spent the next several years stabilizing them and then raising additional capital to re-vision and redevelop those outdated shopping centers, power centers, and enclosed malls across the country.

Gone were food courts, replaced with dining terraces featuring upscale, table service restaurants. Movie theatres with recliner seating and 4D experience replaced department stores lost to bankruptcy. Experiential operators with bowling alleys, gaming, and other activities supplanted big box tenants that had downsized to smaller inline spaces. Entire wings of enclosed malls were converted to office use, with end anchor parcels ground-leased to hotel operators, which in turn demolished decaying department store buildings to erect new mid-rise hotels.

These investments, however, came at a cost and took time. Under decades-old documents, consents had to be obtained from long-term stakeholders in these retail properties, like anchor owners and national tenants, and often required owners to give concessions as consideration. Municipal authorities had to approve changes in use, and design review boards had to sign off on entirely new concepts and looks. These were not vanilla box spaces for soft goods retailers but uniquely designed and constructed spaces for gyms, live concert venues, or restaurant tenants. Construction alone, which was often specialized, frequently ran tens of millions of dollars.

And then, just as those projects were hitting their strides, with tenants in some cases setting dates to open their doors, COVID hit. Suddenly, plans to start collecting rent from these entirely redeveloped, repositioned, and re-visioned centers and then sell those profit-making, revenue-generating properties prior to loan maturity at the end of 2020 or 2021 were thwarted.

Painting a Complete Picture

So, although owners and developers of retail properties can summarily tell stakeholders that revenue is down and debt service is behind because COVID hit retail hard and tenants stopped paying rent, that does not always tell a full or compelling story. This is particularly true when follow-up questions are premised on traditional retailers reopening. Many of the new generation of redeveloped properties that were shifting away from a traditional retail focus prior to COVID cannot be expected to predict a rebound or recovery that is tethered to the rebound or recovery of retail alone.

As a result, it is critical that stakeholders and decision-makers understand how a property arrived on the doorstep of March 2020, whether it stood on the brink of rebirth at that time, and what happened to that property as the result of the pandemic. Was the property ready to turn a corner on something new and innovative? Is that property predominated by uses other than retail that were and will be uniquely affected by COVID or by the public's reaction to COVID, including hesitancy around virus transmission? Are there new tenants, including ground lease tenants, that only recently accepted possession or had not yet opened for business that now may never open and may be seeking to invoke theories of impossibility, frustration of purpose, or mistake to void their contractual obligations altogether?

This full picture may not be pretty, but it is honest. It does no one any favors to imply that sooner or later rent will commence or resume when that may not be true, at least for some material subset of tenants. If a redeveloped mixed-use property now has a critical mass of office, hotel, or experiential tenants, the truth of the matter is, nobody may yet know when office, hospitality, or leisure and entertainment sectors may recover or to what extent those sectors may ever recover.

At first blush, a property owner might worry that disclosure may lead to foreclosure. However, most lenders do not want to be property owners, so they will not foreclose unless they have identified a means to dispose of the property afterward. If the lender views its current borrower as the most capable and likely party to navigate any current uncertainty and, for that matter, turn around the collateral, that lender is more likely to cooperate on a workout than hastily to pursue foreclosure without an exit strategy simply because the borrower has been overtly forthright.

Life During COVID

Knowledge of relevant pre-COVID history and facts is critical in educating major players, but also key are operational implications during COVID. Indeed, being well-informed, and then thoughtfully conveying material information about a property's true costs and impediments to revenue collection during COVID, are also advantageous when working with lenders and investors and during any reorganization proceedings.

When governmental authorities throughout the country issued shutdown orders, shopping center owners of all stripes scrambled to understand what that meant for their various properties across numerous jurisdictions, each with its own requirements. The knee-jerk reaction

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was to say that a mall is not an essential business, so of course malls must shut down. Many outside the industry, including lenders, investors, and bankruptcy judges, assumed that mall owners saved a great deal of money on operating expenses during shutdowns. In reality, it was quite the opposite for many of them.

Many mall owners experienced increased operating expenses during the pandemic as a result of health and safety directives and governmental regulations. Owners also have incurred increased administrative overhead in 2021 due to the influx of tenant audits of 2020 common area expense reconciliations resulting from the increases and/or the inclusion of costs not typically or historically included.

For example, 21 states adopted or deferred to the federal definitions of essential workers and businesses, and 23 other states used the federal definitions as a starting point, sometimes adding more workers and businesses they deemed to be essential during the pandemic.[3] Under the federal definition, food service workers were essential, and in states that utilized that definition, property owners were required to allow those tenants to remain open and operate throughout the pandemic even if all other tenants were required to be closed under shutdown orders.[4]

Accordingly, owners of enclosed malls with food service tenants that remained open had to develop plans to allow those tenants to continue to operate for take-out and delivery service even when the rest of the mall was shuttered. Thus, owners had to continue to heat, cool, and light the mall sufficiently for the employees and suppliers of a small number of food operators to conduct business.

Additionally, mall owners had to employ additional security personnel to ensure that only authorized individuals were permitted to enter the enclosed mall and, once inside, stayed only in that portion of the mall in which they worked or were making deliveries. Meanwhile, many owners could not physically close off any portions of the mall if that created a fire or safety hazard.

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At the same time, owners were also required to implement enhanced sanitation in that center, including increased frequency of cleaning and additional cleaning materials, for the health and safety of food service employees, their vendors, and all security personnel, as well as all onsite property management staff. Of course, stay-at-home and shutdown orders varied from jurisdiction to jurisdiction and often changed weekly, if not daily, particularly at the onset of the pandemic. In short, there was nothing inexpensive about being shut down.

In addition to the expense side, retail property owners have faced many impediments to revenue collection in many jurisdictions throughout COVID. Not only do moratoria on evictions remain in effect for commercial leases in numerous states, but even in states where eviction actions are proceeding, the courts are backlogged and cases are moving slowly. Moreover, the issue of eviction (*i.e.*, obtaining a judgment of possession) is separate from that of rent collection in two primary respects.

First, many jurisdictions still have in place local ordinances and other governmental orders that limit commercial landlords' ability to charge or collect rent, send default notices, or exercise remedies under leases for non-payment of rent if tenants claim their non-payment arises from the pandemic. As a result, without the ability to even enforce lease obligations, retail property owners are several steps removed from evicting tenants that have not paid rent in months, if not for more than a year.

Second, in many jurisdictions eviction proceedings are bifurcated from collections actions. Therefore, even if property owners are able to recover leasable space, many commercial landlords need to pursue separate damages actions to attempt to recover unpaid rent. That requires incurring additional costs and attorneys' fees, and, of course, often entails the risk of pursuing tenants that have no liquidity or assets from which to recover.

Conclusion

Ultimately, whether the issues affecting retail properties relate to pre-COVID circumstances, complications of operations resulting from ever-changing and burdensome health and safety laws and guidelines, or nuanced impediments to revenue collection beyond a simple inability of tenants to pay rent, it is indisputable that the place in which retail property owners find themselves is complicated. There rarely is good reason to dumb that down for lenders, investors, or bankruptcy stakeholders. J

[1] Susan Meyer, "The History and Evolution of Retail Stores: From Mom and Pop to Online Shops," (2020), bigcommerce.com/blog/retail.

[2] Rajiv Lal and Jose B. Alvarez, "Retailing Revolution: Category Killers on the Brink," (20), hbswk.hbs.edu/item/%20retailing-revolution-category-killers-on-the-brink.

[3] National Conference of State Legislatures, "COVID-19: Essential Workers in the States," (2021), ncsl.org/research/labor-and-employment/covid-19-essential-workers-in-the-states.aspx

[4] U.S. Department of Homeland Security, Director of Cybersecurity and Infrastructure Security Agency (Mar. 19, 2020), Memorandum on Identification of Essential Critical Infrastructure Workers During COVID-19 Response (identifying food service within the critical Food and Agriculture sector and requiring that workers in that sector "must be able to access certain sites, facilities, and assets to ensure continuity of functions").