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Considerations When Severing A Master Lease



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A master lease structure is often used where a single landlord (or group of affiliated landlords) and a single tenant (or group of affiliated tenants) intend to lease multiple properties. Typically, all properties under a master lease are subject to the same terms, including rent payment and renewal schedules. By using a master lease structure to cover multiple properties as opposed to individual leases, the parties can streamline administration of a large-scale portfolio of properties.

More importantly, a master lease provides protection to a landlord in the face of tenant insolvency by limiting the risk of a tenant rejection of the lease arrangements under Section 365 of the Bankruptcy Code. If a unitary master lease structure is respected by the bankruptcy court, then the tenant can only reject the lease in its entirety rather than “cherry-picking” and reject-

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ing the lease only as to the less desirable properties.

A well-structured master lease that makes the parties’ intent to form a unitary contract clear will force a tenant-debtor to assume or reject a master lease in whole.

Master lease severance comes with a series of complications. Both the landlord and the tenant under a master lease want to maintain a certain degree of flexibility. Master lease severance comes with a series of complications. Both the landlord and the tenant under a master lease want to maintain a certain degree of flexibility.

While a master lease is generally structured as a single, unitary contract, there are situations where it is beneficial to landlord, tenant or both to sever a master lease. Typically, it is the landlord who holds the right to sever a master lease, and the landlord needs this right in order to preserve

its liquidity. While severance rights do present some risk to a landlord in that they undermine the unitary lease analysis in a tenant bankruptcy, landlords have two main motivations for severing a master lease. The landlord may want to sell one or more of the individual properties under the master lease, and while there is likely no prohibition on selling a single property under the master lease, as a practical matter a master lease with multiple unaffiliated landlords creates unwanted complexities (in particular, making it very difficult to finance).

In addition, a landlord may want separate leases for a financing in order to avoid using the entire premises covered by the master lease as collateral. Tenants generally benefit from the severance of the master lease. While a master lease will frequently allow the landlord to terminate the entire lease upon an event of default, severed leases are often not cross-defaulted, so severance can allow the tenant to compartmentalize the default risk.

Similarly, while a renewal option in a master lease must frequently be exer-

cised with respect to all or none of the properties, the right to renew a severed lease is often not conditioned on the renewal of other leases, so severance can afford the tenant greater flexibility at the time of renewal. Moreover, separating the properties into severed leases provides the tenant with more flexibility in a bankruptcy.

Master lease severance comes with a series of complications. Both the landlord and the tenant under a master lease want to maintain a certain degree of flexibility. While the terms and conditions of the new lease will typically be substantially similar to the terms and conditions of the master lease, the severance can limit some of that flexibility and alter certain of the parties' negotiated rights.

And at a higher level, the principles behind severance are contrary to the notion of the master lease as a unitary contract. These factors often make severance provisions highly negotiated terms in a master lease.

In order to accommodate the severance of a master lease, the parties need to ensure that the rent is properly allocated across the set of properties under the master lease (or that a mechanism for allocation at the time of severance is agreed). This allocation will determine the new rent under the severed lease and the new rent under the master lease.

If the allocation method is flawed, it can allow one party or the other to game the process. The allocation of rent across the individual properties is often done in connection with the execution of the master lease based on the relative values of the constituent

properties—these allocations are sometimes needed if, for example, the tenant has the right to terminate as to a single property for casualty damage, or if the tenant has the right to renew the lease for fewer than all of the properties. The rent allocation can also be done at the time of severance based on the relative fair market values, property revenues (i.e., EBITDA of the tenant's business at the location) or other metrics.

Often in a master lease, the tenant will negotiate for the right to go dark (i.e., cease operations) at an agreed number of properties and/or sublease an agreed number of the properties. Typically, the landlord strongly disfavors go dark and sublet rights, among other reasons, due to concerns that the property will not be adequately maintained if the tenant is not operating it, that a shuttered property will not generate percentage rent for the landlord and will adversely affect adjacent properties of the landlord by diminishing the foot traffic and allure of the area, and that a tenant which is not operating at multiple properties under a master lease is more likely to reject the lease in a bankruptcy.

In many cases, retail properties are subject to ground leases, reciprocal easement agreements or other instruments that restrict going dark and impose consequences that may include a reversion of title. The landlord wants control over who operates the property and wants assurance of creditworthiness. Frequently, the landlord and tenant agree to limit go dark and sublet rights (which are often combined) to a specified number of properties in the portfolio.

When go-dark and sublease rights are limited to a specified number of properties, the severance of the lease requires the parties to determine how those rights will be divided among the severed leases. By definition, if the total number of properties at which the tenant can exercise these rights is simply divided between two severed leases, the tenant's flexibility is limited—the tenant could apply all of its rights across the entire universe of properties prior to severance, and if a disproportionate number of the properties at which the tenant desires to exercise its rights end up in one of the severed leases, the tenant will not have the same flexibility.

Tenants may seek to increase their overall go-dark and sublease rights in order to offset or mitigate this result, and tenants with sufficient leverage in the negotiations may succeed in doing so. Oftentimes, however, the tenant loses out in this scenario. The landlord generally will resist increasing the total number of properties at which the tenant can exercise these rights, and will refuse to allow a tenant to go dark or sublet a property in a severed lease that demises one or two properties, as doing so would likely significantly impair the marketability or financeability of the severed portfolio.

In many cases, the parties will negotiate other accommodations to compensate a party disadvantaged by the allocation of go-dark and sublease rights.

An important consideration for the tenant in negotiating the modification of go-dark and sublease rights in the context of a severance is that any exist-

ing properties which have been sublet or which the tenant has ceased operating need to be taken into account. The tenant cannot be forced to resume operating (and the tenant would not have the right to terminate a sublease), so any limitation on going dark and subletting in a severed lease would have to exclude any previous exercise of those rights under the master lease. The landlord may seek a reduction in the tenant's go-dark and sublease rights under the original lease in this case in order to compensate the landlord for the diminished marketability or financeability of the dark or subleased properties, and to disincentivize the tenant to go dark or sublease in anticipation of a severance.

Similarly, where a master lease permits the tenant to omit a limited number of properties from the exercise of a lease renewal, the parties must agree how to allocate the limited non-renewal rights. As with the allocation of go-dark and sublet rights, the landlord will generally resist allowing the tenant to increase the permitted number of properties and will also resist allowing the tenant to allocate the limit other than proportionately. From the tenant's perspective, ratable allocation of the non-renewal rights will necessarily reduce its flexibility at the time of renewal.

Complications like those posed by the allocation of go-dark, sublease and non-renewal rights can arise whenever a master lease permits the tenant to take actions on a limited basis with respect to the lease or portfolio as a whole. For example, the tenant may be entitled to perform alterations that do

not affect structural integrity without the landlord's consent, or to perform alterations without having to post security or meet financial tests, up to a specified limit (e.g., projects that cost less than an agreed-upon threshold in the aggregate) across the entire portfolio.

A tenant may have the right to cure defaults a certain number of times, or to make a certain number of delinquent payments without incurring late charges or without having to deposit escrows for taxes or insurance premiums. In each of these cases, the parties will need to determine what rights the tenant will have under each of the original lease and the new lease upon a severance.

Another issue that arises when severing a master lease is the extent of the relationship among the separate leases. Should a default under one of the leases constitute a default under the other leases? If a tenant intends to exercise a renewal option under one of the leases, should it be obligated to renew the other leases?

Frequently, the answers to these questions will depend on the impetus for the severance. If the landlords under the separate leases will be unaffiliated third parties, then the parties' rights and remedies under one lease will typically not affect the rights and remedies of the parties to the other leases.

If, however, the landlord is severing a master lease in order to obtain financing for one or more subsets of the portfolio that the landlord will continue to own, then the landlord may want (subject to the views of its lender(s))

to cross-default the leases and condition renewal of one on renewal of the others.

When a master lease is severed, documents other than the severed lease are often required. If there is a guaranty of the master lease, the guarantor will need to deliver a guaranty of the severed lease. If either party to a master lease has entered into a subordination, non-disturbance and attornment agreement with a third party (such as a fee mortgagee, a fee owner if the landlord is the tenant under a ground lease, or a subtenant), then a similar agreement will typically be needed with respect to the severed lease. The tenant may also want to record a memorandum of the severed lease.

Severing a master lease generally entails a number of thorny issues. Because severance can have a meaningful impact on many of the parties' rights and remedies and on their ability to manage and exit their investments in the portfolio, the parties should carefully consider those issues at the outset, prior to entering into the master lease. Failing to do so may result in disputes, and may compromise the parties' ability to address those issues to their satisfaction, when the severance provision is ultimately invoked.