

Legal Update

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IMPORTANT CONSIDERATIONS BEFORE ENTERING INTO A COMMERCIAL LEASE

By Megan Hamilton

There is a reason commercial leasing is a big business – almost every business enterprise will enter into one or more leases for some type of commercial space. Despite the common perception that commercial leases are straightforward, they are complex documents that actually contain numerous separate agreements on a multitude of complex issues. For example, a lease agreement may include terms commonly found in a construction contract, security agreement, subordination agreement, indemnification agreement, and/or restrictive covenant. Although commercial leases are complicated legal documents and most business owners are not real estate or legal professionals, the law presumes that commercial landlords and tenants have equal bargaining power and are sophisticated enough to fairly negotiate their own leases. Yet oftentimes the parties to a commercial lease do not take the time to fully understand and negotiate the terms, instead falsely assuming that the lease form is “standard” or that the law will protect them.

Failure to adequately understand and negotiate reasonable protections in a commercial lease can easily result in misunderstandings between landlord and tenant or, worse yet, costly litigation. A commercial lease can address a myriad of issues, such as what internet provider the tenant can use or what happens if the building is damaged by fire or natural elements. The following is a select list of key topics that should be carefully considered by the parties before proceeding to lease execution:

- **Lease Term and Rent.** All of the economic terms of a commercial lease are interrelated. A longer lease term may result in lower rent or additional tenant improvement money from the landlord, but it also locks the tenant into a space that may not fit the tenant’s business needs after a period of time. Depending on a business’s anticipated future needs, it may make sense to consider a shorter initial term with extension options, or a longer term with the option to terminate after a certain number of years. Extension or termination options can be complicated, both in terms of determining the timing of the exercise of the option and how to calculate any fees and costs associated therewith (including any increase in rent or termination fee). However, such an option may allow a tenant greater flexibility in the future.
- **Improvements and Delivery of Possession.** The construction of the space to fit the needs of the tenant is another area of concern. The lease should spell out who is responsible for performing what improvements, and who is responsible for any cost overruns or additional costs resulting from changes in the plans. The lease should also address responsibility for delays caused by one party or by *force majeure* events (events beyond the reasonable control of either party, like a natural disaster or an act of terrorism). If the landlord is performing any work, the tenant should seek a clear timeline for delivery of the space and should consider requesting a warranty from the landlord regarding any work completed by the landlord since that work could affect repairs that become the tenant’s responsibility under the terms of the lease. If the tenant is doing the work, the landlord should insist that the tenant keep the premises lien-free and establish protections to ensure that the work is completed and all contractors and subcontractors are timely paid. The process and timing for the tenant to obtain any tenant improvement money from the landlord should also be established.
- **Operating Expenses.** A complete discussion of how operating expenses for the building and premises should be allocated between landlord and tenant is well outside the scope of this brief newsletter, but here are some of the most common ways the parties can agree to allocate such expenses:

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- **Gross Lease.** In a gross lease, the base rent is all inclusive and the tenant is not responsible for any operating charges, real estate taxes, or insurance. Note that in a gross lease, the base rent tends to be higher as a result.
- **Modified Gross Lease.** In a modified gross lease, the tenant only pays for certain identified expenses (like utilities or janitorial services) or may pay its pro rata share of all operating charges that are in excess of the “base year” operating charges. In a modified gross lease that uses a base year, the tenant is only responsible for its proportionate share of operating charges that exceed the operating charges payable in the identified base year (usually the first year of the lease).
- **Net Lease.** In a net lease, the tenant pays base rent plus its pro rata share of operating expenses. Leases can be single net (tenant pays base rent plus taxes), double net (tenant pays base rent plus taxes and property insurance), or triple net (tenant pays base rent plus taxes, property insurance, and common area maintenance charges).

When negotiating a modified gross or net lease, the parties must agree which operating expenses may be “passed through” by the landlord to the tenant. This process may involve a detailed delineation of the charges that are included or excluded and may include controls or “caps” on how much the operating charges paid by the tenant can increase each year. In any case, there should be provisions to allow for the landlord to charge based on the estimated costs for the year, with the right to reconcile such costs at the end of the year. The tenant should have the right to audit expenses to make sure they are being fairly charged in accordance with the terms of the lease.

- **Assignment and Subletting.** When a landlord agrees to lease space to a certain tenant, the base rent and concessions offered to that tenant are based on the landlord’s assumption that the tenant will be leasing the space for the entire lease term. Tenants, however, generally desire flexibility in their use of the space in the future, and one of the ways a tenant can obtain such flexibility is by reserving the ability to sublet or assign the lease. Given these competing interests, a landlord will seek to reserve the right to approve any proposed assignment or sublet so the landlord can ensure that the new tenant will be able to fulfill all of the obligations under the lease. The tenant may want the lease to provide that certain transfers do not require approval; for example, if the tenant is acquired by another business and will cease to independently exist.
- **Role of the Real Estate Broker.** Having an experienced real estate broker assist with a commercial lease negotiation can bring valuable insight into the business aspects of the transaction and help the parties negotiate concessions and rent appropriate to current market conditions in the surrounding area. It is important, however, to remember that most real estate brokers are not attorneys. Nonetheless, brokers can provide invaluable business insight to a party and its attorney when all work as a team to go through the various issues involved in a commercial lease, and their commission is built into the rent even if neither party uses one.

The foregoing list highlights just a few of the many key issues that should be considered by the parties before signing on the dotted line of a commercial lease. In a perfect world, where all things go according to plan and everyone is on the same page, a landlord and tenant will enter into the lease and then place it in a drawer to collect dust for the remainder of the lease term. But since the world we live in is far from perfect, it is wise to take the time to carefully understand your lease and the risks involved before proceeding to lease execution.

FVLD publishes updates on legal issues and summaries of legal topics for its clients and friends. They are merely informational and do not constitute legal advice. We welcome comments or questions. If we can be of assistance, please call or write Megan Hamilton 312.701.6873 mhamilton@fvldlaw.com or your regular FVLD contact.

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