

Selected Issues in Commercial Leasing

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Negotiating the terms and conditions of a commercial real estate lease can be a laborious process. Depending on the nature of the lease, the parties involved and the proposed use of the property, there may be only one or two major points to be negotiated, or there could be several. Not all of these issues are “deal-killers,” but some have more potential than others to adversely affect the lease parties. In this article, we’ve highlighted for you several issues (in no particular order) that seem to consistently engender the most discussion and negotiation. These, of course, are not the only lease issues that gain attention and any given landlord or tenant will have its own particular “hot buttons.”

1. Sublease and Assignment. Tenants want the flexibility to sublease space if their business operations scale back, or to assign the lease if there is a change in ownership of the business, or if the tenant is part of an affiliated group of companies and wishes to assign to an affiliate. The landlord, understandably, desires control over who will be its tenant. For example, landlords would not look approvingly on an assignment to a successor tenant of questionable financial stability. Tenants can sometimes negotiate for the right to assign or sublease to a parent entity, a subsidiary, or an affiliate, without having to first obtain landlord’s consent. Whether the tenant in that case is released by the landlord from further liability under the lease is subject to negotiation. In some circumstances, a landlord may demand the right to terminate the lease and recapture the premises upon an actual or attempted assignment or sublease, if the landlord is otherwise not satisfied with the creditworthiness or the nature of the proposed assignee or subtenant.

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2. Operating Expenses. Where the leased premises is part of a larger building, such as a suite of offices in a multi-tenant office building, or part of a larger development, such as a retail store in a shopping center, the allocation of and payment responsibilities for operating expenses (also referred to as common area maintenance, or “CAM” expenses) is often vigorously negotiated. Tenants that occupy the entire premises do not have the same issues--those tenants generally pay all operating expenses of the property. For those leases where tenants are required to pay a percentage of operating expenses, tenants want to make sure that the landlord is not over-inclusive of costs and expenses passed through to tenants. Conversely, the landlord’s intent is to make sure that the actual costs and expenses included in maintaining the building or center are properly allocated to and recovered from tenants. Tenants usually desire to exclude all costs that, under generally accepted accounting principles, would be considered capital in nature, such as HVAC replacement, roof replacement, and structural repairs. Also, tenants often request a cap on, or exclusion from CAM of, certain expenses, such as management fees paid for property management in excess of a specified percentage of monthly rent, costs otherwise recovered through insurance or from another tenant, leasing commissions, etc. Landlords sometimes agree to an annual cap on increases in operating expenses, exclusive of “non-controllable” costs such as real estate taxes, utilities, insurance costs and snow removal.
3. Maintenance, Repair and Replacement Obligations. In a multi-tenant facility, such as an office building, landlords ordinarily retain responsibility for the roof, foundation, exterior walls, and structural elements of the building. Landlords also generally retain responsibility for the maintenance and repair of parking areas and other “common areas,” although the expenses for such maintenance and repair may be passed through to the tenants as CAM expense. Depending on the facility, the size of the tenant, the term of the lease and other factors, the landlord may also retain responsibility for maintenance, repair and replacement of heating, ventilating and air conditioning equipment. Tenants frequently take issue with obligations to make capital repairs or replacements, such as replacement of HVAC equipment, especially in short term leases. Negotiated resolutions regarding HVAC maintenance repair and replacement may include (i) requiring the tenant to keep in force a maintenance contract, (ii) limiting the tenant’s repair obligations to a specified dollar amount per year or per occurrence, or (iii) putting all maintenance and repair obligations on the tenant but *replacement* obligations on the landlord. In general, the longer the term of the lease, especially where all of the premises is leased by a single tenant, then the more the tenant looks like an owner of the premises and the more reasonable it is from the landlord’s perspective to require the tenant to make repairs and replacements, even certain replacements that might otherwise be considered capital in nature.

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4. Co-Tenancy/Continuous Operation Clauses. Some tenants, particularly big box tenants, anchor tenants in a shopping center, or certain highly prized tenants, will require a co-tenancy provision that specifies that the tenant will have no requirement to commence (or continue) paying rent unless and until (a) a specified percentage of the leasable square footage in the shopping center is leased and open for business, and/or (b) one or more specifically named tenants are open for business. Because shopping center tenants benefit from the traffic that each of them generates, the co-tenancy requirement reflects the tenant's concern with the overall activity in the shopping center--more traffic to the center presumably will equate to more traffic to the tenant's store. Landlords are opposed to co-tenancy requirements because (a) once the leased premises are ready for occupancy or for fixturing, the landlord wants no obstacles to the tenant's obligation to pay rent that the landlord may not be able to control, and (b) the failure of one co-tenancy requirement under one lease may have a domino effect, if several other tenants in the shopping center with similar co-tenancy requirements would then be entitled to not open for business, pay reduced or no rent, or terminate their lease if a co-tenancy condition is not met.

The positions of landlord and tenant with respect to a continuous operation clause are similarly polarized. Once the tenant is open for business, the landlord desires the tenant to be obligated under the lease to continuously operate its business in the leased premises during normal hours of operation. Continuous operation is even more imperative for the landlord if other tenants in the center have in their leases opening or continuing co-tenancy requirements tied to the same tenant. Some tenants, on the other hand, may desire the flexibility, should business or competitive reasons justify, of "going dark," *i.e.*, ceasing operation of business without terminating the lease. One negotiated resolution of this issue would be to allow the tenant to go dark, but give the landlord recapture rights if the tenant goes dark for a specified period, (*i.e.*, 60 or 90 days). This resolution accommodates to some extent both the tenant's desire to retain its leasehold without operating the business and the landlord's desire to be rid of any tenant who is not open for business and is not drawing traffic to the shopping center.

5. Signage. For retail tenants especially, visibility is critical. Accordingly, a tenant should confirm early in the negotiations that it will have the ability to put its desired signage in a location acceptable to the landlord. If the tenant is in a shopping center, the landlord will have particular sign criteria that must be met, and there will likely be governmental and contractual restrictions on size, type, and location of signage. Accordingly, any signage issues should be resolved prior to execution of the lease.

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6. Exclusivity and Use Restrictions. Every lease includes (or should include) a provision reciting the intended use of the premises by the tenant. The standard provision identifies the use (for example, a medical office or general business office purposes) and prohibits any other use without the landlord's consent. For some tenants, most often in the retail, food service or specialty use setting, having the exclusive right to operate the primary functions of the tenant's business is critical, and many tenants won't sign a lease without such right. Landlords have to be careful to define the exclusive use right as precisely as possible so as not to inadvertently exclude specific tenants, or types of tenants, that were never intended to be excluded.
7. Expansion, Contraction and First Refusal Rights. For some tenants, the right to expand or contract the size of their leased premises is critical, as is the preferential right to lease space that the landlord desires to either put on the market or lease to another party. The process and timing relating to the exercise of these rights, and what concessions (or payments) might apply if a tenant does exercise one or more of these rights, can involve a fair amount of negotiation.

These are just some of the issues landlords and tenants deal with in commercial leases. There are probably almost as many potential issues as there are landlords and tenants, as everybody has their own hot buttons depending on experience, need, bargaining power, and timing.