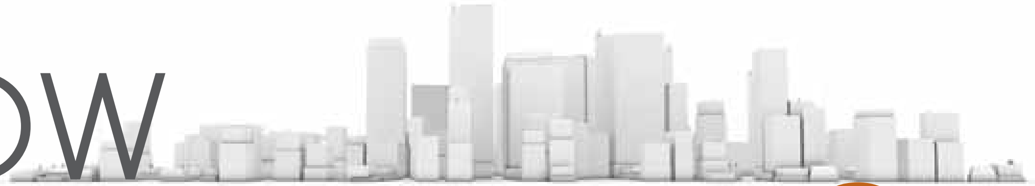

KNOW YOUR LEASE

By Thad Armstrong

This is the second in a series of articles following up on my recent NBIZ *article titled "10 Questions You Need to Ask About Your Lease." Each of the questions in that article touched upon an important issue facing tenants when they are negotiating a commercial lease agreement. This article will focus on the second, third, and fourth of the original 10 questions, giving you a better understanding of the critical issues controlling your (and your landlord's) rights and obligations under your lease agreement.*

Questions to Ask

Question #2: Other Than Rent, What Else Do I Have to Pay?

Most leases require the tenant to pay the landlord for the tenant's proportionate share of the landlord's taxes, insurance, and costs to operate the property. Commercial leases commonly refer to these charges as the "Common Area Maintenance Fee" (CAM) or the "Operating Expenses." The tenant's proportionate share of these costs typically will represent the proportion of the square footage of the tenant's premises to the total square footage of the entire building. If your lease does not require you to pay these charges, you may have a gross lease. The term "gross lease" describes a lease under which the tenant pays a base rental amount, and nothing else, to the landlord. Gross leases, however, are uncommon in traditional retail and office leases. Your lease is most likely either a base year lease or a triple net lease.

The term "base year lease" describes a lease under which the tenant pays a base rental amount, and nothing else, to the landlord until and during a base year of the lease term. The base year is typically the first calendar year of the lease's term. After the base year, the tenant will pay to the landlord the tenant's proportionate share of any increases in the building's operating costs in excess of the operating costs for the base year. For example, assume a base year of 2012; the landlord's cost for property taxes during the base year is $100,000, and the tenant's proportionate share is 5 percent. The tenant will pay nothing for property taxes during the base year of the lease. If the property taxes for 2013 increase to $110,000, the tenant will pay its proportionate share of the increase (5 percent of $10,000).

The term "triple net lease" describes a lease under which the tenant pays, throughout the term of the lease, the base rental amount plus the tenant's proportionate share of operating costs. In other words, the base rent payable to the landlord is the net of taxes, insurance, and operating costs (thus "triple net").

Irrespective of whether a tenant's lease is base year or triple net, the tenant should focus on the actual components of each category of expenses that the tenant will be required to pay. Certain components should be excluded. The list of exclusions is subject to negotiation and can be long. But customary and reasonable exclusions include the following: the landlord's income taxes (as opposed to the landlord's property taxes), the landlord's loan payments, most capital expenses, costs incurred for the benefit of a particular tenant or prospective tenant (as opposed to costs incurred for the benefit of all tenants), depreciation and other non-cash expenses, and the landlord's overhead or administrative costs above a reasonable property-management fee.

Many leases also contain a so-called "gross-up" clause. If the building is less than fully occupied, the gross-up clause allows the landlord to "gross up" certain expenses as if the building were fully occupied. On the surface, this practice seems unfair to the tenant. A properly drafted gross-up clause, however, should cause the tenant to pay for its fair share of the services it receives, while the landlord receives fair reimbursement for the services it provides—no more, no less. Most gross-up clauses, however, are not properly drafted and result in the tenant paying for more than its fair share of costs. In general, costs for building services that fluctuate with occupancy should be grossed up (e.g., janitorial costs), while fixed costs that do not fluctuate with occupancy should not be grossed up (e.g., taxes and insurance).

In addition to operating expenses, a lease might require a tenant to pay to the landlord a percentage of the tenant's gross sales. This "percentage rent" is common in retail leases. A detailed discussion of percentage rent is beyond the scope of this article.

Question #3: What If the Landlord Doesn't Have My Space Ready When I Need It?

Most tenants lease new space because they have an immediate need.

Rarely does a business have the luxury of waiting indefinitely on new space. Delays in possession could occur for several reasons: a prior tenant could hold over beyond its expiration date; a landlord could cause delays in making the new space ready for the tenant's occupancy. As a result, the tenant should negotiate for special rights to protect itself in the event of delayed possession.

The lease should establish two milestone dates for possession: first, an estimated date by which the landlord will give possession of the space, and second, an outside date by which possession must occur. The second milestone date, the outside date, should be no later than the date by which the tenant will begin to incur losses as a result of delayed possession. For instance, the tenant may be forced to pay double rent for holding over in its current space, or the tenant may have hired new employees, relying on having a larger office. These situations could be disastrous for the tenant. While the tenant's rights after reaching each of these milestone dates are subject to negotiation, the following suggestion will offer some protection. The tenant could negotiate for monetary damages in the event of delayed possession, such as a daily amount equal to any increased holdover rent in the tenant's existing space. The tenant could also ask for the right to terminate the lease if the landlord cannot deliver possession of the space by the outside date. Tenant rights of termination are rare in commercial leases, especially if the landlord has invested money in improving the space and has paid a commission, but a tenant with a good bargaining position may succeed in negotiating for this right.

Question #4: How Are My Tenant Improvements Built and Paid For?

Most leases contemplate the construction of improvements to ready the space for the tenant's occupancy. The lease should clearly allocate responsibility for the initial improvements in two respects: (1) responsibility for the actual construction and (2) responsibility for paying for the construction. If the tenant is responsible for completing the construction and the landlord is providing a monetary allowance, the lease should set out in detail the requirements for paying the allowance. The tenant should know exactly when the allowance will be paid and what documentation the landlord will require in order to pay it, such as certificates of completion and releases of liens from contractors.

If the landlord is responsible for the construction on a "turnkey" basis, the lease should be as detailed as possible about the scope of the turnkey work, including the finishes that will be provided to the tenant. Ideally, the final plans and specifications for the turnkey work should be attached to the lease as an exhibit. If the landlord is responsible for the construction and will provide a monetary allowance (rather completing the improvements on a turnkey basis), then the tenant must place tight controls on costs. In this scenario, the tenant should have the right to approve both the final plans and specifications and the pricing before construction starts, and the tenant should have the right to approve subsequent change orders. Otherwise, the tenant could face liability for costs in excess of the allowance that the tenant could not control. **N**

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The information in this column is not intended as legal advice but to provide a general understanding of the issues. Readers with legal problems, including those whose questions are addressed here, should consult an attorney for advice on their particular circumstances.