HUSCH BLACKWELL

Commercial Leasing – "*Everything is negotiable!*"

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The following guide addresses pre-agreement considerations and points for negotiation from the perspective of both Landlord and Tenant.

Pre-Agreement Diligence

- There are many considerations to examine before entering a letter of intent and moving toward lease formation.

Considerations when you are looking for a space

- Make sure the space fits your needs
- What's Market Rent? → Consider seeking a broker's input
- Expansion/Contraction Options
- Term Length

Entity Formation

- Who are the parties?
- Landlord and Tenant must consider use of a special purpose entity.

Landlord's Considerations

- Special Purpose Entities for each property segregates liability
- Landlord needs an entity validly existing in good standing in its state of formation and that is qualified to do business in the state where its property is located.
- Landlord prefers tenants with great credit, high net worth, and assets backing the rental obligations.
- Depending on Tenant's creditworthiness, Landlord will expect credit-worthy entity or individual to stand behind Tenant's commitments.

Tenant's Considerations

- Tenant wants to limit liability so that if there is a default by Tenant under the lease, individual investors are not personally liable.
    - **Solution:** Special Purpose Entities

Deposits v. Guarantees v. Letters of Credit

- What secures the risk of Tenant's default?

Landlord's Considerations

- Landlord doesn't want to invest the time, money and energy in a tenant and the build out of a space for a short period of time if the tenant cannot pay the rent.
    - Best Case Scenario → Letter of Credit
    - Option #2 → Guaranty
        - Should be from a high-net worth individual & cover full performance of Lease
    - Option #3 → Security Deposits
        - Most useful for small commercial spaces

Tenant's Considerations

- Tenant does not want to hold up money for an extended time period that can otherwise be put into the business or otherwise.
    - Best Case Scenario → Limited Security Deposit (e.g., 1-month's rent)
    - Option #2 → Personal Guaranty with Limited Duration or Amount
        - Consider liability caps, guaranty for only first year of lease, etc.
    - Option #3 → Letter of Credit
        - Involves additional transaction costs

Operating Expenses/Pass-Throughs

- How will the cost of occupancy be shared among Landlord and Tenant?
- Most leases require some version of operating expenses that Landlord passes to Tenant for reimbursement (sometimes called "common area maintenance").
- Operating expenses include items such as real estate taxes, insurance, trash removal, landscaping, lighting, maintenance and repair, and snow and ice removal, etc.

Landlord's Considerations

- Landlord wants to own the real estate for investment, and tenants need a place to operate but don't want the long-term commitment of ownership.
- Because tenants actually use the property, tenants should pay for all the costs that come with operating the property.
- Landlord is willing to cover costs related to owning real estate.
    - Best Case Scenario → divide total operating costs among tenants in proportion to their leased space and charge accordingly
        - If Landlord must agree to a cap, only cap controllable costs

Tenant's Considerations

- *Fixed Common Area Maintenance* – Negotiate a fixed Common Area Maintenance arrangement where Tenant has set obligations for the first year with automatic increases each year thereafter
- *Capped Operating Expenses* – Ask for a cap on the first year's amount, with a cap on increases going forward
    - If Landlord will only cap controllable costs, then specify exactly which categories of expenses will be considered non-controllable
        - Taxes, insurance and utilities are typical uncapped costs

- *Pro Rata Share Calculations* – Tenant should find out how the pro rata share will be calculated.
    - Is Landlord trying to exclude any square footage from the project in determining Tenant's Share?
    - Are the other tenants paying their full pro rata share (i.e., is Tenant being asked to subsidize other tenants that are not paying their full pro rata share)?
- *Operating Expense Exclusions* – Review the various categories of operating expenses carefully and negotiate certain exclusions from operating costs that shouldn't be included (e.g., hazardous materials removal/abatement, debt service costs of Landlord's initial improvements)
- *Excluding Capital Expenditures*
    - If Tenant must include capital expenditures, then require capital expenditures to be amortized over the useful life and include only the amortized portion in each year's operating expense
- *Miscellaneous Considerations*
    - Ensure management and administrative fees are capped
    - Require an itemized statement at the end of each year showing the actual costs incurred.
    - Demand the right to audit

Build-Out – Who Does the Work?

- Who has the best contacts in the industry to perform the work for the lowest cost while amortizing this cost over the length of the term?
- When determining who should be responsible for the build-out, both parties should consider the length of the lease and how this cost will be amortized over the term.

<u>Landlord's Considerations</u>

- Landlord prefers to take responsibility for build-out.
    - Must pass these costs through to Tenant in the form of higher rent
- If tenants want to do their own work, require tenants to use reputable contractors that meet Landlord's requirements
- Concerned with tenants' failure to pay for contracted work resulting in contractor's liens attaching to its property
    - Landlord might consider giving Tenant cash and allowing Tenant to contract for its own work in exchange for higher rent.

<u>Tenant's Considerations</u>

- Tenant must decide whether it wants to pay higher rent in exchange for a tenant improvement allowance or turnkey space, or if Tenant would rather pay a lower rent and foot the cost of the leasehold improvements.
- Tenant often lacks construction expertise.
- If Tenant is putting money into the space, Tenant will want a long enough term to allow it to amortize its costs.

Exit Options and Assignments

- What happens when we break up?

<u>Landlord's Considerations</u>

- Best Case Scenario → No assignment right
- Option #2 → Landlord's approval of assignment
- Restrict use of premises to current Tenant's use
- Termination fee compensates Landlord for not getting the full extent of its bargain
- Landlord wants significant advance notice of Tenant's termination

<u>Tenant's Considerations</u>

- Tenant desires customizability and flexibility
- Negotiate termination fee at the outset
- Demand right to assign
- Demand Landlord's reasonableness in approving assignee
- Negotiate a release of liability for Tenant following the assignment provided the assignee meets a specified net worth test

Rights of First Refusal/Option/Offer

- What happens if the relationship goes great?
- Both parties must consider whether to negotiate a Right of First Refusal, or Option, or Offer now, or later.

<u>Landlord's Considerations</u>

- These are time-consuming and limit Landlord's freedom.
- Potentially beneficial for office leases
- Landlord prefers a Right of First Refusal.
    - Allows Landlord to reach a deal with third-party and present to Tenant on a "take-it-or-leave-it" basis
- Avoid Right of First Offer

<u>Tenant's Considerations</u>

- Tenant desires flexibility to expand the premises for growth opportunities.
- At a minimum, Tenant likely wants a Right of First Refusal on contiguous space.
- Right should be on an on-going basis for entire term, not just a one-time right
- Rent on the additional space should be the same as current leased premises.
- Allowance dollars on expansion space should be available on the same basis as allowance dollars allocated for the current space.

Letters of Intent

- Purpose: Reduce basic deal terms to roadmap and ensure the parties are on the same page
- Goal: Avoid unnecessary re-negotiation

<u>Landlord's Considerations</u>

- Helpful to document business terms like term, rent, allowance, use, etc.
- Landlord doesn't want to be bound.

    - Just because a term is not in the Letter of Intent does not mean it is not supposed to be in the Lease!

<u>Tenant's Considerations</u>

- Tenant wants to clearly set forth the lease protections and remedies that are critical to the deal.
- If Tenant wants a Right of First Refusal, an exclusive, early termination right, allowance, renewal options → this is the time.
- Although the LOI is not typically binding, you are far more likely to win the point during the lease negotiation if you can point to the protection in the LOI.

➢ **<u>CAUTION</u>**: Always have leasing counsel review Letters of Intent

- Anytime you are being asked to sign something, there is at least some component of it that will be binding and can have financial and other consequences.