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Navigating Five Lease Landmines

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The cost of leasing corporate office space is normally the second highest expense for most companies and involves many complex financial considerations. Therefore, tenants must take a methodical approach to lease negotiations and diligently scrutinize all details of a proposed lease.

Over the years, our company has identified the top five lease issues that every tenant must balance to minimize cost expenditures and maximize bottom-line profits. They are cited below in order of importance:

Building Operating Expense

This is a very important component of a lease and a subject that I devote a great deal of time negotiating in the Letter of Intent and further in the lease itself. In a nutshell, I pursue the following objectives:

- Establish four-to-five percent caps, non-cumulative and non-compounded, on all annual expense increases. If necessary, a reasonable final position is a cap on only controllable expenses (i.e., all expenses except taxes, utilities, unionized labor, and insurance).
- Include important exclusions from pass-through expenses. One example of an exclusion would be when the landlord is precluded from making a pass-through expense (versus

capitalizing it) unless that expense yields a net present value benefit over the tenant's then-remaining lease term. HVAC is a good example.

- Implement a solid tenant audit right that allows the tenant (for a period of

months beyond the date the cost was incurred.

- Address earthquake insurance provisions for all transactions in California, where it is extremely expensive. Therefore, many landlords do not carry it, but some do so from time-to-time. I include language so that if a landlord elects to carry this insurance the Base Year amount of the lease will be "grossed-up" to reflect such added cost, with the tenant then only paying a proportionate share of annual premium increases.



up to two years) to audit the landlord's books in the event of a pass-through dispute. I then include arbitration language in the event both landlord and tenant are unable to resolve the dispute.

- Require a statute of limitations clause that prevents the landlord from making a pass-through if the date of the pass-through exceeds 18

Subleasing/Assignment

Of course, it is never a tenant's desire to be a landlord in the same building where they lease. However, there may be instances when this might happen, and I include these changes:

- If the space to be subleased is 20 percent or less of the total building area, the tenant is not required to get landlord approval.

- Cap landlord approval costs/review fees so they do not exceed \$1,000, but the amount should be less if the tenant occupies fewer than 5,000 square feet.

- Preclude the landlord from prohibiting a prime tenant from subleasing to another existing tenant in the building or any prospective tenant who is, or who may have been, negotiating with landlord for direct space in the building. An existing tenant in the building, after all, is often the best candidate, and the landlord may have a recapture right, anyway.

There should also be a 50/50 split between landlord and tenant to receive any “net profits” associated with a sublease/ assignment after the prime tenant has deducted all associated costs such as broker commissions, legal fees, landlord approval fees, and any subtenant/assignment improvements the prime tenant covers.

Occupancy Date

Almost all leases specify an approximate commencement date, predicated on either the construction completion date or date of occupancy, whichever is sooner. That said, what if the Premises are not ready with the completed improvements by the projected date, which is usually right after the date that tenant is scheduled to vacate their current facility? Generally, landlords allow tenants no flexibility

in the event of non-tenant- caused delays.

To allow for unexpected delays, it is important to amend the lease in the following ways: First, insert a provision where the new landlord is responsible for any hold-over rent increase at tenant’s currently-occupied building. Second, the tenant should try to obtain the right of a unilateral lease termination in the event the Premises are still not ready for occupancy within 90 days of the proposed commencement date.

Measurement of the Premises

It is very important that a tenant determines the rentable/usable load factor of the Premises and knows/accepts the landlord’s method of calculation before the lease is signed. The landlord and tenant must also mutually agree upon the square footage calculation before the lease is signed. Ideally, this should be spelled out in the lease, but often it is not. Additionally, there should be language in the lease that prohibits the landlord or any future landlord from re-measuring the space and amending the square footage. This problem most frequently occurs when an ambitious new owner acquires the property and looks for creative ways to increase the property’s net income.

Damage/Destruction

Most leases do not afford a tenant any rights whatsoever in the event of

damage/ destruction to the Premises, making it impossible to continue to conduct business at the site. The landlord often has a unilateral right to terminate the lease. What about the tenant’s rights? I always include lease language that allows the tenant to terminate the lease in the event the landlord cannot or will not provide tenant access to the Premises so that the tenant can recommence business within 180 days from the date of damage/ destruction. It is very important that these 180 days begin “from the date of damage/ destruction” rather than “from the date reconstruction begins.”

Conclusion

Negotiating a lease can be a challenging process filled with many pitfalls and landmines, especially when it involves the top five issues that tenants should resolve before signing a binding agreement. Therefore, it is highly beneficial for a tenant to engage a trusted corporate real estate advisor who provides credible, conflict-free representation at the commencement of the negotiation process.

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