Basics of Reviewing Commercial Leases
How to Better Serve Your Tenant Clients

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I. Introduction

1. The current economic environment presents a unique opportunity for those seeking to lease commercial space, whether it be retail, office, industrial, warehouse or special use, i.e. restaurants, storage, garage/repair shop, etc.

2. While all of the above commercial leases each has its own issues, I will attempt, in the limited time available, to point out the major areas of concern that are common to all of them while mentioning specific items that may only apply to one or more, but not all. Some leases are gross rent leases but the vast majority are "Triple net" in nature, which refers to the Tenant paying not only base rent but certain enumerated costs to Landlord that include common area (or building) maintenance, real estate taxes, insurance, cost of services provided and even capital expenditures.

II. Key Components of a Commercial Lease

A. Parties and Guarantors

B. Demise or Lease of the Premises

C. Term and Commencement Thereof and Options to Renew

D. Annual Base Rent

E. Additional Rent, Operating Expenses

F. Security Deposit

G. Use of Premises and Common Areas

H. Improvements and Alternations of Premises by Tenant, Landlord and Owners of Leasehold Improvements

I. Utilities and Services

J. Signage

K. Assignment and Subletting

L. Insurance

M. Liability of Landlord

N. Damage or Destruction of the Premises

O. Condemnation

P. Default

Q. Subordination and Estoppel

R. Rules and Regulations, including Parking

S. Relocation of a Tenant

T. Rights Reserved by Landlord

U. Miscellaneous

2. Will address each of the above individually, as time permits.

3. Conditions Precedent

Before lease is even reviewed make sure space fits Tenant now and in future, zoning is correct and whether or not any governmental approval or licenses are required. Non-conforming use? Outdoor signs? Build-out approval or permits? Will there be hearings? Business location vis a vis competitors and traffic patterns. New construction of premises presents separate issues beyond scope.

III. Parties

1. Entities

A. Entity of Tenant – try to limit liability

B. Entity of Landlord

i. Assets Limited to this Premises

ii. Office Location – on premises?

2. Guarantors

A. Definition – Thank you Professor Spack

B. Try to eliminate or at least limit amount (cap) or duration

3. If parties are related look for special advantages.

IV. Demise or Lease of Premises

1. Defining Premises

A. Different issues for different kinds of premises

i. Free-standing

a. Need common address and legal description – what is included

b. Be sure to include surrounding areas for access, parking, garbage pit, outbuildings, etc.

ii. Office Retail Space

a. How is square footage measured? (Probably includes non-usable space)

b. Is calculated by Landlord's architect

c. Square footage stated in lease will control – confirm if any doubt prior to execution.

iii. Right To Use Common Areas

2. Condition of Premises

a. "As is" or "Acceptable by Tenant" – Acceptance of latent defects

b. Landlord's work

c. Tenant's work – with or without Landlord allowance

d. Attach drawings and/or specs. Be specific.

e. May even enter into "Construction Agreements" and open payment escrows at title company.

f. Lease may terminate at Tenant's option if improvements not complete by certain date, due to Landlord's fault.

3. Common area usage – make sure that Tenant's rights regarding common areas, including parking area, garbage drops and other facilities, are spelled out.

V. Term and Commencement Thereof

Terms range from month to month to multiple decades.

1. Short term v. long term

A. Advantages of short term

i. Less total liability

ii. More flexibility to deal with changes that occur

iii. Try to get initial short term with as many options to renew as possible

B. Advantages of long term

i. Stability – rental rates locked in

ii. Fewer rent increases over life of Lease

iii. Will probably get more rent concessions and better rates

iv. Longer time to amortize fixed costs

C. Define lease year – full or partial, beginning and end

Commencement of Term

D. Does term begin upon the turning over of possession to Tenant for any purpose or upon the opening of business, or another date certain

i. Difficult to pay rent when there is no revenue

ii. Must also pay for Tenants work. Definite cash flow problems.

iii. From Landlord's perspective, he can't rent to anyone else.

iv. Compromise – pay rent when space is ready, not actual opening.

E. Delay commencement date, in any event, until all contingent precedents are met.

2. Option to Renew

A. Get as many as possible, but remember

B. "It is not really a true option unless all terms are negotiated in advance."

C. May still renegotiate if Tenant chooses not to exercise option unless further concessions and demands are met.

VI. Base Rent

1. Begins on commencement date, is set for a specific period, and is paid monthly. May increase during term of initial lease period and during option periods.

2. May increase pursuant to Consumer Price Index.

3. A constant, with above reservations.

4. Limit penalty and interest for late payments, but specifically spell out.

VII. Additional Rent/Operating Expenses, Real Estate, Tax, etc.

1. Generally referred to in triple net lexicon as Landlord pass through expenses. Landlords' ultimate goal is not to reach in his pocket. May be operating or common area expenses.

2. Tenant's biggest concern should be not paying for capital items that improve the property long term, but are not operational or management expenses. Always try to exclude "replacement" language for any equipment. Obviously, the life of the assets that are paid as capital expenditures is much longer than the term of the typical commercial lease. Certainly limit capital expenses to those incurred in order to effect cost savings or comply with applicable laws.

3. A. Lease must state what operating expenses pass through to Tenant or at least list those incurred in the past year on an exhibit. A great deal of time and effort can be expended negotiating this provision, but is worthwhile. Exclude bonus payments, management fees paid directly to Landlord, etc.

B. Make sure cost of expenses are in line with usual and ordinary expense of operating a like facility in the geographic area of the premises, ie. Avoid “sweetheart” and “family” deals and attempts to “pad the operating expense accounts” of Landlord.

4. Real estate taxes passed through are usually the taxes paid in any lease year, not that accrue in the lease year. Tenant actually may be paying for taxes incurred prior to the commencement date, but is cheaper and less cumbersome than delaying payment after lease is terminated. Make sure definition of tax is limited to real estate or substitute tax, not other forms such as use or sales tax.

5. Check Landlord’s insurance coverages and get copies of policies. Make sure that nothing is covered except risks directly associated with the premises. Same concerns regarding sweetheart deals.

6. Additional rent is usually estimated and paid monthly along with Base Rent. An accounting of actual expense is done annually and adjustments or additional payments are made. Check time periods given to make additional payments, and whether or not overpayments are returned to Tenant or credited to next lease year’s payments.

7. Shopping Center leases may include a “breakpoint” or “percentage” rents which refers to Tenant paying to Landlord a certain percentage of gross receipts after reaching a “breakpoint.” The Landlord becomes the Tenant’s partner. Landlord’s justify this provision by claiming the Tenant’s gross is partially based on the traffic generated by the mall’s location. These provisions are also included by Landlord’s in tourist areas (Long Grove) or other special circumstances. Avoid if possible but in any event pay special attention to accounting provisions and who pays for cost of audits.

8. Try to set caps on operating expense increases.

9. Make sure pro-rata share of Tenant is based in rentable space, not rented space.

VIII. Security Deposit

1. May require one to several months’ security deposit, to insure against any lease default or damage to the property.

2. May be in Cash or by Letter of Credit.

3. If Cash, try to get interest to accrue and be credited or possibly even be paid to Tenant.

4. Letters of Credit are much more complicated and usually require the personal assets of principals to be pledged, unless

IX. Use of Premises and Common Areas

1. Try to get general and broad definition of permitted use.

2. Tenant usually must keep premises in good repair (interior) and maintain (but not replace) HVAC System.

3. Make sure of any limitations on use of elevators, loading docks or other common areas.

X. Improvements and Alterations by Tenant, Landlord and Ownership of Leasehold Improvements

1. Must balance Tenant's desire to improve the Premises with Landlord's desire to control construction traffic on Premises.

2. When is Landlord consent required? Usually if cost is over a certain threshold Landlord must approve and Tenant must agree to discharge or insure over any mechanics lien claim.

3. Try to avoid construction management fees to Landlord.

4. Leasehold improvements almost always accrue to Landlord at end of lease.

XI. Utilities and Services

1. Tenant is usually separately metered for utilities, but be concerned if charged on a pro-rata basis. Usage may be different than square feet rented.

2. Make sure what services, if any, are paid for by Landlord at end of lease.

3. Check restrictions on waste disposal.

XII. Signage

1. If retail, restaurant, etc., make sure signage is approved by Landlord and governmental agency prior to lease execution.

2. Get individual signage to be part of multi-purpose building sign, at no cost to tenant.

3. Check restrictions on interior signs in windows, etc.

XIII. Assignment and Subletting

1. Standard clause prohibits subletting or assignment of lease without Landlord written consent.

2. Clause allocates profits from assignment of sublease.

3. Tenant also can't do "end run" by assignment of ownership in tenant entity. Usually triggers Landlord rights of approval.

N.B. If sale occurs Landlord usually negotiates new lease with new owners at higher rent.

XIV. Insurance

1. List required insurance coverages tenants must purchase. May include plate glass replacement, business interruption, general liability, all risk coverage

for personalty and fixtures, fire and extended coverage and worker's compensation.

2. Mutual waiver of cause of action against each other by both parties for any loss that is insured.

XV. Liability of Landlord and Tenant

1. Limits Landlord liability for Tenant's loss or damage to personal property of Tenant. Try to limit to Landlord's negligence only and include liability for Landlord's gross negligence or willful misconduct.

2. Landlord usually limits its liability to its interest in the Premises.

XVI. Damages or Destruction of Premises

1. If Premise is damaged so Tenant can not operate its business therein procedures have to be made to terminate the lease. Traditionally the option was Landlord's, but a reasonable alternative is to give Tenant the mutual rights to terminate the lease if a period of time expires that would be equal to the time that would be necessary for Tenant to obtain a new space and re-open its business, usually six months to one year.

2. Landlord must have the right to terminate the lease, even if Tenant is still doing business from the Premises, if Landlord determines the entire building will be torn down and not repaired.

3. Landlord usually will not agree to Tenant being able to dictate whether or not the Landlord will repair and/or rebuild.

XVII. Condemnation

1. Tenant will never share in any award to Landlord for a taking of the Premises by Eminent Domain Proceedings, <u>however</u>, include provision that Tenant may accept, and negotiate for its own separate award, for diminution in value of its leasehold.

2. Make sure rent will abate pro rata for reduction of rentable space taken by condemnation proceeding.

3. If taking adversely affects Tenant's operation of business, give Tenant right to terminate lease.

XVIII. Defaults

1. Define events of Default: (Avoid "Automatic Defaults")

   A. Tenant's failure to pay any rent or additional rent or any other sum due pursuant to the lease provisions within <u>X</u> days from the due date, and not pay within <u>X</u> days after demand.

   B. Tenant's failure to perform any other provision of the lease and continue not to perform for <u>X</u> days, after Landlord declares a default in writing.

2. <u>Notice to Tenant</u>. Make sure Landlord must give notice of technical default to Tenant in writing and deliver the notice to trigger remedies.

3. <u>Landlord Remedies</u>. Most commercial leases give the Landlord inherent rights in the event of a default, to re-enter the premises, retake possession and expel Tenants, all WITHOUT NOTICE.

In addition, these provisions may also provide that Tenant will be responsible to pay all rent payments after lease termination for the duration of the lease term, after default.

4. VERY IMPORTANT. Make sure to insist that the following provision is added to the Default paragraphs of the lease:

> "Notwithstanding any provision of this paragraph the Landlord must comply with all the provisions of the Illinois Forcible Detainer Act *(cites current statute)*
>
> and that further, in the event the Landlord terminates this lease, Tenant shall only be responsible for rent payments until the premises is re-let and Landlord will use all commercially reasonable effort to relet the premises."

5. Make award of attorney's fees in the event of litigation to the party prevailing, not just the Landlord.

XIX. Subordination and Estoppel

1. Tenant must agree to subordinate its leasehold interest to any new mortgage or general security instrument and to execute any reasonable estoppel certificate, requested by Landlord or its lender. Estoppel certificates state tenant has no causes of action against Landlord, to induce lender to issue new Mortgage.

2. Financing rights of landlord would be severally limited without these provisions.

XX. Rules and Regulations

1. Landlord may promulgate reasonable rules and regulations regarding the use of the common areas and/or building, including parking regulations (as long as Tenant's business is not unreasonably affected).

2. Make sure there is a clause that requires the Landlord enforces these rules and regulations in a non-arbitrary and non-discriminatory manner.

N.B. Make sure you know what current rules and regulations exist before the lease is executed.

XXI. Relocation of Tenant

Unless tenant premises is very small, do not agree to give Landlord the right to relocate the premises within the building or the mall.

XXII. Rights Reserved by Landlord

<u>Example:</u>

1. To use the roof of the premises for whatever purpose is necessary.

2. To enter the Premises, with reasonable notice to show to prospective Tenants, near the end of the lease term.

3. To enter the Premises in the event of any emergency, fire, leaking pipe, etc., or to perform services for Tenant.

4. To sell the Building or Premises or assign its interest subject to the lease.

XXIII. Miscellaneous Provisions

1. Holdover

2. Hazzardous Materials

3. Notices

4. Choice of Law

5. Waive jury trial

6. Counterparts

7. Waiver

8. Jointly and severally liable

9. No Broker

10. Tenant’s right of first refusal of contiguous space

11. Time is of the essence

12. No lease memo recorded, etc.

Negotiate in good faith and if you obtain a balanced lease you did a good job.

A copy of a sample “simple” triple net lease is attached.

Research Resources Acknowledgement

1. “*The Commercial Lease Forumbook, Expert Tools for Drafting and Negotiation*,” by Dennis M. Horn, Editor. American Bar Association Publications, 2004.

2. “*The Commercial Real Estate Lawyer’s Job: A Survival Guide*,” by Brad Dashoff and John Antonacci. American Bar Association Publications, 2009.