

## Commercial Real Estate Leases: Owners Perspective

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Commercial real estate leases appear confusing and complex. Attorneys often complicate matters with legalese and incomprehensible jargon. The uncertainty is intensified by the tenant who needs to occupy the space yesterday. When time is of the essence, both parties work feverishly to get the lease signed. Parties are exhausted by the negotiation, and when the lease IS finally signed, it feels like a miracle. Parties emerge with a halo of relief; the tenant moves into the space and tenant and owner promptly forget about the lease and go about their business ... until the first problem or issue arises. Parties then contact their attorneys and, for the first time, each examines what the lease actually says.

There is an easier way. Commercial leases should follow a simple process. Tenants need functional space at an affordable price with reasonable future guarantees. Landlords want a dependable income stream to service their debt and protection from tenant damage and disturbance.

Here are a few suggestions to consider BEFORE you sign a commercial lease agreement:

### Assess the Prospective Tenant

No amount of legalese can protect you from a prospective tenant who is dishonest, dating payables or teetering on the edge of bankruptcy. Running a credit report and checking references are a good start, but may not uncover a potential problem tenant. You should speak with the prior landlord. If possible, you should tour the tenant's operating premises. The tenant is likely to treat your property the same as the previous owner. You should review the tenant's business plan. If it makes no sense to you, it will make no sense to others.

### Obtain Reasonable Guarantees

Not all prospective tenants have strong financials, substantial liquid assets or even a passing credit history. Even tenants that begin flush with cash can suffer substantial credit deterioration long before their lease expires. Enron and E-Toys are two notable examples. When the market is soft and/or vacancy rates are high, a high risk (financially weak) tenant may be the only game in town. Your choice is to lease to a marginal tenant or let your building sit empty.

A marginal tenant may be a bad tenant, and a bad tenant is worse than no tenant. Your legal fees from a messy unlawful detainer can easily exceed the rent morsels you receive.

If you opt for a marginal tenant, various credit enhancements or security devices can be used to your benefit.

Here are a few ideas: 1.) a BIG cash security deposit 2.) Prepaid rent 3.) Creditworthy Guarantor 4.) Lease Bond 5.) Security Agreement 6.) Letter of Credit. All of these devices should be combined with expedited default terms and nonnegotiable cure periods.

### Security Deposit and Prepaid Rent

A large security and upfront payment is the traditional way to protect against a marginal tenant. However, in a bankruptcy proceeding, a cash security deposit is deemed an asset of the debtor's bankruptcy estate. The owner must obtain relief from the automatic stay to offset the security deposit against damages. In some cases, the bankruptcy court may allow the defaulting tenant to recapture a large security deposit during pendency of the action to reorganize. Amounts that exceed the allowed claimed under Bankruptcy Code Section 502(b) (6) are payable to the bankruptcy estate.

In addition, California law places limitations on the use of a security deposit. Civil Code section 1950.7 provides that a security deposit can be applied to "remedy defaults in the payment of rent, to repair damages to the premises caused by the tenant, or to clean the premises." If the deposit is used to cure defaults in rent, the balance has to be returned to the tenant within two weeks. Under [250 L.L.C. v Photopoint Corp. \(USA\) \(2005\) 131 CA4th 703, 32 CR3d 296](#), the court determined that CC § 1950.7 prohibits a landlord from applying a security deposit to any future rent damages, absent a CC 1950.7 waiver. A landlord may only apply its security deposit to compensate the landlord for past accrued rent or the costs to clean or repair damage to the premises (i.e. not other obligations). Any amount remaining must then be returned to the tenant to avoid a penalty.

### Guaranty

Landlords also routinely seek a credit guaranty from a responsible party. While Section 362(a) of the Bankruptcy Code provides for an automatic stay that prevents the debtor's creditors from taking possession of, or enforcing a lien against, the debtor's property, the automatic stay will not preclude the landlord from pursuing an independent claim against a bankrupt debtor's guarantor.

Choose a financially responsible party to sign a lease guarantee. Individuals made personally liable should never sign as "Jim Smith, President". The word "President" denotes that Jim is signing as an officer of a corporation, not as an individual. Never use dba in the signature line. The tenant will claim the landlord knew not to sue him personally. If there are two or more parties or tenants named on the lease, be certain to provide that they are jointly and severally liable under the lease, lest you sue both and obtain service of process on both.

### Letter of Credit

The letter of credit is my favorite device to secure tenant obligations under a long term lease. For a relatively small fee, the tenant can ask its bank to issue a letter of credit (L/C). For the tenant, the L/C is FAR preferable to a large security deposit because there is no need to tie up large amounts of cash as required in a large security deposit. Company cash remains working capital in the business.

The landlord benefits because the L/C issuer must honor the beneficiary's conforming draws, even if the tenant is bankrupt or insolvent. The automatic stay in bankruptcy court does not apply to L/C draws since courts do not consider the independent draw an attempt to realize on the property of the bankrupt debtor. If a landlord is to obtain the full benefit of the L/C, and not violate the automatic stay, it is crucial that its terms be incorporated into the lease, with express draw down triggers in event of monetary or nonmonetary default. Finally, extend the L/C burn down date at least 90 days beyond the lease termination date to prevent recapture within the bankruptcy preferential payment period.

Sign your lease with the "real" tenant

In college I often ate "mystery meat" in the CAL cafeteria. I had no way of figuring out the true ingredients in the food. Many landlords make the mistake of leasing to a "mystery tenant". They never check to see if the tenant on the lease is the same entity which occupies the space!

Does it matter? Yes. Owners should start by doing due diligence on the tenant's legal entity. Does the legal entity really exist? Is the tenant qualified to do business in California? Is the tenant a valid California Corporation or LLC? Search the California Secretary of State business portal at <http://kepler.ss.ca.gov/list.html> Suspended, forfeited, dissolved and merged entities are easily identified on the public record. The most common reason for suspension of an entity is failure to pay annual tax and filing fees. This indicates a tenant with poor management controls or worse. In addition, run a Patriot Act search.

Under California Corporations Code 2105, "a foreign corporation shall not transact intrastate business without having first obtained from the Secretary of State a certificate of qualification." Unqualified foreign corporations are subject to a penalty of twenty dollars per day for each day unauthorized intrastate business is transacted. More importantly, unqualified corporations cannot enforce contracts until they come into compliance. Corp. Code 2203.

Financial statements should mirror the tenant on the lease. Often I find financials are submitted from a well capitalized parent company, but a different subsidiary without assets actually signs the lease. Never allow a shell entity to sign a lease! Trace revenues to insure they flow into the named entity which signs your lease. Otherwise, your lease guarantees are worthless.

## Ascertain who has Signature Authority

Make certain the person signing the lease on behalf of the tenant has legal and corporate authority to do so. Leases must be executed by individuals with authority to bind the tenant. For corporations, this is obtained by an express resolution or having the right officers sign. Under Corporations Code Section 208(b), a signatory has binding authority because of a specific corporate resolution giving authority on behalf of the corporation.

Pursuant to Corporations Code Section 313, the lease can also be executed without specific authority by two corporate officers: the chairman of the board, the president or any vice president AND the secretary, any assistant secretary, the chief financial officer or any assistant treasurer of such corporation. If, for example, the V.P is also the secretary, the officer must sign twice.

## Define the Shell

Tenant improvement dollars may reap more or less depending on how the shell space is defined. A vanilla shell to one tenant is chocolate to another. Carefully define the base, shell and core to prospective tenants. Some Landlords define the vanilla space prior to delivery as including fire protection and cable risers. Others might consider these items the landlord's discretionary work. Make tenants aware that residual TI's are not part of the base, shell and core.

## Agree on a detailed tenant work letter

The timely completion of tenant improvements and lease commencement is often ground for landlord-tenant misunderstandings. Each party can incur substantial unforeseen or hidden construction costs from delays. The tenant wants to craft the tenant work letter to minimize unforeseen construction costs relating to base building definition issues, defects, and base building code-compliance issues. The tenant also wants to maximize application of the improvement allowance by broadly defining its allowable usage and by keeping the construction cost pricing of the general contractor and subcontractors competitive. In contrast, the landlord wants the tenant work letter to enable it to protect the integrity of the building and to increase its value by restricting the use and disbursement of the improvement allowance, by keeping a tight rein on the selection of the architects, engineers, and contractors, and by enforcing detailed construction rules and regulations.

A detailed work schedule should detail who does what, when and who pays. Bilateral obligations include a hard commencement date, required turnaround period and remedies for controllable delays. Often, the landlord wants the lease commencement date to be as early as possible. In contrast, the tenant wants to delay the lease commencement date until it is able to occupy the premises.

If the tenant controls the tenant improvements, the parties will agree either on a hard date on which the lease will commence or that the lease will commence within a certain

number of days after it is executed. The parties will also usually agree that a hard date can be extended by either landlord delays or certain force majeure delays. To prevent delays, owners should encourage tenants not to use their own architect and engineer for the tenant improvements. Generally, the owner's professionals know the project best and can speed along permits which are vital to meeting completion deadlines.

If the landlord controls the tenant improvements, the parties usually agree that the lease will commence on substantial completion of the premises. The definition of "substantial completion" is a primary focus of lease negotiations. In case of a tenant delay, the lease commencement date may be considered to occur before substantial completion of the premises. Landlords should consider offering a free rent buffer period between substantial completion and rent commencement to allow tenant fixturing, electrical upgrade and move in.

### Use Provisions

Does the tenant's use overly burden building systems, including utilities, HVAC, water, security, conference rooms, chilled water, computer cabling, interior staircases, parking, security entry systems etc.? The installation of land wireless units must not interfere with other tenants. Policing a tenant feud will drain your energy quickly. Place the burden upon the tenant to remove complaints and costs created by their use or do not accept their use in the first place.

### Craft your Default Clause as if your life depended on it

Late charges, interest and default terms may be the most important language in your lease. Allowing tenants a "grace period" encourages creative accountants to play with the float. Avoid notice periods more lenient than California statute. A three day notice to pay or quit is all that is required under California Code, but I often see lease notice language which calls for a 5 day grace period, plus a notice to cure default for 10 days, plus a notice of default for 3 days, plus a statutory or longer notice BEFORE filing for unlawful detainer. This is ridiculous. Be careful of extending the notice for nonmonetary default as opposed to monetary default. If a tenant cuts into the roof, bursts a sprinkler or alters a riser, you do not want to wait 15 days for them to cure.

### Insurance

Do not allow a prospective tenant or tenant's contractor to enter the premises without evidence of insurance. Insist on delivery of a binder prior to tenant entry and fixturing of the space. To avail yourself of the lease protections, commence the lease, absent rent, at the beginning of the fixturing period. The tenant's insurance should be the primary policy. Insurance on an occurrence basis providing single limit coverage in an amount not less than \$1,000,000 per occurrence with an annual aggregate of not less than \$2,000,000 is standard in the market. The tenant should add the landlord as an additional insured by means of an endorsement at least as broad as the Insurance Service

Organization's "Additional Insured-Managers or Lessors of Premises" Endorsement. The policy should be A credit and not contain any intra-insured exclusions as between insured persons or organizations, but shall include coverage for liability assumed under the lease as an "insured contract" for the performance of tenant's indemnity obligations under the lease. Make sure the policy has a tail, covering completed operations, and loss discovered after the tenant departs.

## Indemnities

Indemnity only concerns third party claims made against the landlord or tenant. Claims between the landlord and tenant do not involve indemnity. I recommend that landlords provide indemnity only for the gross negligence or willful misconduct, but not for ordinary negligence. Ordinary negligence should be resolved at law and payment to a third party should be assigned by the court accordingly.

## Sublease and Assignment Rights

The right to sublease cannot be unreasonably withheld in California. Landlords are prudent to carefully scrutinize new lessees and assignees with legal review expenses recaptured from the tenant. A new occupant can disrupt the tenant mix, blight the center or diminish the quality of the tenant mix. Introducing a new occupant to the space requires reviewing financial statements and assessing the potential competition to existing tenants. The lease should allow sufficient time during the consent process for the landlord to analyze the terms and conditions of the transfer and make a final determination on the transferee's financial position.

The lease should contemplate sublease profits and recapture rights. In a rising market, I have known tenants to close their business and sublease the space because it is more profitable and less risk (no employees, pay dates or regulators). Consider who will receive the bonus rent, or bonus consideration, in sublease situations.

## Beware the Tenant who "Tinkers"

Boilerplate lease language allows the tenant to perform nonstructural alterations to the space, below a specified amount, with prior landlord consent. These provisions are always subject to dispute. All alterations or utility installations by the lessee should require written approval of detailed plans. Any approval should be conditioned upon the tenant's procurement of governmental approvals. Common tenant problems result from tapping into chilled water (for supplemental HVAC), increasing electrical capacity, puncturing the roof to mount tenant improvements and overextending building telephone and data services. Tenants who rupture pipes cause tremendous damage. Supplemental HVAC is dangerous and expensive. The lease should address who pays and who has the responsibility for abatement of hazards resulting from tenant alternations.

## Operating Expenses

When the tenant has an obligation to pay CAM (Common Area Maintenance) charges, the landlord has a duty to provide services which maintain the condition of the property. Tenants typically share proportionately in either the cost of CAM or increases in CAM above a base year, depending on their lease.

After base rent, operating expenses are the largest amounts due. Typically, landlords create broad operating expense provisions which can include everything from property management fees, to capital costs, charitable contributions, all types of “insurance” and charges for government-mandated child-care facilities located in the building. The full pass through of increases in taxes and assessments can dramatically increase tenant costs.

Tenant’s desire to narrow the operating expense language. They seek to exclude as many foreseeable expenses as possible and any capital or recurring cost which is unforeseen when the lease is executed. Operating expense language is tied to present tangible and real benefits to the tenant, not future investments.

The tenant also wants the right to audit the landlord's books and records to verify the propriety of all pass-through expenses. This is a common source of landlord/tenant disagreement. Tenants “gang up” on landlords suspected of topping off the operating expenses. A tenant may also want to negotiate a cap on increases in operating expenses to limit its future exposure for costs over which the tenant has little control. For instance, sale of the property is generally the largest single increase in operating expenses and some tenants agree to pay only one sale reassessment increase during the leasehold.

California provides no express right to audit landlord operating statements, and I suggest not granting one. If you have 25 tenants, you will have 25 different agents in your offices attempting to audit your records. Like ants on a popsicle, it can get very tiresome. Some Landlords refer disputed items to an independent certified public accountant. Others preclude dispute if the statement of operating expenses is audited by an independent certified accountant, and the summary audit is distributed to tenants. This eliminates the threat of “contingent fee audits”. Some landlords allow tenants to dispute operating expenses only if they exceed 110% of the prior year’s operating expenses. Some owners grant each tenant the right to view the successful audit of any other tenant with all tenants getting the benefit of any adjustment.

### Damage and Destruction

These provisions allocate the risks of unforeseeable damage and destruction that could cause termination of the lease or that could cause the lease to remain in effect while requiring one or both of the parties to expend large sums to remedy uninsured casualty losses:

The tenant wants the damage and destruction provisions to enable it to maintain the lease in existence, in case of a casualty, if damage can be repaired quickly at the landlord's expense. If not, the tenant wants to have the right to terminate its lease obligations. In

either case, the tenant may want to have its rent abated if the premises must be vacated because of damage or destruction or for repairs.

The landlord wants the ability to keep the lease in effect unless the reconstruction period is too long, the uninsured cost to reconstruct is too great, or the mortgage holder decides to use a substantial portion of the insurance proceeds to retire the mortgage debt.

### Rental Abatement

Rental abatement was once a controversial issue in California. Today, Tenants by agreement can repair and deduct when necessary. In return, Landlords should require that tenants carry business interruption insurance; the rent is paid in event of an unforeseen interruption in the business.

### No Arbitration

Arbitration or alternative dispute resolution methods are not beneficial to a property owner and should be avoided in commercial leases. Landlords have their best opportunity for an expedited recovery by litigation in a court before a judge without a jury. Arbitration is expensive, affords no right to appeal and is no faster than summary adjudication afforded landlords in disputes over possession. While mediation is an effective tool in settling disputes other than eviction, it should remain a voluntary alternative available to parties by their mutual agreement.

### Quiet Enjoyment and Nondisturbance agreements.

During the late 1970's and 1980's, tenants began to request nondisturbance protection because the threat of foreclosure had become so prevalent, and landlords and lenders resisted such requests. Landlords and lenders are now generally amenable to granting nondisturbance agreements to substantial tenants and in some cases even prefer to include such agreements in their lease documentation. In return, Landlords and lenders request that tenants execute subordination and attornment agreements. Tenants are afforded the assurance of quiet enjoyment in return for granting subordination and lease guarantees.

### Bankruptcy

Beware of boilerplate lease provisions which violate Federal Bankruptcy law (most of them). Leases which list the filing of bankruptcy as an "event of default" are unlawful. Federal law prohibits the landlord from declaring a default based on merely the tenant's filing of a bankruptcy petition. If a guarantor files for Chapter 11 protection, the limit of the guaranty may be capped at the amount of the lease rejection damages. Excess tenant improvement contributions may result in a creditor claim that such contribution is a preferential payment and subject to an offset against other claims to which landlord may be entitled. In addition, if the landlord obtains a large security deposit, his or her ability to retain funds may be capped at the amount of lease rejection damages.

## Severability

Many leases fail to include a severability provision. If a provision of the lease is held to be invalid or unenforceable, as the bankruptcy example above, the remainder of the lease or the application of that provision to persons or circumstances other than those as to which it is held invalid or unenforceable, should not be affected. Each provision of the agreement should remain valid and be enforced to the fullest extent permitted by law. If a tenant succeeds in invalidating portions of the lease, a mortally wounded contract will fall at the mercy of judicial construction, absent a severability clause. The landlord is forced to rely upon principles of judicial construction and ascertain whether or not the invalid clause is, or is not, essential to the continuation of the agreement as a whole.

## Options to Renew

Options to renew work to the tenant's benefit, not the owner's. If you choose to grant an option, be sure to require that the tenant is in occupancy of the full premises, is not in default, has not changed in effective ownership and has not assigned or sublet the space. Require that notice be given well in advance of exercise; otherwise, you may waste time marketing a space for a tenant who renews. Provide that "time is of the essence"; otherwise, a court may provide for a late election since courts abhor a forfeiture. Never accept option language "under the same terms and conditions as this lease". A court may hold you to repeat the tenant improvement allowance, free rent periods and rent holidays!

## Removal of Trade Fixtures

California Civil Code Section 1013 states "When a person affixes his property to the land of another, without an agreement permitting him to remove it, the thing affixed, except otherwise provided in this chapter, belongs to the owner of the land, unless he chooses to require the former to remove it or the former elects to exercise the right of removal provided for in Section 1013.5 of this chapter".

Tenants often request the right to remove tenant improvements from the space at the end of the lease term. However, permission to remove should not negate the landlord's right to REQUIRE removal. Parties should specifically articulate which personal property items will be removed and how the tenant will return the space to its original condition.

Asking the tenant to remove improvements at the end of the lease term requires a careful distinction between "original improvements" and "tenant's improvements." A landlord can remove original improvements before or after the lease, but rights for prior removal by the preceding tenant can be waived if a succeeding tenant wants the space as is.

## Closing

In conclusion, commercial leases, unlike residential leases, are not subject to most consumer protection laws. Each commercial lease is customized to the needs of the parties and generally subject to extensive negotiation. Courts will construe your

agreement according to the expressed terms, so draft your commercial lease carefully before signing.

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