Ten Grenades Hiding in Tenant Commercial Leases: What You Didn't Bargain For Could Blow Up Your Business

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After salaries, the most expensive line item for most businesses is real estate fixed costs, often those arising from rent obligations as a tenant. This article will identify and discuss the more significant "grenades" in leases that can greatly increase the total costs of occupancy ("TCO") for a tenant.

1. *Wham, Bam, No Thank You CAM (Common Area Maintenance Charges)*

Overview: Apart from fixed rent (and in some retail leases, percentage rent), the tenant's TCO is most affected by CAM charges. Without caps (often 3-5% per year) on so-called controllable operating expenses (excluding property taxes, insurance and utilities), limits on CAM reconciliation periods, and a fair formula for amortizing the cost of capital improvements over their useful life, tenants can find themselves unprotected and vulnerable to gouging. Tenants with leverage should use it (large square footage, good credit, desirable/hot use, good operator with proven track record). CAM considerations:

(a) *Tenant's Percentage Share*. This should be straightforward; tenant should pay its pro-rata share of the overall CAM costs for the center. Yet, the formula in some leases states that tenant's share of CAM is its square footage as a numerator, divided by the square footage of all tenants open and operating (versus all square footage in the shopping center). Using this open and operating formula, the tenant has to pay greatly in excess of its pro rata share if there is vacant space in the center. In effect, the landlord is getting the tenant to subsidize its poor lease-up effort or inferior location, which hurts the tenant twice over.

(b) *Amortization of the Cost of Capital Expenditures over Their True Useful Life*. The tenant should pay for things like roofs, HVAC and other capital expenditures (as distinguished from ordinary repairs and maintenance which are expensed yearly) gradually over their useful life, not all at once in a lump sum. The IRS guidelines should govern; not a landlord's shortened version of useful life. Landlord's incentive is to categorize an expense as ordinary, rather than capital, so that it gets reimbursed in one up-front lump sum. Lease language should address these issues.

(c) *Audit Rights and Deadline for Reconciliation of CAM Charges – Avoiding the Nasty Surprise: "Sorry, but we forgot to bill you for CAM for the last ump-te-ump*

months/years." A lease should have a deadline for CAM reconciliation (which always seems to go in the landlord's favor) of 90 or 120 days following the end of the prior year. That way, the old CAM Catch-up mess can be avoided and the tenant can rest assured that it won't get presented with a giant unanticipated CAM bill. Insist on audit rights, at least annually, to keep the landlord and its management company honest (whether captive or outside).

(d) *Caps and Management Fees – Catch landlord if you can; cap if you can*. A tenant who genuinely has some leverage in the negotiations should request that all controllable OPEX (operating expenses) be capped so that they do not increase by more than, say 3-5% per year, year over year (not cumulatively). Management fees should not exceed 4% of gross revenue, or 10% of controllable operating expenses. Look out for double dips (management fee and an administrative fee), which in the aggregate, exceed a reasonable fee.

(e) *Exclusions from Operating Expenses*. Any experienced real estate lawyer will have a list of exclusions from OPEX. The landlord might even have its own pre-approved list. Attach the list as an exhibit to the lease to keep CAM costs in check.

(f) *Separate Cost Pools*. Okay, only if fair and well-defined. Drive-throughs, patios and loading docks that benefit only one tenant must be paid for solely by that tenant.

2. *Assignment and Subletting - I Gotta Get Outa Here*

Overview: Sometimes things in the real world don't go as planned, whether due to uncontrollable (remember 2008?) or controllable economic circumstances and life events. A tenant must have reasonable flexibility to sublease or assign the lease. Tenant enthusiasm is high for a new business or a new location. You will never see a pro-forma that doesn't predict success; but then reality can collide with expectations.

(a) *Permitted Transfers (without landlord consent)*. Beware of clauses giving the landlord the right to consent to a change in control of the tenant entity. That consent should be automatic, until there is a 50% change, not a 25% change.

(b) *Negotiate Pre-Approved Criteria for a Permitted Transfer*. Beware also when the landlord requires equal or greater net worth than the existing tenant, especially if the existing tenant is wealthy. Landlords will agree to a well-thought out list of relevant criteria, which, if met, will defeat the landlord's prerogative to refuse to the transfer.

3. *Hazardous Materials - Things that Glow in the Dark*

Overview: Landlords love it when tenants agree to pay haz mat clean-up costs through CAM, for contamination that they did not cause. This is an uncapped liability for a tenant. That is a landlord risk of owning land, not the tenant's risk. Landlords should not pass through clean-up costs caused by other tenants, midnight dumpers or off-site sources, whether preexisting or caused during the lease term. Rather, only if tenant causes the problem should tenant pay to remediate it.

4. *Options – A Tenant's Best Friend*

Overview: Options come in two flavors: options to renew and options to expand. Tenants should always negotiate hard for options to renew. What tenant wants to build a business at a certain location and then be forced to move, especially after the tenant may have spent lavishly on tenant improvements to attract customers? Options are a one-way street benefitting tenants, so get 'em. If the business is going well, the tenant will exercise the option. If not, adios. A wise tenant will not leave itself open to a rent gouge by a landlord who takes advantage because a tenant did not have an option to renew.

5. *Going Dark, Co-Tenancy - Ghost Centers*

Overview: No tenant wants to try to survive in a center with lots of vacant space and inadequate foot traffic. These ghost centers exude failure and also pose security risks. If the tenant has sufficient leverage (large enough or a desirable use or trade name), that tenant should negotiate for co-tenancy provisions, such that if one or more anchors or other key tenants leave the center, the tenant can terminate its lease and also leave.

6. *Exclusives, Use Clauses, Control Areas and Radius Clauses – What's the Use?*

Overview: Every tenant will want an exclusive; more valuable tenants should be able to get them. Beware of unduly restrictive radius clauses that prevent a tenant from operating a competitive store under the same trade name within a certain radius, of, say, over three or five miles. Large tenants can often demand and get control areas, such that no changes can be made within the defined area in front of their stores without their permission.

7. *Insurance and Indemnification – When Things Go Bad*

Overview: Every tenant should have its insurance consultant carefully review the insurance and indemnification sections of the lease. There could be problems.

(a) *Insurance Gotchas*. Deductibles that are too low are expensive and should be resisted. A large enough tenant, especially a regional or national one, should be entitled to self-

insure, based on agreed-upon criteria such as aggregate sales thresholds. Earthquake insurance is expensive; it should only be required as a CAM pass-through if it is required by the lender for the shopping center. Flood insurance should only be required if the center is in a flood plain. A.M. Best's insurance ratings for insurance companies (ability to pay claims and reserves) should be reasonable and not too restrictive. A rating of A-VII is often used. An A rating will often be too limiting.

8. *Landlord Carve-Outs – The Double Standard Lives*

Overview: Virtually all leases limit the landlord's liability to a tenant. This approach should be acceptable if limited to the landlord's ownership interest in the center or project. Unacceptable landlord positions include provisions that state that the landlord is not liable for its own gross negligence or reckless misconduct, or that of its agents or contractors.

9. *How Do You Like Your Boilerplate – Rare or Well Done?*

Overview: Every clause is in a lease for a reason, so pay attention, tenants. Every contract, including a lease, is a risk allocation device. Landlords pay lawyers to draft leases that can sometimes be unfair and unduly burdensome to tenants. A seasoned real estate lawyer will know what is customary and fair, and what is going on in a certain marketplace for a given product type. Also, the so-called "Miscellaneous Provisions" at the end of the lease can be a clever place to hide onerous lease provisions without flagging them. These can be easy to miss.

10. *"Gotchas for a $1,000, Alex" – Landlord's Grab Bag of Other Tricks*

Overview: It is often said that "the devil is in the details." This is especially true for contracts, leases included.

(a) *Letters of Intent/the LOI*. Letters of intent are very important. While they are often drafted by landlords or their brokers, lawyer input and review is recommended on behalf of the tenant. Why? For starters, if a business point (one that neither the broker nor the client thought of) is not incorporated into the letter of intent, it may end up DOA, as in dead-on-arrival, when it comes to putting it in the actual lease. Further, if a tenant's specific concerns are not addressed up front, they too might never make it into the lease. Sometimes LOIs are treated as form documents, when in fact, they must be customized to the particulars of the transaction at hand.

(b) *Work Letters*. These are a bit of an art-form unto themselves. TIs (tenant improvements) are important. Carefully define the scope of work. TI dollar allowance versus turn-key? Warm shell vs. cold shell (how defined)? Landlord's work vs. tenant's work?

(c) *Condition of Premises*. Always take photos to establish the base-line condition. Watch out for provisions requiring demolition of certain improvements at the end of the term.

(d) *Security Deposit*. Under California law, landlords can only retain these funds for specified purposes, ordinary wear and tear excepted.
(e) *Destruction*. Either tenant or landlord should have the right to terminate the lease if the restoration takes longer than six to nine months (not the landlord only). Tenant should keep what it is lawfully awarded; don't let landlord snatch it.
(f) *Condemnation*. A partial taking test that ignores the tenant's parking needs is dangerous.
(g) *Utilities*. Consider the benefits of separate metering.
(h) *Compliance with Laws*. Should be at landlord's expense if the law so provides.
(i) *Signage*. If there is any chance of getting it, bargain hard for it.
(j) *SNDA*. Technical document; contact counsel. If a tenant agrees to subordinate and attorn, it should be sure to get non-disturbance protection in return.
(k) *Holding Over*. The penalty should not exceed 150% of the prior rent (never double).
(l) *Memorandum of Lease*. Get it if you can, tenant. Once recorded, it puts third parties on notice of the existence of your lease.
(m) *Lease Guaranty*. Sorry; these are tough and are generally non-negotiable.

Summary

A shopping center is a symbiotic relationship between a landlord, who controls tenant mix and overall attractiveness of the center, office building or industrial park, and the tenants, who help build the value of landlord's investment in its property.

In difficult economic times, tenants try to renegotiate their rent to gain concessions to help them survive. Some tenants puff on this. Landlords are caught in a tough bind too. What tenant ever approached its landlord and said, "Hey, things are going pretty well, so I want to share and give back some of my relieved rent." Oh sure.

Landlords and tenants must each honor the legitimate expectations of the other. This is true in any relationship, personal or professional. The most successful relationships are those that embrace that reality and tend toward transparency. Landlords and tenants depend upon each other. Add in loyal customers, who the tenants have built, and all parties can not only survive, but thrive.

It's not "just a lease." It's an obligation, with significant financial and operational impact. Though it may sound self-serving, getting an experienced real estate lawyer (not a moonlighter) involved up front in lease review will cost a few shekels, but could produce value many times over during the course of the landlord-tenant relationship and help the tenant avoid nasty surprises.

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