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Seminar 15

Leasing Boot Camp II: All the Fun of Leasing Boot Camp I, But with Twice the Roman Numerals

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Introduction:

When you're handed your first few leases as a practicing attorney, it can feel daunting. You just spent a few years (and a lot of money) attending law school, but what in the world is all of this? Why were you never taught anything in law school about leases or the clauses that you are now being asked to review and comment upon? It's a moment that no leasing attorney ever forgets. Asking questions of your superior can often feel like an admission of ignorance. With a good mentor and a bit of time working your way through different lease forms, suddenly they start to look more alike than different. Over time, you'll begin to recognize similar clauses and provisions and learn fallback provisions that help to get a lease into a mutually agreeable format as between landlord and tenant. But, even as you feel like you're getting the hang of things, it's easy to become overly mechanical in terms of reviewing and negotiating leases. The goal here is to take a step back to analyze a number of issues that require certain lease provisions that may not always be a focus when learning retail leasing and to provide insight as to why such provisions are important to a leasing transaction as a whole. We'll analyze some "big picture" concepts as well as discuss more nuanced arguments a leasing attorney might take, with an eye toward those "ah-ha!" moments as to why certain provisions are necessary in a robust lease that adequately protects the interests of each party involved. While it would be impossible here to dig into each and every common lease provision to discuss its overall significance, we aim to touch on a few key concepts that are not always focal points for those new to retail leasing.

1. Limiting Your Client's Liability

One of a lawyer's main functions in representing a client is to protect the client's interests and limit the client's liability. When representing a client starting a business and entering into a new lease, always discuss with the client whether incorporating or forming an LLC is a prudent first step toward protecting your client's personal interests and assets. Landlords are typically comfortable with allowing an LLC as a tenant, but given the limited financial backing that a new LLC likely has as of the date of its creation, the landlord will likely insist upon a personal guaranty from a party associated with the LLC to act as the landlord's security in the deal.

If a personal guaranty is required, the ultimate service to a tenant client is to limit their personal liability on a lease. This can be done in a number of ways, but the most common technique is incorporating some sort of burn-off provision into the guaranty. A "burn-off" is a mechanism by which, after a certain period of time, the guarantor is either relieved of his/her personal liability, or the guarantor's personal liability is decreased.

Some landlords will agree that a burn-off of a personal guaranty is appropriate once the landlord has recouped its out-of-pocket costs associated with the lease. Landlord's out-of-pocket costs are expenses such as brokerage commissions paid by the landlord, costs associated with landlord's work preparing the premises for occupancy, and collection costs associated with enforcing the guaranty. If a landlord is unwilling to limit the personal guaranty to landlord's out-of-pocket costs associated with entering into the lease, one fallback position is to suggest limiting the guaranty to the landlord's out-of-pocket costs and one year of rent from and after the date of a default. This is commonly referred to as a "rolling" guaranty. Note that there could be several other factors affecting the landlord's position, depending on the structure of the deal, but if you can get a landlord to agree to this concept, you've done a great job protecting your tenant client's personal interests.

As a landlord representative, one would want to limit the landlord's liability, as well. If you're representing the landlord, it's important that your lease contain an exculpation clause. An exculpation clause is commonly buried in the boilerplate language at the end of lease forms and it serves to limit the landlord's liability to only the landlord's interest in the subject property. In theory, the maximum that a tenant could recover from the landlord if the tenant prevails in a lawsuit would be the landlord's ownership interest in that property, and that property alone. Such limitation may or may not be valuable. Tenant's counsel may want to attempt to limit landlord protections in certain instances such as fraud or hazardous material remediation. Tenant may also want to ensure that if the landlord's liability is limited to landlord's interest in the property alone, that such interest also includes the rent, insurance, condemnation, and/or casualty proceeds of the property.

Lenders are particularly focused on exculpation clauses in leases relating to real estate projects that they are financing. If a lender forecloses on a property and assumes the role of "Landlord" under a lease, a lender wants to know that all of its company-wide assets are not put at risk, just its interest in the property upon which it has foreclosed.

2. Limiting Your Client's Obligation to Reimburse Pass-Through Operating Expenses

In most retail leases, in addition to the obligation to pay base rent, the tenant typically has some obligation to reimburse landlord for tenant's proportionate share of the landlord's costs of operating its building or shopping center. These costs are collectively referred to as "operating costs," "common area expenses," "common area maintenance," or "CAM." Such costs can typically include: (i) landlord's costs of insuring the property; (ii) landlord's real estate taxes associated with owning the property; (iii) utility costs (parking lot lighting, sprinkler/water for landscaping); (iv) security costs; and (v) general repair, upkeep and maintenance of the property. Overall, it is important to understand how a tenant's pro rata share is being calculated and what operating costs are being excluded and included.

An important distinction in operating costs is the difference between those costs which are "controllable" by the landlord and those which are "uncontrollable". Seldom will a landlord agree to limit annual increases in uncontrollable expenses (like taxes, insurance, and utilities), but often landlord will agree that the controllable operating expenses will not increase year-over-year by more than three percent (3%), four percent (4%) or five percent (5%), for example.

Negotiating a "cap," such as the percentage mentioned above, or a dollar amount, of maximum controllable operating expenses in a given year for your tenant client will give operational and budgeting certainty, giving tenant some bit of control over expenses that they do not manage. Since these expenses will be incurred by the landlord and passed through to the tenant on an annual basis, these provisions of the lease are important to reign in, since they will come into play every single year during the term of the lease. Understand the difference between cumulative and non-cumulative caps to further protect your client.

3. Making Sure Tenant Client's Extension Options are Legally Enforceable

Extension options may be provided at the conclusion of the original term. If a lease contains an option for tenant to extend the original term of the lease, sometimes the option rent is specified. However, often times the lease will state that the rent for such extension term will be at "market rent" or "fair market rent" to be determined by the landlord and the tenant at the time of tenant's exercise of the extension option. Unfortunately, as the amount of rent is an essential part of a lease, this is an unenforceable provision because it merely amounts to an "agreement to agree." In order to make this provision enforceable, extension option provisions contemplating "market rent" or "fair market rent" should set forth a specific process as to how the market rent will be determined.

When representing the tenant, one should evaluate whether the market rent determination language sufficiently defines the determination mechanism so as to keep it from being an unenforceable "agreement to agree." Enforceable language should concisely detail the specific process for determining what market rent is and should always contain a stipulated remedy if the parties are unable to agree (for example, arbitration with retained and independent brokers or other persons with specific qualifications to be outlined in the lease). Without such a specific process, the renewal option may be rendered worthless.

4. Giving Your Tenant Client the Broadest Assignment/Subleasing Rights Possible

Both landlords and tenants have legitimate interests in controlling assignment and subleasing rights in the lease (both for themselves and as to the other party). As a broad generalization, landlords and tenants want the freedom to transfer from both sales and organizational perspectives. Landlords want to control tenant mix and protect themselves based on the factors they may have used when deciding to lease to a particular tenant (such as financial strength, retail performance, or existing co-tenancy requirements). Tenants would do well to preserve exit strategies for themselves.

When a business is struggling and the tenant needs to find a way to get out of the lease or reduce its costs, tenants will often attempt to find a replacement tenant to either take assignment of the lease or to sublease all or a portion of the tenant's space to help reduce the tenant's rent costs. Most landlord form leases require landlord consent for a tenant to assign a lease or sublet all or a portion of its premises. A well-negotiated assignment or subletting provision on behalf of a tenant should take unilateral discretion out of the landlord's hands to provide the tenant with some flexibility. While blanket rights for a tenant to assign a lease or sublease a premises may be hard to obtain for all tenants, landlords will usually agree to some softened standard, such as an agreement by the landlord not to unreasonably withhold the landlord's consent to an assignment or sublease. Further, for certain types of assignments or subleases, landlords will often agree that landlord consent is not required. This includes transfers of the lease to tenant-affiliated entities for flexibility in business structuring, mergers, consolidations and asset purchase type transactions.

Negotiating and closing a business transaction is difficult enough. If the tenant's lease allows for certain business transactions to occur without landlord approval or consent rights, then the transaction can potentially be accomplished with one less party involved in the assignment or sublease deal.

Other concerns include whether or not a party should be released after a transfer and whether or not there should be a net worth requirement.

5. Attempting to Negotiate Out the Landlord's Relocation Right

Landlords often have a right to relocate smaller (non-anchor) tenants to an alternative premises within a shopping center. We all remember from law school that real property is unique, so it seems a little strange that a landlord could unilaterally require a tenant to relocate to a new space of the landlord's choosing. For tenants without a lot of leasing experience, it can be somewhat alarming to be sold by the landlord on a particular space, only to receive a draft lease from the landlord which allows for an unfettered right to relocate the tenant to a different space.

The reason that landlords often insist upon having some sort of relocation right is because it allows the landlord flexibility—flexibility to, for example, reconfigure or extensively remodel or add to the shopping center or lure other attractive tenants to the center with promises of certain placement within the center. Another example is allowing flexibility to expand or contract tenant space: your client is leasing the middle bay of a three (3) bay shopping center and one of the end-cap tenants is looking to expand. The landlord can potentially make that work for the expanding tenant if landlord has a right to relocate your client out of the middle bay and into the other end-cap space.

A tenant should always initially attempt to negotiate the landlord's relocation right out of the lease, but if the landlord refuses (which is often the case on a small shop deal), a number of safeguards can be put in place to protect the tenant. First, the relocation should always be accomplished by the landlord at the landlord's sole cost and expense (and include tenant's moving or other out of pocket expenses for smaller items such as new business cards, etc.). The relocation premises should be built-out to a quality at least comparable to the quality and utility of the original premises, not to mention size, visibility, and configuration. Other particulars to consider include: (i) requiring that the relocation be accomplished on a weekend with minimal downtime for the tenant (with rent abatement during the period of closure); (ii) requiring that the relocation space be between a particular range of sizes, with no increase in the tenant's rent if the relocation premises is larger than the original premises; (iii) the requirement that the relocation not occur at specific times of the year, such as March or April for a tax prep tenant scrambling near tax time and/or give tenant ample advance notice prior to the relocation to anticipate the move; or (iv) a tenant right to terminate the lease if it does not approve of the landlord's proposed relocation space.

6. Important and Unique Concepts in Restaurant Leases

As restaurants continue to gain popularity as the flashy new anchor tenants in real estate developments, a number of restaurant-specific lease concepts will increasingly arise in lease negotiations for a well-planned restaurant space. Being aware of these concepts and thoroughly contemplating them during lease negotiations is an important aspect of negotiating a restaurant lease, as omitting these concepts can prove costly as the restaurant builds out its space to get open.

A. Scrubbers.

Scrubbers are increasing in popularity, both as a landlord requirement and a requirement per applicable codes and ordinances. A "scrubber" is a piece of equipment which filters odors out of hood exhaust generated by restaurant operators. As developers have moved toward constructing office and residential components on top of street-level retail, scrubbers have become more commonplace. Without a scrubber, a restaurant user at street level might jeopardize the ease with which a landlord can lease or sell multi-family or office constructed above retail. Suddenly those fancy balconies aren't as much of a selling point as originally envisioned. Scrubbers can be costly to install and maintain, so if you're doing a deal with a first-time restaurateur, be sure that they've priced one into their budget. Also, from a property management perspective, scrubbers should be treated similarly to HVAC units. Tenants should be required to maintain service contracts and provide evidence thereof to their landlords.

B. Grease Traps.

Grease traps are nothing new, but as a new lawyer unfamiliar with the inner workings of a restaurant, you may never have heard of them. These are code-required systems that catch grease generated by restaurants which store the grease for safe collection and disposal from time-to-time. As food halls and restaurant-heavy mixed-use projects become more common, it's important to be sure that your lease correctly contemplates how grease trap repair, maintenance and invoicing will work in the real world. A typical landlord-oriented form lease will place repair and maintenance obligations on the tenant, but, increasingly, landlords are constructing communal grease traps which service all or a portion of a retail development. For a communal grease trap, the repair and maintenance obligation should be on the landlord, with the costs thereof being equitably apportioned among the grease trap users. This is typically accomplished as a proportion, with the cost being allocated based upon a restaurant's square footage relative to the square footage of all restaurant users connecting to the communal grease trap.

C. Financing.

It's important for landlords to have a firm understanding of the capitalization structure of their restaurant tenants. Of course, this is a material point as security deposits, guaranties and letters of credit are negotiated when deal-making. Once a lease is signed, restaurant operators will often apply for funding from traditional and SBA lenders. In connection with that financing, lenders will typically require the landlord to enter into a landlord lien waiver or a landlord lien subordination agreement with the lender whereby the landlord acknowledges that the lender has a lien right to certain restaurant collateral which is superior to the lien interests of the landlord. When and if a restaurant defaults upon its lease obligations, a restaurant lender will attempt to foreclose upon its lien to obtain legal possession of the collateral which, likely (at least partially), secured the lender's loan to the restaurant. The landlord can typically negotiate a number of safeguards to protect its interests when and if a lender attempts to foreclose, but lenders will likely require a priority position, and that's something that landlords just have to stomach to make a restaurant deal happen. Lenders will typically agree not to disturb the day-to-day operations of a property as they take back their collateral, including the waiver of the ability to conduct an auction or sale from the restaurant space, which can be particularly disruptive to the aesthetic and day-to-day operations of high-end developments.

D. Franchisor Riders.

If a landlord is doing a lease deal with a restaurant concept that is a part of a franchise system, the franchisor will almost certainly require the landlord to enter into an agreement directly with the franchisor which grants to the franchisor certain rights in the event of a default by the franchisee-operator. Franchisors invest significant resources into identifying and securing sites, and if a franchisee-operator isn't living up to its obligations or expectations, the franchisor will want the ability to take back the space and either operate the restaurant or assign the Lease to another, better-qualified, operator. These franchisor riders are typically attached to the back of the Lease, but all parties to the lease should be aware of their obligations to provide notice to the franchisor following a default by the franchisee/tenant or even the landlord under the lease. Failure to provide a copy notice to the franchisor and opportunity to cure the default can create liability to the franchisor that no landlord or tenant would want to take on. Just because the franchisor's rider in the back of the lease doesn't mean that it's any less important in prudently managing the day-to-day operations of a property featuring restaurant uses.

Conclusion:

When reviewing and negotiating a lease for a client, remember that leases are living, breathing documents. They are intended to govern the relationship between two parties for a number of years, even decades, and they can certainly involve the exchange of significant sums of money. For a lot of businesses, rent is the number two expense after personnel costs. It's important to keep the big picture in mind while you focus on the highly detailed language and concepts contained in each section of a lease.

Once a lease is executed, it is rarely opened again throughout the term…until something goes wrong. Taking the time to carefully and thoughtfully review and negotiate a lease will improve your client's position and leverage when, and if, an issue arises in the landlord/tenant relationship.