

“Leases should accurately reflect not only the term sheet economics, but also the allocation of responsibilities and liabilities that can impact or change the economic deal.”

The ABCs of Leasing

Q: WHAT ARE SOME OF THE BASICS OF NEGOTIATING LEASES?

TIMOTHY M. SMITH: Negotiating leases requires an understanding of the type of space being leased, how the rent economics are structured, and how services (including maintenance and repairs) are provided to the premises. Leases provide cash flow to pay expenses and fund improvements and can enhance the value of the property for financing and sale purposes. Each lease provision not only affects a client’s rights and remedies, but can significantly affect property value; accordingly, the division of responsibilities, both operationally and economically, needs to be accurately reflected. Always keep in mind the “ABCs of Leasing”:

A—Ask clients, property managers, and brokers the right questions to understand the context of the deal, “how the property works”, rights of existing tenants, and the key non-letter of intent (LOI) points to cover in the lease.

B—Be sure to factor in future flexibility when negotiating lease provisions.

C—Cover key points during the LOI stage, especially for significant leases.

Q: COULD YOU EXPLAIN SOME OF THE DIFFERENT TYPES OF LEASES?

TMS: Office leases are typically modified gross structures, in which the landlord’s base line operating expenses and real estate taxes are included in the fixed rent (with tenants being responsible to pay increases in such base line amounts), and the landlord provides most of the services. Under industrial leases, tenants perform more obligations and pay more expenses, such that the base rent is “more net” to the landlord. In retail leases, tenants pay a fixed rent and typically pay a pro rata share of CAM charges and real estate taxes without a base year. Retail tenants often also pay a percentage of the tenant’s gross sales as additional rent.

Q: WHAT COMPRISES THE BASIC ELEMENTS IN A LETTER OF INTENT?

TMS: LOIs set forth the road map for the deal. The larger the space or the longer the term, the more detailed the LOI should be. The LOI should identify the tenant (and, if applicable, the guarantor), address the rent economics, set forth the estimated delivery date and condition of the premises (including any landlord’s work obligations and TI allowances), and the security deposit, among other items. In addition, the LOI should spell out the length of the initial lease term, options to extend, and any parking or signage rights.

Q: HOW DOES LEVERAGE FIGURE INTO NEGOTIATIONS?

TMS: Understanding your leverage when negotiating a lease is very important. Tenants usually have maximum leverage at the LOI stage. Size and length of tenancy and the lease’s impact on the property’s valuation influence leverage, as do market conditions.

Q: HOW DOES THE IDENTITY AND CREDIT OF A PARTICULAR TENANT AFFECT A PROPERTY?

TMS: The market reputation and credit of a particular tenant significantly influences how investors, purchasers, and lenders value a property. From the landlord’s standpoint, matching the financial statements provided prior to lease execution to the named tenant is very important. If the named tenant lacks sufficient credit (or does not have a separate balance sheet), landlords will often require a larger security deposit or a guaranty from the parent entity in connection with the lease.

Q: HOW DO PARTIES PROVIDE FOR FUTURE FLEXIBILITY IN LEASES?

TMS: Tenants often negotiate for flexibility in assignment/subletting clauses, whereas landlords want to maintain control over who becomes its tenant. Because a corporation’s strategy and focus changes over time, many tenants (especially retailers) will also negotiate for a flexible permitted use clause. Tenants should take a long-term view by negotiating for an option to extend the lease beyond the initial term. If the tenant has leverage, it will negotiate for future expansion rights and, if possible, and the right to terminate the lease (or certain space) at an earlier date. Landlords will often want concessions from the tenant in return for granting these rights. Landlords will want to reserve, among other items, the right to relocate the tenant and make changes to its building and to enter the tenant’s premises for building repairs and alterations.

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