

The Not-So-Standard Commercial Lease

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A “standard” commercial lease usually favors the landlord, but with attention to its contents and negotiation of its terms, it can benefit the tenant.

IT ALWAYS AMUSES ME when a client who is not in the real estate business calls and says that he or she will be sending me a “standard office lease.” The client usually says that it is not a matter of great urgency, but requests us to give the lease a quick looking over. Nothing seri-

ous—just that the lease is on a take-it-or-leave-it basis, the broker has already worked out a term sheet, and the client didn’t engage me or any other attorney in the initial stages (searching for the premises or dealing with the real estate broker). Consequently, the client will have had very

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little, if any, voice in the numbers formulating the transaction. In such a situation, there isn't much more left to negotiate than the base year upon which real estate tax escalation will be charged, the verification of the current amount of rent inclusion costs or electricity meter installation costs, and the accuracy of the tenant's "share" of operational costs. Not exactly the heart of the deal.

THE REALITY OF THE STANDARD LEASE

- The casual "once over" for the standard form lease is also likely to be requested for something which is, in reality, a rather complicated document. It might be some version or adaptation of the "Standard Form of Lease" (including the usual rider), either issued by the New York Board of Title underwriters (used in many situations by smaller firms for small leases with a voluminous attached rider) or perhaps the form used by the Association of the Bar of the City of New York. There are likely to be 50 to 75 comments on it. If the proposed lease is of a sizeable proportion, there may be master computerized content of 30 to 100 or more pages. The object of this article, however, is not to criticize or unduly condemn any forms of lease or any landlord which issues its "standard" or pro forma lease for particular premises. The effort here is to address some of the issues that typically arise, and to provide guidance on them, so you can help out the client who needs a little more than just perfunctory "lawyer blessing" on a very important document.

Assignment Or Subletting

Most leases in large cities expressly prohibit assignment or subletting whether by operation of law, transfer of interests of the tenant or otherwise, including the disallowance permitting the premises or any part thereof to be occupied or used for desk space, mailing privi-

leges or otherwise, unless expressly permitted by the landlord.

Assignment: Entire Interest

As is the case in New York, if the landlord arbitrarily withholds its consent to an assignment or subletting, and such a clause is allowed to remain in the lease, a tenant has no basis upon which to argue against the landlord's decision. In New York, as opposed to several other states, the landlord may be arbitrary in withholding its consent to an assignment or subletting.

An assignment in the lease by a tenant conveys the tenant's entire interest or estate to the assignee of the lease. The assignee steps into the shoes of the assignor-tenant and assumes all the obligations under the lease in most instances. In that situation, the landlord/tenant relationship is created between the landlord and the assignee, although, in most cases the original tenant-assignor remains liable to the landlord under the lease for all the leasehold obligations. Only in very few situations such as recapture by the landlord and a subsequent subletting would a tenant be successful in negotiating a release of its obligations under the lease.

Sublease: All Or Less Than Entire Interest

A sublease on the other hand, is a further leasing by a tenant to a subtenant of all or part of the premises which has been demised to the tenant under the lease. A sublease runs for a term which is less than the remaining term of the lease. Should the premises be demised by a sublease for the entire remaining term of the lease it will be deemed an assignment. Most subleases therefore, have a term which ends at least one day before the expiration date of the main lease.

Landlord's Consent

In considering a consent to subletting or an assignment, landlords generally restrict such

rights in order to accomplish certain objectives. These can include:

- Retaining control of the building and the demised premises;
- Taking advantage of upswings in the market place; and
- Controlling the use of unused space which may affect other tenants in the building.

If the landlord agrees to not unreasonably withhold its consent to an assignment of a lease or a subletting, then the landlord cannot withhold consent on economic grounds, and in New York the landlord is restricted to certain objective criteria (some of which, however, remain questionable, such as the right to decline an assignment or subletting if in the landlord's sole judgment it would change the character of the building).

Typical Criteria For Consent

Most landlords spell out such criteria in several pages of the lease. Among such criteria would be:

- The creditworthiness of the subtenant;
- The character of the subtenant's business;
- The subtenant's proposed use of the demised premises; and
- The nature of the subtenant's occupancy.

Landlords also restrict tenants against subleasing or assigning to more than a certain number of occupants per floor to prevent overcrowding. Restrictions also reach any party with whom or with which the landlord is actually dealing, or current occupants of the building. Most landlords treat the transfer of a controlling interest of a tenant as an assignment which requires its consent and limits a subletting to the same or similar use as that occupied by the tenant.

Recapture Rights

Landlords are in some cases including recapture rights in the event of a subletting or an as-

signment. In such cases, landlords require a lead notice period when the tenant intends to sublease or assign, along with a detailed description of the transaction. When the landlord insists on a right of first offer, the provision in the lease requires a description of the transaction, including the details relating to the proposed assignee or subtenant. When the Landlord has the right of first refusal, the landlord requires a delivery of the assignment or sublease to the landlord to trigger its consent or recapture rights. Landlords may impose different recapture rights such as:

- Termination of the lease with respect to the portion of the space affected;
- Taking an assignment of the lease; and
- Preserving the right to sublet the space proposed to be subleased.

Recapture of a portion of the space raises all sorts of interesting questions:

- Who will be responsible for construction costs with respect to a partial recapture?
- How will the rent and additional rent be adjusted?
- What responsibilities will the landlord, subtenant or assignee have with respect to returning the recaptured space and in what condition?
- Who pays brokerage costs?

Expansion, Shrinkage, And Buy-Back

In some instances, tenants initially take more space than may be needed with the provision made for either expansion and, until expansion, for subletting the space which is not needed over the initial term. Tenants also may negotiate an assignment or subletting of right to its successor in interest, affiliates, or subordinates under a definition of such parties normally provided in the lease. Premises shrinkage and buy back provisions are also found in current large city commercial leases.

Profit-Sharing And Exemptions

A sublet or an assignment which was consented to, usually provides a profit sharing of sublease rent with the landlord. Profit definitions appear in most leases and normally the word "profit" is exclusive of:

- Legal fees;
- Brokerage commissions;
- Advertising expenses;
- Unamortized tenant's improvement costs;
- Allowances; and
- Free rent periods.

Exemptions also include any sums paid to the landlord for its own examination of the sublease or the assignment documentation. A consideration for an assignment or sublease usually includes all funds received by the tenant from whatever source and however characterized subject to the foregoing exemptions. Such consideration covers any rent consideration paid to the tenant directly by any subtenant including any other amount received by the tenant from or in connection with a subletting, including but not limited to any sums paid for the sale or rental or consideration received on the account of any contribution of tenant's property. Consequently, subletting and assignment clauses especially in high rise office buildings usually take up about 10 percent of the lease draft pagination.

Tenant Obligations = Additional Lease Costs

When a client determines that a presumptive "fee savings" low overhead review of a lease should take place, the client may be missing several cost items in addition to the considerations discussed above. A standard form lease—and even one which is more "tailored" for larger premises—might include certain tenant obligations such as its compliance with all "legal requirements" which are defined within the lease either specifically or by general reference. Such

a clause might entail a responsibility on the part of a tenant for:

- Compliance with the Americans with Disabilities Act;
- Installation of sprinklers or compliance with fire codes; and
- (Especially in older buildings) asbestos remediation.

This list is only partial, and many other things could cause potential extra cost including possible alterations paid for by the tenant. If the standard lease is not carefully reviewed and negotiated, the general assignment of obligations might make the tenant responsible for a variety of co-compliance reconstruction or renovation projects.

Insurance Considerations

Most general office clients will also rely on an insurance agent to confirm that adequate coverage has been obtained and issued to satisfy the landlord. Although this approach sometimes works, it is much better to think in terms of the tenant's potential for liability. In addition to the typical "all risk" policy, a tenant should consider whether it needs to obtain its own specific forms of insurance, including:

- Fire damage legal liability and water damage legal liability insurance;
- Boiler and machinery insurance;
- Data processing insurance;
- Business interruption insurance. Business interruption insurance provides not only rental coverage for a tenant, but also coverage for additional expenses when a tenant must find adequate substitute premises for a interim period of time due to reconstruction of its leased premises;
- Liability or third-party insurance (such as commercial general liability insurance) covering bodily injury and property damage to third

parties on an occurrence basis. Owing to the amount of coverage usually demanded, a tenant will seek to align primary coverage along with an umbrella or excess coverage for higher liability limits at cheaper cost.

Subordination Waiver

A subordination waiver is recognized by insurance carriers but the parties must notify the insurance company of such a waiver, which must be clearly drawn in the lease. Normally, an insurer is requested to issue an endorsement to the existing policy waiving its “subrogation” recovery rights against the negligent party in the event of a casualty.

Alterations Of The Premises

Another area of concern to most tenants is the alterations portion of a lease. A tenant who intends to be a multi-floor user of office space, or who otherwise has some negotiating leverage, may insist on performing its own initial alterations. In these instances, when tenant allowances are granted, or initial alterations have been negotiated to be performed by either the landlord or tenant’s operatives, a detailed work letter is issued as a part of the lease setting forth conditions and a performance index for the tenant’s plans and specifications. The tenant’s plans and specifications are subject to the landlord’s review and acceptance and the tenant is usually responsible for the risk of any delay. The terms of any alteration right are important to a tenant seeking possession of improved space within a certain time limitation. In addition, there may be issues of allowance for construction or free rent periods, which may have tax implications that the tenant must weigh and consider. Many of the smaller leases provide that a tenant will take the premises “as is” without any particular obligation on the part of the landlord to perform any work, with the possible exception of painting the premises.

Suitability Of Premises

A tenant may want to get a professional architectural or engineering review of the quality of the premises and its facilities. For example, a qualified engineer should be hired to advise the tenant relating to:

- The actual usable space;
- The appropriate floor loading (which the tenant would be responsible for observing);
- Whether specific extra strength flooring and/or cooling (in addition to normal air-conditioning) may be necessary due to the tenant’s operation; and
- The technology which the tenant will use in the leased space.

Depending on the scope of the tenant’s improvements, it may also be necessary to determine whether the electrical capacity of the premises is sufficient for the tenant and whether the premises can operate as a “smart” space permitting Internet access, video conferencing, security and indoor environmental technology, and so on.

Rent

Rent in commercial leases is usually calculated on a square foot basis. The tenant’s share of annual escalation expenses and real estate taxes incurred by the landlord are also usually based on a ratio between the size of the tenant’s space and the total square feet of the building in which the tenant occupies space although recently some leases have included an escalation based on union porter wages, an older method of calculation. The square footage can also include hallways, lobbies, and other types of common areas not totally occupied by the tenant. Any uncertainty about the square footage can be a money burner for the tenant, so getting a professional calculation is always well worth it.

Commencement Date

The easiest way to pinpoint the commencement of the lease period is pretty obvious: set an agreed upon, exact date. A tenant will insist on some remedy in the lease if the landlord can't deliver the space to it by the lease commencement date. The landlord might even lose the tenant when this happens. However, clauses addressing inability to perform or deliver usually grant the landlord *carte blanche* with respect to delivery by setting the basis of any tenant remedy far into the future. A strong tenant or large space user can negotiate these clauses to its advantage.

If the tenant is responsible for building out its space before the move in, the lease commencement date might be the date when the space is ready for the tenant; that is, when all the work is substantially finished except for punch list (minor) items that won't have a big effect on the tenant's ability to use the space. If the tenant takes possession of the space and starts operating its business before landlord's build-out work is substantially completed, the lease could begin at that time. Tenants often complain that a "substantially completed" space really isn't usable. The tenant should accept the fact that the work will be deemed substantially completed when a certificate of occupancy (temporary or final) has been issued that permits tenant to enter into occupancy. However, especially in larger cities, the issuance of a "final" certificate of occupancy must be actively pursued.

Certificate Of Occupancy

Landlords insist that tenants do not violate the existing certificate of occupancy ("c/o") covering the leased premises and the building of which it is a part. A specific lease clause covers such restricted use, and puts the compliance responsibility solely on the tenant. The tenant should review the existing c/o to determine if the premises can be legitimately occu-

ried for the purposes leased, and insist on a representation by the landlord that no violation of the c/o will be deemed to occur by the tenant's occupancy for the purposes defined in the lease. The tenant should avoid phrases like "for no other purpose."

Security

A security deposit demanded by the landlord is a fact of life in most leases. Landlords have become wiser to the fact that small- to medium-sized e-businesses can have early success or almost immediate failure. Consequently, it is not uncommon to see demands for security deposits of three to six months for smaller office leases—or even double that figure depending on the type of business conducted by the proposed tenant. A strong financial statement, a larger space user, and a tenant well known in an industry, will all contribute to a lower security deposit demanded by the landlord. At times, based upon the net worth of a tenant and the other criteria mentioned, a tenant might negotiate for no security deposit at all or a deposit which may be returned in installments over the course of the term of lease. Interest on the deposit is still in vogue, subject to certain administrative charges which a landlord endeavors to make covering its overhead.

Non-Disturbance And Attornment

Many modern leases require an attornment by the tenant to a superior lessor or mortgagee holding a superior lien on the premises should there ever be an occasion when such superior holder takes over the premises and the landlord's position. Depending on the tenant's strength, the tenant should always negotiate for a non-disturbance clause surrounding its attornment so that it may remain in peaceful possession of the premises during a landlord's credit default or other catastrophe befalling a landlord. Most banks and other financial insti-

tutions which are the principal creditors of a landlord have now progressed to the point of issuing very sophisticated non-disturbance agreements which must be carefully reviewed by a tenant. Most non-disturbance documentation relieves a successor of the landlord of most of the obligations undertaken by the actual landlord, for example, exempting such successor from any construction or renovation responsibilities. Thus, in sum, the stronger the tenant, the more flexible the non-disturbance agreement will be.

CONCLUSION • The issues discussed in this article merely scrape the surface of what would

be negotiated or included in a “standard” office lease. In-depth analysis based on the term sheet and the landlord’s draft lease would obviously have to occur so that after a line-by-line review, the essential object would be to place the tenant on a more even keel with the landlord. Obviously, since the landlord owns the space in most cases, and is offering an estate of years to a tenant without discussion of purchase options and the like, the landlord will have certain lines in the sand that it will not cross. But a careful review of a commercial lease slanted in the landlord’s favor, can often produce many changes for the benefit of a tenant.

PRACTICE CHECKLIST FOR The Not-So-Standard Commercial Lease

Commercial leases are complicated documents, so the client who wants you to do a cursory review of one is doing itself a disservice. There are many important issues to consider, and to negotiate for the best possible terms.

- Assignment of the tenant’s rights is usually prohibited in most commercial leases, but the right can be negotiated. If the consent clause does not prohibit the landlord from withholding consent arbitrarily, the tenant may never be able to exercise the right in some jurisdictions.
- Additional lease costs. A standard form lease might include certain tenant obligations such as its compliance with all “legal requirements” which are defined within the lease either specifically or by general reference.
- Insurance considerations. In addition to the typical “all risk” policy, a tenant should consider whether it needs to obtain its own specific forms of insurance including fire damage, business interruption, liability, and so on.
- Alterations of the premises. If alteration of the premises is permitted, the tenant’s plans and specifications are generally subject to the landlord’s review and acceptance.
- Suitability of the premises. A tenant may want to get a professional architectural or engineering review of the quality of the premises and its facilities.
- Rent. Rent in commercial leases is usually calculated on a square foot basis, so getting a professional calculation is always well worth it.
- Non-disturbance and attornment. Many modern leases require an attornment by the tenant to a superior lessor or mortgagee holding a superior lien on the premises should there ever be an occasion when such superior holder takes over the premises and the landlord’s position.