



JACKIM LAW GROUP LLC

JANET JACKIM
ATTORNEY AT LAW

Negotiating a commercial lease? This article contains tenant-friendly practice tips for real estate agents and tenants.

“Landlord’s Lease is *How Many Pages?*
101 Practice Tips for Negotiating a Tenant-Friendly Commercial
Real Estate Lease”

by *Janet Jackim*, Attorney, Jackim Law Group LLC

Introduction. This article analyzes provisions in commercial real estate leases often overlooked by the commercial tenant or its real estate agent. Consideration of the following practice tips during lease negotiations may produce not only a more tenant-friendly lease but also cost savings and operational benefits to the tenant.

1. *Why the definition of “premises” can be the most important provision in the lease.* Describing the premises as “Suite 202” or “1600 N. 32nd Street, Phoenix, AZ” may be the correct location, but these common descriptions fail to clearly define the rights and responsibilities of landlord and tenant as to the intended premises.

Practice tips: A clear definition of “premises” can save the tenant money when various charges payable by the tenant are determined under the lease. If the definition is clear, the tenant can insist that the calculation of these charges reflect the correct or exact number, not an *estimate*, of square footage used to calculate rent obligations.

- *Estimates or approximations of square footage usually equate to an inflated square footage number.* When an estimate of the premises’ square footage is made, neither the landlord nor the tenant know exactly the basis for calculating common area maintenance, taxes and insurance costs, resulting in one of the parties—typically the landlord—using a larger number.
 - Many common area maintenance calculations are based upon the “tenant’s proportionate share” calculation, which is the percentage obtained from the ratio of the square footage of the premises to the square footage of the building, warehouse or shopping center. Misstating or approximating the premises’ square footage can result in tenant paying more than its fair share of expenses over the term of the lease.

- When it comes to determining the tenant's common area expenses year to year, assume that landlord's property manager is burdened with onerous amounts of data and that no 2 leases are alike. Provisions describing the premises in a lease can be overlooked or misinterpreted. A specific and clear definition of "premises" gives the tenant a fighting chance to challenge a CAM assessment based upon erroneous data or misinterpreted lease provisions.
- *A casualty occurrence puts the definition of "premises" to the test.* Especially when the tenant is but one of many in a shopping center, warehouse or building, a specific definition of "premises" is also important if a catastrophic event occurs, such as a water or roof leak, the failure of a structural component, or a fire or other casualty. In that event, the rights and obligations of the tenants and landlord have to be determined with reference to the lease's definition of "premises".
 - Adjusters will determine the cause and location of the casualty. If the fire originated in a dumpster located on the premises, tenant will likely be liable for repairs to the building, but if the dumpster is located in the common areas, landlord is responsible. If an interior pipe between suites bursts, responsibility for repair work will turn on the definition of "premises"--if the lease describes the "premises" as including water lines within the premises, the tenant, not the landlord, must repair and compensate others for their damages.
 - After causation and location are determined, look to the lease to determine whose insurance policy pays for what damage. If the premises is not clearly defined, a dispute may arise between landlord and tenant and their respective insurance carriers may deny coverage.
 - Often a lease will include a landlord-friendly waiver provision that arises upon the occurrence of a casualty. Typically, even if landlord caused damage to tenant's premises and property, this waiver provision may release landlord from responsibility for tenant's damages.
- *The dividing line between landlord and tenant may be as simple as defining the interior or exterior of the walls.* A carefully drafted definition of "premises" should provide answers to questions and concerns typically raised when a casualty occurs. The definition of "premises" should include the following terms:
 - The legal description of the property of which the premises is a

part.

- If the premises are in a building, warehouse or shopping center, the definition of “premises” can describe its outer boundaries as being “to the middle of the interior walls and not the exterior walls, glass, doors or surrounding walkways”. Doing so limits the casualty responsibilities of the tenant or shifts some of those costs to adjacent tenants and/or the landlord.
 - As to retail store premises, the tenant may want to control and pay for “exterior” areas surrounding or adjacent to the premises, such as windows, doors, parking spots, security systems in the glass and doors, patios and storefronts. If so, each of these areas should be specified in the definition of “premises”.
 - Areas that are for common use should be excluded from the definition of “premises”.
- *Size matters.* I suggest that a measurement of the square footage of the premises be taken prior to executing the lease.
 - Building Owners and Managers Association International (“BOMA”) has established various guidelines and procedures for measuring commercial buildings. See <http://www.boma.org/MEASUREMENTSTANDARDS/Pages/default.aspx> for details.
 - Formal measurements can be done by the tenant’s or the landlord’s engineer. Informally, the broker (*without representation or guarantee*) or the tenant can make the measurement. Report the finding to the landlord and request an adjustment to square footage.
 - Most landlords will require that the measurement be done and the total square footage be agreed upon before execution of the lease and will preclude tenant from challenging the size thereafter. Alternatively, the measurement can occur after the lease is signed but the parties have to agree upon the result within a specified number of days or the landlord’s measurement applies.
 - Check landlord’s calculation of the tenant’s proportionate share to ensure that the correct square footage of the premises is the numerator of the calculation and that an appropriate adjustment has been made on the property manager’s books and records.
 - The tenant should carefully review annual common area

maintenance reconciliations and budgets to confirm that the correct proportionate share calculation has been made, as adjusted by the corrected square footage of the premises.

2. *Coping with change--new or different uses in the premises.* Typical commercial leases limit the tenant's business in the premises to the described "use" and for no other use without landlord's prior approval. Yet during a lease term of 5 or more years, the tenant's business may ebb and flow with the times and may change from one business strategy to another. Product lines can become fragmented or outdated by technological change, necessitating a new business plan, products or services. Or, a tenant may want to sell its business and assign the lease, but the prospective tenant/successor owner may have a different use in mind for the premises.

Practice tips: If possible, avoid a lease provision that requires landlord's approval to changing the use definition (assuming the proposed use still complies with zoning requirements). It unnecessarily minimizes the salability of the lease and business.

- *Avoid discretionary consents or approvals.* If the lease permits landlord to exercise its *discretion* over considering a change of the "use" provision, consider the following alternative provisions:
 - Propose a more tenant-friendly provision that would permit the change upon tenant paying a fee (typically, \$500-\$1,500) to landlord.
 - Propose that landlord's consent to the change not be unreasonably withheld or delayed.
- *Will the business change its products, services or operations?* Ask the tenant for a forecast of its business plan over the term of the lease. Will the business, industry or marketplace likely change over the next 5 years? Will the business add new business divisions, services and/or product lines? Will a service business add retail sales?
- *Plan for future use changes by expanding the "use" definition.* If the answer to any of the above questions is in the affirmative, the definition of "use" in the lease needs to be broadly worded in anticipation of a changed use. For example, adding the phrase "and all related services and sales as reasonable or necessary to Tenant's business in the premises" expands the "use" provision.
- *Tie the "use" provision to the products and services of a competitor over the lease term.* Consider tying the "use" provision to a competitor's or the industry's offering of products and services. For example, adding the phrase "and such products and services offered from time to time by other Mexican food restaurants in Arizona [alternatives: *in the West, in the*

United States, within a 20 mile radius of the premises, etc.]” to the “use” provision expands the tenant’s right to enlarge its business as the marketplace changes.

3. *Using “exclusivity rights” as a sword and a shield.* Closely tied with “use” provisions in the lease, “exclusivity rights” are desired by the retail tenant but dreaded by the landlord. Most retail tenants do not want competitors locating nearby, so they want the landlord to agree to refrain from adding a new tenant with products or services similar to those offered by a current tenant. In a down or only slightly expanding market this is especially important to retail tenants. The landlord, however, does not want to limit the range of possible tenants or the revenues of current tenants, especially if landlord gets percentage rent from some tenants.

Practice tips: Typically there are 2 ways to document “exclusivity rights”: (i) including a provision in the lease whereby the landlord agrees not to permit competing businesses, or (ii) including the provision of (i) and recording the exclusivity right against title to the shopping center, warehouse or building.

- *Alternative 1:* Landlord agrees not to permit a new tenant from conducting all or some of the business described in the current tenant’s “use” provisions.
 - If the “use” provision is broadly worded, tenant gets a lot of protection from competition. This “use” provision is valuable to the salability of the lease and business.
 - An inartfully defined “use” provision such as “dental practice and no other use” is not very valuable to a current tenant if a prospective tenant whose business is orthodontia is permitted in the center. While the prospective orthodontist tenant will protest that the 2 uses are different, undoubtedly there will be some overlap to the current tenant’s dismay.
- *Alternative 2:* Landlord agrees not to permit a new tenant from conducting all or some of the business described in the tenant’s “use” provision and records a memorandum against title to the center, warehouse or building describing the specific “use” protections.
 - The memorandum of exclusive use rights describes in detail the owner of those rights (the tenant) and what uses are specifically protected.
 - Recording the memorandum against title gives notice to the world (that is, prospective tenants and lenders) of the tenant’s “exclusivity rights”.

- *Enforcing “exclusivity rights” through the power and finances of the landlord.* In addition to defining the protected “use” and the landlord’s agreement not to violate the “exclusivity rights”, this provision should also include the following protections for the tenant:
 - That the landlord agrees to stop any existing tenant who competes. Stopping this violation can include a requirement that the landlord sue the existing tenant to force compliance with the “exclusivity rights” and declaring the existing tenant in default of its own lease, potentially resulting in the forfeiture of the lease by the violator.
 - That the landlord agrees not to permit any existing tenant to assign its lease or sublet the premises to a new tenant whose business will compete with the protected “use”.
 - That the landlord will annually or quarterly require each tenant in the shopping center, warehouse or building to execute an estoppel letter certifying that it is not competing with the “exclusivity rights” of other tenants.
 - That if landlord does not stop competition from violating the exclusive rights, the protected tenant has various remedies, including terminating the lease or reducing rent and other damages.
 - That the landlord and its affiliates will not compete with the exclusivity rights, in the event that landlord operates its own business in the center, warehouse or building.
- *Enforcement of “exclusivity rights” is usually a 2-way street.* Be aware that to *give* “exclusivity rights” a landlord may need to *get* the following provisions from tenant:
 - That in the event of the tenant’s default of its lease, the “exclusive rights” provision automatically expires.
 - That tenant’s abandonment of the premises or the termination of the lease (whether early or at the end of the lease) results in the automatic termination of the “exclusive rights”.
 - That tenant must notify landlord of “exclusive rights” violations so that landlord has an opportunity to cure before tenant can exercise various remedies.
 - That the sales or services of other tenants in marginal amounts which would otherwise violate the “exclusive rights” are excluded from tenant’s protections.

4. *If not closely monitored, common area maintenance expenses can become a money pit.* Common area maintenance expenses (referred to as “CAM’s”) are expenses, costs and fees incurred by the landlord to operate a shopping center, warehouse or office building. CAM’s include common area landscaping, utilities and management expenses and each tenant is typically allocated its share of the CAM’s based upon the size of the tenant’s leased premises to the whole center, warehouse or building. CAM’s are considered additional rental obligations.

Practice tips: CAM’s are a variable lease provision that, if modified to the tenant’s benefit, can yield *considerable* rent savings. Tenant-favorable CAM provisions include the following:

- *A very specific definition of “premises” can reduce tenant’s monthly CAM expense.* For example, if the office being leased is “estimated at” or is “approximately” 2,000 square feet but in actuality is 1,750 square feet, tenant’s proportionate share and monthly CAM payment will be smaller.
- *Size matters.* See Practice Tip Section 1. above. Determine the square footage by having a measurement done, notify the landlord and change the proportionate share in the lease accordingly.
- *Historic CAM financials can be revealing.* Review the historical and current (estimated) CAM budgets. If possible, historical data should be provided for at least 2 prior years.
 - Look for trends in expenses (up or down) over time, which may reveal new accounting standards, unnecessary expenses or corrections to past practices that may not be applicable to the tenant’s lease provisions on CAM’s.
 - Look for new categories of expenses, for example a new property management fee, outside accounting fees or a marketing association, or the deletion of other expenses, which might be evidence of the manager’s combining of several expenses.
- *Only the lease defines the tenant’s CAM obligations.* Compare the proposed lease provisions on CAM’s to details in the historic and current (estimated) CAM budgets. Do they coincide or differ? If they differ, the current (estimated) budget as applied to the lease needs to be revised to reflect the lease provisions, and vice versa. The lease and the property manager’s interpretation of its CAM provisions, as accounted for in the reconciliations and budgets, should match.
- *Annual auditing of CAM’s keeps the landlord and its property managers honest.* Include the tenant’s right to audit the CAM’s, including the

tenant's right to receive copies of the backup documentation on every CAM (for example, the utility bill, the landscaping invoice and annual contract and the parking lot sweeper's bill).

- Landlords and their property managers typically fail to tailor their CAM financials and budgets to each tenant's individual lease provisions on CAM's. Standardizing the reporting and collecting of CAM's is easier and cheaper, but not necessarily correct if a lease contains atypical CAM provisions.
- Landlords and their property managers may use standardized CAM accounting programs that do not reflect the property's peculiar characteristics, the landlord's lease form or a particular tenant's CAM provisions. Errors in computing CAM's applicable to an individual tenant are common.
- *Extend the period for paying the prior year's underpayment of CAM's.* If the prior year's CAM's were underpaid, include a provision permitting tenant to pay the underpayment over an extended period rather than with the next month's rent.
- *Certain expenses should not be charged as CAM's.* Certain expenses should be excluded from the CAM calculation because they are not properly chargeable to all tenants, including the following:
 - CAM's that favor or are being incurred for one tenant only.
 - CAM's relating to portions of the center, warehouse or office building not accessible by tenants or the public or that exclusively serve a third party.
 - Replacement costs of the common areas.
 - Capital improvements related to the development or refurbishment of the center, warehouse or building.
 - Principal or interest payments on the loans secured by landlord's mortgages on the center, warehouse or building.
 - Costs and expenses incurred in connection with leasing space at the center, warehouse or building, including leasing commissions, advertising expenses, and legal fees for the preparation of leases.
 - Court costs and legal fees incurred to enforce the obligations of other tenants.

- Costs recoverable by landlord under its insurance policies.
- Costs resulting from defects in the construction or renovation of the center, warehouse or building.
- Costs or expenses not directly related to the center, warehouse or building, such as accounting fees, fees for preparing tax returns, income taxes and compensation paid to officers, executives or partners of landlord.
- Interest, late charges or penalties incurred as a result of landlord's failure to pay its bills in a timely manner.
- Management and/or ownership fees in excess of a stated percentage.

5. *Dates, dates and more dates.* The typical commercial lease includes numerous dates requiring the tenant's and its real estate agent's close consideration. When does the lease have to be signed (the "Execution Date"), or the landlord goes on to the next potential tenant? When does rent start (the "Rent Commencement Date), after any rent concession period? When does the tenant get possession of the premises ("Possession Date"), either prior to the Effective Date or after? When does the lease become effective (the "Effective Date") and binding upon landlord and tenant? When must tenant open for business (the "Opening Date") and have its tenant improvements completed? When must the renewal or extension option (the "Option Date") be exercised? Each one of these dates can be different from the others; each has different terms and obligations of the tenant to be fulfilled and may have varying effects upon the tenant's pocketbook.

Practice tips: The tenant needs to have a diary system of reminders in place to ensure that important due dates are not missed. The tenant should maintain either a computer-based or hard copy calendar that notifies him/her in advance of dates that require action. For example, many commercial leases require the exercise of a renewal extension or option to purchase months before the end of the lease term, without which the extension or option is lost.

- *When I negotiate a lease, I also prepare a lease summary and a list of important due dates.*
 - Prepare a calendar of important due dates for the tenant (e.g., when rent commences, when a renewal must be exercised, when a guaranty expires, etc.).
 - At the beginning of the lease, send an email reminding the tenant of the end of the free rent period.

- *Exercise options or renewals in writing; generally, verbal exercises are not binding.* If an option to purchase or renew or extend the lease is to be exercised, it must be in writing. We suggest the exercise be sent to the landlord by 1st class mail and certified mail, return receipt requested, so that a record is made of the landlord's receipt of it.
- *An estoppel certificate can definitively establish 'variable' lease dates.* A landlord may require an estoppel certificate (or "Commencement Date Agreement") from the tenant whereby landlord and tenant set forth their agreement on lease dates that may be variable or dependent upon receipt of a certificate of occupancy, the commencement of construction or other occurrences. Be careful about the following provisions:
 - "There are no defaults": This provision eliminates any complaints the tenant has concerning the condition of the premises after signing the estoppel certificate.
 - "Tenant has accepted the improvements (or the premises) in their AS IS condition": This provision means that on accepting possession of the premises, tenant alone is responsible for its condition. I suggest adding the following: "...except as to latent defects and conditions." By adding this provision, tenant may later complain that about a non-obvious condition and get the landlord to fix it.
 - "Landlord's work has been completed" or "Landlord's work is substantially completed": If during a walk-through prior to tenant accepting possession of the premises a punch list of items remains to be done by the landlord, tenant should not sign the estoppel certificate or, if signing, note on the certificate that work remains to be completed by landlord and a list of those items).

6. *I want to sell my business, now what?* Most commercial landlords do not want the tenant to sell its business, assign the lease, or sublease to a third party. It's messy (remember, landlords just want to collect rents and pay their bills with that revenue) and realize value appreciation. However, many small business owners see the sale of their business as their retirement plan or their personal brand of franchising a number of locations. Planning for the future disposition of the business when entering into a commercial lease is an important component of tenant's overall financial package of the lease.

Practice tips: When entering into a commercial lease, tenant is typically bound to the premises for years; thus, planning for the future is an important responsibility of the tenant and its real estate agent. Some tenants enter into a lease planning to sell their business immediately, others elect or for various reasons seek to sell their business. In that event, the assignment and/or subletting provision in a commercial lease comes into

play. Preferably, that provision was negotiated prior to executing the lease and it gives the tenant several alternatives.

- *A lease provision that permits assignment means dollars in the tenant's pocket.* Negotiating the tenant's right to assign the lease as a component of the sale of its business is key to tenant's receipt of substantial monies on disposition of the business. A lease provision that prohibits assignment or subleasing is worth substantially less than one that permits assignment/subletting.
- *When the lease prohibits assignment, various alternative provisions may persuade the landlord to permit an assignment under terms or conditions.* In lieu of a lease provision prohibiting assignment, we suggest one or more of the following alternatives:
 - Landlord is paid a one-time payment of \$X (which is more than a nominal payment) on the successful closing of the sale of the business. In other words, make the landlord a virtual partner in successfully closing the sale and assignment.
 - Include parameters dictating how the prospective purchaser/tenant can prove its creditworthiness such as having at least equal net worth to that of the current tenant, experience in the industry, and/or additional guarantees, that, if met by the prospect, amount to an automatic approval of the assignment of the lease.
 - Tenant pays landlord a nominal sum (\$500) for landlord's (and its attorney's) review and processing of paperwork concerning the proposed assignment.
 - Have the landlord agree to give tenant an estoppel agreement, certifying (for the ultimate benefit of the prospective purchaser) that there are no defaults, all rent has been paid to date, the amount of the security deposit, etc.
 - That on assignment, the current tenant is released from all obligations of the lease and the tenant's guarantors are released from the guaranty. Concurrently, the new tenant agrees to assume all of the former tenant's obligations under the lease. Suggest recording an assignment of lease form in the public records. The disposition of tenant's security deposit should be dealt with in the assignment.
 - That if landlord does not respond to the tenant's written request for approval of the assignment within 10 days, the assignment is deemed acceptable to landlord—this is a quick and inexpensive

way for the assignment to be approved.

- Arizona law requires that the landlord exercise decision-making “reasonably”, unless the lease provides otherwise. What is “reasonable” is dependent upon the facts and circumstances. If the proposed assignment of a lease is from an experienced retail operator to the operator’s child, landlord’s refusal to consent is not unreasonable; conversely, if the proposed assignment is to a similarly experienced operator, landlord’s refusal to consent to the assignment would likely be unreasonable.
- *What not to include in an assignment provision.* Assignment provisions like the following are unfavorable to a tenant:
 - A prohibition on assignment over the lease term.
 - The landlord’s discretion in granting consent to the proposed assignment.
 - Sharing the profit of the sale of the business with the landlord.
 - Sharing the difference between the total monthly rent payment and the profit realized in a sublease.
 - A limitation on the number of assignments over the lease term.
 - The submission of comprehensive financials and tax returns of the current or new tenant to the landlord as a condition precedent to approval.
 - An increase in the terms of the personal guarantee, such as the length or amount of the guarantee.
- Failure to obtain the landlord’s consent when required by the lease can be a breach of the lease. The result can be disastrous to the tenant, including eviction, a lawsuit for the landlord’s damages (future rentals), and/or a lawsuit for the business purchaser’s damages when the assignment and sale fails.

Conclusion. Practice tips suggested in this article favor tenants negotiating a commercial lease. When the key term “premises” is specifically defined, the tenant may achieve savings on common area maintenance charges, premises maintenance and repair costs, and casualty expenses. When the key term “use” is defined with the future in mind, tenant gains some flexibility in expanding the business beyond its initial use, tenant’s exclusivity rights can be protected, and the value of the lease on a sale of the business is heightened. Alternative provisions for defining these key terms and strengthening

protections afforded by the lease to the tenant are suggested.¹

About the Author: Janet Jackim has practiced commercial real estate and business law since 1978, having represented *Fortune 500* companies as well as numerous Arizona-based retailers, service providers, and manufacturers on real estate acquisitions, sales and developments, financial crisis workouts and commercial leases. Janet can be reached at (480) 556-1973 or jjackim@jackimlaw.com for a confidential consultation.

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