

The Golden Rules of Negotiating Leases

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The only thing that stays the same is change. You have probably heard this phrase used in many contexts, but it has never been more appropriately used than in a recent client meeting regarding the negotiations of a commercial lease renewal. In this particular meeting, we were renegotiating a lease that originally commenced in 2001. As you can imagine, the difference in the economy between 2001 and 2011 resulted in a significantly different negotiation this time around.

Typically, articles written about negotiating commercial leases focus on the negotiations from the viewpoint of either the landlord or the tenant. These articles also tend to focus on the current status of the most frequently negotiated business terms. These business terms tend to vary dramatically depending on factors such as the state of the economy, current vacancy rates, and many others. This article, however, will instead focus on principles ("Golden Rules") that should be adhered to when negotiating a lease regardless of whether you are a landlord, a tenant, or in a landlord or tenant favorable environment.

Golden Rule #1: The Type of Property Matters.

The type of commercial space will have a substantial affect on the lease terms being negotiated. Retail, office, warehouse, or a combination necessitates attention to different business terms. For example, a retail tenant is often going to be more concerned about negotiating the appropriate lease term due to the retailer's concern about establishing goodwill at allocation and then being forced to move to a new location. Retailers and office tenants will also be concerned about maximizing signage rights, whereas many warehouse tenants are not as concerned about this issue.

An increasing concern and point of negotiation in shopping mall or strip center leases is a tenant's "go dark" rights. Go dark rights give the tenant the right to cease operations without breaching the lease so long as it continues to pay rent. Over the last few years, negotiating go dark rights has become of increasing importance to tenants due to the downturn in the economy and the tenant's desire to be able to save its variable costs by shutting down operations at certain locations. On the other hand, landlords are reluctant to grant such rights based on concerns about the affect of such closures on other retailers in the same development and possibly the loss of percentage rent due to the loss of sales. However, landlords of warehouse or office space may be less concerned about closings as long as rent is paid. Another business term related to the type of property that often gets overlooked by landlords and tenants is the environmental compliance provision. Landlords and tenants of warehouse or industrial space should be particularly concerned about the environmental representations and warranties made in the lease. Tenants only want to be responsible for contamination caused by the tenant or hazardous materials introduced onto the premises by the tenant. Landlords should be cognizant of the permitted use of a warehouse or industrial space and should negotiate reasonable protections to guard against contamination of the property by the tenant.

Golden Rule #2: Form Leases Always Favor the Landlord.

In commercial leasing, there is no such thing as a "standard form." Each commercial lease needs to be carefully reviewed by the parties and properly negotiated to fit their particular circumstances. In addition, it is important that the parties understand that commercial leases are different than residential leases in that there are far fewer applicable laws or administrative regulations governing the resulting contractual relationship. New business owners who have never been involved in a commercial lease situation are particularly shocked to find out that the numerous consumer protections that apply to residential landlord-tenant relationships are not applicable to their commercial leases. In fact, there is an old adage that "gross" leases were so named not because of how the rent is calculated but because they are "grossly" unfair to tenants.

Golden Rule #3: Consumer Protection Laws Do Not Apply.

How different can commercial and residential lease negotiations and documents be? The answer is completely different. I have had numerous clients, either before or after executing a lease, tell me that they have negotiated many leases before to only find out later that the leases they were referring to were residential leases and not commercial leases. The lessons learned in residential lease negotiations do not necessarily transcend to commercial transactions. One of the most significant differences between residential and commercial transactions is the economics of the landlord-tenant relationship. In a residential lease, the tenant is charged a gross amount of rent per month. While some commercial landlords offer gross lease terms, the economics of the majority of commercial leases include one or more additional amounts of rent beyond a gross amount per square foot. Tenants who are delighted to find space offered at a certain rate per square foot are often shocked to discover that the actual out-of-pocket amount paid per month is substantially more than expected after variable expenses such as common area maintenance costs, real estate taxes, insurance, marketing or promotional fees, or percentage rent is added in. Before signing a lease, tenants need to understand the true economics of the landlord-tenant relationship by considering the total costs incurred. On the other hand, landlords need to conduct an appropriate amount of investigation to determine what costs are typical for similarly situated properties in order to remain competitive in the current marketplace.

Golden Rule #4: The Goal for Both Landlords and Tenants Should Be to Achieve Mutually Beneficial and Commercially Reasonable Terms.

While there are certainly exceptions to the general rule, most landlords and tenants should strive to negotiate lease terms that are mutually beneficial and commercially reasonable in the circumstances. Negotiations focused on commercially reasonable and mutually beneficial terms will usually result in more efficient and timely completion of negotiations. For a landlord, it will result in increased tenant goodwill and an enhanced reputation with tenant brokers.

One example of this Golden Rule is the frustration of a tenant's attorney when reviewing a landlord friendly lease that includes tenant indemnification obligations but not mutual obligations for landlord. For example, in a lease for a shopping mall or strip center property, if the tenant agrees to indemnify the landlord for damages caused by any activities that take place within the premises, then it would be commercially reasonable for a landlord to agree to indemnify and hold the tenant harmless for activities that take place within areas of the center that are controlled by landlord, such as common areas.

Another frequently negotiated provision where reasonableness is the goal should be a tenant's ability to sublease or assign the lease. Tenants often seek flexibility by being able to sublease or assign the lease to a party who purchases substantially all of the tenant's assets or, in the case of larger commercial tenants, the ability to reorganize its business and assign the lease to the new entity. Landlords should consider allowing for such flexibility. On the other hand, landlords seek reasonable assurances of payment which may be obtained by including certain parameters that a subtenant or assignee must meet before a lease can be assigned to them. Another option is to require that the original tenant remains responsible for certain obligations even after sublease or assignment.

Golden Rule #5: What Goes Around Comes Around.

The pendulum of commercial lease negotiations swings frequently and often times very dramatically. The last decade is strong evidence of this. While both landlords and tenants want a "good deal", each should also consider the effect of their negotiating strategy on their long-term business plan.

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