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**THE BASICS:**  
*Commercial Leases*

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*The confidence to proceed.*



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## INTRODUCTION

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Commercial leases may involve almost any kind of space and purpose, although office, industrial and retail leases are the most common. Leases can range from relatively simple affairs of a few pre-printed pages, to enormously complex legal documents with hundreds of pages of highly negotiated text, exhibits, schedules and ancillary agreements. Unlike many other transactions respecting real estate, leases create a long-term relationship between the landlord and the tenant. Therefore, it is in everybody's best interest that the relationship between the parties be spelled out accurately and equitably. Regardless of the size and complexity of the document, most leases will address certain fundamental principles that, depending on the drafting of the provisions in question, may benefit the landlord, the tenant, or both parties. Landlords and tenants, especially those with relatively little experience in commercial leasing, ignore these provisions at their peril. This guide provides landlords and tenants with a basic introduction to some of these key principles. It is by no means exhaustive, but is intended simply to highlight some of the many issues that the parties to a commercial lease need to consider and address.

## THE GRANTING CLAUSE

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A lease is an agreement whereby one party (called the “landlord” or “lessor”) grants a right of possession in a particular piece of property (typically called the “premises” or “leased premises”) to another party (called the “tenant” or “lessee”). All true leases will contain a clause which states that the landlord “leases the premises to tenant” and the tenant “leases the premises from landlord.” Depending on the law and custom in the state where the premises is located, the lease may use words like “grant,” “let” or “demise” in the granting clause. Such language is required to create a true “leasehold estate” in favor of the tenant. In the absence of such granting language, the instrument may be deemed a mere license rather than a lease. The distinction between a lease and a license is that a lease give the tenant exclusive possession of the premises against the world (including the landlord) during the term of the lease, while a license gives only a privilege to occupy the space for a particular purpose at the will of the landlord. Similarly, a license is generally considered to be revocable at the will of the landlord, while a lease is not. The careful tenant, therefore, should be certain that what it is entering into is a true lease, and not merely a license agreement.

## THE COMMENCEMENT DATE

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The question of when the lease begins may be more complex than it first appears. The commencement of the lease may be broken into several interrelated but independent concepts, such as the “Effective Date,” the “Occupancy Date” and the “Rent Commencement Date.”

- **The Effective Date.**  
This is typically the date on which the lease is fully executed and takes legal effect as a contract. The tenant may not yet have a right to occupy the premises nor any obligation to pay rent, but the lease is in full force as a contract between the parties.
- **The Occupancy Date.**  
This is the date that the tenant has the right to enter and occupy the premises. Often, the landlord will need to prepare the premises for the tenant's occupancy (by cleaning and repairing the space, constructing new improvements, etc.). It is therefore common for the tenant not to take possession of the space until some time after the lease is signed. The tenant ordinarily does not pay rent prior to taking possession of the premises.
- **The Rent Commencement Date.**  
Landlord's will sometimes provide a period of free rent at the beginning of the lease term as an incentive for the tenant. In such a case, the tenant may not be required to pay rent for a period of weeks or months after it occupies the premises. This is sometimes referred to at the “Free Rent Period.” The date on which the Free Rent Period expires and the tenant is required to commence paying rent is referred to as the Rent Commencement Date.

These dates may all occur on a single unified date, or may be spread out over a period of weeks or months. Additionally, the term of the lease (that is, the date on which the lease expires) can be based on any one of these dates. If the lease is for a term of 5 years, does the 5-year period run from the Effective Date, the Occupancy Date or the Rent Commencement Date? Be sure that the terms of the lease reflect the business deal between the parties and that there is no ambiguity.

## RENT

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Rent is typically paid in advance on the first day of each calendar month. That is to say, the rent that is paid on January 1 pays for the tenant's occupancy of the premises during the month of January. Rent consists of "minimum" or "base" rent, which is the basic amount the tenant is paying to occupy the space, and "additional rent," which is all of the other amounts the tenant owes to the landlord during the term of the lease.

Where rent is concerned, leases may be broadly broken into two categories: gross rent leases and triple net leases. The principal distinction between the two is how certain operating expenses and other landlord costs are passed through to the tenant.

- **Triple Net.**

In a triple net lease, the "base rent" or "minimum rent" is the amount of rent the landlord expects to receive net of landlord's costs and operating expenses. Therefore, in addition to the base or minimum rent, the tenant will be expected to pay its share of all the landlord's costs and expenses incurred to operate the building. The three "nets" in a triple net lease are the costs incurred by the landlord for (i) the physical maintenance, repair and management of the property, (ii) real estate taxes, and (iii) insurance. The tenant will typically be charged its proportionate share (based on the square footage of the premises as a percentage of the total square footage of the building) for each of these expenses. The landlord may require the tenant to pay an estimate of these charges along with monthly installments of rent, with a reconciliation of actual expenses taking place after the end of each year. The determination of what expenses are included or excluded from these costs, and how costs are verified and reconciled, can be the source of much negotiation between the parties, and is beyond the scope of this guide. There can be as many variations on this theme as there are landlords and tenants. Triple net leases are more typical for retail and office premises.

- **Gross Rent.**

In contrast to a triple net lease, a tenant paying gross rent will pay a single pre-determined rent that includes all costs incurred by the landlord to maintain and operate the property. Because the landlord is taking the risk that operating costs may increase faster than the rent,

the landlord typically builds a cushion into the rent to protect against being caught short. Therefore, while gross rent leases may be simpler to administer, the tenant may risk overpaying for the landlord's costs. Gross rent leases are more common for industrial and warehouse premises (although these may be structured as triple net leases as well).

In some retail leasing situations (particularly in malls and shopping centers), it is common for the tenant to pay the landlord a percentage of the tenant's gross income generated at the premises in addition to the other elements of rent described above. This "percentage rent" is a way for the landlord to share in the success of the tenant, and as such is typically not payable until the tenant has earned a certain threshold of gross receipts called the "break point." The exact amount of the breakpoint can be another area of negotiation between the parties, with the tenant wanting it higher, and the landlord wanting it lower.

## PERMITTED USE - EXCLUSIVES

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One easily overlooked aspect of a commercial lease is the particular use that a tenant is permitted to undertake in the premises. Sometimes this is relatively simple and straightforward. Where the tenant intends to use the premises for general office use, it may be sufficient to describe the use in just that way, as “general office use.” However, in industrial and retail situations, it may be necessary to describe with greater detail what the tenant can and can not do in the premises. For example, if the tenant intends to use the premises to warehouse goods for distribution to retail outlets, the lease may need to address specific related issues, such as the maximum weight that the floor of the premises can support, hours of operation, the permitted height of storage facilities to comply with code requirements and sprinkler capacity, etc. In any commercial leasing situation, the parties should think carefully about the particular operations of the tenant in the premises and address any specific issues directly so they do not become a problem later.

In some situations, particularly with respect to retail tenants in malls and shopping centers, landlord's may grant certain tenants an exclusive right to operate a particular kind of business or sell a particular kind of product. For example, a tenant that wants to operate a pizza restaurant in a shopping center will not want another tenant in that same center to also operate a pizza restaurant. In such a case (assuming the landlord is willing to grant such an exclusive), not only should the pizza tenant's lease contain a clause granting it the sole right to operate a pizza restaurant in the shopping center, but the leases of each other tenant in the center should contain a prohibition against operating a pizza restaurant. Of course, such provisions can be much more complicated than they first appear. Is a grocery store that sells frozen pizza in its frozen food case violating the exclusive? Should a full service Italian restaurant chain that serves pizza as one of many menu items be prohibited from operating in the center? Questions like these need to be thoroughly thought through by both landlord and tenant, and carefully drafted to give the tenant the protection it needs without unduly restricting the landlord's ability to lease other space in the shopping center.



## TENANT IMPROVEMENTS

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Frequently, a new tenant moving into a space (even space that is already configured as office, warehouse or retail space) will need the physical premises modified to meet the tenant's particular needs and operations. Such alterations, referred to as "Tenant Improvements," may be simple or complex, ranging from new carpets and a fresh coat of paint, to a complete refit of the space. The scope and design of the Tenant Improvements will be a key matter of negotiation between the landlord and tenant.

It is not unusual for the landlord to provide some amount of money to finance the design and construction of the Tenant Improvements (typically called the "Tenant Improvement Allowance"). Whatever the amount of the Tenant Improvement Allowance, the funds are ordinarily amortized with interest over the life of the lease and added to the rent the tenant pays. In such a case, the landlord is acting like a bank by loaning the tenant the funds necessary to fit-out the space.

The Tenant Improvement Allowance may be paid by the landlord to the tenant in cash to allow the tenant's contractor to undertake the work, or the landlord may undertake the work itself on the tenant's behalf and agree to pay for the work up to the amount of the Tenant Improvement Allowance (with any overage being paid by the tenant). The latter scenario is more common, particularly among larger landlords that have the wherewithal to undertake construction projects.

The construction of the Tenant Improvements can raise many of the same issues that any other construction project might raise, including the selection of the contractor, design of the improvements, budgeting issues, oversight of construction, etc. Additionally, the tenant often does not occupy the premises and begin paying rent until some time after the Tenant Improvements are complete. One thing the parties will need to consider is what happens if the completion of construction is delayed. This raises its own questions: Is the tenant entitled to an abatement of rent for each day of delay? If the delay drags on for some extended period of time, does the tenant have the right to terminate the lease and find space elsewhere? As you can see, even a relatively simple tenant fit-out can require careful thought, planning and drafting in the lease.

## MAINTENANCE

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The determination of which party, landlord or tenant, has responsibility for a given element of maintenance will often turn on the kind of space that is being leased and the particular use of the space undertaken by the tenant. For a typical office or retail premises, it is not uncommon for the landlord to be responsible for the exterior of the property, the structural and load bearing elements of the building, the common areas and the roof, while the tenant is responsible for maintaining the interior non-structural elements of its premises, as well as its own fixtures and equipment. With respect to the heating and air conditioning systems in the building, the landlord will often maintain the elements of the system serving multiple tenants while the tenant maintains the elements of the system within its premises or solely serving its premises. Regardless of the breakdown of responsibilities, the tenant under a triple net lease, usually reimburses the landlord for the tenant's proportionate share of the landlord's cost of maintenance by paying additional rent (or, if the lease is a gross rent lease, these costs are already build into the rent).

Sometimes the landlord wants to control all aspects of the maintenance of the property, including the interior of the premises. This may be true where the building is new or a particularly high quality property and the landlord wants to be certain that the property is being maintained to a high standard. Alternatively, in some circumstances, the parties may decide that the tenant maintains the entire building, inside and out. This is most likely to occur where the tenant leases an entire building from the landlord.

One common area of friction between landlords and tenants is whether the tenant is required to reimburse the landlord for the costs of repairs or maintenance that are in the nature of capital improvements to the property. A capital improvement is one that has a relatively long useful life and which the landlord can depreciate for tax purposes. Things like repaving (as opposed to restriping or resealing) parking areas or driveways, replacing (as opposed to repairing) a roof, or constructing new additions to the building fall into this category. Because of their long useful life, it is unfair to pass the full cost of capital improvements through to a tenant that may not get the full benefit of them during the remaining term of its lease. For example, if the landlord repaves the parking lot (with a useful life of ten years), and the tenant only has two years remaining on the term

of its lease, then the tenant could wind up paying the full cost of the improvement while the next tenant would get most of the benefit of the improvement without having to pay for it. To remedy this situation, landlords will often pass through only a portion of the cost of a capital repair during each year of the remaining lease term. For example, if the improvement has a useful life of ten years, the landlord will charge the tenant one-tenth of the cost in each remaining lease year. If the tenant only has two years remaining in its term, then it winds up paying two-tenths of the cost (an appropriate amount for its use during the term). This process is referred to as “amortizing” the cost of the capital improvement. Landlords will often tack on an interest factor to the amortization to account for the fact that the landlord has laid out the full cost of the improvement up front but is being repaid over time.

## INSURANCE - WAIVER OF SUBROGATION

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Insurance in a lease can be broken into two broad categories: liability coverage and casualty coverage. Liability coverage protects the insured against third party claims arising due to personal injury or damage to property. Casualty insurance protects the owner of real estate against damage to its building due to fire or other casualty.

In a typical lease, the tenant carries its own liability insurance protecting against harm to persons or property that occur on the premises or which are due to the tenant's own negligence or misconduct. The landlord is ordinarily named as an additional insured under this policy so that the landlord is also protected against these risks. Note that the landlord will usually not carry separate liability insurance against these same risks in order to avoid competing insurance claims.

Conversely, it is the landlord that ordinarily carries the casualty coverage on the building (with tenant paying its proportionate share of the cost of such insurance as additional rent if the lease is triple net). The tenant is normally not named as an additional insured on the landlord's casualty insurance because the tenant does not have an ownership interest in the building.

The lease should contain a "waiver of subrogation" clause. While technical, this can be one of the most important clauses in the lease if there is a major casualty at the property. The concept is relatively simple – the landlord insures its interest in the building and the tenant insures its interest in its own property and equipment located within the premises. If there is a casualty and the building and/or the premises are damaged, the parties agree that each will look solely to its own insurance to be made whole, and each agrees not to sue the other for such claims regardless of who may be at fault for the casualty. The clause also provides that the parties' insurance carriers will not be permitted to sue the other party under a theory of subrogation (thus the term "waiver of subrogation"). There are many variations on these provisions, some of which favor the landlord at the expense of the tenant. The language can be quite technical and should be reviewed carefully. However, if properly drafted, a carefully crafted waiver of subrogation can benefit both the landlord and the tenant.

## DEFAULT - REMEDIES

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The lease should spell out with specificity exactly what constitutes an “Event of Default” under the lease. Tenant’s will typically want to receive written notice of the alleged default and an opportunity to cure the default before the landlord is permitted to exercise its remedies. Therefore, for example, the lease may provide that an Event of Default will exist if the tenant fails to pay rent and does not remedy the situation within five (5) days after receiving landlord’s written notice of such failure. Non-monetary defaults (like the failure to make required repairs) may take more than five (5) days to cure, and so a longer notice and cure period may be negotiated. Other defaults (such as the lapse of the tenant’s insurance policy) may result in immediate harm to the landlord, and so no notice or cure period may apply before the landlord may declare an Event of Default to exist.

The remedies available to the landlord upon and Event of Default by the tenant should be set out in the lease and may vary from state to state. Usually, the landlord is permitted to terminate the lease and recapture the premises. Sometimes the landlord is permitted to recapture the premises without terminating the lease, and thus the tenant continues to have the obligation to pay rent even though it is no longer in possession. In this case, the landlord usually has to offset the rent sought against the tenant by any rent paid by a new tenant of the premises. In some jurisdictions, the landlord may accelerate the rent for all or part of the remaining term of the lease. Again, local law and custom will dictate what remedies are, or are not, available to the landlord.

## ASSIGNMENT AND SUBLETTING

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Under some circumstances, a tenant may wish to sublet part of its premises to a third party, or to assign its interest in the lease altogether. It is not unusual for the landlord to prohibit such subletting or assignment without the landlord's consent. Other transactions may also constitute a prohibited transfer, such as the sale of substantially all of the tenant's ownership interests or assets to a third party or the merger of tenant with another entity.

Before signing the lease, the tenant should consider what sorts of transfers should be permitted without the landlord's consent. For example, transfers to an affiliate of the tenant may not harm the landlord, and may therefore be permitted. If the ownership interests in the tenant entity are held by individuals, those individuals may want the ability to convey their interests into a trust or other estate planning entity for their own benefit or the benefit of their family members. If such transfers do not result in a change of the control or management of the tenant, they may be acceptable to the landlord. Similarly, the tenant may want the freedom to assign the lease to a party purchasing the interests in, or assets of, the tenant, or to a party merging with tenant. It would be unfortunate to have an otherwise favorable transaction for the tenant be thwarted by the provisions of the lease. On the other hand, landlords have a genuine interest in the continued creditworthiness of their tenants and on understanding who is in control of the tenant.

## SUBORDINATION - ESTOPPEL CERTIFICATES

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If the landlord has obtained mortgage financing for the property, or does so in the future, the landlord's lender may require the tenant to enter into a separate agreement directly with the lender commonly known as a Subordination, Non-Disturbance and Atornment Agreement. The purpose of this agreement is to assure the lender that the lease is subordinate to the lien of the mortgage. In other words, if the lender were to foreclose the mortgage, it would not be bound by the lease. Since this would be detrimental to the tenant, the agreement usually also states that the lender agrees to honor the lease and not disturb the tenant's occupancy of the premises so long as the tenant is not in default of the lease. The tenant also agrees to "atorn" to the lender (that is, recognize the lender as its landlord) in the event that the lender forecloses the mortgage. Lenders also like to add other provisions into these agreements that benefit them but may be burdensome to the tenant. For example, the lender may require notice from the tenant of any landlord default and an extended period of time to cure such default. The lender may refuse to be bound by any amendment to the lease that it does not approve in writing, and may not be bound by any prepayment of rent more than one month in advance.

If the landlord is entering into new financing for the property, or if the landlord is selling the property, the lender or buyer is likely to require an estoppel certificate from the tenant. An estoppel certificate is a document in which the tenant is asked to certify certain factual statements about the lease. The purpose of the certificate is to give the lender or buyer assurances about the status of the lease, and to make it more difficult for the tenant to take a factual or legal position after closing that contradicts what was previously disclosed in the certificate. The factual statements in the certificate can address a wide variety of matters ranging from the effective date of the lease, to the current amount of monthly rent, to tenant's acceptance of the landlord's improvement work, to whether any defaults by the landlord exist under the lease. These factual statements need to be reviewed carefully and, where necessary, modified to reflect circumstances as they actually exist.

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