

Commercial Leases: Strategies During Tough Times *(or Any Time)*

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The Agenda for Today's Presentation

We will cover the essentials of commercial lease negotiation, including:

- The process of negotiating a lease
- Working with professionals—brokers and attorneys
- What the lease terms mean
- How to plan an exit strategy
- Lease Strategy “Dos and Don’ts”



Contract Basics

What is a Contract?

- Agreement between two or more parties to do or promise to do something
- Can be oral or written, implied or express, and legally enforceable or not
- In a commercial setting, a contract in writing that clearly sets out the terms of the agreement ultimately will be the best protection for a business
- Oral (not in writing) agreements are enforceable, but what is agreed to can often be disputed



Contract Basics cont'd.

What is the difference between a Commercial and Residential Lease?

Commercial Lease versus Residential Lease

- Residential tenant has significant protections under law
- Commercial tenant's rights are governed by the lease contract



Before Negotiating a Contract or Lease

What should a business do?

Evaluate needs

- Effective Lease and “Exit” Strategies begin before anything is signed
- In developing an Exit Strategy, a person should consider and negotiate lease terms which will limit personal liability should the need arise to terminate the lease
 - It is not necessarily just for negative events or economic downturns
 - Downturns can be an opportunity for expanding a business
 - Selection of a location is an important factor in the success of a business



Before Negotiating a Contract or Lease cont'd

What should a business do?

Research the space

- Physically inspect the space
 - Will it work for the specific type of business?
 - Does the Certificate of Occupancy and Zoning Resolution permit the business' use?
 - Will it work for potential future uses or businesses?
 - Obviously, cost is critical but the space needs to work now and in the future

Seek the advice of professionals

- Brokers can be instrumental in giving alternatives to fit a businesses' needs
- Legal counsel can help navigate potential minefields and hidden costs in a lease such as taxes and insurance fees



Before Negotiating a Contract or Lease cont'd

What should a business do?

Review all existing contracts and leases

Determine the type of entity that will be on the Contract or Lease

- Sole Proprietorship, Corporation, Limited Liability Company
- Type of Entity can impact exit strategy by possibly insulating the business from personal liability
 - For example, a Sole Proprietorship is personally liable on all contracts



Culture of Lease Negotiation

Oral lease agreements will not protect a business

Seek to get a letter of intent or term sheet

- Sets forth essential terms of the deal and gives the lessee a general road map of what the lease draft should include, such as:
 - Name of Landlord and Tenant
 - Building address
 - Description of property
 - Use of Premises
 - Rent
 - Security Deposit



Culture of Lease Negotiation cont'd

Leases are drafted by landlords

- No such thing as a “standard” form in commercial leasing
- Landlords often use “pre-printed” forms
 - Often favor landlords
 - Potentially has many “gotchas” that can impede strategies
- Leases do not always reflect the facts or letter of intent
 - Must be carefully reviewed to make sure it reflects business deal
 - If something discussed is not in the final lease, then do **not** make the deal



Terms of the Lease

Basic Terms

- Building address
- Name and notice address of Tenant
- Name and notice address of Landlord
- Premises
- Basic rent
- Additional charges
 - Real estate taxes
 - Operating expenses / common area costs
 - Utilities
- Security deposit
 - Can it be reduced/eliminated over the course of the term?
- Length of term of the Lease (when does it start/end)



Terms of the Lease cont'd

Other Essential Terms

Permitted uses

- This can be critical to an exit strategy - it is important to keep the permitted uses very vague in a lease to protect subletting rights
- Often the “standard” lease limits use to a very specific use
- It is unlikely that the party that you assign your lease to or sublet the space to will have the same use
 - For instance, a book store may have a hard time subletting *only* to another book store



Terms of the Lease cont'd

Other Essential Terms cont'd

Insurance

- Essential to have
- Lease will require at least casualty and liability insurance
 - The levels and types of insurance will depend on what is negotiated between the Landlord and Tenant before the lease is signed
- Policy should be regularly reviewed by an insurance agent
 - Can be a potential area of cost savings
 - Make sure any indemnity obligations are covered



Terms of the Lease cont'd

Other Essential Terms cont'd

Free rent periods

- Important if making alterations before opening space
- Don't want to have to pay rent before income from store starts

Renewal option(s)

- Start-up business may want a shorter initial term with renewal options
- Gives more flexibility and limits obligations if the business does not succeed

Signs

- Businesses must have the right to have signs for the business (name, sales, etc...)
- Typical lease restrictions on signs hinders use and exit strategy
- Permit "closing" and "going out of business" signs



Terms of the Lease cont'd

Other Essential Terms cont'd

Initial construction

- Who will do the construction?
- Who will pay for it?
- Who will own the fixtures after the lease is over?
- Who has to remove furniture or other items at the end? This can be a significant additional cost
- Limit the fees that Landlord can charge to review plans or supervise work



Terms of the Lease cont'd

Other Essential Terms cont'd

Repairs and maintenance

- Landlord's obligations must be written—there is no “implied” duty to repair in commercial leases
- Landlord should maintain and repair the “structure” of the building, building systems and common areas
- Landlord should be obligated to minimize interference with the business
- If critical repair item is within the space, negotiate the right to do work and have credit against rent
- Landlords will resist requests to have Tenant terminate or have rent credit rights
- Tenant service/maintenance contracts should be carefully reviewed on a regular basis



Terms of the Lease cont'd

Other Essential Terms cont'd

Default

- What events can trigger a default?
 - Failure to pay rent
 - Failure to perform obligations
 - Vacating or abandoning the space (typical provision in the “standard” pre-printed form)?

- Must have notice and chance to cure the default

- Resist an acceleration of rent provision (not in the “standard” pre-printed form but often added by Landlords)



Terms of the Lease cont'd

Other Essential Terms cont'd

Termination; End of Term

- Make sure Landlord is obligated to quickly return the security deposit
- Keep track of rent payments
- If last month's rent was paid upon execution of the lease—don't pay it again
- At the end of the term of the lease, avoid any requirement that Tenant need to restore the space to its original condition or remove fixtures or other improvements
- Avoid high "holdover" rent penalties and consequential damages



Terms of the Lease cont'd

Other Essential Terms cont'd

Cancellation Right

- Landlords will resist, but it is worth asking for, regardless of the cost of exercising the right
 - It gives you a seat at the table to further negotiate
- Cost will certainly be less than remaining rental obligation

Specific Use Limitations

- In a retail setting, this can limit to whom the space can be marketed
- Operating and Continuous Use Covenants
 - These Covenants provide that a business must remain open and should be avoided if a business is seasonal
- The Tenant can be in default if provision is not made for closure and renovations after a sale
- If a seasonal business, may need to carve out certain months (e.g., winter for an ice cream shop)



Terms of the Lease cont'd

Assignment/Subletting Rights

If effectively negotiated, these are a Tenant's most powerful strategies to get out of the lease or permit someone else to use it

- Typical sublet and assignment provisions in a lease give the Tenant no meaningful rights
- Negotiate these terms at the outset, when drafting the term sheet or letter of intent
- Certain events should not require Landlord's consent
 - Mergers, acquisitions and sales of businesses
 - In an office lease, occupancy by affiliates



Terms of the Lease cont'd

Assignment/Subletting Rights Cont'd

- Limit net worth tests as condition of Landlord's consent
- Limit the ability of Landlord to share in profits and make sure you get your costs back
- Permit "sharing" arrangements, licenses and concessions
- What will the responsibilities be after the assignment/sublet?
 - If the owner has given a Guaranty, the Tenant needs to have the right to provide a new guarantor and be released



Terms of the Lease cont'd

Assignment/Subletting Rights Cont'd

- Additionally, Landlords often add provisions making it even more difficult for the Tenant to assign or sublease the space
- Provisions Include:
 - Landlord may recapture the space. If this occurs, the Tenant no longer has the right to sublease or assign the space.
 - > Limit recapture rights to a termination of the lease-not a “back lease.” In “a back lease”, the Landlord subleases the space back from the Tenant, which keeps the Tenant on the hook for its obligations under the lease



Terms of the Lease cont'd

Assignment/Subletting Rights Cont'd

- Provisions Cont'd
 - Landlord has a right to share in any profit the Tenant makes from subleasing the space or assigning the Lease
 - Landlord is not required to reply in a reasonable period of time to Tenant's request to sublet or assign the space
 - Landlord is not required to be reasonable in granting its consent
 - The space may only be sublet or the lease assigned for the "permitted use"
 - > For example, if the permitted use of the space is only as a bookstore, the ability to sublease the space or assign the lease will be limited to only a different bookstore, which may be difficult or impossible and unreasonably restricts your flexibility



Typical Landlord Impediments to Tenant Exit Strategies

Relocation

- Landlord might have a right to relocate the Tenant elsewhere in the building
 - ***Strongly resist agreeing to this type of provision***
- If Landlord insists:
 - May want to consider different building, especially for retail businesses that intend to build up a customer base
 - Location in the building of new premises will be critical
 - Tenant must have the right to approve of the configuration, size, and layout of any new premises
 - Tenant need not relocate until the new premises are fully built out at landlord's expense
 - Landlord must pay all direct and indirect relocation costs

Typical Landlord Impediments to Tenant Exit Strategies Cont'd

Landlord Termination Rights for Demolition or other Purposes

- This can be a death blow to a budding business
- Must build-in long notice periods and other objective conditions
- Similar to relocation, Landlord may negotiate costs associated with moving

Personal Guaranty of Individual Owners

- Not unusual for Landlord to require especially if Tenant is a limited liability company or corporation
- Director and Officers of not-for-profit entities should strongly resist any personal liability
- Limit the extent of the Guaranty
- Provide for Substitute Guarantors in the case of lease assignment or retirement
- Limit extent of liability to the estate of the owner



Typical Landlord Impediments to Tenant Exit Strategies Cont'd

Personal Guaranty, cont'd

- Provide for increased security deposit if acceptable substitute guarantor not available
- So-called "Good Guy" Guaranty
 - Not a full lease guaranty
 - Only responsible for rent up to surrender of lease by Tenant (or certain period after surrender)
 - Tenant not released
 - Expressly exclude any "acceleration" of rent upon lease termination

Limiting Renewal and Expansion Options

- Landlord's often try to limit these valuable rights to the "named" tenant
- The ability to transfer these to a party you sell a business to may make or break the deal



Lease Strategies Dos and Don'ts

Dos

- Do** carefully assess your needs in terms of growth and downturns
- Do** get brokers and attorneys involved at an early stage
 - Attorneys' expertise at spotting potential cost issues can more than offset their fees
 - Tenant brokers are typically paid by Landlord even though they represent you
- Do** require assignment and subletting flexibility and sharing rights
- Do** review your existing agreements frequently to know your rights
- Do** try to limit extent of guarantees and amount of security deposit



Lease Strategies Dos and Don'ts cont'd

Dos

Do require the right to “go dark”

- Although a business may still be paying rent, this can significantly reduce overhead and, on an interim basis, give the business time to get back on its feet

Do try to limit the initial out-of-pocket costs

- Landlord doing work or providing allowances
- Preserves lines of credit and savings for possible down-turns

Do get it in writing

Do be cooperative and forthcoming in trying to work out a solution



Lease Strategies Dos and Don'ts cont'd

Don'ts

- **Don't** be in a hurry
 - In this market many good locations will be available
 - Be aware that this can take many weeks or months to complete between negotiating terms, the lease and construction
 - Build this time frame into the business plan
- **Don't** consider a location solely on the rental terms
- **Don't** overlook the necessity of getting necessary permits or court approvals and impact on the timing
- **Don't** sign Landlord's form without negotiation and addressing important provisions to preserve exit strategies



Lease Strategies Dos and Don'ts cont'd

Don'ts

- **Don't** be hesitant to talk to Landlord about concessions during lease negotiations or in existing deals
 - Landlord may prefer to have occupied space versus vacant space even at a reduced rent
 - Knowing the agreements and exposure by way of security deposits and/or guarantees can give a business significant leverage
- **Don't** rely on oral agreements
- ***Don't ask, don't get!***



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