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In the Spotlight

Conducting Leasing Due Diligence? Watch for These Nine Lease Provisions

By John Hutmacher

A purchaser of income-earning commercial real property must take steps to confirm the integrity and enforceability of the rental income stream. Below is a brief explanation of nine aspects of leases that should be reviewed by the purchaser or its legal advisers during the due diligence period.

1) Completeness of Lease Documentation. A review of the lease documentation received from the vendor often reveals that there are missing pages and unsigned or missing amendments and extension agreements. Since the purchaser needs an accurate snapshot of the documents forming the entire lease, the vendor should be asked to explain any gaps in the documents and provide any missing items. The information contained in estoppel certificates, which tenants will be asked to sign to confirm financial and other terms of their leases, should match the information contained in the leases. If the purchaser waits until after the due diligence date or the closing date to investigate gaps or discrepancies in lease documentation, it will likely be too late to do anything about it.

2) Outstanding Tenant Inducements. Unexpired free rent and rent abatement periods, payment of leasehold improvement allowances and completion

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Take Caution Before Transferring Portions of a Project (Especially to Affiliates)

By Xavier L. Gutierrez

Because the challenges facing a developer multiply when it no longer owns an entire project, careful planning and documentation are required in advance of any transfer. While this article addresses issues that arise when different portions of a project are owned by different parties (transfers in general), the main focus is on the issues that arise when different portions of the project are owned by affiliated parties (transfers to affiliates), primarily because those issues are easy to overlook.

Who Is the Declarant Under the Declaration?

The document that spells out the purpose of the project and sets forth rules for its development and operation may have one of several acronyms, such as CC&Rs (covenants, conditions, and restrictions), REA (restrictive easement agreement), and RAGE (Restriction Agreement and Grant of Easements). We'll call it the Declaration.

Typically, the developer is designated as the declarant under the Declaration, which declarant is excluded from most limitations imposed on other parcel owners, but which retains significant approval rights. Its goal is to retain as many of the rights it would have enjoyed if it had remained the sole owner of the project. Given the significant rights held by the declarant, it is important to consider who the declarant is under the Declaration.

At least initially, the declarant is the entity that owns the land, but circumstances may require the initial owner to transfer portions to affiliates. Perhaps the most common reason for transferring portions to affiliates is financing. For example, a lender may require transfers to newly formed single-purpose entities and/or the developer may subdivide the project to finance only those portions of the project that are constructed and leased. Portions may also be transferred to different affiliates when multiple uses are contemplated or for estate planning purposes. If a portion of the project is transferred to an affiliate, will such affiliate have the same omnipotent authority that the declarant enjoys under the Declaration?

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In This Issue

Bridging the Gap

Concepts Useful in Negotiating Commercial Leases

By Myles Hannan

Some of the more contentious provisions in commercial leases have to do with the landlord's right to recapture the leased premises upon an assignment or sublease; relocation of the tenant to other space; co-tenancy; netting of expenses; and acceleration of rent upon a default. Often the parties will be at loggerheads over these provisions and pessimistic that their differences can be bridged. However, there are concepts that can serve to bridge the gap, and this article discusses some of them in the context of those types of lease provisions.

RECAPTURE

The lease provision states:

> Except for any assignment or sublease permitted pursuant to Section 21.4 above, in the event of (i) a proposed assignment of this Lease, or (ii) a proposed sublease in excess of fifty percent (50%) of the rentable area of the Premises (singularly or in combination with previous subleases then in effect), Landlord shall have the right, by notice to Tenant delivered within ten (10) business days after Landlord's receipt of Tenant's Proposal Notice (and in lieu of the granting or denial of consent provided for above), to terminate this Lease as to all of the Premises (in the event of an assignment) or as to the proposed subleased portion of the Premises only (in the event of a sublease), in each case for the balance of the Term.

However, the tenant may be a defense contractor entering into a 10-year lease and needing to have the flexibility to sublet space at times during the Term to meet the ebb and flow of contract awards. The 50% threshold is of no help, and the landlord is not willing to limit its recapture rights to assignments or subleases for the remainder of the lease term. What to do? One answer: nullification, as in the following provision:

> Notwithstanding the foregoing provisions of this subparagraph to the contrary, if within three (3) business days following delivery of Landlord's notice of termination, Tenant advises Landlord in writing that Tenant nullifies in all respects Tenant's proposed assignment or subletting, as the case may be, then Landlord's notice of termination will be deemed rescinded and the Lease will continue in full force and effect with respect to the entire Premises.

The landlord may wish to relocate the tenant, but not at the cost of losing the tenant. In such a case, nullification can be used to bridge the gap …

Thus, nullification gives the tenant a chance for a free look at whether the Landlord is going to recapture or not and then, if Landlord does seek to recapture, the opportunity to make the hard decision of whether it is better to hold the space fallow or lose it entirely.

RELOCATION

The lease provision, as thus far negotiated by the tenant, states:

> Landlord shall have the right at any time, upon giving Tenant not less than thirty (30) days' notice in writing, to provide and furnish Tenant with space elsewhere in the Building of approximately the same size as the Premises and to place Tenant in such space. In the event of any such relocation of Tenant, Landlord shall pay for Tenant's reasonable moving and relocation costs and for the comparable buildout of the new space. In the event that Tenant is unwilling to relocate to such new space as herein provided, Landlord or Tenant may terminate this Lease.

In the case of relocation, the positions of the landlord and the tenant are reversed from their positions when a recapture is involved. The landlord may wish to relocate the tenant, but not at the cost of losing the tenant. In such a case, nullification can be used to bridge the gap, *i.e.,* "In the event that Tenant so notifies Landlord that it intends to terminate this Lease, Landlord may, within three (3) business days after receipt of such notice from Tenant, nullify its request that Tenant relocate, whereupon this Lease shall continue in full force and effect."

CO-TENANCY

Now, let us consider the retail tenant that seeks to negotiate a co-tenancy provision whereby in the event the regional mall has less than three anchor stores operating, the tenant need not open for business and if the condition persists for a specified period of time, may terminate its lease. The landlord does not believe that it can finance the mall if it is subject to this "domino-effect" among the inline tenants should an anchor close. What to do? One answer: a shift from fixed rent plus percentage rent to percentage rent only, if the co-tenancy requirement is not met.

Whereas nullification is an "I withdraw my request — let's just keep going" concept, "percentage rent only" provisions in retail leases, are more like "I don't know how badly your failure is affecting me — paying percentage rent only will be automatically corrective of the damage done." Let us examine how that

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Negotiating

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works. The co-tenancy requirement for three anchors is, of course, premised upon the fact that anchors draw traffic to the mall and traffic is a major factor in generating the volume of sales that the retailer requires. Yet, if the tenant's sole remedy is to terminate its lease upon the loss of an anchor store, it faces the loss of its investment in leasehold improvements, the loss of an otherwise good location, and the interruption of its business. Its rent is premised upon a sales volume that will be difficult, if not impossible, to attain with less than three anchor stores in the mall.

In that situation, changing the tenant's rent obligation to percentage rent only, either until the anchor store is replaced or for some finite period of time, after which Tenant may terminate its lease if the failure continues, might provide the solution. Certainly in the case of percentage rent based upon a natural breakpoint (*i.e.,* payable on sales exceeding an amount equal to rent divided by the percentage in question), percentage rent only would be a near perfect measure of the impact of losing the anchor and fair to both of the parties.

'Net of Expenses'

Other areas where the views of the parties are quite different are those involving the netting of expenses against an obligation to pay money. Take, for example, the standard provision in Assignment clauses:

> In the event that the rent or other consideration received by tenant upon an assignment or transfer, net of the expenses reasonably incurred by Tenant in connection therewith, exceeds the Rent payable hereunder, Tenant shall pay fifty percent (50%) of such excess to Landlord.

Landlord will want to have those Tenant expenses amortized over the term of the sublease or, in the case of an assignment, over the remaining term of the Lease, so as not to be deferred in its sharing of the "profit." Tenant, on the other hand, will argue that it bears the credit risk of the subtenancy and, therefore, should be entitled to recover its costs in total prior to any kind of profit sharing. Now let us flip the situation to the one where the lease provides that the landlord, following a default by the tenant and a successful reletting, may recover its cost of reletting before crediting the tenant with the reletting rent. Here, the shoe is on the other foot, with the tenant arguing strenuously that it is only fair that these costs be spread over the term of the reletting as they have produced a rent stream over that period and the landlord equally strenuously arguing that it is adding insult to injury for a defaulting tenant to attempt to lessen its liability by using the landlord's expenditures to do so. The tenant has a better negotiating position in the former case than in the latter. However, even in the default context it might successfully argue that the expenses be amortized over the entire term of the reletting, even if that term is for a period longer than the remaining term under the defaulted lease.

Rental payments, however, are yet to be made over time, and so their acceleration would create a windfall to the landlord.

Acceleration

Acceleration provisions are often hotly contested, with the tenant claiming it should not have to make payments except at the times provided for in the lease and the landlord insisting that given the breach, it is entitled to recover the amount remaining due as damages. Thus, in order to overcome the common law principle that "Rent is not a debt until due," landlords often provide in their leases that at the landlord's option, the rent for the remainder (or but for a termination of the lease would have been the remainder) of the term of the lease may be declared due and payable at once. Note how such an acceleration of the rent payments differs from the acceleration of a loan. The loan was paid out and is repayable over a period of time at interest. Therefore, acceleration of the principal balance is not subject to being discounted to present value. Rental payments, however, are yet to be made over time, and so their acceleration would create a windfall to the landlord. For that reason, accelerated rent should be discounted to present value, *i.e.,* the amount which if invested over the period of time in question, at the stated interest rate, would equal the sum of the remaining rent payments.

The tenant could, however, go on to make another point. Unlike the case of a loan, the funds were not advanced by the landlord and with the lease terminated, the landlord will have the opportunity to relet the space and recover some portion of its loss there as well. For this reason, tenants often demand that the remaining rent be reduced by the fair rental value of the space. However, that would put the landlord at risk if the determination of fair rental value, however and by whomever made, should turn out to be faulty (as to who makes the determination, provisions range from silence, *i.e.,* an objective standard, to "landlord in its reasonable discretion," to "which Tenant is able to demonstrate by clear and convincing proof"). In order to avoid that risk, some landlords, if willing to credit the tenant with amounts realized by reletting, will agree to refund reletting monies to a tenant who has paid accelerated rent only when, if, and as collected.

Conclusion

These examples perhaps illustrate that even the most contentious lease issues can often be resolved by concepts such as those mentioned here, which bridge the gap and permit the parties to reach final agreement on a lease.