

Rethinking 'standard' lease provisions

If tenants now hold the upper hand in negotiations with landlords, what should be on the table?

It has become a tenant's market. Commercial vacancy rates are increasing, rents are dropping and leveraged landlords face the challenges of constrained cash flow.



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COMMENTARY

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Mounting job losses and consumer retrenchment suggest that these challenges could become tougher. There are certain risks imposed on tenants by standard landlord lease provisions that may no longer be acceptable.

When negotiating a lease, tenants should recognize that the landlord they know and trust may not be around or in control going forward. Given the current capital market conditions and lower property valuations, owners are less likely to sell. But such conditions increase the likelihood of involuntary control changes. If the landlord defaults on the loan, the lender may insist that a receiver be appointed. If the landlord enters bankruptcy, it becomes a "debtor in possession" subject to bankruptcy court powers. As a result of foreclosure, the property will be sold either to the lender (most likely, a large financial institution) or a third party such as an opportunistic buyer. So, the lease itself becomes more critical than ever in protecting whatever rights the tenant can negotiate.

What rights might tenants negotiate for under these circumstances? For one, tenants could beef up their remedies. Landlord leases invariably bar self-help and offset rights, which would permit a tenant to fulfill unsatisfied obligations of the landlord and deduct the cost from rent otherwise due. On top of that, commercial leases limit the landlord's liability to the extent of its equity in the property and reserve long cure periods. So, the tenant of an insolvent landlord would have essentially no remedies at a time when building services are most likely to suffer as a result of cash flow constraints.

Of course, it would be unwieldy, to say the least, for all tenants of a building to retain, say, separate HVAC contractors when the chillers fail. But if a large tenant needs a portion or components of the building maintained and cannot tolerate delays, self-help and offset would likely be the most cost-effective remedy.

As for building operations, tenants might look closer at operating expense reimbursement provisions to promote cost efficiency. Hiring affiliated property managers is one way a landlord can pull money out of a project – fees to such managers can be subjected to reasonable caps. If a building needs substantial deferred maintenance, the landlord's right to reimbursement of capital expenditures needs to be fairly tailored so that the landlord doesn't have an open checkbook.

Similarly, if property values are decreasing, so should assessed values. Landlords will generally agree to credit tenants with their "pro

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rata share" of property tax reductions obtained through tax appeals. But a large tenant also should have some influence on the decision to initiate an appeal in the first place. Perhaps the landlord should be required to consult with a large tenant on that decision.

Since the rents could increase during the lease term, a tenant should look carefully at current standard lease provisions containing contingent termination rights. For example, eminent domain and casualty provisions give the landlord termination rights if such events make the building or premises unusable. As generally presented, such provisions might be invoked to terminate the below-market rent lease, but not those of higher-rent tenants who are similarly affected by the casualty event.

Anti-assignment provisions often void an assignee's rights to exercise renewal options – whether at market or pre-specified rents. Also, a tenant should consider if the lease protects it from the landlord's failure to provide possession of the premises on time. Landlords often agree to rent abatements for delayed possession – even tenant termination rights for long delays. But if delayed possession causes the tenant to lose an advantageous rent structure, the appropriate remedy would be indemnification from the landlord for the additional costs a tenant will incur as a result of the delays.

Similarly, standard landlord language subordinates the tenant's interest to existing and future loans. Large tenants are generally able to reach an agreement with the lender to not disturb the tenant's possession in exchange for subordination. Otherwise, a foreclosing lender could wipe out the lease – and might be motivated to do so if market rent exceeds the lease rent. For the same reason, tenants of every size should now consider requiring a nondisturbance agreement both from the current lender and as a condition for subordinating to future loans.

These are some of the now standard lease provisions that warrant a closer look in light of potential landlord insolvency or the need to protect rents negotiated during a tenants' leasing market. Finally, don't forget to get it in the letter intent – or it may be very difficult to get in the lease.

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