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Newsletter, June 2017 Lease LOIs

This article explains the letter of intent (“LOI,” a.k.a. term sheet or MOU) to be used for negotiating a commercial lease. The LOI comes early in the process, and it’s the best place to negotiate basic deal terms. An LOI clarifies the deal, and lets the parties know early whether a deal can get done, before they’ve invested a lot of money in the process. LOIs usually are non-binding. Here are the most important terms for a lease LOI:

Personal Guaranty. I believe this is the number #1 issue for an LOI – whether the lease will be personally guaranteed. Negotiation is hard on this point. To break an impasse, consider a guaranty that expires after a couple of years; or offer an increased security deposit in lieu of the guaranty. The increased security deposit can decrease over time, e.g. 25% a year.

Term of Lease and Renewal Options. The term of lease is always a trade-off. A longer initial term locks in the rent for a longer period (which rent the tenant hopes will be under-market in the future), but a shorter term is safer because the tenant gets to exit earlier. The ideal medium is a shorter initial term plus options to extend for additional terms, for example, one 5-year term plus two 5-year options. Understand that the rent usually will bump up to fair market value at the start of each extended term.

As for the renewal options, the LOI should state their number and duration, how rent in each renewal term is fixed, and the window in which the tenant can exercise options (e.g. between 3 and 9 months before the end of term).

Rent Commencement Date. The tenant must investigate the time needed to get permitting and to complete tenant improvements. The tenant wants to schedule the start of rent payments to match the time needed to open for business in the premises. Before signing the LOI, the tenant, and the tenant’s contractor and architect, should map out a timetable for when the premises can open for business. This includes a visit to the local government permitting office to see if it will issue a permit for the tenant’s particular use at the location. For difficult situations, the tenant should require a permitting contingency so that, if the tenant can’t get permits, the lease is voided.

Rent and Triple Net Expenses. The LOI should state the base rent and how it increases. Landlord also should give an estimate of monthly pass-through expenses, e.g. common area maintenance (CAM), insurance and taxes. If tenant will demand a cap on CAM expenses, or an exclusion of capital improvements from CAM, the LOI is the place to negotiate it.

Signage. The LOI is a good place to negotiate for space on monument signs, signs on outside walls, and signs to be put on the inside of the plate glass window.

Form of Lease. This one is important to me as a lawyer. I'm the guy who has to read the lease, and yes, I'm paid for it, but it's really boring. If the tenant wants to save on legal time and fees, then in the LOI the tenant should require that the landlord use a standard lease form, for example the CAR or AIR forms. Otherwise the landlord might use a lease of unknown origin, that runs from 50 to 100 pages of dense text, that does not fit the deal, and that is filled with mistakes. Both the tenant and landlord's attorneys will waste a lot of time fighting through a non-standard lease. That said, most landlords will only use their own lease form, even if non-standard, because they're used to it.

Misc. If parking is limited, specify the tenant's number of reserved or non-exclusive parking spaces. If the landlord will give a tenant improvement allowance, state it here.

One last comment. You'll read a lot about measuring the square footage of the premises, and that's important if rent is calculated on a square foot basis and for the tenant's percentage share in triple net expenses. How the space fits the intended use, however, is more important than the raw square footage. Square footage is a misleading number. It can be defined to include common area or utility rooms that are outside the rentable space, and it can include useless corners and closets within the space. Even if the square footage isn't inflated, the layout of a premises with a lesser square footage might give more usable space than a bigger square footage, based on the tenant's needs. I advise comparing the rent for different offices based on the premises themselves, not their square footage.

Well, another article is done, and this time I shut up sooner, leaving more room for the jokes.

Cicero

- Politicians are not born; they are excreted.
- If you have a garden and a library, you have everything you need.
- Gratitude is not only the greatest of virtues, but the parent of all others.
- If we are not ashamed to think it, we should not be ashamed to say it.
- Never injure a friend, even in jest.

This last one reminds me of a thought from Ben Franklin: It is generally agreed to be folly to hazard the loss of a friend rather than to lose a jest. But few consider how easily a friend may be thus lost. Depending on the known regard their friends have for them, jesters take more freedom with friends than they would dare to do with others, little thinking how much deeper we are wounded by an affront from one we love.

