



# MATT DICKSTEIN

## Business Attorney

Making legal matters easy and economical for your business

39488 Stevenson Place, Suite 100, Fremont, CA 94539

510-796-9144. matt dickstein@hotmail.com matt dickstein.com

## Newsletter, February 2011 Understanding Commercial Leases

In this article I explain the basics of commercial leases. As a lawyer I represent both landlords and tenants, so in this article I'll walk the middle road between the two sides. Given that most commercial leases are extremely long, I can only explain a few basic concepts here. Call me if you need to talk about anything else in your lease.

**Tenants and Guarantors.** Begin your analysis of a lease with the tenants and guarantors. The tenant is initially responsible to pay rent. If the tenant is poorly capitalized (for example, a startup corporation) the landlord likely will require a guarantor for the lease. The landlord pursues the guarantor if the tenant goes broke and can't pay the rent. Most guarantors rue the day they sign on the dotted line. Although Frank Sinatra can sing, "regrets, I've had a few, but then again, too few to mention," he probably never was a guarantor stuck with the long-term lease of a bad tenant.

**Tenant Improvements.** The landlord might offer some tenant improvements to entice a tenant to sign the lease. A landlord will only do so if the market is soft and tenants are hard to find for the premises. The landlord then increases the base rent through the first few years of the lease to get repayment of its up-front costs for the tenant improvements. Nothing is free in this world.

**Taking Possession of the Premises.** When the tenant takes possession of the premises, both sides need to be very clear about the condition of the premises. Most leases have the tenant take possession of the premises in "as-is" condition, so the tenant must be doubly satisfied with their condition. From the landlord's perspective, you don't want your tenant to feel cheated, angry and vindictive from day one, so make sure your tenant receives the premises as promised.

**Option Terms.** When evaluating an option for extending a lease term, make sure you understand how rent is calculated. Most options require a fair market rental at the time of the option term, which is fair enough (but the devil is in the details). Tenants: Calendar the time window within which you must notify the landlord of your exercise of an option term! Miss your window and you lose your option.

**Gross or Triple-Net?** There are two basic flavors of commercial lease – gross leases and triple-net leases. In a gross lease, the landlord charges a flat rent that covers all of the landlord's costs associated with the premises. In contrast, with a triple-net lease the landlord charges a base rent, then passes through

to the tenant an additional amount to cover the tenant's share of the building's property taxes, insurance premiums and costs of common area maintenance. Neither type of lease is cheaper than the other. Since nothing is free in this world, the rental for a gross lease just incorporates the costs that would be passed through in a triple net lease.

Note: it's hard to find a true gross lease anymore. This is because most so-called gross leases contain "stops," that is, they are modified triple-net leases in that the tenant pays its share of increases in expenses after lease year 1. Call if you want me to explain more.

**Rent.** You can understand base monthly rent, so I won't belabor the point. Triple-net pass-through charges are more interesting. Nearly every tenant in a triple-net lease will complain of sudden and drastic increases in triple-net costs, for example, costs for major work on the building, miscalculated back utility costs, or higher property taxes. A surprising triple-net bill can tap out a tenant's cash flow and put the tenant in default under the lease. To reduce this risk, tenants bargain for caps and exclusions on triple-net costs. Landlords despise caps and exclusions, however, not least because they make the calculation of rents very difficult. Lastly, note that in a shopping mall, tenants pay an additional amount called percentage rent, which is a piece of their gross profits.

**Maintenance.** Usually a tenant is responsible for maintaining the inside of the premises (including electricity, plumbing, floor slab, windows, front glass and door) while the landlord is responsible for exterior walls and roof. Keep your eyes on HVAC – leases differ on how they treat the costs of maintenance and replacement of heating, ventilation and air conditioning systems.

I hope this article is useful to you. As always, I only glossed over the outlines of the subject. A lease is a major financial commitment so please talk with a lawyer before signing one. Call me if you need to talk more.

## John Wooden:

Be prepared and be honest.

Be quick, but don't hurry.

If you don't have time to do it right, when will you have time to do it over?

If you're not making mistakes, then you're not doing anything. I'm positive that a doer makes mistakes.

Do not let what you cannot do interfere with what you can do.

Things turn out best for the people who make the best of the way things turn out.

Never mistake activity for achievement.

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