

Practical Tips for Commercial Leases

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§ 1. Nonresident owner

Under Code § 55.1-1401 any individual who owns and leases commercial real property within a county or city in the Commonwealth must appoint and maintain an agent who (i) if such agent is an individual, is a resident of the Commonwealth, or if such agent is a corporation, limited liability company, partnership, or other entity, is authorized to transact business in the Commonwealth and (ii) maintains a business office within the Commonwealth. Every lease executed by or on behalf of nonresident property owners regarding any such real property shall specifically designate such agent and the agent's office address for the purpose of service of any process, notice, order, or demand required or permitted by law to be served upon such nonresident property owner.

The name and office address of the agent appointed as provided in this section shall be filed in the office of the clerk of the court in which deeds are recorded in the county or city in which the property lies.

No nonresident property owner shall maintain an action in the courts of the Commonwealth concerning property for which a designation is required by this section until such designation has been filed.

§ 2. Identify the parties

The proper identification of the parties is basic to any contract. Unfortunately, it is often treated too casually with serious consequences later on.

If the tenant claims to be a corporation, an independent check of its corporate existence, and good standing as well as the identity of its officers and directors are important. A communication to the Clerk of the State Corporation Commission in Richmond is time well spent. If the tenant is an individual, his or her marital status should be identified. Consideration should be given to having the spouse sign as a co-obligor where their assets are jointly owned. If the tenant is a partnership, consider having all of the general partners sign the lease. The refusal of any of them to sign will serve as an early warning to the landlord of possible future problems. The time to solve it is before the lease is signed.

A lease that identifies the tenant as “ABC Corp., a corporation to be formed,” where ABC has not been incorporated, is *void*. Do not do it. Have the owners of the company either form the company before signing the lease or sign personally as promoters with right to transfer and novate with the new company after it has been formed.

§ 3. Identify the property

Check the square footage set forth in the proposed lease. If a drawing of the leased space is described in an attachment to the lease, be sure that the drawing is actually attached to all copies of the lease even during negotiations and lease drafts. The drawing should be initialed by all parties.

Mistakes can be made. If the drawing is attached later and one of the parties claims that it is the wrong layout, serious difficulties can result.

§ 4. Use of property

Restrictions on the use of the demised property are strictly construed against the landlord. For this reason, permitted and prohibited uses should be stated with clarity. For example, if the landlord wants to restrict the use to a restaurant business and does

not want any carry out or drive-through window business, then the additional restrictions about carry out and drive-through window business must be stated with precision and clarity. A restriction of use to a “fast food type” restaurant will not preclude the tenant from operating a drive-through window business or carry out business.

Moreover, to simply restrict use to that of a restaurant will not limit the tenant as to the kind of restaurant he can operate. If a landlord wants to limit the number of Chinese restaurants, for example, in the center, then the lease must state that the tenant may not operate the restaurant as a Chinese restaurant or carry out business.

If a tenant wants to be protected from direct competition within the shopping center, then the lease must specify the restrictions in use which the landlord agrees will be included in future leases with other tenants. Moreover, the already existing restrictions, if any, on use by the current tenants must be examined before signing a lease so that the tenant is secure from not only a future competitive business but also from an adverse change in use by an existing tenant. It is likely that a landlord will not allow a prospective tenant to see other tenant leases, therefore, a written declaration by the landlord stating the existence of, or non-existence of, tenant restrictions will have to be relied upon by the tenant.

It is important to remember that in the absence of specific restrictions written into the lease, when economic times are difficult the landlord will put competing stores side by side just to fill up the spaces. This happens more often than one would suspect.

In reference to the assumption and sale of a lease where the tenant is in bankruptcy, a landlord may consider having very specific limits on its use written into the lease. In the event the property is sold in bankruptcy, a restrictive use provision may have a chilling effect on the sale of the lease. This certainly could benefit a landlord.

In order to deal with the problems that a landlord faces in a shopping center where a lease is assumed and sold in bankruptcy, the landlord may consider including a carefully structured tenant mix provision in order to limit the available buyers of the lease in bankruptcy.

Moreover, since the sale in bankruptcy requires adequate future assurances, the lease may contain provisions that spell out what those future assurances will have to be. Moreover, to avoid the “going out of business” sale that may occur in bankruptcy and adversely affect the center, provisions in the lease may be included to limit the time and duration of such sales to minimize any damage to the center.

§ 5. Options for renewal and options to buy

Options for renewal or to buy are strictly construed and are generally

time sensitive. The option must clearly identify not only its precise scope, the time frame within which the option is to be exercised, but also the manner in which it is to be exercised. Options should leave nothing to future negotiation. While it is permissible to leave some non-essential contract terms to future determination, an objective standard for their future determination should be specified in order to avoid having the entire option fail for lack of an essential term. When the tenant exercises his option, he must do so exactly as stated in the lease.

A provision that states “Time is of the essence” should be included to protect the landlord.

An option to renew, or to buy, at a future rent, or price, *to be negotiated* is not enforceable. If the landlord refuses to honor the tenant's effort to renew or to buy, a court would not negotiate or guess what the deal was intended to be. The term of the renewal as well as the rent to be paid (or an objective method to determine the rental) is needed.

If the lease says that the option can be exercised if tenant is not in default, then define the term “default” to be clear that it means after a notice to cure has been given by landlord. With this clarity, case law holds that any default, with or without a prior notice to cure, will bar the option from being renewed.

The time and manner of giving notice to exercise the option should be spelled out. Leases will use either a “no-later-than- date,” or a “window-in-time” technique.

The use of certified mail to give the notice is the most commonly specified method. If, however, the landlord refuses to accept a certified letter, and then later claims he did not receive the notification, the tenant may have to litigate the notice issue. The tenant should allow himself enough time to personally serve the notice of the exercise of his option if the landlord has refused to accept the certified mail. The lease should also specify personal delivery as a method of giving notice.

If the landlord wants to limit the option as to time, a provision for its expiration should be included. Otherwise, a holdover tenant may claim the right to exercise the option.

§ 6. Lease commencement date

If the lease commencement date is to be other than the date of the lease or is related to an event, such as the completion of a tenant's or landlord's improvements to the property, the method for fixing that date should be stated with great clarity.

In some cases, the rent begins even though the unit is not ready. While this is a subject of negotiation, anything that will delay possession of the property to the tenant or the payment of rent should be specified and clearly detailed.

§ 7. Base or minimum rent

It is customary that rent is paid *in advance* of each month. To accomplish this, a clear statement to this effect should be made in the lease. This is necessary to prevent later disputes about application of rent payments. At common law, a payment on June 1st pays the rent for the month of May. Do not omit this clarification in the lease.

Those payments which are to be included within the definition of "rent" should be clearly identified, *e.g., real estate taxes, common areas, maintenance (CAM) and the like*. Accordingly, if a default occurs in those payments, the remedies for a nonpayment of rent apply and the landlord's lien attaches.

§ 8. Rent escalations

The most common form of rent escalation is the one tied to the Consumer Price Index (CPI). The selection of the CPI index is seldom negotiated but it can be important. It should be carefully considered.

A tenant should want to negotiate a ceiling on the increases. Generally, the ceiling will be on total increases or on the amount of the increases per year. CPI increases have a compounding effect which should always be borne in mind. Minimum increases are a popular tool for the landlord to insure that his increases in operating expenses will always be covered.

Another method to deal with adjustments is to negotiate a fixed periodic adjustment or one based on a sliding scale. These can be tied into something other than the CPI if the parties so choose. Pay attention to the compounding effect in negotiating the terms of any of these.

§ 9. Rent concessions

The popularity of rent concessions reflects the current economic factors of supply and demand. Rent concessions are a method for the landlord to entice tenants into a new project without reducing the rent stated in the lease. The landlord's lender will look to the value of the property as measured, in part, by its rental income. It is for this reason that the landlord will not reduce the rent as stated in the lease even though he will let the tenant stay an agreed-upon period of time without paying rent. The net effect is to reduce the overall rent the tenant is paying without impairing the value of the property as reflected in the leases themselves.

§ 10. Percentage leases

Percentage rents are popular in shopping centers and yield a lower base rent to the tenant. When dealing with this type of rent,

one should examine the industry as a whole in that locale and what percentage rents are being paid for comparable space.

Percentage rent is normally tied to the tenant's gross sales. The definition of "gross sales" or such other figure that will be used to compute percentage rent, should be carefully defined. Will "gross sales" include sales taxes and discounts given to customers? The definition is usually a factor of negotiation and the relative bargaining position of the parties.

The timing of the payment of percentage rent is negotiated to fit the situation of the parties. In a higher volume business, a more frequent accounting will yield payments of rent sooner, therefore a quarterly or monthly accounting may be demanded. In some situations, the landlord may accept an annual or semi-annual accounting.

The accounting method to be employed by the tenant and the cost of the audit should be detailed. Moreover, how often the audit will be by a CPA should be considered. Most often, an audit by a CPA, at the expense of the tenant, is an option to be exercised at the discretion of the landlord.

If the success of the tenant's business is an important element to both parties, then a provision for the termination of the lease in the event an agreed-upon level of gross sales is not reached within a certain time frame will provide needed protection for the parties.

§ 11. Net leases

The cost of operating the center or building is important to landlords in setting their rent. If the landlord's expenses are to be paid entirely by the tenant, then the tenant can often negotiate a lower rent. On the other hand, where the tenant wants to pay a flat rent that includes everything, then the landlord must be concerned about the escalation of expenses throughout the term of the lease. This concern will manifest itself in higher rents.

The parties should evaluate the level of services to be provided by the landlord. If the landlord wants to pass on the cost of managing the warehouse/office building to the tenant, the tenant should inquire as to whether the landlord will create a subsidiary management company and charge a separate management fee which in turn will be passed on to the tenant. If the tenant is capable of managing the building himself, there may be a significant savings in cost.

A lease in which the expenses, in whole or in part, are passed on to the tenant are referred to as "net leases," "triple net leases" or "net, net, net leases." These terms should be avoided in writing the lease. The meaning of these terms may vary from owner to owner, realtor to realtor.

The true meaning of these terms lies in the details of the lease and not in these descriptive titles. In negotiating a net lease or triple net lease, the expenses that will be paid by the tenant, in

whole or in part, should be spelled out in detail.

The tenant should examine the language carefully to determine if the landlord's debt service is included. If it is, the tenant should determine if the language of the lease will allow the landlord to refinance the project, thereby increasing his mortgage payment, which he can in turn pass through to the tenant as increased rent. If the base rent is low enough, this may be acceptable to the tenant but the tenant should understand exactly what is provided in the lease.

Uncontrolled management fees, debt service and the like, can be real problems later on for a tenant if he did not realize in advance that this could happen.

Moreover, one should be alert as to whether the automatic rent escalation provisions of the lease will be applied to the expenses regardless of the actual amount.

§ 12. Real estate taxes and proration

Real estate taxes, in whole or in part, are commonly passed on to the tenant. The lease should specify if the tenant will be paying all of the real estate taxes or just the increases of the taxes over an agreed-upon base year.

In addition, the lease should be clear as to whether the tenant or the landlord will pay any special assessments that may be imposed by taxing authorities. Certainly, if the county wants to improve the road in front of the demised property and imposed a special assessment, one needs to know in advance whether that burden will fall on the landlord or the tenant or both.

In addition, how is the tenant's share of the taxes computed? Of course, the parties may, and often do, agree in advance on what the percentage share will be. If a formula is provided, a sample of its actual application should be included to avoid a later dispute over interpretation.

If a percentage figure is used, the source of that percentage figure should be known. If the tenant's pro rata share is based on square footage of space, then the tenant should be mindful of the difference between "leased" space and "rentable" space. Usually, the formula will be based on the relationship between the number of square feet in the tenant's leased area and the total number of square feet in the project or building. If, however, the description of the total number of square feet is tied into the number of square feet that are actually leased as opposed to the total available for rental, the tenant will pay a higher pro rata cost because of unleased space.

It is recommended that the ratio be the number of square feet in the tenant's space as divided by the total "rentable" square footage; and not the total "rented" square feet.

§ 13. Water

If the tenant is to pay for a pro rata share of the water to be used in the entire center or in the whole building, he should know the existing or contemplated business uses of the other tenants. Laundries, car washes, restaurants and the like are notoriously large users of water. The pro rata share of the overall cost of water, based on square footage of the lease space, would be unfair to a tenant who has a modest water use, such as a retail clothing store. Independent metering or a revised formula would be appropriate.

§ 14. Insurance

A landlord wants to be sure that his property is protected and that any potential tort liability is protected by requiring the tenant to maintain a minimum level of liability and property insurance. Such lease provisions should establish not only the amount of insurance but the financial standing of the insurance company to be used by the tenant. A typical lease may require that the landlord approve the insurance company that the tenant plans to use. Any other objective standard would be appropriate so long as the landlord can be sure that the insurance company that tenant contracts with will be in business and able to pay if there ever is a covered loss.

Insurance provisions in a lease normally require the tenant to name the landlord as a "named insured." A certificate each year to prove the existence of such insurance is important to protect the landlord.

The extent of coverage for the benefit of the landlord is a matter to be determined based on the type of property, its use and condition and who maintains it.

The extent of the insurance will be an important cost to the tenant and should be carefully considered as a cost of doing business in that particular space.

§ 15. Rules and regulations

Owners of commercial buildings and shopping centers will want to promulgate rules and regulations for the control of parking, cleanup, garbage, use of the building, hours, etc. Before signing a lease, the tenant should be aware of these rules and determine if there is any substantive rule which will prevent him from functioning later on. For example, if the air conditioning is going to be turned off after 7 p.m. and on the weekends, and you conduct business in your office on the weekends, certainly this should be resolved before signing the lease. If the landlord will charge extra to turn it on for the tenant, the method of calculating those charges should be disclosed and considered.

The landlord will want to incorporate the rules and regulations into the lease including any reasonable modifications thereto. The lease should treat a breach of the rules the same as a breach of the

lease. The tenant will want the modifications to not materially affect his tenancy.

§ 16. Duty to repair

As a general practice, the tenant in most shopping centers or freestanding buildings has the duty to maintain the interior of the property, its heating and air conditioning plant and equipment. The landlord will usually maintain the building, its roof, and the pipes leading into it. The variations on this theme are numerous.

It is important to understand the difference between the duty to repair and maintain as opposed to the duty to replace. For a landlord with an old air conditioner, a provision requiring the tenant to replace as well as repair and maintain will save him a great deal of money and cost some luckless tenant a great deal when the compressor goes bad and has to be replaced.

The obligation of repair should not be left vague or general. The obligation to repair and maintain should be clearly distinguished from the obligation to replace.

In the absence of a contract provision to the contrary, a tenant is not liable for damage to the property which is not caused by his neglect or fault. The absence, therefore, of clear language on this issue could leave the parties in a difficult situation should something go wrong.

Language identifying the party on whom the duty to maintain the property in compliance with all applicable government health, safety and fire codes is imposed as needed.

§ 17. Landlord's liability to tenant

Typically, landlords try to relieve themselves from liability to the tenant for anything they or their employees, or contractors do unless the act or omission was one of recklessness or gross negligence. Tenants generally negotiate this to hold the landlord liable for his negligence. If, for example, a landlord does not protect the water pipes from freezing when the furnace breaks, an exculpatory clause exonerating the landlord from liability except for gross negligence could relieve him of all liability for the loss of tenant's business when the pipes burst.

Moreover, landlords write in language waiving any liability to the tenant for consequential damages, lost profits, etc. This type of clause will usually specifically mention water damage caused by busted pipes, roof leaks, floods, etc.

Other provisions can completely relieve the landlord from all liability for any act except those obligations imposed by the lease.

Still more extreme are provisions which will relieve the landlord from *all* personal liability under the lease and the tenant may only look to the property to recapture any loss he suffers. This is known as a "non-recourse" lease. The effect of this type of clause could be tragic for the tenant. Suppose the landlord has pulled all of the

equity out of the property by refinancing along the way where the tenant has subordinated to the new financing. When liability occurs for which the landlord would otherwise be responsible, under a non-recourse lease, the tenant may be hard pressed to collect his damages from the equity of the property which may, in this example, be gone. Otherwise, the lease proceeds will be the only other source of recovery.

These clauses can be found buried in a complicated lease in more than one place. Care in the lease review should be taken. For example, the non-recourse language may appear in the landlord liability section as well as in the definition of landlord hidden in what looked like an insignificant definition.

§ 18. Assignment and sublease

Traditionally, the landlord wants to control who his tenant will be and require that any assignment or sublease be approved by him in writing before it may occur. Landlords do not want their tenants trading in the leased space as if it were a commodity.

Tenants negotiate this to require the landlord to “not unreasonably withhold such consent.” Generally, these clauses will not define the term “reasonable.” If special circumstances are contemplated for the future, then language to deal with it should be included.

A prohibition of assignment or sublet clause will not stop the owner of tenant corporation from selling his corporate stock to someone else, thereby bypassing the requirement for permission from the landlord. The same problem exists, in part, with limited partnerships also.

The solution for the landlord is to restrict the transfer of any corporate stock in the tenant corporation or any partnership interest without the landlord's consent; or to limit any such transfer to less than a controlling interest. In this way the tenant can bring in a minority partner without the landlord's consent. Mergers, consolidations, dissolutions and liquidations should also be specifically restricted for the landlord's protection.

A typical restriction will state that any such transfer by the tenant, or its owners, partners, or stockholders, will be deemed an assignment or subletting within the meaning of the lease requiring landlord's consent. A failure to obtain that consent will be a breach of the lease.

All restrictions on transfer will be strictly construed against the landlord.

Another item to negotiate here is the right to transfer the lease in a family revocable trust for estate tax planning purposes.

§ 19. Fixtures and trade fixtures

When the tenant leaves the property with wires hanging down, water pipes capped, holes in the walls, etc., the time to have solved

this problem was at the lease negotiation. When a landlord knows that a tenant is going to be installing equipment, lighting, cabinets, freezers, stoves, kitchen hoods, shelving, etc., provision for their final disposition should be made in the lease. If the agreement of the parties is that everything remains when the tenant vacates, then language to that effect should be written.

If, on the other hand, the tenant is allowed to remove equipment, then the manner of their removal should be specified and the condition of the property after their removal should be clearly described. Detail here will solve many problems later.

§ 20. Condemnation clause

It is typical in today's commercial market that the lease provides for termination of the lease on condemnation of the demised property, and that the tenant cannot recover any lost value in the lease from the landlord. Unless the condemnation clause in the lease prohibits it, a tenant can recover for those lost fixtures which under the lease he had the right to remove. If the annexed personalty is a fixture under Virginia law, its ownership is taken by the condemning authority and included in the award to the landlord. The tenant's right to recover for the fixture's value is controlled by the contract. If the lease permits the tenant to keep ownership and to remove it at the end of the lease, which right has now been taken by the condemning authority, the tenant can recover his damages for the fixtures from the total award made to the landlord.

In the event of a partial condemnation, the parties should negotiate either a manner to terminate the lease or a rent abatement. The lease can give the tenant the right to terminate if it chooses or to reduce its rent. The landlord may want this right also. The rights of the parties in condemnation in terms of a lease provision are a function of the relative bargaining power of the parties.

§ 21. Casualty—Total or partial

Where the property is destroyed by casualty, typical leases will give the tenant the right to either terminate the lease or take a rent abatement until the property is fixed if the cost of restoration is beyond an agreed-upon dollar limit or not reparable for more than a certain number of months. The dollar limit or a description of the state of destruction at which the tenant can terminate the lease becomes important. If the landlord has to rebuild because of the requirements of his lender, he will not want the tenant to leave. On the other hand, most tenants cannot remain out of business for too long.

The landlord will not want the tenant to terminate the lease while the tenant will want that option left open to him.

Whether the landlord is obligated or not to restore the premises is important. For a landlord to agree to rebuild, he should be

confident that his insurance is adequate.

§ 22. Jury trial

Landlords traditionally want the tenant to waive the right to a jury trial. The attorney for the landlord should include this in his leases.

§ 23. Subordination and nondisturbance

In order for the landlord to refinance his property, he must require the tenant to subordinate to any such new financing. Otherwise, the lenders will not agree to make the loans.

An enticement that can be given to the tenant to agree to this is a non-disturbance provision that requires the lender to agree to not terminate his lease (assuming tenant is not in default), but to let it continue on even if there is a foreclosure. This is a sensible and commonplace provision.

Without this protection, a subordination of the lease could result in the tenant's lease being terminated in the event of landlord's default on his mortgage or could force the tenant to renegotiate a higher rent with the new owner after a foreclosure sale. With the non-disturbance clause, the tenant has some protection against losing his business because the landlord failed to pay his mortgage.

The lender will want the tenant to agree to attorn to the lender or a subsequent purchaser in the event of a default, takeover, or foreclosure sale. This is standard.

§ 24. Submetering, energy allocation equipment and ratio billing

Written authorization in the lease is mandated by Code § 55.1-1404 in order for a landlord to undertake submetering or use energy allocation equipment which is not owned by a public utility or ratio billing. If the landlord plans or contemplates the installation of such equipment or system, then the lease should contain language covering the use thereof.

§ 25. Acceleration clause

It goes without saying that a landlord should include an acceleration of rent clause in the lease in the event the tenant breaches, and the landlord has to take over the property. Without it, a landlord cannot recover future rents until they accrue.

In view of the comment by the Virginia Supreme Court holding an acceleration clause to be an unenforceable penalty, some language should be added to the acceleration clause one drafts to protect the landlord. The main area of concern is that the provision takes into account the difference between the rent paid

under the lease and the future market rental value of the property as well as the likelihood of re-letting. I suggest that your provision mention in some fashion the nature of the market, and the parties' reasonable expectations as to future market values and likelihood of re-letting in the event of a breach by the tenant. Such language should establish clearly that parties have taken these factors into consideration and agree that the acceleration of rent is not a penalty but a reasonable estimation of future damages.

It is recommended that the language contain a formula that yields something less than a full balance of term acceleration. For example, in a lease with 10 years or more remaining on the tenant's breach, the acceleration would be a percentage of the remaining years, *e.g.*, 70% of the remaining years reduced to present value as liquidated damages. If there is less than 10 years but more than five years, then 80% of the remaining years reduced to present value would be accelerated. If less than five years remains, then 90% of the remaining years reduced to present value would be accelerated. In this way, the court can see that real consideration to the factors has been given.

It is further recommended that landlords add a provision that waives the tenant's right to claim that an acceleration clause is a penalty. Such a written waiver is binding.