SMALL LEASES WORKSHOP[1]

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I WHAT IS A "SMALL" LEASE?

A There are many objective ways to characterize a lease as "small," most with varied levels of usefulness. Some of the objective ways of measurement are discussed in detail below. For purposes of this article, however, it is more useful to define a "small" lease by its reflection in the eyes of the parties to the lease and their counsel. Accordingly, a lease is considered "small" when, due to the nature of the details of the transaction and the parties to the transaction, counsel for either party is called on to provide an extra layer of analysis to that which is typically provided. Namely, superimposed over the typical obligation to review, discuss and negotiate the terms and conditions of the lease, is the obligation of counsel to focus on only those issues that are likely to have a direct and significant impact on the client's business operations and economic bottom line and to view the negotiation through a "market" lens, being sure to modify any points of negotiation to fit the relevant bargaining strengths of the parties and the economics of the deal.

That is not to say that some lesser level of review is required in a small lease - the level of substantive review is the same. Counsel for a party to a small lease, however, provides the most value to its client when able to discuss the terms and conditions of the lease and their likely impact on the client's business operations *in the context of the deal as a whole and the relative market in which the property exists*. While all leasing attorneys should offer advice within this context, when dealing with a small lease, the margin of error is smaller. Although the size of a lease is relevant to both the landlord and tenant, because the norm is for a landlord to circulate the same lease form for all deals in any particular location, regardless of size, this article will focus on the more complex role of representing the tenant in a small lease, while providing relevant landlord concerns where notable.

B The following are some common examples of what may be considered a "small" lease as the term is used in this article. Some or all of the following factors may be present in any single deal and will influence each party's view of the "size" of the deal.

i) **The relative size of the premises is small when compared to the size of the building and/or the landlord's portfolio.** Square footage alone is not always a sufficient criterion for determining a small lease. Rather, the leverage resulting from the size of the space is more informative. While most can agree that a 2,000 square foot space is small, there may be great disagreement as to whether a 15,000 square foot space is small. In fact, the average size space leased in Boston in 2006 was 18,000 square feet. Consider the relative leverage of a tenant leasing 15,000 rsf in a 30,000 rsf building versus the leverage of a tenant leasing 15,000 rsf in a 500,000 rsf complex.

[1] This article focuses on a typical multi-tenant commercial office lease, although many of the concepts are also applicable on other commercial leasing contexts.

ii) **The total rent due throughout the term is small and does not support more than a minimal amount of transaction costs, including time spent by the client and legal fees.** Neither a landlord nor a tenant desires to expend time or money that is disproportionate to the economics of the deal. This is usually the case when the square footage of the space is small, but may also apply for larger space where the rents are low such as may be found in warehouse or industrial space. Also, in such a lease, the maximum exposure for some tenants may the aggregate rent due for the term. That is, although they are unable to operate at the premises for whatever reason, they always have the option of moving out and operating elsewhere.

iii) **The term of the lease is short.** When the lease term is short, not only is the total rent due throughout the term likely to be small (see discussion above), but the exposure of the parties is limited by the decreased likelihood that the attendant risks will surface during the shortened period of time. Also relevant is the fact that an undesirable situation may be bearable for some period of time, even if it would not bearable for a term of five or ten years.

iv) **The lease is of minimal importance to the client.** This factor often overlaps with the other factors cited above leading to the same determination, particularly for a landlord client. This factor, however, becomes a major point of conflict in any deal when the lease is, despite being relatively small in objective terms, of major importance to the tenant or the tenant is highly risk averse and is willing to invest a disproportionate amount of time and money in order to avoid as much risk as possible, paying little regard to likely impact. Thus, the lease is small to the landlord but NOT small to the tenant. For example, in the eyes of the tenant for whom the space represents its sole location and/or the heart of its business operations, the ramifications of a "relocation clause" are the same whether the space is 2,000 square feet or 50,000 square feet. While the duration of the attendant interruption from any such relocation might be less for the smaller space (that is, the move may be accomplished more quickly), the impact on the tenant may be equally unacceptable. Counsel's role in this situation is made more complex because of the conflicting views of the "size" of the deal.

II THE ATTORNEY'S ROLE

A **Letter of Intent**. It is at the letter of intent stage where many of the critical business terms of the lease are determined by the parties. In many leases, counsel are often not involved until after the letter of intent has been signed and the lease has been drafted and circulated. Regardless of when counsel is involved, a complete and accurate review of the signed letter of intent and confirmation that it has been properly incorporated into the lease is a crucial part of counsel's role in representing both the tenant and the landlord in any lease. In the situation where counsel is involved during the letter of intent stage, counsel should be sure that the letter of intent, which is most likely non-binding, does not harm the client's position going forward, and that the failure to address certain points does not imply a waiver of rights unless intended. Silence in the letter of intent does not typically imply a waiver of the point left unaddressed, except with respect to certain "special" rights as described below. Often the parties agree to a shortened description in the letter of intent of the relevant points, but as long as the letter of intent is non-binding and does not *contradict* the tenant's position on any particular point, this course of action proves to be an efficient way to proceed to the next step in the leasing process where the lease is to be drafted and circulated. Except for matters of absolute necessity to the tenant, it is not realistic or efficient to attempt to negotiate heavily the letter of intent. If the concerns raised below are not addressed in the letter of intent, they should be addressed in the lease. Commonly addressed in the letter of intent are the following:

i) **Parties**. Confirm that the entities listed are accurate. It is not uncommon that the incorrect tenant entity is identified in the letter of intent and this can lead to frustration for both landlord and tenant. The landlord will want to confirm that the identified tenant is the entity for which creditworthiness has been reviewed and approved, and the Tenant must be aware that the entity identified as "Tenant" is generally the only party with a legal right to occupy the premises. Each party should be sure that, unless intended, no individual is stated to be the tenant or has any liability under the lease.

ii) **Premises**. Confirm that the rentable area is accurate and that the location of the space is identified with sufficient specificity. A floor plan may be attached but is more typically provided at the lease stage. Prior to lease execution, the tenant may want to confirm the rentable area of the premises with its architect. It is important that the tenant understand that rentable area is not the same as usable area and the relevance of the difference.

iii) **Term & Commencement Date**. It is essential that the parties be clear about when the term begins. Vague language can result in extended lease negotiations, and at times, results in no lease being agreed upon. If it is an "as-is" deal and the space is vacant, then the commencement date is often fixed and the term expires on a fixed date. If there is work to be done by the landlord, or delivery is contingent upon an existing occupant vacating the premises, then the term should not commence until substantial completion of the work and delivery of the space to the tenant free of prior occupants. The commencement date provision of the lease will need to incorporate these concepts and will be a floating date. Often an estimated commencement date is specified as to when these conditions are likely to occur, but there is no mention of the rights of the parties in the event of a delay in delivery. This is fairly typical in a letter of intent but needs to be addressed in the lease This issue is addressed in greater depth below.

iv) **Rent Commencement Date**. If there is a "free rent" period, it should be so specified. If the commencement date is floating, then the free rent period should apply only after the commencement date is determined. A fixed rent commencement date coupled with a floating commencement date can eliminate the free rent period completely.

v) **Initial Improvements.** The letter of intent may contain a general description of the improvements to be made to the Premises (and other areas of the project). When possible, these should be accurately and completely described by lease execution. If they remain to be determined after the lease is executed, the scope of landlord's approval rights should be clearly identified and the lease should require the landlord to be reasonable. If the tenant has concerns that its improvements are atypical and may not be approved by the landlord, this should be raised as early in the deal as possible.

vi) **Base Rent.** Confirm rates, increases and dates of increase are accurate.

vii) **Additional Rent**. The parties must specify how operating expenses and taxes will be handled and determine the relevant base year, if any. It is important that the tenant understand additional rent as it is just as important as the negotiation of base rent. It can have a major impact on the economic value of the lease to either party. A tenant should obtain historical data on the costs and increases for the building in order to get a sense of what these costs have been in the recent past. While heavy negotiation of this provision is not likely to prove useful at the letter of intent stage, there are some significant provisions that should be addressed during the lease negotiation and which are addressed in greater depth below.

viii) **Hours of Operation**. The parties should have agreement as to the hours when HVAC will be provided and whether the cost is a part of operating expenses or is a separate charge. If the building hours are inconsistent with the tenant's business operations, then there may be significant additional cost to the tenant for overtime services which could impact the economic valuation of the lease by the tenant. Further, if tenant's business operations require it, the tenant must confirm that overtime services are available at all necessary times and what the likely cost will be.

ix) **Use**. The tenant's proposed use must be permitted at the space, but the use permitted in the lease should not be so specific so as to eliminate flexibility in connection with subleases and assignments. For example, "general office use" is preferred to "general office use for the operation of a software development firm" the latter of which may be acceptable to the tenant but will severely curtail the tenant's ability to assign or sublease. A tenant also needs to understand that merely because a use is permitted under a lease, it does not mean that use is permitted under applicable law. A landlord will want to preserve a proper tenant mix and limit the uses in its building in compliance with laws.

x) **Parking**. If any is provided at the project, it should be specified (often handled in terms of a parking ratio), including cost, location and exclusivity. This issue may be of varying importance to the tenant but where parking is crucial, the terms should be addressed in detail.

In addition to the foregoing items, when intended by the parties, the following terms are also addressed in the letter of intent, and failure to do so is generally interpreted as an agreement to omit the following items from the lease:

1. Premises Expansion Rights
2. Term Extension Rights
3. Lease Termination Rights
4. Premises Contraction Rights

The significance of these "special" rights should not be underestimated by either party, regardless of the size of the lease. They are often crucial in determining the flexibility of the lease as it relates to a tenant's business plans.

B **Understanding Tenant's Business**. It is crucial that counsel be familiar with the tenant's business and day to day operational needs and plans for the future. Some important information that should be obtained from the tenant is as follows:

i) Are there any contemplated corporate transactions which may implicate the assignment and subleasing clause? If so these need to be considered and addressed.

ii) If the tenant is aware of an impending financing, counsel should review the lease to confirm that there are no impediments to the financing, including landlord liens that might interfere with the security interest that will be granted in connection with the financing.

iii) Counsel must fully understand what will be done at the space - is the use permitted under the lease and by law? does the space provide sufficient electrical capacity and other utilities to support tenant's planned use?; who will be occupying the space - is this party permitted to occupy the premises under the assignment and subleasing clause?; when will the offices be open for operation - is this consistent with the hours of operation of the building?; what is the

impact on the tenant's business of an interruption of services or a relocation clause?; what improvements or upgrades are necessary for tenant to operate in the premises?

While the negotiation of tenant remedies or rights on some of these items may be unrealistic in a small lease, the tenant needs to be advised of the risks prior to lease execution so that it may consider alternative ways to protect itself and determine whether the premises are appropriate for its needs.

iv) Counsel should have a discussion with the tenant as to any issues of particular importance, from the tenant's perspective, which is likely to include any past negative experiences that the tenant representative has encountered in prior leases.

C **Manage Tenant Expectations**. Many small leases involve client contacts who are not real estate professionals, but instead are officers or employees of the tenant entity and have been "tagged" as the party responsible for finalizing the lease. While they may be an excellent CFO or CEO or office manager, such a person's familiarity with the commercial leasing market is likely limited and they will be relying heavily on counsel's opinions and advice. In such a case, the need to review and explain the lease is heightened due to the lack of familiarity and the fact that it is common for many lease provisions to be counterintuitive to a layperson and seemingly unfair or unequal. It is also important to explain certain realities to the client. Namely, the reality is that most landlord's use the same lease form for all leases, regardless of size; that the form is drafted heavily in favor of the landlord; that the landlord has an interest in uniformity of leases so as to be able to run the building without having to read each lease line by line each time an issues arises; that the landlord's ability to accommodate a tenant may be limited by the landlord's lender; that uniformity of leases may make the building more marketable to prospective purchasers; that the landlord will be less inclined to make changes to the lease or spend time and money in connection with a tenant's review of the lease when it considers the lease small; and that when the market is robust, there may be other tenants willing to sign the lease with minimal comment.

D **Review and Discuss the Lease with Tenant**. Even though many of the provisions in a small lease may not be subject to negotiation, it is important that counsel review the terms and conditions of the lease with the tenant and explain the major rights and obligations and answer any questions that the tenant may have in order to confirm that the tenant understands the lease as a whole. This may also trigger additional concerns of the tenant and may highlight issues that are simply unacceptable to the tenant, causing the tenant to seek alternative space. In such a situation, this would be a favorable result to the tenant as compared to the situation in which the tenant is in a lease that does not allow the tenant to conduct its business. In a small lease counsel's role may be one of educator more than negotiator, and the goal is to eliminate surprise after the lease is signed.

E **Advise Tenant of Risks and Likely Areas of Negotiability.** Armed with a firm understanding of the lease and the impact of its terms and conditions on the tenant's business operations and economic bottom line, counsel must advise the tenant of the resulting risks and advise the tenant which of the more substantive risks are likely to be subject to success in negotiation with the landlord. "Likely success in negotiation" is a subjective judgment to be made by counsel and will be based on consideration of the likely impact of the negotiated change on the landlord's bottom line, the landlord's likely level of tolerance for expending time and money engaging in a substantive negotiation, and a determination of whether the requested change is consistent with what the market will bear. At either end of the decision spectrum, sit (a) issues that are of absolute critical importance to the tenant but are not considered to be "market", and (b) issues

that are of minor significance to the tenant but which are clearly "market" changes and would likely be acceptable to most landlords.

III SUBSTANTIVE REVIEW.

A **Critical Issues**. In reviewing the lease counsel should focus on the key points that are most likely to impact the tenant on an operational level and with respect to the tenant's economic valuation of the lease. Counsel, based upon an evaluation of (i) the qualitative resulting impact on the tenant, (ii) the probability that the risk will surface during the term, and (iii) the likelihood that the point is negotiable based on the relevant leverage and market conditions, will provide comments to the landlord. In addition to the issues that are discussed above which may have been addressed at the letter of intent stage (see discussion above concerning the review of the signed letter of intent and its incorporation into the lease) some of the critical points in a lease are as follows:

i) **Commencement Date and Delivery Issues**.

- Is the commencement date fixed or floating?
- If floating what are the triggers for commencement?
- Even where the space is being delivered "as-is" the tenant should require that it be vacant, free of personal property and debris, broom clean.
- The tenant should require that the building systems be in good working order and condition upon delivery.
- Will the space be delivered in compliance with laws?
- Will the tenant require early access for purposes of installing its tel/data wiring and cabling?
- The parties should agree to enter into a commencement date agreement memorializing the date of commencement when not fixed in the lease.

ii) Initial Construction.

- Where the landlord is doing the work, there will need to be specific plans and specifications describing the work which have been carefully reviewed and approved by the tenant. There should also be a deadline for completion and the parties need to understand what their rights and remedies are in the event of a late completion. Late delivery of the space could severely impact the tenant in its relocation plans and could also cause unanticipated holdover costs or possible eviction at its current space. In such a situation, the tenant should seek a rent abatement for the delay and/or a termination right if the delay continues for an unreasonable period of time.
- Where the tenant is doing the work, the landlord will need to approve the plans and specifications and tenant's contractor. In such a situation, the rent commencement date is likely a fixed date and timing is of great importance to the tenant. Accordingly, there should be a limit on landlord's time to respond to tenant requests for approvals and a requirement that the landlord be reasonable in making such a judgment. Any delay in approval of the plans or the contractor translates into a day for day penalty equal to daily rent. Also, Tenant should be aware of any requirement that it hire union labor in connection with its alterations.

iii) **Improvement Allowance**.

- If the Landlord is doing the work at the tenant's cost but has agreed to provide a "Tenant Improvement Allowance" then there needs to be a price protection built into the lease in order to protect the tenant from cost overruns. If the scope of work is too small to obtain

multiple bids, then the tenant will want other protections including the right to modify its plans if the estimated cost is too high and/or a cap on its exposure if the landlord's estimate proves inaccurate. The tenant should beware of unanticipated construction management fees of the landlord that will be deducted from the Allowance.

- If the tenant is doing the work and is entitled to an Allowance, counsel should confirm that the tenant has the right to draw on the allowance monthly and that the conditions to draw are reasonable. Also, tenant should confirm what the Allowance may be used for, i.e. engineering and design? moving costs? cabling and wiring? furniture and equipment? may it be applied towards rent if unused? The tenant should beware of potential construction management fees of the landlord that may be deducted from the Allowance.

iv) <u>Use and Hours of Operation</u>.

- Is the contemplated use permitted?
- Will the tenant be the only entity occupying the space? Is it incubator space? Are there portfolio companies?
- Are the building hours consistent with the tenant's work hours?
- Does the lease permit tenant 24/7 access and use?

v) **<u>Electricity</u>**.

- Is there sufficient electrical capacity for tenant's use?
- How is the cost of electricity handled? Is the cost included in the base rent? Are there separate meters measuring tenant's consumption? If not, is tenant's share based on a fair allocation? Are there heavy users for whom tenant will be bearing a disproportionate burden?

vi) <u>Landlord Services and Interruptions.</u>

- Are all expected services provided under the lease? HVAC, janitorial, elevator, security.
- What is the availability and cost of overtime services?
- If there is no recourse to the tenant for interruptions in services, be sure to advise tenant to obtain business interruption insurance.

vii) <u>Building/Premises Repair and Maintenance</u>.

- Typically, Landlord is responsible for the property and the building, its structure and systems, and the tenant is responsible for the interior of the premises.
- If the lease provides for the tenant to be responsible for the maintenance of any systems serving the premises, the tenant should be aware of this and should explore the associated costs.

viii) **<u>Additional Rent</u>**.

- Confirm that the base year is correctly identified.
- A 'gross-up" provision must be included and must apply to the base year.
- Confirm the manner of payment and how and when the amounts are reconciled annually after actual amounts become available.
- The tenant should have a right to audit the operating expenses.
- Also, be sure to provide for exclusions of inappropriate charges from operating expenses.

ix) <u>Exit Strategies; Assignment and Subleasing</u>.

- Unless the tenant was able to negotiate a termination right at the letter of intent stage, it is likely that the tenant's only option when its seeks to exit the premises, is to assign or sublease.
- It is imperative that landlord's consent should not be unreasonably withheld, conditioned or delayed.
- The tenant should seek the right to assign or sublease without landlord consent to related parties (affiliate transfers) and in connection with mergers or asset sales provided a certain net worth test is met. Neither the profit provision nor the recapture provision (see below) should apply to such a transfer.
- Does the landlord have the right to share in the sublease profit? Typical is a 50/50 split. The tenant should have the right to deduct its out of pocket costs before sharing the profit.
- Does the landlord have the right to recapture the space? If so, there should be a relatively quick time period during which landlord must exercise this right.

x) **<u>Defaults and Remedies</u>**.

- The tenant should have the right to notice and a reasonable cure period before being deemed in an "Event of Default." Typical is 10 days for payment defaults and 30 days for other defaults.
- If an Event of Default occurs and the lease is terminated, the tenant should make the landlord whole and give the landlord the benefit of the bargain which the parties negotiated. Beware of liquidated damages provisions that permit the landlord to collect the full amount of rent due without having to deduct the fair market rental value.
- Does the landlord have a duty to use reasonable efforts to mitigate its damages?

xi) Attorneys Fees.

- Although often placed in the boilerplate language section, it is very important, particularly in a small lease, that the lease provide for an award of attorneys' fees to the prevailing party in a lease dispute. Leases often include such a provision for the benefit of landlord, but the value to the tenant for a mutual provision should not be overlooked. In any dispute under the lease, the tenant is unlikely to escalate the dispute to the point of hiring counsel unless the matter is of great financial significance due to the likely cost of attorneys' fees. A mutual provision of this nature will make it more likely that the tenant will be able to pursue legitimate disputes under the lease regardless of size.

B **<u>PROVISIONS TO WATCH OUT FOR</u>**. In addition to a review of the foregoing key points, counsel should also note any of the following provisions and attempt to negotiate them out of the lease:

i) **Relocation**. If the tenant does not succeed in deleting such a provision, it should obtain some limits on the landlord's right to relocate including when and how many times it may done during the term, a reimbursement of tenant's out of pocket costs incurred in connection with the relocation, protection that the new space will be similar to the existing space and that the improvements will be the same.

ii) **Landlord Termination Rights** (other than in connection with fire, casualty and eminent domain proceedings).

iii) **Stock transfers being deemed subject to assignment/sublet requirements**.

iv) **Personal Guarantees**.

v) **Landlord's Lien**.

vi) **Specific Performance**. More leases are including a limitation on the rights and remedies of tenant in the event that the landlord withholds its approval under the lease and the lease provides that the landlord will not unreasonably withhold such approval. In such a case where the tenant asserts that the landlord is being "unreasonable" in contravention of the lease, the landlord limits the tenant to a right to pursue specific performance. Whether this has become a "market" provision is debatable but in any case, if the tenant cannot negotiate the provision out of the lease, it should seek an expedited arbitration process to reach a quick and inexpensive result or risk losing any interested subtenant to delay.

vii) **Complete Acceleration of Rent Following a Default**. While this is enforceable in Massachusetts, it is not a market provision and can have harsh results for a tenant.

IV. CONCLUSION.

Negotiating a small lease on behalf of a tenant can be a difficult task. It involves a heightened level of analysis and market knowledge due to the decreased tolerance of the parties for the expenditure of time and money in connection with any negotiation. It requires counsel to walk a fine line in which counsel advises the client as to risks that are likely to impact its operations, while at the same time providing a realistic and efficient approach to the lease negotiation. Counsel must have a feel for the relative leverage of the parties and the current leasing market and must have a deep understanding of the tenant's day to day needs and concerns. In a small lease, the goal can not be to get a lease that is "fair" to both parties and that addresses every likely contingency and event. The goal is to provide the client with a workable lease at a cost (both in terms of time and money) that makes sense in light of the deal terms, the economic value of the lease, and the client's risk tolerance. There may be the occasional client who is so risk averse that it is willing to negotiate the lease as much as the landlord will bear, regardless of the cost. This is a rare situation. For all other clients, counsel must look for the point where the law of diminishing returns begins to apply and the value of time and money expended on the review and negotiation of the lease begins to out weight the likely value to the tenant of further revisions.