

OREGON STATE BAR REAL ESTATE LAND USE 2013 SUMMER CONFERENCE

PRACTICAL TIPS FOR NEGOTIATING LEASES

Friday, August 9, 2013: 1:15pm Breakout Session

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I. Delivery of Premises.

A. Definitions.

1. Description of Premises.
2. Description of Project/Retail Center/Office Building.

B. Condition of Delivery.

1. Landlord's Objectives.
 - a. Premises delivered "as is, where is", subject to Landlord's Work, if any.
 - b. No Landlord obligations regarding the condition of the project outside of the Premises.
2. Tenant's Objectives.
 - a. Premises must be suitable for Tenant's intended use.
 - b. Building systems serving the Premises must be in good working order.
 - c. Premises is delivered in compliance with applicable laws, including ADA.
 - d. Project sufficiently complete for conduct of Tenant's business.

C. Construction Issues.

1. Typical improvement construction scenarios.

- a. Turnkey -- Landlord constructs shell and all interior improvements required by Tenant at Landlord's sole cost.
- b. Landlord builds shell, building standard improvements and tenant improvements, with Tenant receiving a construction allowance and reimbursing Landlord for the difference, if any.
- c. Landlord builds shell and Tenant, at its cost, constructs interior improvements.
- d. Tenant constructs building and interior improvements at Tenant's sole cost and expense (typical ground lease).

2. Landlord's Objectives.

One of Landlord's principal motivations is to collect rent as soon as possible. Where Landlord is responsible for constructing the tenant improvements, Landlord can: (i) control the process, (ii) complete construction as soon as possible, and (iii) often earn a fee (which Landlord will argue is compensation for bearing the construction risk). Landlord's goal in negotiating a build out provision is to:

- a. Fix the rent commencement date on the date the improvements are substantially complete, notwithstanding the requirement to correct punch list items.
- b. Include a definition of "Tenant Delay" to protect Landlord from delays in completing construction due to the failure of Tenant to timely perform.
- c. Treat Tenant's acceptance of the Premises as Tenant's acknowledgment that the Premises are in good condition subject only to latent defects and punch list items, with a specific limitation on the period within which Tenant can ask that such latent defects and/or punch list items be corrected.

3. Tenant's Objectives.

Tenant wants high quality improvement at low costs. Tenant does not want to pay rent before the tenant improvements are

completed. Tenant's goal in negotiating a build out provision is to:

- a. Establish specific standards for the quality of Landlord's work.
- b. Eliminate or limit Landlord's fee for construction administration.
- c. Require competitive bids from subcontractors in each trade.
- d. Require that Landlord present Tenant with a detailed estimated cost breakdown. To the extent Landlord is providing a tenant improvement allowance with respect to only a portion of the tenant improvements (with Tenant paying all amounts in excess of the allowance), the cost breakdown should be reviewed to determine if any already completed improvements are included.
- e. Define "Tenant Delay" narrowly. Tenant must be sure the construction schedule is realistic, and that Tenant is given advance notice of a potential Tenant Delay and a period to cure such potential delay. Further, Tenant should only allow Landlord to exercise its remedies to the extent a Tenant Delay actually causes a delay in construction.
- f. Obtain the right to enforce warranties and guaranties directly.

4. Description of Improvements.

Ideally, final plans and specifications will be attached to the lease. If this isn't possible, the parties should attach some description of the improvements and establish a procedure for approval.

5. Performance of Work.

- a. Landlord.
 - (1) Greater construction expertise.
 - (2) Multi-tenant building.
- b. Tenant.

- (1) Minor work -- control costs.
 - (2) Uniformity required for national chain.
 - c. Acceptance of Work.
 - (1) "substantial completion" -- minor punch list items which do not hinder Tenant's full use and operation of the premises.
 - (2) Punch list -- preparation procedure.
 - (3) Effect of failure to specify a defect.
 - d. Delivery.
 - (1) "Pre-delivery" notice?
 - (2) Tenant remedy for late delivery -- daily penalty fee or free rent/termination right if delay past drop dead date.
 - (3) Landlord remedy for Tenant delay -- accelerate obligation to pay rent one day for each day of Tenant delay.
- 6. Tenant Improvement Allowance Reimbursement Procedures.
 - a. Lump sum payment or "construction" draws.
 - b. Preconditions for disbursements.
 - (1) Issuance of certificate of occupancy.
 - (2) Receipt of all lien waivers.
 - (3) Architect's certificate that work completed in accordance with plans and specifications.
 - (4) Tenant opened and paying rent.

II. **Key Dates.**

- A. Commencement Date.
- B. Rent Commencement Date.



OUR LAWYERS COVER A LOT OF GROUND.

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1. Landlord's delivery of Premises.
 2. Landlord's substantial completion of Landlord's Work.
 3. Tenant opens for business.
 4. A specified number of days after Tenant obtains building permits.
- C. Expiration Date.
1. Tie to Rent Commencement Date.
 2. Extend expiration date to a convenient time of the year.
- D. Tenant's Due Diligence Termination Rights.
1. Building permit approval/sign permit approval.
 2. Title Review.
 3. Environmental Review.

Landlord practice pointer – Tenant termination rights should have a “use it or lose it” provision.

- E. Extension/Renewal Options.
1. Exercise window – Landlord re-leasing time.
 2. Void if Tenant defaults/assigns/subleases.
 3. Rental Rate.
 - a. Fixed at lease execution.
 - b. Greater of fair market rent or rent charged prior to exercise.
 - c. Discount for no transaction fees?
 - d. Arbitration – baseball vs. split the baby.

III. Use Clauses.

- A. Permitted Uses.
- B. Exclusive Uses.

- C. Prohibited Uses.
- D. Hazardous Substances.

- 1. Landlord's Objective.

- Landlord only responsible for the presence of Hazardous Substances on the Premises prior to the date possession of the Premises is delivered to Tenant to extent remediation required by applicable laws.

- 2. Tenant's Objectives.

- a. Tenant only responsible for the presence of Hazardous Substances on the Premises as a result of an act of Tenant.
 - b. Remedies, including abatement of rent and termination rights, for closure due to Hazardous Substance not caused by Tenant.

IV. **Assignments and Subleases.**

- A. Distinction Between Assignment and Sublease.
- B. Landlord's Perspective.

- Landlord wants to be able to control who occupies the Project and for what uses. Occupants must be creditworthy, not adversely affect the reputation of the building, not increase Landlord's ownership risks or adversely affect other tenants of the building or project.

- C. Tenant's Perspective.

- Tenant's obligations will continue even though Tenant's circumstances change, such as the death of an individual, a downturn in Tenant's business, a change in the retail tenant's concept or a merger or consolidation of a corporate tenant resulting in the space becoming unnecessary. Tenant wants the flexibility to find other users to occupy all or a portion of the space and assume some or all of Tenant's remaining obligations under the lease. In addition, the other provisions of the lease (such as the lease's use clause and its restrictions on alterations) must be flexible.

- D. Restrictions on Assignments and Subleases (sole discretion vs reasonable).

- E. Circumstances in which it is reasonable for Landlord to withhold Landlord's consent.
1. The transferee's financial condition is inadequate.
 2. The transferee's proposed use is different than Tenant's use.
 3. The nature of the proposed use may result in: (i) an increase in insurance premiums, (ii) an increased risk with respect to the use or release of hazardous materials in the building or project, (iii) increased likelihood of damage or destruction, (iv) increased density or pedestrian traffic through the building or project, or (v) the installation of new tenant improvements which are incompatible with existing building system components.
 4. The expected percentage rent for the transferee's business is less than that of Tenant.
 5. The transferee is a labor union, foreign or domestic governmental entity, public utility or tax-exempt organization.
 6. The transferee is an existing occupant of the building or project, or a person or entity Landlord has dealt with previously with respect to leasing space in the building or project.
 7. In the case of a sublease, the monthly rental and other economic concessions result in the effective rent being less than the monthly rent Landlord is asking for similar space in the building or project.
 8. In the case of a sublease, the proposed subletting would result in more than a specified number of subleases of portions of the premises being in effect at any one time or more than a specified number of subleases during the term of the lease.
- F. Landlord Recapture Rights.

1. Landlord's Perspective.

Because of the importance of controlling the Project, Landlord will often include a "recapture" clause in the lease. If Tenant seeks Landlord's consent to an assignment or sublease under a recapture clause, Landlord has the option to "recapture" the space, terminating the lease. By recapturing the space, Landlord will release Tenant from any further liability under the lease. Landlord will presumably exercise this option (and forego having Tenant remain liable on the lease) if

Landlord wants control of the space or if Landlord can relet the space at a higher rent.

2. Tenant's Perspective.

Tenant is in a difficult position of having to market the space subject to Landlord's ability to kill the deal at the last minute. Tenant can minimize this problem by requiring Landlord to decide whether to exercise Landlord's recapture option earlier in the process.

- a. Lease to have a clear (and short) time period within which Landlord must exercise its recapture option.
- b. Ability of Tenant to withdraw its request to assign or sublet if Landlord notifies Tenant that Landlord intends to terminate the lease.
- c. In the case of a proposed sublease, Landlord's recapture right only applies to the sublet space and the lease will be amended to reflect the reduced size of the leased premises, with the rental rate and Tenant's share of taxes and insurance adjusted accordingly.

G. Exceptions from Restrictions on Assignment or Subletting.

1. Transfers by an individual tenant to an entity controlled by Tenant.
2. Transfers by Tenant to an affiliated entity.
3. Transfers by way of merger, consolidation or the acquisition of assets or capital stock (however, if the lease is a retail lease, Landlord will want to condition the approval of such transfer on, among other things, the proposed transferee having sufficient retail experience and there being no change in the use of the Premises).

H. Bonus Rent.

1. A "bonus" rent clause entitles Landlord to receive some or all of the rent or other consideration payable by a transferee as a result of the lease transfer to the extent the new rent exceeds the existing rent.

2. This additional rent may be in the form of a lump sum payment in the case of a lease assignment or higher subrent in the case of a sublease.
3. Landlord will justify their "right" to bonus rent on the theory that Landlord, not Tenant, is in the real estate business, and only Landlord is entitled to increases in rents due to increases in the value of the real estate.
4. Tenant will want deducted from bonus rent all of Tenant's leasing costs.

I. Continuing Liability of Tenant.

Where Tenant assigns its interest in the lease, Tenant will remain liable for all of the obligations of the lessee under the lease unless Landlord specifically releases Tenant from Tenant's obligations under the lease.

V. **Repairs and Maintenance.**

A. Typical Landlord obligations, but varies with type of tenancy.

1. Structure, foundations, roof and common areas.
2. No Landlord obligation until given notice of need for repair.
3. Can cost of Landlord's repair and maintenance work be passed through to Tenant as Operating Expenses?

B. Typical Tenant obligations, but varies with type of tenancy.

1. Maintain interior of Premises in good condition and repair (except for office, HVAC and building systems).
2. Responsible for any of Landlord's obligations to extent due to act or omission of Tenant or Tenant's agents, employees or contractors.

C. Emergency Repairs. Can Tenant perform (and repair and deduct from rent)?

D. Janitorial Services vs. Maintenance. Who performs?

E. Compliance with Laws Issues.

1. Landlord's Perspective.

Tenant responsible for complying with all laws applicable to the Premises. Can cost of Landlord's compliance with laws costs be passed through to Tenant as Operating Expenses?

2. Tenant's Perspective.

Tenant only responsible for complying with laws applicable to Tenant's specific use of the Premises (as opposed to general office/retail use of the Premises. If Landlord accepts this approach, Tenant should also be responsible for any other alterations required due to any action of Tenant or Tenant's agents, employees or contractors.

VI. Damage and Destruction.

A. Landlord's Perspectives.

1. No Tenant termination right.
2. Maximum flexibility regarding Landlord termination rights (for example, damage to the Project but not the Premises).
3. Preserve lender's right to take insurance proceeds to pay down debt.
4. Limit repair obligations to extent of available insurance proceeds.
5. No interruption of rental income stream (typically Tenant will be entitled to whole or partial rent abatement, but Landlord's income stream will be protected by rental income insurance paid for by Tenant as part of Operating Expenses).
6. No obligation to rebuild tenant improvements installed by Tenant.

B. Tenant's Perspectives.

1. Terminate lease if repairs are not expected to be completed within specified time.
2. Abatement of rent (and all other periodic charges).
3. No obligation to commence payment of rent until sufficient move in period.
4. Greater termination rights for damage at end of term of lease.

5. Require Landlord to exercise termination rights non-discriminatorily.
6. Termination rights if significant portions of Project (but not Premises) destroyed.

VII. Defaults.

A. Tenant Defaults.

1. Monetary Defaults.

a. Landlord's Perspective.

Tenant should be in default if Tenant fails to pay rent when due or if Tenant fails to pay any other monetary obligation within five (5) or ten (10) days after receipt of written notice.

b. Tenant's Perspective.

Notice required even for the failure to pay rent on time.

c. Compromise.

The first two (2) times rent is not paid when due in a consecutive twelve (12) month period Tenant will not be in default if Tenant pays such overdue rent within ten (10) days of notice that rent is overdue. The one exception to this is if Tenant occupies a significant portion of the building since the failure of such a large tenant to pay rent when due may be the difference between whether Landlord can pay the mortgage when due.

2. Non-Monetary Defaults.

a. Landlord's Perspective.

Tenant will be in default if Tenant fails to cure a non-monetary breach within a specified period (usually thirty (30) days) after receipt of notice of such breach.

b. Tenant's Perspective.

If the breach cannot be cured within the thirty (30) day period, the lease should provide that so long as Tenant has commenced the cure within the thirty (30) day period and thereafter diligently pursues the cure, Tenant should not be in default of the lease.

B. Landlord Defaults.

1. Failure to deliver space when promised or failure to complete the tenant improvements or defects in Landlord's Work.
2. Failure to repair/maintain the building, the building systems or the common areas.
3. Failure to timely reconstruct the Premises upon a casualty.
4. Breach the covenant of quiet enjoyment.
5. Failure to consent to a proposed assignment or sublease, or a proposed change of use or alteration of the premises.
6. Failure to perform any other Landlord covenant (including, an expansion option, an extension option, an exclusive use clause or other similar rights).

VIII. Remedies.

A. Landlord Remedies.

1. Keep lease in place and collect monthly rent.
2. Terminate lease and accelerate rent (subject to Landlord's mitigation obligations).
3. Perform Tenant's obligations at Tenant's cost.
4. Enter Premises by self-help means.

B. Tenant Remedies.

1. Self Help.

a. Tenant's Perspectives.

- (1) Tenant wants self-help remedies because Tenant fears that without such rights it may be difficult to force Landlord to perform Landlord's obligations under the lease.
- (2) Broad self-help rights enable Tenant to remedy a problem where Landlord does not believe a problem exists.

- (3) Self-help remedies are especially important with respect to repairs. For example, a roof leak may cause significant disruption to a Tenant's business. By obtaining broad self-help remedies, Tenant will be able to quickly repair the roof on Landlord's behalf without incurring significant business losses.
 - (4) A request for self-help remedies typically is accompanied with a request for rent offset rights. Tenant will seek offset rights to obtain a sure method of reimbursement for any self-help costs incurred by Tenant.
- b. Landlord's Perspectives. Landlord will object due to:
- (1) By granting self-help remedies, Tenant will exercise Tenant's self-help remedy in circumstances where Landlord believes no Landlord obligation exists.
 - (2) Landlord wants to control repairs, especially in a multi-tenant building.
 - (3) Landlord wants an opportunity to cure any Landlord default.
 - (4) Tenant will not pursue cost-effective remedies.
 - (5) Landlord will not want to allow Tenant offset rights since it will adversely affect Landlord's cash flow and offset rights may also violate the terms of Landlord's financing documents.