

SELECTED LEASING ISSUES

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I. RENT

If the essence of the landlord's obligation under a lease is to provide possession of the leased premises to the tenant, the reciprocal obligation for the tenant is to pay rent. There can be a variety of somewhat esoteric legal issues surrounding the covenant to pay rent – is the right to receive rent a real or personal property right?; when does the obligation to pay rent become a debt?; are past due rents conveyed with the property? – that can arise in various litigation scenarios. For the transactional lawyer, however, the issues surrounding rent are straightforward:

How much should be paid?
How often?
Starting when?

A. Determination of Rent – The rental amount can be determined in a variety of methods. A lease will typically have the following elements associated with clauses concerning the payment of rent:

1. Stated amount

- a) Determination based on area – per acre; per square foot**
- b) Comparable rates**
- c) Statutory formula – rent is established by applicable statute for some areas**

2. Commencement date

- a) Occupancy**
- b) Opening for business**
- c) Stated date in the future**

3. Increments for payment

- a) Monthly**
- b) Annually**

4. Additional rent

- a) Taxes, insurance, expenses**
- b) Enforcement issue**

Common Issues:

When does the obligation to pay rent commence; this can be an issue in leases which required the landlord to install improvements or the commencement of rent is to occur following the happening of an event, such as “completion of construction.”

What is the rent; if rent is stated on both an area basis (i.e. \$26.00 per square foot per annum for 1,000 square feet), but also in a total amount (i.e. \$26,000 per year), controversies can develop if the area of the premises is not exactly as stated in the lease.

B. Performance Based Rent

1. Percentage Rent

- a) Primarily retail concept**
- b) Natural vs. fixed break points**
- c) Percentage of net rental income (NOI) for ground leases**

2. Other volume measures

3. Ancillary clauses

- a) Definition of sales (or other volume measurement)**
- b) Obligation to operate – prohibition on “going dark”**
- c) Radius clause**

4. Measurement period

- a) Partial years**
- b) Post-termination obligation to pay**

Common Issues

Continuous operation clauses; there are inherent problems trying to enforce a continuous operation clause. One approach is to provide for liquidated damages in a stated amount in the event the covenant is breached. Another remedy is a recapture right on the part of the landlord if the tenant ceases to operate.

Definition of Gross Sales; the provisions of a lease that define what is and what is not included in sales has become something of a work of art. From a landlord's perspective, the greatest challenge is to try to think of how the tenant's business might change over the term of the lease and how that may affect how revenue is generated.

C. Escalation of Rent

- 1. Stated percentage**
- 2. Consumer price index**
 - a) Urban consumers**
 - b) Wage earners**
 - c) Geographical area**
- 3. Producer price index; wholesale price index**
- 4. Calculation**
 - a) Base year**
 - b) Adjustment period**
 - c) Effective date of new rate**

Common Issues:

Disappearing Index; problems can arise if the index is either incorrectly identified or disappears – the “Gold Clause” problem. One alternative is to provide for an alternative method of determining the escalation.

D. Market Rate Adjustments

- 1. Common in longer term leases or to establish rent during option periods**

2. Concept of “fair market value”

3. Third party determination

a) Appraisal

(1) One, two or three appraisers

(2) Qualifications

(3) Method of appointment

b) Timing

Common Issues:

Look-See Concept; parties are always hesitant to trust their economic fate to a third party appraiser. In the context of options, either the tenant or the landlord may want the right to terminate the exercise of an option if the appraisal result is unsatisfactory.

Definitions of Fair Market Value; for a relatively simple concept, controversies arise over the definition of “fair market value” and “fair market value for comparable space.” In the ground lease context, disputes can arise concerning the use of the property and the appropriate capitalization rate. In the context of commercial space, issues such as tenant improvement allowances and tenant concessions can impact the determination of the rental amount.

II. LEASE SECURITY DEPOSITS

Landlords are always interested in having some security for the performance of the tenant’s obligations. The amount and form of security is generally determined by a variety of factors, including the length of lease, the financial commitment required by the landlord and the financial strength of the tenant.

A. Bonds

1. Issued by third party, typically a surety company

2. Rating/Federal Register

3. Cost

B. Letters of Credit

1. Issued by banks

2. Drawing conditions

3. Expiration dates

C. Cash – Cash Is Good

1. Payment to landlord

2. Control of account – perfection of security interest

Common Issues:

What is secured; consider having the security that is given relate to obligations other than the payment of rent, such as an obligation to repay the cost of tenant improvements. Splitting the deposit amount different obligations can be used to attempt to avoid limitations on the rental obligations owed following a bankruptcy.

Expiration Issues; letters of credit have stated durations – normally a year or two. If a letter of credit is taken as security, there needs to be a monitoring system in place to make certain that a replacement LC is received prior to the expiration of the current LC.

III. TERM

The term of the lease should be a relatively straight-forward concept. Defining when the term begins and when it ends can prove to be difficult, however, particularly if the commencement of the lease is dependent upon acts by third parties beyond the control of the landlord.

A. Commencement Date

1. Date of occupancy vs. date on which obligations under the lease are effective

2. Stated duration – months or years

a) Partial periods

b) Annual periods vs. calendar years

3. Confirmation of commencement of term

Common Issues:

Drop Dead Dates; leases that involve improvements to property may be conditioned upon the issuance of permits, completion of construction or

other events not totally within the control of the landlord and tenant. To avoid the “never beginning – never ending” lease, a date certain by which the event triggering commencement has to occur should be stated in the lease. If the lease has not commenced by that date, the obligation of the parties terminate.

Open for Business; leases that require the landlord to construct improvements to a specified standard create the possibility that the tenant will argue that the term has not commenced since the improvements do not meet the specified standard. As a general rule, if the tenant is using the premises, the term should be deemed to have commenced.

B. Options

- 1. Number and duration of option periods**
- 2. Notice of exercise**
 - a) Method of exercise**
 - b) Effect of late exercise**
- 3. Timing of exercise**
 - a) Minimum notice period**
 - b) Maximum notice period**

Common Issues:

I Forgot; problems always arise if the tenant fails to give notice. Some tenants bargain for notification rights (i.e. the landlord must notify the tenant of its failure to timely exercise the option before the option lapses. Landlords should timely confirm with tenants that an option has lapsed if notice has not been given and that the landlord is relying on the tenant vacating the space.

C. Rights of First Refusal

- 1. ROFR vs. ROFO**
- 2. Notice periods**
- 3. Definition of space subject to ROFR**
- 4. Triggering Event**

Common Issues;

I don't have to answer; care needs to be taken in defining the event that triggers the ROFR and the information that is required to be given by the landlord in order for the tenant to respond. Avoid requirements such as an obligation to deliver a signed lease to trigger the ROFR.

Brokerage Commissions; if there is a right of first refusal, there can be some confusion as to whether a brokerage commission is due if the ROFR is exercised. This should be discussed with the broker at the outset to avoid disputes.

IV. MAINTENANCE AND REPAIR

The maintenance provisions of a lease offer the most opportunity for on-going disputes between the landlord and tenant. Most of these problems can be minimized by clearly delineating in the lease the respective responsibilities of the landlord and tenant to maintain the property.

A. Allocation of Responsibility

1. Landlord's duties

- a) Define area of maintenance (i.e. structural repairs; foundation repairs; roof repairs; parking lot repairs; common area repairs, etc.)**
- b) Define standard of maintenance (i.e. "good order and repair," "neat and clean condition")**
- c) The fully serviced lease**
 - (1) Specific janitorial standards**
 - (2) Reimbursement obligations**

2. Tenant's duties

- a) Define area of maintenance, which is normally the premises**
- b) Define standard of maintenance**
- c) Removal of improvements**

3. Self-Help

4. Common Area Maintenance

- a) **Define included and excluded expenses**
- b) **Method of allocation**
 - (1) **Proportion of area**
 - (2) **Use of service**
- c) **Adjustment and caps on increase**
- d) **Define standard of maintenance by landlord**
- e) **Audit rights**

B. Other Clauses

- 1. **Surrender and redelivery**
- 2. **Damage/destruction/condemnation**
- 3. **Insurance**
- 4. **Alterations**

Common Issues:

Maintenance vs. surrender; while it is common for a lease to provide that the tenant's obligation to surrender the premises to the landlord in good repair is subject to "normal wear and tear," that phrase is often missing in the maintenance clauses. This can lead to an on-going maintenance obligation that is inconsistent with the obligations under the surrender clause. Similarly, a landlord's obligation to maintain a facility in a "first class condition" needs to incorporate the concept of depreciation and aging over time.

Removal of Improvements; there can be endless arguments over who has the responsibility to remove tenant improvements. The lease should specify which improvements are to be removed and at whose cost.

V. ASSIGNMENTS AND SUBLEASES

This clause is the subject of negotiation by most tenants. From the tenant's viewpoint, the assignment provision is an "exit" clause that allows the tenant to mitigate the business risk of entering into a long-term lease arrangement. From

the landlord's viewpoint, these provisions offer an opportunity to re-price the space and to avoid the risk of being forced into a business relationship with an unknown tenant.

A. Assignment vs. Sublease

B. Consent of Landlord

1. Reasonable vs. reasonable business judgment vs. sole discretion vs. nothing

2. Factors to consider

a) Identity and business of occupant

b) Financial condition

c) Reputation

d) Effect on other tenants

e) Effect on premises

f) Percentage rent

g) Exclusives and use restrictions

3. Use clause in lease

4. Effect of disapproval

a) Transfer is void

b) Recapture right

C. Indirect assignments

1. Merger

2. Sale or other transfer of ownership interests

Common Issues:

Event Risk; it is relatively common for mergers and other corporate reorganizations not to be considered assignments. These transactions can have a dramatic effect on the credit worthiness of the tenant. Landlord' might consider exempting such transfers so long as there is no adverse effect on the credit rating of the tenant.