SMALL TENANT LEASE NEGOTIATING

Key leasing issues a startup, small tenant or non-profit can successfully negotiate.

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Introduction. Startups, small tenants and non-profits who are negotiating with a landlord for office space need not surrender to every demand that the landlord makes and every position it takes. Although such parties may not have as much negotiating leverage as a Fortune 500 company leasing 25,000 square feet of space, they have some leverage in almost every lease transaction, especially if they pick their battles carefully.

Startups, small tenants and non-profits that plan ahead are most likely to negotiate successfully. Early on in the process, these tenants work with a team of experienced brokers and attorneys specializing in commercial real estate. Tenants who are pragmatic and articulate their positions for customary areas of tenant-flexibility, will successfully address many of their concerns, and materially improve the terms of their lease. Some lease revisions that are likely to be successfully negotiated by tenants are discussed below.

- **Assignment Rights & Permitted Transfers.** Most business owners expect that their lease requires them to get landlord's consent if the tenant wishes to assign its lease or sublease the premises to a third party. Such business owners may not expect however, that their lease also requires landlord' consent for any change of control or transfer by operation of law. A tenant should have the flexibility to transfer its lease if all of its ownership interest (e.g., stock) or assets are sold, or if the tenant's legal entity is merged into another company. To ensure this flexibility, tenants should negotiate that its landlord's consent is not needed if the tenant assigns its lease to a successor corporation in a merger, or to the party that purchased all of tenant's assets or property. It is customary for landlords to agree to this request, provided that the successor tenant has the same net worth as the original tenant.

- **Common Area Maintenance Expenses.**

  - **Audit Rights.** Standard office lease forms contain no procedures for a tenant to review landlord's calculation of Common Area Maintenance expenses (CAM), or to resolve any disputes a tenant may have with the landlord about such amounts. The tenant should ensure that the lease provides for a customary audit right to resolve such disputes should they ever arise. The audit right provision should state that a dispute will be resolved by the parties through consultation in good faith within some

reasonable period of time, and that if the dispute cannot be resolved in this time-frame, the tenant should have the right to conduct an audit by an independent certified public accountant. Further, it is customary for the landlord to pay for the audit costs if the audit reflects an overcharge of 5% or more.

- **Exclusions.** A tenant should be weary of reimbursing the landlord for the cost of capital improvements or replacements to the building the premises are in. The general argument is that capital improvements or replacements that add value to landlord's building, or otherwise are for equipment that lasts well past the tenant's lease term, should be costs that the landlord bears. Two customary exceptions concern capital items to comply with new laws, and capital items incurred to reduce operating expenses. While a tenant should bear the cost of capital expenditures for new laws enacted after the tenant's lease commences, a landlord should not pass-through costs to correct any legal violations existing on the commencement date. With respect to capital items designed to reduce operating expenses, tenant should only pay for improvements which Landlord reasonably believes will reduce operating expenses (and then only to the extent of such savings). Ideally the language would provide that the cost of any such permitted capital improvement should be amortized over the useful life of such item, though some landlords try to use a shorter amortization period.

- **Alterations.** Most leases prohibit any alteration without the landlord's consent, which read literally would restrict interior painting, carpeting or even hanging a picture or diploma. Every tenant should be able to negotiate some rights regarding cosmetic alterations. A tenant should not need to seek the landlord's consent every time the tenant wishes to make a minor non-structural alteration that does not adversely affect the building's central systems and is not visible from outside the building. Often times landlords attempt to have an annual dollar limit on permitted alterations. A useful benchmark for this is that paint and carpet typically costs at least $5.00 per square foot. A reasonable landlord will agree to some exception for the tenant's cosmetic alterations.

- **Other Lease Provisions.**

  - **Abandonment/Occupancy Requirements.** It is not uncommon for an office lease to provide that the tenant is in default if it abandons the premises. Landlords leasing *retail* space are very hesitant to agree to a tenant's right to go dark. In an office building, however, this is not the case. Tenant's occupancy of the premises is far less important to the landlord. There are a variety of reasons a tenant may desire to cease operations at its premises (while still paying rent). For example, the tenant may want to have a temporary closure for restructuring, rebranding or other activity that would cause the premises to be closed for an extended period of time. In an office lease, as long as a tenant pays rent, has insurance and maintains the premises as needed, a tenant should not be at risk of default simply for ceasing business operations at its premises.

- **Mitigating Damages.** If a tenant defaulted on its lease, ancient law allowed a landlord to take no action to limit the landlord's damages (like trying to find a new tenant for the property). The more modern view of business contracts, as well as leases, is that a landlord should have some obligation to use reasonable efforts to limit (mitigate) the landlord's damages. Certainly, it is not in the landlord's interest to keep the defaulting tenant's space empty without rent when the landlord could have found another tenant for the space. Tenants should be aware, however, that this is a sensitive topic for landlords. Landlords are very wary about being second-guessed by a tenant who has already defaulted on its lease, as to whether the landlord has done enough to mitigate its damages. A tenant's request that the landlord include a mitigation-of-damages provision in the lease, will be better received if the tenant agrees the landlord does not have to accept below-market rent or make renting the defaulting tenant's space a priority over leasing other vacant space in the building.

- **Punitive Damages.** Arguably, a lease is in the nature of a business contract, setting out the parties' respective rights and obligations. The common principle is that punitive damages are not appropriate for an ordinary breach of a contract. Leases are not, however, universally regarded as contracts. A tenant should ask that both parties waive their claims for lost profits or punitive damages. Landlords may agree to such a change, though they often carve-out damages arising if a tenant holds-over at the end of the term and fails to move out of its space at lease expiration.

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