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## NEGOTIATING COMMERCIAL LEASES

### PART I

At some time in the life of their business, most business owners will find occasion to lease commercial space. While owning business real estate can be desirable, many businesses cannot afford a significant cash outlay, particularly at the development stage. For those contemplating a new lease or lease extension for your business, the purpose of this article is to assist you in becoming familiar with the types of issues that are often negotiated in commercial leasing transactions. You should still obtain the advice of knowledgeable professionals – brokers and attorneys - related to your specific transaction. Nevertheless, you should be well-equipped to understand common lease terms, and to be sure they are addressed appropriately in your lease.

The most common types of commercial properties include industrial spaces for manufacturing operations, warehouse space for storage and distribution, retail locations, office buildings, and specific use properties (e.g., child care facilities or convenience stores). Lease forms will vary depending upon the type of commercial property involved, the physical situation of the property (i.e., are you leasing the entire building or a space in a larger building?), the business sophistication of the landlord, allocation of property expenses, and other factors. You may be presented with a lease form that is two pages (yes, this has happened – once), or it may be a ¼ ream of paper. Beyond 20 pages or so, additional content likely consists of excruciating detail as to how miserable your life will be if you do not pay rent. While this may be a slight bit of an exaggeration, as a rule of thumb, longer leases do tend to favor the landlord and shorter leases often work just fine for the tenant. If you are leasing property, most likely the landlord will propose a form of lease, and you may even be asked to sign it when it is handed to you. Do not do this! Review the entire lease before signing, and get the advice of an experienced attorney. If you happen to be dealing with a landlord who does relatively little leasing and offers you the opportunity to propose a form of lease, run – don't walk – to your attorney's office and ask them to prepare a lease form for you – preferably no more than a few pages! While it may involve more expense up front to have your attorney prepare the lease, you will have a lease that squarely protects your interests, and hopefully much less time invested in negotiating with the landlord.

Following is a topical discussion of terms that are often negotiated in commercial leasing transactions. This Part I addresses rent, the property description, the lease term, leasehold improvements and signage. Most of the issues are approached from a tenant's perspective, since landlords tend to be more experienced in leasing issues and terminology, but landlords may find the discussion helpful as well.

#### **Rent**

Rent is a good place to start, since it is probably the first question that most people ask. "How much is the rent?" As you look at available properties, you will want to compare the cost per square foot of alternative properties, and the lease rate is often quoted at a rate per square foot. Note that the quoted rate is an annual rate, so if you lease 1,000 square feet at \$12.00 per foot, your annual rent will

be \$12,000 and your monthly rent will be \$1,000. If you are looking at office or retail space and the rate is quoted based on “rentable” square footage, be aware that the number of square feet of space advertised includes a “load factor” (i.e., a percentage of the common areas), and will not be the actual number of square feet available for use in your space. For example, if you lease 5,000 rentable square feet in a building with a load factor of 20%, you should consider when making comparisons that your space will consist of only 4,000 usable square feet. Also, be sure to include all other expenses that must be paid by the tenant (such as taxes, insurance, common area charges and maintenance) when making per-square-foot cost comparisons between alternative properties, because these additional charges will often vary from one property to another.

Leases may be described as “triple net” or “full service”, and the reality is that there are a variety of hybrids of each. A triple net lease is generally understood as a lease in which the tenant will be responsible for property taxes, casualty insurance, utilities and most repairs. Maintenance obligations will vary depending upon a number of factors, but in perhaps the majority of triple net lease arrangements, the landlord is responsible for “structural” repairs and maintenance, and the tenant is responsible for interior and non-structural repairs. A full service lease is one in which the quoted lease rate includes all property-related expenses, including taxes, insurance, utilities, maintenance, routine cleaning, janitorial, and maybe even replacement of light bulbs! Sometimes the tenant is responsible for these expenses only to the extent they increase in future years. As you would expect, base rent rates will generally be higher for full service leases than triple net leases, all else being equal.

### **The Property Description**

This seems really basic, but be sure that your lease clearly describes the specific space that you are leasing, its location (within a building or shopping center) and the number of square feet upon which rent is being calculated. Ask your real estate agent to measure the space to verify the quoted square footage. Insist that a floor plan drawing be attached to the lease, depicting the location of your space and the floor on which it is located. If you are leasing an entire building, be sure you understand clearly the underlying land that is included in the lease, and your rights to use of that land. A survey attached to the lease would be helpful.

Review the lease carefully to see whether it includes a relocation clause. These are somewhat common in retail leases in larger shopping developments, and generally do not include a lot of restrictions on the landlord’s ability to exercise the right. A relocation clause generally allows the landlord to relocate your business at any time during the term of the lease by giving notice, and the landlord may have the right to move you to another similar location within the shopping center, or perhaps even another nearby shopping center owned by the same landlord or an affiliate. It may be possible to negotiate this provision out of a lease. If not, you should at least ensure that the landlord is required to give you adequate notice, that the relocation space must be reasonably similar in size, appearance, accessibility and other factors, and that the landlord will reimburse your moving expenses, upfitting expenditures, costs of replacing letterhead and advertising materials, and whatever other expenses you might reasonably incur related to the move. It is not difficult to see why relocation clauses can be difficult to negotiate!

Retail leases may include a “percentage rents” clause. The purpose is for the landlord to share in the profitability of your business if the location does well, rewarding the landlord for a successful shopping development, and theoretically should result in a relatively lower base rent rate. If you are unable to negotiate to remove this provision from your lease, understand that you will be required to provide financial information to your landlord on a continuing basis, which can put you at a disadvantage in future lease negotiations if your business is doing well. It is not unusual to see a percentage rents clause in a lease for which it is entirely inappropriate, and in those cases it may not be difficult to negotiate to have the language removed entirely.

### **Lease Term**

Landlords will often desire a longer lease term, which provides benefits such as increased stability, higher value if the property is marketed (assuming that the lease rate is at or above market), less frequent lease re-negotiations, and reduced risk of vacancy. As a tenant, you may prefer a longer term lease if you want to lock in favorable lease terms to provide greater stability for your business, to avoid future relocation costs, or to convince the landlord to make an investment in renovating the property. However, your business may be better served – particularly for start-up or fast-growing businesses – by a structure that allows you maximum flexibility. When balancing these factors, consider also the investment you will need to make in the leased location, and whether you will be able to secure rights to the property for a sufficient time to justify your investment. If you are looking at a new location, a relatively short lease term with multiple options to renew (preferably at a fixed rate or fixed adjustment factor) may be ideal, if you will not have to make a large investment in upfit. However, you should also consider the impact of a short lease on the landlord’s willingness to invest in the property, as discussed in the next section.

If it is important that you have possession of the property by a particular date, with any required landlord work completed, the lease should specify the required delivery date or timeframe. Some leases will specify an “effective date”, which is the date the landlord and tenant are bound to the terms of the lease (often the date of signing), a “lease commencement date” (generally the date on which the tenant will take possession), and possibly a separate “rent commencement date”, which is the date on which the tenant is required to begin paying rent. Be sure you understand the difference between these dates and how they tie into other lease provisions, and that they accurately reflect the negotiated lease terms.

### **Leasehold Improvements**

If you are willing to commit to a significant minimum lease term (3-5 years or more), the landlord may be willing to make certain improvements to the property before you move in. For example, it might be necessary to make repairs to render the property fully functional and ready for occupancy, or you may want the paint or carpet updated to improve the appearance of the space. It may be necessary for you to finish or alter the interior of the space to meet your specific needs. If the tenant will be responsible for renovations, landlords are often willing to contribute an “allowance” toward the expense, which may be stated as an amount per square foot leased, or as a flat amount. Be sure to discuss early in the

leasing process any improvements or renovations that you think are necessary, and whether the landlord will be willing to share in the expense.

Most leases will require the landlord's permission before the tenant is authorized to make any renovations or alterations to the property. Preferably, the lease will state that the landlord's permission cannot be unreasonably "withheld, conditioned or delayed", or something similar. Nevertheless, you should ensure that any alterations that you initially plan to make to the property, either before you take possession or afterward, are listed specifically in the lease as landlord-approved alterations. Oftentimes the tenant's permitted alterations, or any work that the landlord has agreed to perform, are set out in an exhibit to the lease agreement. If the landlord is required to complete certain work that you expect to be completed before you take possession, be sure that the lease specifies a required completion date, or that it at least provides that you will not be obligated to start paying rent until the landlord's work is completed.

### **Signage**

Many leases require that any signage be approved by the landlord and installed in compliance with applicable laws and regulations, such as local zoning restrictions. The lease should specifically authorize any specific signage desired by the tenant and known at the time of lease negotiation. Sign vendors can provide specific details and drawings to be incorporated in the lease, and can also assist with ensuring that local regulations are satisfied. Rights to space on any pylon or directory sign for the property – generally provided by the landlord – should be addressed in the lease. A tenant should never assume that the landlord will approve signage later, as the location and appearance of tenants' signs can be an issue of great importance to a landlord, particularly if the property is occupied by multiple tenants. As you negotiate signage, understand that the landlord may be legitimately concerned about setting precedents that will not go unnoticed by other existing or future tenants.

### **The Final Analysis**

After reading this Part I and installments to follow, you should have a better understanding and comfort level with the commercial leasing process. Still, you would be well served to obtain the assistance of knowledgeable professionals to walk with you through locating property for your business and negotiating the lease arrangements. A commercial real estate agent who is knowledgeable in his or her local market can be invaluable in helping you to understand and negotiate the best lease arrangements, not to mention locating properties that best fit your needs. Generally, it costs you nothing to obtain this assistance, and it can save you a lot to have an experienced negotiator on your team. After you locate a suitable property and as you negotiate terms, it would be wise to involve an attorney experienced in commercial real estate before you finalize the basic terms – often reflected in a term sheet or letter of intent – which will form the foundation of your lease agreement.

Some lease forms are more balanced than others, but you need an experienced attorney to assist you in determining which terms are reasonable, and which are not. The landlord's initial draft of a lease oftentimes does not accurately reflect all the terms already agreed in the term sheet, and there may be

other issues of interest to you as tenant, which are not reflected in the term sheet. Obtaining professional advice in commercial leasing transactions can save you many times the expense, particularly if everything does not go quite as you planned with your business.

In Part II, this article will continue with a discussion of maintenance obligations, insurance, personal guaranties, subleasing, and an explanation of some of the “legalese” (the language that attorneys learn in law school) that usually comprises the back half of the lease agreement.

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