

'Caveat emptor' applies when looking at a lease

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Most business people would never walk into a courtroom without a lawyer, or face an IRS audit without an accountant, but many of them negotiate long-term, high-dollar leases without professional advice.

Crafting a lease that protects your interests is a complex process. It requires knowledge of market conditions, finance and the landmines of potential liabilities and obligations.

Without competent professional assistance, signing a lease can lead to multimillion dollar mistakes. Just as the legal system is devised by lawyers for lawyers, commercial real estate is designed by owners and lenders for owners and lenders.

It is essential tenants have an exclusive agreement with a commercial real estate representative. Unless they have signed such an agreement, commercial brokers are agents or subagents of the owner.

Once there is an exclusive contract with a commercial real estate representative, they become the tenants' representatives, resources and advocates. They assist tenants in finding the right property for the right price and negotiating a contract that protects the tenants' long-term interests.

"Caveat emptor" — let the buyer beware — applies to leasing as well as buying.

The leasing process is much like civilized warfare; half the battle is in knowing the right questions to ask. If the tenant doesn't ask, the landlord won't tell.

There are hidden nuances and important implications that most people — however sophisticated their business backgrounds — don't know about or understand. The issues tenants fail to raise can often come back to haunt them.

Some areas of risk

There are many areas where a tenant's interests are at risk. Each issue should be covered in a well-executed lease contract. Here, the focus is on negotiating improvements to the property, one of the first issues tenants face in negotiating a lease.

● Government regulations and ordinances may change during the term of the lease and require the landlord to upgrade the building. Most commercial leases state if the landlord spends money to comply with federal, state or local regulations, the tenant must pay the entire cost.

For example, a tenant signs a lease and the next year the City of Austin decides all buildings must have sprinkler heads 100 feet apart. The original building code stated they had to be 150 feet apart. The landlord has no choice but to comply with the new city ordinance and will require the tenant to pay for the changes.

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Depending on the amount of square feet the tenant is leasing, compliance could cost a significant amount of money. In most cases, the tenant fails to consider this potential liability and must pay for the improvements.

Instead, the tenant could insist on a clause in the lease stating if new regulations are adopted by any governmental agency, the landlord — not the tenant — must pay for them.

● Major capital improvements are required by the tenant's business. Over what period of time will they be amortized and how will this affect the tenant's renewal options?

The tenant is in the high tech industry and must pay for additional cabling, extra power and other improvements totaling \$500,000. These customizations are not transferable to another site.

The landlord offers the tenant a five-year lease. If the tenant agrees, the entire \$500,000 must be amortized over a five-year period and costs \$100,000 a year for the life of the lease. When the five-year lease comes up for renewal, the landlord may demand a substantial increase in rent because he knows the tenant has invested a large sum in the improvements and will not want to walk out on the investment.

The best way to deal with the renewals is to do it up front, negotiating a series of renewal options at fixed rates. This gives the tenant an option to renew at known costs. It also provides the tenant a choice not to renew if the property becomes functionally obsolete.

● Tenant requirements far exceed the landlord's dollar allowance for building improvements.

In this example, the tenant is willing to sign a 10-year lease, but requires a million dollars worth of customized construction. The landlord will only allow \$500,000 for these upgrades.

To solve this situation, the tenant requests a loan of another half million dollars outside the improvement allowance to complete the needed construction. In order to recoup this money, the landlord charges the tenant a fair market interest rate and structures repayment of the loan as "additional rent."

This is an arrangement that allows the tenant to get the needed improvements without borrowing

money from a bank and limiting the ability to borrow additional funds for business needs.

Instead of a \$500,000 bank loan, the tenant will be able to amortize the loan from the landlord over the 10 years of the lease. The tenant's rental obligation is considered short term, which will not restrict the working capital line of credit.

● With a tight schedule and high construction costs, the tenant needs full value from the contractor and a timely completion of the work.

Here, the landlord hires a contractor and subcontractors to do the tenant's buildout and takes bids on the project.

The tenant wants to make sure the landlord chooses the most reliable, high quality contractor at the best price. In addition, the tenant needs the project completed on schedule.

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To avoid problems, in negotiating the lease the tenant must have the right to recommend other approved contractors and subcontractors, review all bids and contracts, approve the quality of the work and specify rules for timely performance of construction.

A clause mandating liquidated damages for every day the contractor is late is a powerful incentive for on-time performance. The contract should be clear on when the lease takes effect. It should not begin before a certificate of occupancy has been issued and the space is safe and usable.

These are just four issues tenants may not understand and can cost them a lot of money over the life of the lease. Obviously, the larger and more complex the lease, the more sophisticated representation and negotiation are needed.

Whether a lease is relatively simple or complicated, the key to gaining an equitable contract is for the tenant to be aware of hidden implications and nuances. That's where the tenant's exclusive agreement with a commercial broker can be invaluable. The broker's job is to protect tenants' interests and limit the obligations and liabilities.

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