

From PLI's Course Handbook

*Negotiating Commercial Leases: How Owners & Corporate Occupants
Can Avoid Costly Errors—Spring 2009*

#18155

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MISSION NEARLY IMPOSSIBLE—
EFFECTIVELY REPRESENTING THE
SMALL TENANT IN A SMALL LEASE
TRANSACTION — TOP 12 ISSUES

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- Landlord Leasing

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Michael E. Meyer has developed a national reputation as one of the preeminent leasing attorneys in the United States. He regularly represents many of this country's leading financial institutions, accounting firms and law firms in connection with major lease transactions throughout the United States. Representative of the major leases he has done for tenants recently include Bank of America (200,000 sq.ft.), City National Bank (330,000 sq.ft.), The Capital Group (300,000 sq.ft.), TCW (200,000 sq.ft.) and Rand in Santa Monica.

Mr. Meyer is considered one of the country's leading authorities on renewal rights, the establishment of fair market rental rates pursuant to arbitrations, the assignment and subleasing provision, and the inter-relationships between the tenant improvement agreement and the rent commencement date. He is a member of the board of directors and executive committee of the Building Owners and Managers Association (BOMA) in Los Angeles. He has served as judge pro tem in the Los Angeles Municipal Courts and presently serves as an arbitrator for the American Arbitration Association. He developed the definition of fair market rental rate which, in one form or another, is used in numerous major lease transactions, and has been intimately involved in many arbitrations/mediations involving fair market rental rates—the most recent, involving Screen Actors Guild, Rosenfeld, Meyer & Susman, Nestle, Saban Entertainment and Sony with major landlords including Jerry Snyder, Douglas Emmett, Equity Office, Heitman and Transpacific.

In 2002, Mr. Meyer was named CoreNet Global's Real Estate Professional of the Year and the *Los Angeles Business Journal* named him one of the 25 Most Powerful Attorneys in Los Angeles. In 2002 and 2004, he was named one of the 100 Most Influential Lawyers in California by the *Los Angeles Daily Journal* and the *San Francisco Daily Journal*. The respected English publication *Chambers USA: America's Leading Lawyers for Business* ranks him in California's top tier for real estate law, calling him a "commanding name as a leasing expert." In a vote by his peers, which was published by *Los Angeles* magazine, Mr. Meyer has been ranked in the Top 100 of all the Super Lawyers in Southern California. In 2005, 2006 and 2007, he was named among the 500 Leading Lawyers in the United States by *Lawdragon*. He is also listed in the *Guide to the World's Leading Real Estate Lawyers*, the *International Who's Who of Real Estate Lawyers* and the *International Who's Who of Business Lawyers*, published by Who's Who Legal. In 2007, the *California Daily Journal* named Mr. Meyer to its list of the Top 100 Attorneys in California. Practical Law Company's *Which Lawyer? Yearbook 2007* recognized him as one of the three "Leading Individuals" in real estate law in Los Angeles, and *Lawdragon* named him among the Lawdragon 500 Dealmakers in America. In 2008, he was named among *Lawdragon's* 500 Leading Lawyers in America. Mr. Meyer is a member of DLA Piper's firmwide Policy Committee and is the managing partner of DLA Piper's Los Angeles offices.

In November 2006, Mr. Meyer was honored by the Weingart Center Association at "Striking Out Homelessness and Poverty," a benefit event at Dodger Stadium, for his extensive efforts to help victims of poverty return to work. Proceeds from the event went to the Weingart Center in downtown Los Angeles to contribute to its work delivering high-quality human services and providing leadership and innovative solutions to break the cycle of homelessness and end poverty. He is on the board of directors of the Jackie Robinson Foundation, Sheriff's Youth Foundation, Los Angeles Police Foundation, Reviving Baseball in Inner Cities, and LA Sports & Entertainment Commission.

In March 2007, *Real Estate Southern California* magazine published "The Laws of Baseball," an article focusing on Mr. Meyer's lifelong love of baseball and his service on the board of directors of the Jackie Robinson Foundation.

Mr. Meyer has lectured to numerous city organizations, including real estate brokers, landlords and developer groups, interior design groups and real estate appraisers. He also has presented various seminars to BOMA, PLI, CLE, CEB, Los Angeles County Bar Association, State Bar of California and the American Bar Association. He is a member of the American College of Real Estate Lawyers.

Civic and Charitable

- Board of Directors, Jackie Robinson Foundation
- Board of Directors, Los Angeles Sports & Entertainment Commission
- Board of Directors, Los Angeles Police Foundation
- Board of Directors, Los Angeles County Sheriff's Youth Foundation
- Board of Directors, Boy Scouts of America (Greater Los Angeles)
- Board of Directors, United Way (1992-1995)

27 March 2009

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MISSION NEARLY IMPOSSIBLE

EFFECTIVELY REPRESENTING THE SMALL TENANT IN A SMALL LEASE TRANSACTION – TOP 12 ISSUES

Each practicing lawyer who specializes in commercial real estate leasing has his or her own idea as to what is the most difficult transaction to do really well. Top vote-getters for difficult tasks are build-to-suit Lease transactions and retail shopping center anchor tenant Leases. The transactions that I believe are the most difficult to do well are the sublease and the Small Lease. I will leave the discussions of the complexities of doing a sublease for next year and just concentrate on the Small Lease.

I will, for the purposes of this article, define a Small Lease as a lease of 4,000 square feet for a period of four years at a rental rate of \$15.00 per RSF net (“Small Lease”). That means that the Landlord will collect \$60,000 in Basic Rent for a year. For those of us who are bad at math, \$60,000 divided by 12 months equals \$5,000 per month, which is the Basic Rent the Landlord will receive each month and out of which it must service its debt, pay for expenses that can’t be passed on to, and recouped from, tenants as Operating Costs and hopefully make a little profit. Under those circumstances, it is not practical for a Landlord to want to enter into meaningful Lease negotiations where, if the parties are not practical, the legal fees could approach six months’ Basic Rent.

The difficulty in negotiating a Small Lease arises in part because while the Landlord (and the Tenant) are not in a position to devote the time, and expend the legal fees, necessary to properly negotiate a Lease that will protect the legitimate interests of both the Landlord and the Tenant, the Landlord and Tenant in almost all cases enter negotiations where the following factors are present:

A. The Landlord presents the same form lease to a tenant for the 4,000 RSF Small Lease transaction and for the 100,000 RSF lease transaction;

B. The issues, for the most part are, when dealing with a 4,000 RSF Small Lease transaction are the same issues as the issues one encounters with a 100,000 RSF lease transaction;

C. The typical Tenant can be hurt just as much (proportionally) on a 4,000 RSF Small Lease transaction as a Tenant can be hurt on a 100,000 RSF lease transaction.

A lawyer can of course decide (and many in fact do decide) not to represent a Tenant on a Small Deal. However, if the lawyer accepts the assignment, the lawyer must manage the client's expectations.

I recommend that the lawyer tell its client the facts of life as described above and state that there is little chance the Tenant client can receive all of the necessary and important protections that a large, sophisticated Tenant can typically secure in a typical, level playing field type of market. The client should be told that there are some Landlords who are more reasonable than others and that if the Tenant wants meaningful protections, there are a select few Landlords to be avoided because those Landlords are not flexible. I recommend that the lawyer talk to the client to find out if they have certain hot buttons and, if they do, the lawyer should try to make sure that those hot buttons are addressed in the Lease. The lawyer should make a list of its top ten issues, based on the lawyer's and client's subjective evaluation of how likely it is something will happen, the practical consequences to the Tenant if it does happen, the client's hot buttons, and the probabilities that the protection can be obtained. Here is my own subjective top ten list.

1. Reasonableness and Good Faith.

In a typical Lease, there are numerous provisions in the Lease where the Landlord has the right to exercise discretion, make an allocation or determination and where the Tenant is prevented from taking certain action without obtaining the Landlord's consent. The Landlord typically has numerous statements in the Lease providing that the Landlord can act in its sole and absolute discretion and a major "markup" of the Lease would have to take place unless the Tenant is successful in asking the Landlord to always act reasonably. Accordingly, for small Tenants and large Tenants alike, we recommend that the following provision be utilized:

"Regardless of any reference in the Lease to sole and absolute discretion or words to that effect, but except for matters which (1) could have an adverse effect on the structural integrity of the Building Structure, (2) could have an adverse effect on the Building Systems, or (3) could have an effect on the exterior appearance of the building, whereupon in each such case Landlord's duty is to act in good faith and in compliance with the Lease, any time the consent of Landlord or Tenant is required, such consent shall not be unreasonably withheld, conditioned or delayed. Whenever the Lease grants Landlord or Tenant the right to take action, exercise discretion, establish rules and regulations or make allocations or other determinations (other than decisions to exercise expansion, contraction, cancellation, termination or renewal options), Landlord and Tenant shall act reasonably and in good faith and take no action which might result in the frustration of the reasonable expectations of a sophisticated Tenant or Landlord concerning the benefits to be enjoyed under the Lease."

2. Approval Criteria for Tenant Improvements.

When a Tenant leases space, the Tenant has in its mind an idea of what it wants to construct in the way of improvements. Some Landlords are more fussy than others, but there are many Landlords who will not want a Tenant to make improvements if they think that those improvements will make the space less attractive to the next Tenant. These issues need to be cleared up right away. Many Tenants like to have exposed ceilings. Would it be reasonable for a Landlord to say deny consent to such a request? We don't want to speculate as to what would

be reasonable under the circumstances and instead suggest that the Tenant insert the following provision as the “Approval Criteria” for the Tenant’s improvements.

“Landlord may not withhold or condition its consent to the making of an alternation or improvement unless the making or installation of the improvements or alterations would (a) adversely affect the Building Structure, (b) adversely affect the Building Systems, (c) not comply with applicable laws, (d) affect the exterior appearance of the Building, or (e) unreasonably interfere with the normal and customary business operations of the other Tenants in the Building (individually and collectively, a “Design Problem”).”

3. Operating Expenses.

Operating expenses have become more and more complicated. A contest has developed to see which attorney can come up with the longest list of operating expense exclusions. When I look at most of the exclusions, if the item was not listed as an exclusion, then absent a specific provision in the Lease which expressly sets forth that item as an inclusion, the item would still not be considered an operating expense. For example, brokers commissions, tenant improvement allowances, ground lease rent, interest on loan payments, charitable contributions, etc., are almost always listed as operating expense exclusion, but if they were not listed as an exclusion, then they would still not be an operating expense absent a specific reference in the Lease to such item as an inclusion. That being said, there are other exclusions which are imperative in a Lease, otherwise a Tenant can be hurt and surprised. Examples are major increases in operating expenses because of capital expenditures, large deductibles (i.e., in the event of an earthquake), Proposition 13 tax increases, failure to address Proposition 8 decreases (for base year Leases) and failure to include a proper gross-up provision in base years Leases. The following provisions, if included in a Tenant’s Lease, will minimize the chances that a Tenant could get hurt on operating expenses.

“A Very Abbreviated List of Operating Expense Exclusions:

A. Costs of items considered capital repairs, replacements, improvements and equipment under generally accepted accounting principles consistently applied or otherwise (“Capital Items”), except for (i) the annual amortization (amortized over the useful life) of costs, including financing costs, if any, incurred by Landlord after the Commencement Date for any capital improvements installed or paid for by Landlord and required by any new (or change in) laws, rules or regulations of any governmental or quasi-governmental authority which are enacted after the Commencement Date; or (ii) the annual amortization (amortized over the useful life) of costs, including financing costs, if any, or any equipment, device or capital improvement purchased or incurred as a labor-saving measure or to affect other economics in the operation or maintenance of the Building (provided the annual amortized costs does not exceed the actual cost savings realized and such savings do not redound primarily to the benefit of any particular Tenant other than Tenant);

B. Costs incurred by Landlord for the repair of damage to the Building, to the extent that Landlord is reimbursed by insurance proceeds, and costs of all capital replacements, regardless of whether such repairs are covered by insurance (except

if permitted under subsection A. above) and cost of earthquake repairs in excess of twenty-five thousand dollars (\$25,000) per earthquake (which for this purpose, an earthquake is defined collectively as the initial earthquake and the aftershocks that relate to such initial earthquake);

C. Costs incurred in connection with upgrading the Building to comply with the current interpretation of disability, life, fire and safety codes, ordinances, statutes, or other laws in effect prior to the Commencement Date, including, without limitation, the ADA, including penalties or damages incurred due to such non-compliance;

D. Any increases of, or reassessment in, Real Property Taxes and assessments in excess of two percent (2%) of the taxes for the previous year, and any increase in Real Property Tax resulting from a change in ownership of the Landlord or from major alterations, improvements, modifications or renovations to the Building or the Land (collectively, "Transfers") except that Operating Expenses shall include the portion of Real Property taxes resulting from or attributable to an assessed value of the Building and Land greater than the market value per rentable square foot at the inception of the Lease resulting from a change in ownership; or

E. Any other expenses which, in accordance with generally accepted accounting principles, consistently applied, would not normally be treated as Operating Expenses by comparable Landlords of comparable buildings.

If the Building does not have at least one hundred percent (100%) of the rentable area of the Building occupied during any calendar year period (including any calendar year(s) falling within the Base Year), then the variable portion of Operating Expenses for such period shall be deemed to be equal to the total of the variable portion of Operating Expenses which would have been incurred by Landlord if one hundred percent (100%) of the rentable area of the Building had been occupied for the entirety of such calendar year with all tenants paying full rent, as contrasted with free rent, half rent or the like ("Gross-Up Provision").

If Landlord receives a reduction in Real Property Taxes attributable to the Base Year as a result of a commonly called Proposition 8 application, the Real Property Taxes for the Base Year and each Lease Year shall be calculated as if no Proposition 8 reduction in Real Property Taxes was applied for and/or received."

4. Condition of the Premises.

The Tenant wants to make sure it is not surprised by the condition of the Premises or "hidden" costs that it might encounter once it starts to construct its tenant improvements. Any smart Landlord would like to have the Tenant agree that the Tenant will accept the premises in its "as-is" condition. The term "as-is" might mean different things to a Landlord and to a Tenant. What the Tenant needs to do in order to make sure that it is getting a reasonably fair deal is to insist that the Landlord agree that, notwithstanding the fact that the Tenant has otherwise agreed to accept the premises in its "as-is" condition, the Landlord will make sure that when the premises are delivered to the Tenant for the commencement of business operations (in

situations where the Landlord is going to construct the tenant improvements at no charge or cost to the Tenant because the Landlord envisions that the cost of doing the improvements is minimal), or at the start of the construction of the tenant improvements (in situations where the Tenant is granted an allowance and either the Landlord or Tenant is constructing the tenant improvements with the Tenant agreeing to pay for the cost of the construction in excess of the allowance), with the Building and the Premises, including the Building Structure and Building Systems (as defined below), seismically sound, in first class condition and operating order and in compliance with all laws applicable to new construction, disregarding variances and grandfathered/grandmothered rights. By obtaining this minimal protection, the Tenant at least knows that the air conditioning and lights will be working and that to the extent the Landlord has received variances for code work (i.e., the ADA) that would be lost once the Tenant started to construct its tenant improvements, the Landlord would pay for the cost of bringing the building up to code prior to the Tenant paying for the other costs of installing its tenant improvements. Accordingly, the Tenant should seek to have the following provision included in the Lease:

“Building Structure and Building Systems. Landlord agrees that at all times it will maintain the structural portions of the Building, including the foundation, floor/ceiling slabs, roof, curtain wall, exterior glass and mullions, columns, beams, shafts (including elevator shafts), stairs, parking areas, stairwells, escalators, elevator cabs, plazas, pavement, sidewalks, curbs, entrances, landscaping, art work, sculptures, washrooms, mechanical, electrical and telephone closets, and all Common Areas and public areas (collectively, “Building Structure”) and the mechanical, electrical, life safety, plumbing, sprinkler systems (connected to the core) and HVAC systems (including primary and secondary loops connected to the core) (“Building Systems”) in first class condition and repair and shall operate the Building as a first class office building. Notwithstanding anything in this Lease to the contrary, Tenant shall not be required to make any repair to, modification of, or addition to the Building Structure and/or the Building Systems and/or the Site except and to the extent required because of Tenant’s use of all or a portion of the Premises for other than normal and customary business office operations and/or to the extent required because of Tenant’s installation of improvements or alterations which do not constitute normal, typical and customary business office improvements.”

5. Commencement Date.

It is seldom that the commencement date is properly addressed in a form lease. In a typical Small Lease, the Landlord will construct the tenant improvements. If the Landlord agrees to construct the tenant improvements at no cost to the Tenant, then it is important for both the Landlord and the Tenant to make sure that what constitutes the tenant improvements that will be constructed by the Landlord at no cost to the Tenant is accurately described in the Lease. In a situation where the Tenant pays nothing for the construction of its tenant improvements, then the commencement date on a Small Lease should read as follows:

“The Commencement Date shall be the earlier of (i) the date that the Tenant commences business operations from the premises or (ii) the first business day of the week following the Tenant’s receipt of a five (5) business day factually correct notice that the tenant improvements are substantially completed or would have been substantially completed but for Tenant Delays (as defined in the Lease).”

This provision is fair because the Tenant will not get free rent since the Tenant will start to pay rent on the day it commence business operations, and yet it will make sure that the Tenant isn't sitting at its desk on a Tuesday morning when its receives a telephone call from the Landlord advising that the tenant improvements have been substantially completed and the rent starts. Most Tenants find it more convenient to move in over a weekend and need the five day notice in order to get the telephones installed, to arrange for the delivery and installation of its furniture and equipment and to move into the Premises. The installation of furniture and equipment is seldom included within the work that the Landlord is going to perform.

Tenant Delays under this scenario seldom occur, but to make sure that there is no unanticipated Tenant Delay because the Tenant forgot to sign off on plans, etc., the following provision should be also inserted:

“No Tenant Delay will be deemed to have occurred unless and until the Landlord provides the Tenant with a notice specifying the Tenant's action or inaction which constitutes the Tenant Delay and Tenant fails to cure such occurrence or non-occurrence on the day that it receives the notice.”

The inclusion of this provision will help the Landlord establish that a Tenant Delay occurred and the Tenant was aware of it, but most importantly, it protects the Tenant from surprises.

The same commencement date provisions should be used when the Tenant receives a tenant improvement allowance and the Landlord is going to construct the tenant improvements. To the extent the Tenant receives a tenant improvement allowance and the Landlord is going to construct the tenant improvements, the Tenant needs to ensure that there is some price protection, especially in situations where the cost of construction will exceed the allowance. Normally, it is not practical or realistic to bid out small jobs for a Small Lease. Nevertheless, the Tenant needs to secure reasonable price protection and we recommend that the following provision be utilized:

“In constructing the tenant improvements, to the extent practical, Landlord agrees to bid out major trade items to three subcontractors, each of whom has a reputation for quality of work, timeliness of performance, integrity and financial stability. After reconciling the bids for inconsistent assumptions, the low bidder shall be selected in each instance. Where it is not practical and/or reasonable to bid out any element of work, then the Landlord shall select a subcontractor for each such item that has a reputation for quality of work, timeliness of performance, integrity and financial stability and cause that subcontractor to charge Tenant on the same basis that the subcontractor charges Landlord when it performs comparable work for the Landlord's own account (where the Landlord absorbs the entire cost and does not pass any of it on to the Tenant). If Landlord hires a contractor, it will cause the contractor to charge the Tenant on the same basis that that contractor would charge the Landlord when it performs similar work for the Landlord's own account (where the Landlord absorbs the entire cost and does not pass any of it on to the Tenant).”

6. After-Hours HVAC/Extra Services/Extra Utilities.

Many Landlords look at the supplying of after-hours HVAC, extra services and extra utilities as a separate profit center. Since the Tenant has no choice as to where it is going to get its after-hours HVAC, the Tenant needs to be protected. We typically ask for, and receive, the following protection for a Tenant:

“It is to be understood and agreed that any after-hour air conditioning costs will be reduced to the extent that any other tenant has requested utilization of the system, with such overall cost to be prorated. Tenant shall be charged for any after-hour air conditioning costs, extra utilities and extra services at Landlord’s Actual Cost. “Actual Cost” shall mean an amount equal to the actual out-of-pocket incremental extra costs to Landlord to provide such after-hour air conditioning (or other additional services or utilities), without markup for profit, overhead, depreciation or administrative costs.”

7. Renewal Rights.

If a Tenant has leased space and the space works for the Tenant, the Tenant may over a period of time put its own money into the space and certainly does not want to be put to the inconvenience of having to move. Accordingly, a Tenant should be comfortable in requesting a right to extend the term of the Lease and asking that the Landlord allow the Tenant to exercise that right at a fair definition of market. Typically, Landlords try to “finesse” this issue by coming up with a definition of market that excludes all concessions, which at a minimum causes a great deal of confusion and at a maximum produces a bad result for the Tenant. In addition, typically Landlords insert a provision stating that the rent will be at the higher of market (which is fair) or the rent in effect during the last month of the Lease term (which is not fair). Under these circumstances, in a marketplace such as the one we are experiencing in 2009, any Tenant who thought they were getting a renewal right finds, because the real estate market has collapsed in many parts of the country, that their right to renew at the higher of market or the rent in effect during the last month of the Lease term is in effect no right to renew at all because market rents are less than half of the rent currently being paid by the Tenant. Accordingly, Tenants should not be bashful about requesting rights to renew, utilizing a realistic definition of fair market rental rate, and not agreeing that the rent cannot be below the rent the Tenant is paying during the last month of the Lease term. In addition, many Landlords want this right to be “personal” to the Tenant, but this is something that a Tenant should resist because the Tenant’s ability to find an assignee will be greatly increased if the Tenant can transfer the entire Lease along with the renewal right. However, the Tenant should be very careful about transferring the entire Lease to someone who could renew because the Tenant would not be released from liability in the event of a renewal and the Tenant does not want to be in a position where it seeks to avoid or minimize a rental obligation for the last two years of the Lease term only to find that its assignee exercised the renewal right for another four years and then defaulted, thereby increasing the Tenant’s liability to a significant extent. Accordingly, we recommend that the following provision be inserted:

“Tenant shall have Options to Extend the lease for two (2) consecutive four (4) year periods for all or any part of the premises and any space added to the premises pursuant to the exercise of Tenant’s expansion rights. Tenant shall be required to give Landlord no less than six (6) months prior written notice of Tenant’s election to exercise an Option to Extend. Such

extension shall be upon the same terms and conditions as the Lease except that the rental rate for each option period shall be at a Fair Market Rental Rate (as defined below) and the base year for operating expenses shall be adjusted forward to the first full twelve calendar months of the extension term.

The term "Fair Market Rental Rate" shall mean the annual amount per rentable square foot that Landlord has accepted in current transactions between non-affiliated parties from new, non-expansion, non-renewal and non-equity tenants of comparable credit-worthiness, for comparable space, for a comparable use for a comparable period of time ("Comparable Transactions") in the Building, or if there are not a sufficient number of Comparable Transactions in the Building, what a comparable landlord of a comparable building in the vicinity of the Building with comparable vacancy factors would accept in Comparable Transactions. In any determination of Comparable Transactions appropriate consideration shall be given to the annual rental rates per rentable square foot, the standard of measurement by which the rentable square footage is measured, the ratio of rentable square feet to usable square feet, the type of escalation clause (e.g., whether increases in additional rent are determined on a net or gross basis, and if gross, whether such increases are determined according to a base year or a base dollar amount expense stop), the extent of Tenant's liability under the lease, abatement provisions reflecting free rent and/or no rent during the period of construction or subsequent to the commencement date as to the space in question, brokerage commissions, if any, which would be payable by Landlord in similar transactions, length of the lease term, size and location of premises being leased, building standard work letter and/or tenant improvement allowances, if any, and other generally applicable conditions of tenancy for such Comparable Transactions. The intent is that Tenant will obtain the same rent and other economic benefits that Landlord would otherwise give in Comparable Transactions and that Landlord will make, and receive the same economic payments and concessions that Landlord would otherwise make, and receive in Comparable Transactions. If, for example, after applying the criteria set forth above, Comparable Transactions provide a new tenant with comparable space at Thirty-Two Dollars (\$32) per rentable square foot, with a Ten Dollar (\$10) base amount expense stop, three (3) months at no rent to construct improvements, four (4) months' free rent, Fifty Dollars (\$50) per usable square foot tenant improvement allowance, a "lease takeover" obligation in the amount of One Hundred Thousand Dollars (\$100,000), a brokerage commission of Fifty Thousand Dollars (\$50,000), and certain other generally applicable economic terms, the Fair Market Rental Rate for Tenant shall not be Thirty-Two Dollars (\$32) per rentable square foot only, but shall be the equivalent of Thirty-Two Dollars (\$32) per rentable square foot, a Ten Dollar (\$10) base amount expense stop, three (3) months at no rent to construct improvements or three (3) months' additional free rent in lieu of such construction, an additional four (4) months' free rent, Fifty Dollars (\$50) per usable square foot tenant improvement allowance or payment in lieu of such allowance, One Hundred Thousand Dollars (\$100,000) cash payment in lieu of a lease takeover, a payment to Tenant's then broker of a Fifty Thousand Dollar (\$50,000) brokerage commission (or if Tenant is not then represented by a broker, Tenant shall receive a rent credit in the amount of the brokerage commission that Landlord would have otherwise been required to pay) and such other generally applicable economic terms.

Landlord shall determine the Fair Market Rental Rate by using its good faith judgment. Landlord shall provide written notice of such amount within fifteen (15) days (but in no event later than twenty (20) days) after Tenant provides the notice to Landlord exercising Tenant's option rights which require a calculation of the Fair Market Rental Rate. Tenant shall have thirty

(30) days (“Tenant’s Review Period”) after receipt of Landlord’s notice of the new rental within which to accept such rental in writing. In the event Tenant fails to accept the new rental proposed by Landlord, Landlord and Tenant shall attempt to agree upon such Fair Market Rental Rate, using their best good faith efforts. If Landlord and Tenant fail to reach agreement within fifteen (15) days following Tenant’s Review Period (“Outside Agreement Date”), then each party shall place in a separate sealed envelope their final proposal as to Fair Market Rental Rate and such determination shall be submitted to arbitration in accordance with subsections (a) through (e) below. Failure of Tenant to so elect in writing within Tenant’s Review Period shall conclusively be deemed its disapproval of the Fair Market Rental Rate determined by Landlord.

In the event that Landlord fails to timely generate the initial written notice of Landlord’s opinion of the Fair Market Rental Rate which triggers the negotiation period of this Section, then Tenant may commence such negotiations by providing the initial notice, in which event Landlord shall have fifteen (15) days (“Landlord’s Review Period”) after receipt of Tenant’s notice of the new rental within which to accept such rental. In the event Landlord fails to accept in writing such rental proposed by Tenant, then such proposal shall be deemed rejected, and Landlord and Tenant shall attempt in good faith to agree upon such Fair Market Rental Rate, using their best good faith efforts. If Landlord and Tenant fail to reach agreement within fifteen (15) days following Landlord’s Review Period (which shall be, in such event, the “Outside Agreement Date” in lieu of the above definition of such date), then each party shall place in a separate sealed envelope their final proposal as to Fair Market Rental Rate and such determination shall be submitted to arbitration in accordance with subsections (a) through (e) below.

(a) Landlord and Tenant shall meet with each other within five (5) business days of the Outside Agreement Date and exchange the sealed envelopes and then open such envelopes in each other’s presence. If Landlord and Tenant do not mutually agree upon the Fair Market Rental Rate within one (1) business day of the exchange and opening of envelopes, then, within ten (10) business days of the exchange and opening of envelopes Landlord and Tenant shall agree upon and jointly appoint a single arbitrator who shall by profession be a real estate lawyer or broker who shall have been active over the five (5) year period ending on the date of such appointment in the leasing of comparable commercial properties in the vicinity of the Building. Neither Landlord nor Tenant shall consult with such broker or lawyer as to his or her opinion as to Fair Market Rental Rate prior to the appointment. The determination of the arbitrator shall be limited solely to the issue of whether Landlord’s or Tenant’s submitted Fair Market Rental Rate for the Premises is the closer to the actual Fair Market Rental Rate for the Premises as determined by the arbitrator, taking into account the requirements of this Section. Such arbitrator may hold such hearings and require such briefs as the arbitrator, in his or her sole discretion, determines is necessary. In addition, Landlord or Tenant may submit to the arbitrator with a copy to the other party within five (5) business days after the appointment of the arbitrator any market data and additional information that such party deems relevant to the determination of Fair Market Rental Rate (“FMRR Data”) and the other party may submit a reply in writing within five (5) business days after receipt of such FMRR Data.

(b) The arbitrator shall, within thirty (30) days of his or her appointment, reach a decision as to whether the parties shall use Landlord’s or Tenant’s submitted Fair Market Rental Rate, and shall notify Landlord and Tenant of such determination.

- (c) The decision of the arbitrator shall be binding upon Landlord and Tenant.
- (d) If Landlord and Tenant fail to agree upon and appoint an arbitrator, then the appointment of the arbitrator shall be made by the Presiding Judge of the Superior Court, or, if he or she refuses to act, by any judge having jurisdiction over the parties.
- (e) The cost of arbitration shall be paid by Landlord and Tenant equally.”

8. Assignment and Subleasing.

Tenants frequently have a change in business plan and find that they either have too much space or too little space and need to get rid of the space that they have leased. Most Leases impose unreasonable restraints on a Tenant’s ability to assign or sublet. The Landlord’s primary concern should be to make sure that in connection with any assignment or subletting, it is not accepting a sublessee or an assignee who would cause the Landlord to be in violation of an exclusive that the Landlord has granted to another tenant or which would allow the Tenant to sublease or assign to somebody who is not comparable in quality and stature to the then-existing Tenants of the project, or to a Tenant who would violate the use restrictions. Accordingly, the Tenant needs to focus on the assignment and subletting provision and I suggest that the Tenant propose the following provisions:

“Tenant shall have the right at any time to sublease, assign or otherwise permit occupancy of all or any portion of its space, without Landlord’s approval or consent, to (i) any related entity, subsidiary, parent company or affiliate of Tenant, any company in which Tenant has a controlling interest, or to any successor corporation, whether by merger, consolidation or otherwise or to any person who purchases all or substantially all of Tenant’s assets and (ii) an entity which, with respect to the people working in the Premises, consists of people which previously worked at the Premises and are now splitting off from Tenant. Tenant may retain one hundred percent (100%) of any revenues derived from the Sublease.

“In addition, notwithstanding any other provision of the Lease to the contrary, Tenant shall have the right to sublease or assign all or any portion of the Premises during the initial or extended lease term to any third-party subtenant (provided such assignment or sublease will not cause the Landlord to be in violation of an exclusive granted to another Tenant) of a type and quality suitable for a first-class office building with Landlord’s prior written consent which will not be unreasonably withheld, conditioned or delayed. Tenant may retain fifty percent (50%) of any revenues derived from the sublease.

“Whenever Landlord is entitled to share in any excess income resulting from an assignment or sublease of the Premises, the following shall constitute the definition of “Profits”: the gross revenue received from the assignee or sublessee during the sublease term or during the assignment, with respect to the space covered by the sublease or the assignment (“Transferred Space”) less: (a) the gross revenue paid to Landlord by Tenant during the period of the sublease term or during the assignment with respect to the Transferred Space; (b) the gross revenue as to the Transferred Space paid to Landlord by Tenant for all days the Transferred Space was vacated from the date that Tenant first vacated the Transferred Space until the date the assignee or sublessee was to pay Rent;

(c) any improvement allowance or other economic concession (planning allowance, moving expenses, etc.), paid by Tenant to sublessee or assignee; (d) brokers' commissions; (e) attorneys' fees; (f) lease takeover payments; (g) costs of advertising the space for sublease or assignment; (h) unamortized cost of initial and subsequent improvements to the Premises by Tenant; and (i) any other costs actually paid in assigning or subletting the Transferred Space or in negotiating or effectuating the assignment or sublease; provided, however, under no circumstance shall Landlord be paid any Profits until Tenant has recovered all the items set forth in subparts (a) through (i) for such Transferred Space, it being understood that if in any year the gross revenues, less the deductions set forth in subparts (a) through (i) above (the "Net Revenues"), are less than any and all costs actually paid in assigning or subletting the affected space (collectively "Transaction Costs"), the amount of the excess Transaction Costs shall be carried over to the next year and then deducted from Net Revenues with the procedure repeated until a Profit is achieved."

"Notwithstanding anything to the contrary set forth in the Lease, Tenant agrees it will not terminate this Lease if Landlord unreasonably withholds consent to an assignment or sublease and Landlord agrees that Tenant may enforce its rights hereunder by an action for damages and/or specific performance."

9. Defaults.

Most default sections of the Lease are unreasonably broad and contain many outdated default provisions which are either unenforceable (bankruptcy), unrealistic (vacancy in an office project) or overly harsh (incurable defaults). Accordingly, I recommend the use of the following provisions:

"Default by Tenant. The occurrence of any of the following shall constitute an event of default ("Event of Default") hereunder on the part of Tenant:

(1) Nonpayment of Rent. Failure to pay any installment of Rent due and payable hereunder, upon the date when payment is due, such failure continuing for a period of ten (10) business days after written notice of such failure; or

(2) Other Obligations. Failure to perform any obligation, agreement or covenant under the Lease, other than Tenant's obligation to pay Rent, such failure continuing for thirty (30) calendar days after written notice of such failure or such longer period as is reasonably necessary to remedy such failure, provided that Tenant shall continuously and diligently pursue such remedy until such failure is cured.

All notices to be given pursuant to this Section ___ shall be in addition to, and not in lieu of, the notice requirements of [*California Code of Civil Procedure Section 1161*]."

10. Hazardous Materials.

The hazardous materials section of most leases are lengthy and difficult to read. However, the Tenant in a Small Lease can provide for itself the essential protections by

negotiating for the inclusion of the following provision: “Notwithstanding anything in this Lease to the contrary, the liability of the Tenant, and any indemnities provided by the Tenant, shall not extend to Hazardous Materials that were not placed on the premises, in the building, or on the land upon which the building is situated by the Tenant, or by any of Tenant’s agents, contractors and employees. In addition, Landlord shall not include in operating expenses, or pass on to Tenant directly or indirectly, the cost incurred by Landlord in monitoring, reporting, testing, abating and/or removing Hazardous Materials that were contained in the premises, in the building and/or on the land upon which the building is situated at the time that the Lease was executed.”

11. Subordination, Non-Disturbance and Attornment and Subordination Agreement (“SNDAA”).

While this article is about my top ten issues, I am throwing in this section about the receipt of an SNDAA as a wildcard issue. While it is very difficult to obtain a SNDAA in a Small Lease transaction, if a Tenant in a Small Lease transaction can obtain one from any current lender, this is a great protection to receive. Typically, if there is a loan, ground lease or prior encumbrance recorded with respect to the building (collectively and individually, “Recorded Encumbrances”), the Lease could terminate in the event of a foreclosure by the lender or holder or the encumbrance. Almost always, the typical Recorded Encumbrance is simply a loan. Since the last downturn in the economy, lenders have been much more willing to enter into SNDAA’s with a tenant because most foreclosures occur when there is a downturn in the economy, and lenders want to be in a position where they can make sure that the tenant will not be released from its liability under the lease merely because there has been a foreclosure. Obviously, in a short term lease, there is less risk. In addition, in situations where the tenant has not paid to construct its tenant improvements, a foreclosure by a lender, even if the lease terminates, is not the unmitigated disaster that would occur with respect to a large transaction where a tenant may have put hundreds of thousands or even millions of dollars into its tenant improvements. Requesting and obtaining a SNDAA from a lender will significantly increase the protections available to a tenant. In a major lease transaction, the inability of a tenant to receive a meaningful SNDAA would be a deal breaker, but in a Small Lease, the Tenant and its lawyer have to evaluate the practical circumstances in order to determine how hard to press to receive an SNDAA. When a tenant desires to obtain an SNDAA, I recommend that the following provision be utilized:

“Landlord agrees that, prior to the earlier of: (1) the Commencement Date, (2) the exhaustion by Tenant of its Tenant Improvement Allowance (as defined in the Work Letter Agreement), or (3) twenty (20) days after the date of full execution of the Lease, it will provide, without cost to or charge of, Tenant with non-disturbance, subordination and attornment agreements (“non-disturbance agreement”) in favor of Tenant from any ground lessors, mortgage holders or lien holders (each, a “Superior Mortgagee”) then in existence, substantially in the form of Exhibit “__” attached hereto. Said non-disturbance agreements shall be in recordable form and may be recorded at Tenant’s election and expense. In the event Landlord fails to provide such commercially reasonable non-disturbance agreements within the time frame set forth in this Section, Tenant shall have the right, exercisable at any time thereafter, to give ten (10) business days’ written notice to Landlord terminating the Lease. In the event Landlord does not provide Tenant with the applicable non-disturbance agreements within such ten (10) day period, the Lease shall terminate and Landlord shall reimburse Tenant all of Tenant’s

out-of-pocket costs incurred in connection with the design and construction of the Tenant Improvements and Tenant's legal fees incurred in connection with the review and negotiation of the Lease and this provision shall survive the termination of the Lease.

Landlord agrees to provide Tenant with non-disturbance agreement(s) substantially in the form of Exhibit “__” attached hereto, in favor of Tenant from any Superior Mortgagee(s) of Landlord who later come(s) into existence at any time prior to the expiration of the Term of the Lease, as it may be extended, in consideration of, and as a condition precedent to, Tenant's agreement to be bound by Lease Section __. Said non-disturbance agreements shall be in recordable form and may be recorded at Tenant's election and expense.

Notwithstanding anything to the contrary set forth in this Lease, in the event that Landlord fails to pay to Tenant (i) the Tenant Improvement Allowance (including allowances for expansions, renewals, initial construction, remodeling or refurbishing), or the cost incurred by Tenant of constructing or completing the Tenant Improvements which were required to be constructed or completed by Landlord at Landlord's expense, (ii) **[*the Lease Takeover Payment*]** (as hereinafter defined), (iii) any final arbitration award or court judgment, or (iv) **[*return to Tenant any Security Deposit*]**, the Superior Mortgagee or such other successor to the interests of Landlord and/or the Superior Mortgagee shall pay to Tenant, together with interest at the Interest Rate (as defined in Section __) , such unpaid amounts and shall recognize and honor any remaining credit of Base Rent and/or Operating Expenses. In addition, Superior Mortgagee or any other successor to the interests of Landlord and/or Superior Mortgagee shall pay to _____, Tenant's broker, any unpaid commission that was due and not paid by Landlord to Tenant's broker, together with interest thereon at the Interest Rate. With respect to all such payments, interest thereon shall be computed from the date such amounts should have been paid until the date such amounts are in fact paid.

All non-disturbance agreements shall acknowledge that, and Landlord hereby independently agrees that, to the extent Landlord has failed to fulfill its obligations with respect to the payment of any (i) Tenant Improvement Allowance (including allowances for expansions, renewals, initial construction, remodeling or refurbishing), or the cost incurred by Tenant of constructing or completing the Tenant Improvements which were required to be constructed or completed by Landlord at Landlord's expense, (ii) **[*monetary obligations arising out of Tenant's existing lease at _____ which Landlord has agreed to directly or indirectly assume (“Lease Takeover Payment”)*]**, (iii) unpaid arbitration or court award, (iv) **[*unrefunded security deposit*]**, (v) remaining credit of Base Rent and/or Operating Expenses, or (vi) unpaid commission due and owing to Tenant's real estate broker (“Key Obligations”), and to the extent Superior Mortgagee has failed to fulfill its obligations with regard to the payment of such Key Obligations as provided in the preceding paragraph, Tenant may deduct the amount of the Key Obligation which Landlord has not paid, together with interest thereon at the Interest Rate, from the Rent next coming due and payable, from time to time, under the Lease.

In addition to the foregoing, Landlord agrees that in the event Landlord has failed to pay its Key Obligations, Tenant may deduct the amount of the Key Obligations which Landlord has not paid, together with interest at the Interest Rate, from the Rent next coming due and payable, from time to time, under the Lease. Landlord further agrees that, upon Tenant's request, Landlord will provide Tenant with a preliminary title report within **[*_____ (___)*]** business days following such request by Tenant.”

12. Surrender Condition.

In order for a Tenant to get more realistic protections as to the surrender condition of its Premises, we recommend the inclusion of the following provision:

“Notwithstanding anything in this Lease to the contrary, Tenant will not have to remove any tenant improvements that existed in the Premises on the date the Premises were delivered to Tenant or which existed in the Premises as of the date the Lease was executed or made pursuant to the Work Letter or the Alterations section of the Lease as long as such tenant improvements constitute normal and customary business office improvements and in no event shall Tenant be required to repaint, replace, repair or patch wall or floor coverings or patch small holes in the walls and floors or remove cables, wiring or conduits not installed by or on behalf of Tenant.”

CONCLUSION

Every lease transaction is at the same time standard and unique. A good lawyer needs to understand its client’s business and the practical needs of the client in order to effectively make the subjective decisions to determine which provisions should make a short list for the negotiation of a Small Lease.