

Renting and Leasing Properties

For Both Tenants and Landlords

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15 Critical Factors to Investigate Before You Sign the Lease...

You should investigate the following before *signing* a lease:

- The landlord and other tenants.
- The local real estate and business market, including zoning restrictions and planned building code or infrastructure changes.
- Gross versus net lease.
- Options to renew, expand, cancel, and purchase.
- Sublet and assignment rights.
- Your present *and* projected needs.
- Rentable vs. usable space and common areas.
- Projected changes in operations, e.g., in a few years will you be assembling or manufacturing products?
- Escalation and cost-of-living clauses.
- Base year, bumps, and stop provisions.
- Repairs and maintenance.
- Casualty renovation clause.
- Rent abatement and business interruption insurance.
- Security deposits and the payment of interest.
- Subrogation, liability, and indemnification clauses.

Get yourself a good local broker to help you negotiate the lease terms.

How to Look at Your Lease

You say you signed your lease years ago? That doesn't mean this **Resource Report** doesn't apply to you. You can use many of the cost-saving alerts when renegotiating your existing lease, exercising current lease options, or arranging insurance coverage for your rental properties. So save this Report for future reference.

If you rent property to others, this Report also will help you view a lease agreement from a *tenant's point of view* so you are ready to respond to tenant questions and concerns.

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Renting is a form of debt that requires large cash outlays over the full term of the lease. That's why new and existing rental agreements deserve the same detailed attention as any other debt instrument where you live with the interest rate, repayment terms, prepayment penalty, and restrictive provisions over many years.

When evaluating a lease, keep in mind two things: (a) today's rental market is fairly volatile and lease terms, unlike regular business loan agreements, fluctuate widely depending on the condition, location, and demand for the property or building, and (b) lease terms, no matter what the leasing agent or landlord tries to tell you, are negotiable.

But before you start chipping away at the standard business or personal lease agreement placed in front of you, you need to do some preparation. First, educate yourself on the supply/demand situation for real estate in the geographic area where the property/building is located. Second, get a handle on your company's current and projected space needs. And third, list all the "what if" conditions and developments that could affect those projections.

If all of this sounds like too great an undertaking, consider the total dollar impact of the lease you're preparing to sign or have already signed. The following is typical.

Monthly rental of \$3,000 times 12 months times 10-year lease	\$360,000
Cost-of-living escalator (3%)	52,000
Pass-through costs (\$2,400 a year)	24,000
Insurance and taxes (\$6,000 a year)	60,000
Maintenance and repairs (\$3,000 a year)	30,000
Renovations before moving in	<u>10,000</u>
Total 10-Year Commitment	<u>\$536,000</u>

As illustrated, a lease commitment of only \$3,000 per month for 10 years represents a contingent liability of \$536,000; write the lease for 15 years and that liability increases to \$850,000. And how about your *personal* guarantee to meet all of the lease payments?

Thomas J. Martin, *Publisher*
The Business Library

If this Report is not applicable to you *today*, save it for future reference or pass it along to other executives and investors in rental property.

How to Protect Yourself

Many business executives lease their office, manufacturing, or other business space — and for good reason: They want to devote all available capital to building their businesses by investing in marketing, sales, and working capital rather than having it tied up in fixed assets. That's good business sense.

It's also good business sense to invest the same care and attention in negotiating a lease as in negotiating any other business agreement. A lease is a complicated legal document; it shouldn't be negotiated casually nor signed without the advice of both a good real estate broker and legal counsel. A lease contains many traps for the tenant who hasn't considered all the options and costs. But a well-negotiated lease also can reap big rewards and provide a measure of security and stability for the tenant who plans ahead. Here is some advice to get you started.

■ *Know the market:* Real estate is an extremely *localized* business. This means far more than the fact that the same square footage in comparable buildings will rent at different rates in different locations. It means that you, the tenant, must be familiar with market forces at work in the location of the building, local government and zoning regulations on its use, and the reputation and track record of the landlord.

■ *Contact professionals:* There are many sources of information to help you negotiate the best rental agreement and determine what's standard. You might contact real estate management firms, members of the zoning board, building contractors, industry development specialists, and real estate appraisal companies. All of these sources will help you better understand the current market, where it is headed, and what the standard language and costs are in rental agreements being negotiated for similar properties.

■ *Ask questions:* Even if the building and its location appear ideal, you will need to ask how it is managed and maintained. Who are the other tenants? Could existing or planned building code, zoning, or infrastructure changes restrict your ability to operate and expand? Are there adequate parking facilities for employees

and the volume of visitors to the building? Will the lease be on a “gross” basis (the landlord pays for taxes, utilities, insurance, etc.) or a “net” basis (the tenant pays for these expenses)? If you can’t use the premises because of damage or a disaster, do you have to continue paying rent?

■ *Investigate the landlord:* Have you checked out the landlord’s reputation for good management and fairness, and his financial condition? Have you spoken to other tenants to determine how happy they are with the building, its location, their leases, and the landlord?

Big-Dollar Questions to Ask

No matter what a broker or landlord tells you, a rental agreement is always negotiable. Depending on the market conditions at the time of your negotiation, either you or the landlord could have the most leverage in your discussions. Keep in mind that you will be negotiating much more than just the square-foot rate. The answers to the following questions can significantly affect your total dollar commitment.

- Who is responsible for insurance, utilities, and taxes?
- What is the rentable versus the usable space, i.e., the square footage you will be paying for but not using? What is the loss factor?
- Who will pay for alterations and repairs prior to moving in? This will be your responsibility if the lease specifies acceptance of the property *as is*.
- Are there step-up provisions in the rental amount? If so, how often and how much? What is the formula for calculating increases?
- Is there an operating pass-through clause by which the landlord passes on increases in his operating costs (e.g., building employee salaries)? Is there a cap or limit on the amount by which your costs can be increased each year? Is the base year against which increases are measured fair and reasonable?
- Are security deposits held in an interest-bearing account?
- Can you use the property for *any purpose* or is it restricted (e.g., there are non-manufacturing and non-disturbance clauses in the lease)?

And What About the Future?

It's always advisable to negotiate a lease with these possibilities in mind: *first*, that at the expiration of the lease you may wish to remain; *second*, that you may wish to leave before the lease is up; and *third*, that you may wish to buy the property at the end of your lease. Try to provide for these possibilities with the following lease provisions.

- *Right to renew:* The advantage of a renewal option is simply that, should you decide to stay after the lease expires, the terms of the renewal clause are often *more favorable* than the terms would be under a new lease negotiated at that time. In addition, with a renewal option, you have peace of mind that you don't have to vacate the premises at the end of the initial lease period. *Try to specify:* The length of time for which you can renew beyond the original lease and a limit on the amount by which the rent can be increased in the new lease.

- *Right to cancel:* With a cancellation clause, you usually will have to pay a penalty for vacating the property before the lease expires, but at least you will be spared a big contingent liability for the remaining term of the lease. *Try to specify:* The amount of the penalty (it should vary, based on how long you have remaining on the lease) and the amount of advance notice you must give.

- *Right to purchase:* If you are the principal or only tenant, try to build in an option to buy the building even if you have to pay extra rent to get the option. *Two questions:* (a) Is the property likely to increase in value, preferably by at least 5% to 10% annually? (b) Can a portion of your rental payment be applied against the purchase price? (That's usually feasible in soft rental markets.) *Try to specify:* When you can exercise your right to buy the building and the terms on which you can make the purchase (i.e., so much downpayment, so many years to pay, etc.).

- *Right to sublet:* With this clause, you have the option to sublet part or all of the property if your needs change or you have to move to a new location. The clause should state that your landlord cannot *unreasonably* withhold his or her consent to your subletting. *Caution:* Do not accept a verbal promise. Get the consent in writing in the lease contract. *Try to specify:* The right to assign your lease to the subletting party so all liability passes to the new tenant.

- *Right to rent more space:* In some instances, again depending primarily on local market conditions, it may be possible to get an option clause in the lease to rent more space at a later date, sparing yourself the headache and expense of having to move when you outgrow your current space. However, you may have to pay a premium for this option. At the minimum, get the *right of first refusal* on new space that comes on the market in your building. *Try to specify:* When you can exercise the right to add more space and on what terms.

7 Property and Casualty Risks to Guard Against

The moment you sign a new lease for space, you assume a variety of contractual risks. If you know the risks, you can protect against them. If not, the price can be very high. Use this checklist with your insurance broker to be sure your insurance covers the potential risks in new or existing rental agreements.

- Even though your landlord has insurance, does his or her insurer have *subrogation rights* against you, i.e., you can be sued by the landlord's insurer for damages and personal liability claims caused by you? If so, consider additional fire and water damage liability insurance or insert a *joint waiver of subrogation clause* in your lease.

- Does your lease make you liable for damages to the structure of the building? If so, does your existing insurance protect you against this potential liability? You also don't want to pay for inherent defects in the building; that's the responsibility of the landlord and it should be spelled out in the rental agreement.

- Do your operations, say some minor assembling or manufacturing, cause an overall increase in the landlord's fire and casualty insurance rates? If so, are you liable for the difference and what is the amount?

- What happens if you can't use the leased facilities for any reason (e.g., fire, strike)? Do you have to continue paying rent? If so, do you have *rental insurance* or *business interruption insurance* to reimburse you for the paid rent and other costs of not being able to operate your business at its usual location?

- Do you have insurance to *indemnify* you against third-party claims

resulting from your negligence or noncompliance of the lease terms? If so, be sure this contingency is covered in your general liability policy.

■ Is your business *umbrella* policy coordinated with the above potential insurance risks? Umbrella insurance protects you against claims made in excess of your general liability insurance coverage.

■ *Special risks:* If you are responsible for the heating boiler, you may need boiler insurance. If you are responsible for glass and your facilities contain a lot of glass, you may need plate-glass insurance. Depending on your location, you may also need protection against flood, earthquakes, hurricanes.

Negotiating the Basics

You want to understand all of a lease's provisions but you don't want to negotiate them all with equal intensity. Lease agreements are very detailed documents and it's easy to get bogged down. Keep in mind that many lease provisions are standard. You want to focus on the basics of what you are leasing and what you are paying. Here are some suggestions to keep you focused.

#1: How much space?

Measure the space. You want to know how much space you are getting and how much you are paying for. They're not always the same thing. The fact is there are various ways to measure space in different geographical areas. For example, a landlord may measure from the outside wall, even though that space is not usable to you. Or he or she may include the common utility room, or part of the hall and elevator space, in calculating the square feet of space for which he is charging you.

#2: Is the space ready?

Once you've determined the space is adequate, draw up a list of repairs, improvements, and replacements you would like made to accommodate your needs. *Examples:* Replace floor tiles, repair doors, add lights. Then, when the lease negotiations begin, put these items onto the bargaining table. It starts the negotiations off at a businesslike pace and you are far more likely to get these changes and concessions from the landlord before you sign the lease than after you move in.

#3: What will it cost?

You don't want to overlook any cost or expense for which you will be charged. For example, in most buildings, the landlord will ask that each tenant share in the building costs — heat, common electricity (in the halls and elevators), maintenance, etc. If so, find out what percentage of the total costs you're responsible for based on your space. Also get a written estimate of the expenses from the landlord.

Many buildings have a single master meter for utilities. The landlord, often with the help of a utilities consultant, decides how much each tenant uses, and thus, is charged.

What to do: Request that the lease provide you with the right or option to bring in your own consultant and, if there's a difference of opinion, the right to arbitrate the difference. *Better yet:* If possible, consider getting a separate meter for your space so you can monitor the use and charges.

#4: How much can costs go up?

Most leases contain one or more rent escalation clauses. The most basic form of escalation is based on the landlord's increase in taxes, insurance, operating expenses, etc., over the first year's expenses. The most equitable approach is to pass through a percentage of these increases, based on the area you're leasing.

What to do: Avoid a clause where the pass-through amount represents more than the landlord's increase, or where the pass-through is a fixed annual percentage. If you can, try to negotiate a maximum limit on any escalation, say, no more than 3% over the prior year.

Some lease agreements contain a cost-of-living escalator clause or one that is

tied to the annual pay increases given to the lessor's maintenance staff. *Try to avoid that*; escalation clauses tied to wage rates can increase your rent rapidly since the annual increase in wage rates is usually greater than the overall rate of inflation.

What to do: If you must agree to a cost-of-living escalation, try to limit it to a percentage of the total increase (for example, 75% of the increase). If the market is soft, you may be able to specify a base year two or more years forward. Be sure you understand how the escalation formula is applied. Not all landlords use the same method or definition.

#5: When can costs rise?

In evaluating escalation clauses in your lease, pay close attention to the base year or stop clause provision. The terminology can be confusing. As a tenant, you pay escalation on all the landlord's costs *above* the base or stop. You want as high a base or stop clause as possible. If your lease calculates increases against a base year, you may even try to negotiate a future year as your base.

Example: Let's assume that your annual rental amount is \$20 a square foot, with a base or stop clause of \$5 per square foot. If your share of the landlord's increased expenses is \$3 per square foot in the second year of the lease, you pay no escalation. If it rises to \$7 in the third year, you pay only \$2 a square foot (\$7 less \$5 base), not the full \$7 increase.

#6: How long are you locked in?

The landlord may try to get you to take a short-term lease of up to five years if the market is tight, or a long lease if the market is soft. Remember, the real estate market moves in cycles and sometimes these cycles are short-lived. Remember, too, that a low-rent, short-term lease sometimes can be more expensive than a higher-rent, longer-term lease because you are only committing yourself to the shorter-term lease period.

What to do: You should be able to negotiate good rental terms if you take a long-term lease with a renewal option. Unless the market is very tight in your area, a landlord usually will agree to this since it reduces vacancy and brokerage fees, as well as any alteration costs for a new tenant.

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Many of the ideas discussed in this **Resource Report** are negotiable items that will have a material impact on you during the full term of the lease. Landlords do make concessions to keep their occupancy rates at or near breakeven. Potential tenants should feel comfortable in negotiating hard to obtain those provisions which substantially affect their total rental liability. □

Reference —

Exhibit 1: Know These 17 Rental Terms — page 13

The small print and technical terms in leases can cost you money and time.

Know These 17 Rental Terms To Negotiate the Best Lease

In negotiating for office, factory, or warehouse space, you're confronted with an array of technical and legal jargon. Here are some of the common lease terms used by landlords, lawyers, and real estate agents.

As Is. When space is leased "as is," the tenant accepts the rental property in the condition in which it is found. The tenant assumes the responsibility and cost of any repairs or improvements.

Base Year. This is a term used in calculating rent escalations. The cost levels in the *base year* of the lease agreement are those against which future increases are measured. As long as inflation continues, earlier base years will require larger escalation payments, which will increase your annual rental expense. There also could be a different base year for each lease component — electricity, oil, taxes, etc.

Bumps. Fixed annual increases in the base rent (e.g., \$3,000 per month for the first five years, then \$3,500 for the last five years), as opposed to escalation-derived increases, which are basically percentage increases.

Cap. Commonly known as an "escalation cap," this is an agreed-upon maximum beyond which escalations will not rise.

Consumer Price Index (CPI). Base rent (or other fees or charges, such as electricity) increase along with the current rate of change in the CPI. Various "wrinkles" may be inserted, such as selecting the CPI increases for the nation as a whole rather than the region where the property is located.

Direct Metering. An arrangement by which each tenant has his own meter and is billed directly by the utility for electricity actually consumed.

Escalation. This term describes lease provisions for increasing rents to protect the lessor's (owner's) rental income against inflation by passing on increasing costs to the tenants.

Types of Escalation

- *Tax escalation* apportions increased real estate taxes among all tenants, each of whom bears a percentage of the annual increase equal to the percentage of building space occupied.
- *Pass-through of operating costs* allocates the owner's direct operating costs to the tenants (as defined in the lease, but generally such items as fuel, insurance, etc.).
- *CPI formula* equates the annual rental increases with the increase in the Consumer Price Index.

Gross Lease. The owner is responsible for payment of taxes, utilities, insurance, etc., but these costs are usually within the annual rental paid by the tenant.

Net Lease. Under this type of lease, a tenant pays the owner an agreed-upon rent and directly bears certain costs of the building (e.g., real estate taxes, fuel, and insurance).

Quiet Enjoyment. The responsibility of the landlord to make sure the tenant is able to use the space for the purpose intended. For example, a research company requiring a quiet environment rents the third floor of a building. The landlord then rents the fourth floor to a music recording company. The research company would have grounds to cancel the lease. In addition, failure of the landlord to provide essential services or to make necessary repairs may violate the covenant of quiet enjoyment.

Rentable Area, Usable Area, Loss Factor

- *Rentable area* is the square footage for which rent is actually being paid. Often, other provisions within the lease are based upon this figure (e.g., rental escalation).

- *Usable area* is the space actually occupied as measured in square feet. This does not include public corridors, stairwells, bathrooms, and other similar areas.
- *Loss factor* is the difference between rentable and usable area, expressed as a percentage of the former. For example, if the total rentable area is 10,000 square feet and the usable area 8,000 square feet, the loss factor is 20% (2,000 divided by 10,000).

Security Deposit. A sum of money paid by the tenant to the owner and held by the latter for the term of the lease. The money serves as protection for the owner against damages to the property, default or other liabilities. In the absence of these occurrences, the security deposit is returned to the tenant at the end of the lease period. Depending on state law, interest on security deposits may be required.

Standard Tenant Installation. The work which the owner will undertake, at his own expense, to prepare the premises for occupancy. Typically, if the tenant requests that all or part of the work not be performed, the owner will provide an agreed-upon credit for the work not done.

Subleasing or Assignment. A *sublease* arrangement occurs when a tenant creates a new contractual arrangement with a third party for all or part of the lease term. The original tenant is still fully obligated under the terms of the lease but collects rent from the sublessee according to the terms of the sublease agreement.

An *assignment* occurs when the original lease is assumed by a third party and the tenant may or may not remain obligated. The precise rights and responsibilities in the sublease and assignment situations are normally specified in the lease.

Take-Back. An agreement whereby the landlord agrees to "take back" a part of the space rented. For example, a tenant contracts to rent 25,000 square feet of space for ten years, but needs only 20,000 square feet for the first two years. The landlord agrees to take back 5,000 square feet for the first two years. The take-back agreement is a valuable option that builds in the right for a growing tenant to expand into that space at a later date.

Use Clause. A clause in the lease which defines and restricts the nature of the business which a tenant can conduct in the leased premises.

Work Letter. Part of the lease which defines the allocation of costs and the responsibilities to be assumed by the owner or tenant in the preparation of the leased premises for occupancy.

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Use this **Resource Report** as a reference with your advisers *before* negotiating any lease agreement. Also recognize that, depending on state and local laws as well as zoning regulations, the terms of your lease can vary significantly compared to leases in other locations. Again, use a lawyer and real estate agent who are well versed in lease transactions. You may even decide to hire a real estate consultant to sit in on lease negotiations with you. Only you can decide how much help you need, based on the length and dollar value of the lease. □

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This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **29** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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