

Lease Abstracting as a Foundation Stone for the Acquisition, Ownership and Management of Commercial Real Estate

By David I. Tesler, Esq. CEO LeaseProbe, LLC

The income producing nature of commercial real estate is made possible by the rental stream that a tenant is willing to pay to the owner in return for the leasing of space within the property. The source for this rental obligation, along with all existing rights and obligations of the tenant and owner is laid out in the lease.

When purchasing existing commercial real estate, essentially two primary items are being acquired – the actual physical property and its underlying leases. Both require thorough review. The due diligence on the physical property will center on the structural integrity of the building, an environmental study of the premises, zoning matters and assuring clean title. The topic of this article will focus on the second item; the critical need to examine each of the underlying leases in its entirety.

A commercial lease is an agreement between a Landlord and Tenant that defines the entire association between both parties throughout the life of the lease. The lease sets forth “big picture “ items such as lease term, rental obligations, common area maintenance charges (CAM), renewal rights as well as technical items, but of no less import, such as proper notice address, insurance requirements, signage allotments, and tenant audit rights. The lease is the instruction manual, road map and the sole rule book governing the relationship between the owner and tenant.

It should be noted though that thoroughly reviewing the lease alone is never sufficient. There are invariably many other documents associated with the lease that are no less important to fully review. The entire lease file should include the lease together with all schedules and exhibits, amendments, commencement date letters, memoranda of lease, side letters, estoppel agreements and correspondence. Each of these “additional documents” can contain significant and meaningful data that must be captured to fully understand the property and each tenant. For example, schedules and exhibits often contain information such as tenant improvement allowances, broker commissions, permitted and prohibited uses, radius restrictions to name just a few. Commencement date letters are invaluable to ascertaining the correct starting date and all critical dates that flow from that initial date. Estoppel agreements confirm to all parties the state of the most significant elements of the lease and often point to existing problems, if any. Correspondence between owner and tenant often provide invaluable insight into trouble spots within a building or a landlord/tenant relationship.

A lease abstract is a summary of key financial, business and legal information in a commercial real estate lease and all associated documentation. A lease abstract should also bring to the reader’s attention any unusual lease provisions, financial

obligations or other issues of import. The abstract's specific level of detail should depend on the purpose of the abstract.

Lease Abstracting for Acquisition

Accurate lease abstracts must be the starting point when considering a commercial real estate acquisition. The ultimate source for much of the data required for financial due diligence, cash flow modeling and projections can be found within the lease documents. The abstracts, at minimum should include:

- All current and future financial information to assist in computing the property's value, including basic rent, additional rent, tenant improvements, lease commissions, etc.
- All critical lease dates, including lease expiration dates, rent step-up dates, renewal and option dates, etc.
- Each tenant's CAM, taxes and insurance responsibilities, structure and payment methodology, all of which can differ from tenant to tenant
- Other rights and obligations detailed in the lease that could impact upon the property's value.
- Potential or existing problems that can be gleaned from landlord/tenant correspondence often found within a lease file. Examples of such problems include rent delinquencies or chronic maintenance and repair issues.

This information is the foundation for effective acquisition due diligence. There are many surprises lurking throughout the lease. There is no shortcut to learning about every aspect of a particular property. Every page of every document within the lease file could contain information that would significantly impact the property's value. Ignore or skim through this documentation at your peril.

Lease Abstracting for Ownership and Management

As discussed, there are some items within each lease that are critical to abstract when performing due diligence prior to acquisition. There are many other provisions found within the lease that may not be as significant prior to an acquisition but assume great importance for the future ownership and management of the property.

Real estate companies take two approaches to reviewing leases for ownership and management. Some companies first request a more limited "due diligence abstract" and then request a comprehensive lease abstract if the property is successfully acquired. Other companies choose to abstract the lease only once and to have that abstract serve both due diligence and ownership/management purposes. The advantage of the first approach lies in cost savings if the property is not eventually acquired. However, it is faster and more cost effective to review the abstract and

leases simultaneously. In addition, a thorough initial review allows the potential owner to learn more about the property early in the process.

Lease abstracting for ownership and management is significantly more comprehensive in nature. Its purpose is to succinctly summarize each and every provision that will likely be of use throughout the term of the lease. The abstract should serve as a guidepost, pointing the reader to the exact place in the lease should more information be required.

As multiple parties within a real estate company require access to lease information, a lease abstract should contain information that a property manager, lease administrator, accountant, financial officer and attorney would all require. The abstract should provide a meaningful summary of critical terms aimed at each person at the company requiring access to the lease and prevent the aimless task of opening and reading the lease in its entirety each time a question arises. A real estate company that has a comprehensive and accurate lease abstract that is widely distributed to all relevant personnel will save hundreds of man hours throughout the term of the lease. In addition to the man hours saved, a lease abstract should note all critical dates that require action. One large real estate company recently shared with me that had they known that a particular tenant missed their window of opportunity to automatically renew their lease with written notice, they would have notified the tenant as such and had the opportunity to remove that tenant who was paying significantly lower than market rent. The real estate company's failure to manage their critical dates resulted in a significant loss of rental income.

Ultimately, every company may have different conceptions about how comprehensive an abstract should be. There is no one or right answer to this. For a handy list of commonly abstracted provisions please visit www.leaseprobe.com/scope.

Performing due diligence prior to acquiring property and then owning and managing that property requires constant access to the underlying commercial real estate leases. Knowing what is contained within the lease files and then having easy access to that information is a critical requirement and frequent need for every commercial real estate owner.