

COMMERCIAL REAL ESTATE LEASES

Excerpt From “Lease Clause Analysis - Issues of Significance”

Sample Lease Agreement Language Included For Reference

The following pages contain an excerpt taken from the 73-page "Lease Clause Analysis - Issues of Significance" section of the "How To Lease Commercial Real Estate" course. It deals with the issues surrounding the damage and destruction clause found in most every commercial lease. The information provided with respect to this lease clause is indicative of the depth and balance found throughout the course. We hope this sample proves useful in its own right.

The author, Steve Wennerstrom, has over 25 years of commercial real estate experience representing a host of institutional landlords and currently assists AT&T in leasing and purchasing properties nationwide. Having negotiated many millions of dollars in lease transactions over the years, he has developed this home study course as a "Quick Start" program of instruction so that others will have no need to learn by the costly trial and error method. If you wish to learn more about the course, , please visit our website located at <http://www.cfcfe.org>.

Although seasoned professionals will find it to be a valuable reference tool, the course also provides the "hard core" techniques needed to competently navigate through the process of leasing commercial real estate. The course, in over 140 jam-packed pages, offers a real-life, nuts and bolts, step-by-step approach to leasing commercial real estate together with sample leases, fill in the blank forms, worksheets and invaluable templates for putting together the all-important "Request For Proposal" (RFP).

This course is for anybody and everybody who is, or would like to be, involved with leasing commercial real estate. It doesn't matter whether you're a tenant, landlord, asset manager, property manager or one of their advisors, such as a broker, attorney or insurance agent. The information contained in this course will immediately catapult your ability to competently lease commercial real estate.

The materials contained in the following pages have been specially prepared as part of an educational presentation on the issues which surround negotiating a commercial real estate lease. While the focus of negotiations is usually directed toward the issues of base rent and concessions, there remain a host of important concerns which are often overlooked, misunderstood or under-negotiated, even by sophisticated landlords, tenants and their real estate representatives. This presentation provides a layman's interpretation of each lease clause contained in the sample commercial lease, highlights many of the more significant issues and offers practical ideas and suggestions.

These materials speak to a limited number of concepts and strategies in real estate leasing transactions. They are not intended to constitute an analysis of any limiting or qualifying laws or principles and they should not be construed as legal advice or opinion. Use of the Sample Commercial Leases included as a part of this educational presentation, in whole or in part, would have important legal consequences and the parties should consult legal, and tax or other counsel prior to their use in any real estate transaction.

Most sections of the sample lease form are the same for all different types of leases and have been designated as "universal" sections. The other sections have been tailored for specific types of property, uses or options and are identified as such. Each section of the lease will be analyzed; if the section is not universal, then differences will be noted.

ARTICLE 7.00 CASUALTY AND INSURANCE

7.01 Substantial Destruction. If the leased premises should be totally destroyed by fire or other casualty, or if the leased premises should be damaged so that rebuilding cannot reasonably be completed within ninety working days after the date of written notification by Lessee to Lessor of the destruction, this Lease shall terminate and the rent shall be abated for the unexpired portion of the Lease, effective as of the date of the written notification.

Explanation - Section 7.01 Substantial Destruction (Universal). Provides that upon "substantial destruction" of the leased premises, the lease is terminated. There is substantial destruction if the leased premises are so damaged they cannot be rebuilt within ninety working days after the destruction.

7.02 Partial Destruction. If the leased premises should be partially damaged by fire or other casualty, and rebuilding or repairs can reasonably be completed within ninety working days from the date of written notification by Lessee to Lessor of the destruction, this Lease shall not terminate, and Lessor shall at its sole risk and expense proceed with reasonable diligence to rebuild or repair the building or other improvements to substantially the same condition in which they existed prior to the damage. If the leased premises are to be rebuilt or repaired and are untenable in whole or in part following the damage, and the damage or destruction was not caused or contributed to by act or negligence of Lessee, its agents, employees, invitees or those for whom Lessee is responsible, the rent payable under this Lease during the period for which the leased premises are untenable shall be adjusted to such an extent as may be fair and reasonable under the circumstances. In the event that Lessor fails to complete the necessary repairs or rebuilding within ninety working days from the date of written notification by Lessee to Lessor of the destruction, Lessee may at its option terminate this Lease by delivering written notice of termination to Lessor, whereupon all rights and obligations under this Lease shall cease to exist.

Explanation - Section 7.02 Partial Destruction (Universal). Provides that if the leased premises are partially destroyed, the lease is not terminated and Landlord shall make the necessary repairs with an adjustment in rent. This section covers the situation where the leased premises can be reasonably repaired within ninety working days after the destruction.

1. DAMAGE AND DESTRUCTION - THE ISSUES

Virtually every commercial lease deals with the possibility of casualty damage. The tenant must know whether it can use the premises within a reasonable period after the damage, or whether it must make alternative leasing arrangements. The tenant must also know whether it will be required to spend additional funds to return to normal business operations.

A. Triggering Events.

The extent or type of damage which triggers the casualty clause is of crucial consideration. The consequence of the damage is that the lease may terminate or, at least, that there will be a period of rent abatement or other significant modification of the rights of the parties.

- 1) Some leases refer to damage by fire or other insured casualty. This is of obvious danger to a tenant since damage may occur from an uninsured or even uninsurable event. Accordingly, from the tenant's perspective, the triggering event should be any damage or destruction, whether insured or

insurable, and most landlords would agree to this. This amounts, in part, to an assumption of a business risk, since the landlord may not be able to insure the rental stream for certain occurrences. For single, net-leased buildings, the risk is often passed on to the tenant.

- 2) A great many leases permit rental abatement only where the damage or destruction is not due to the fault of the tenant. This is at variance with the notion of waiver of subrogation and the careful tenant will seek to eliminate this qualification. Otherwise, the tenant will have to be sure that its own business interruption insurance is sufficient to cover the risk.
- 3) Where the tenant is at fault, however, the landlord might require that any applicable deductible amount be borne by the tenant. The tenant will want to resist this since it does not have control over the terms of the landlord's policy.

B. Extent of Damage.

- 1) The typical office lease casualty clause provides for an abatement of rent during the restoration period, but it is important for the tenant to focus not only on the damage to his own premises, but also to anything impacting the normal conduct of his business, such as access, building services and utilities, adverse effects on business due to construction activities or unsightly surroundings, smoke damage, and the like. Thus, the tenant will want the abatement period to apply so long as the premises are not useable for his business purposes. Even damage which is solely confined to other tenant space may have an adverse impact by reason of reconstruction activities – this could extend not only to common areas but to activities in other tenant space.
- 2) The sophisticated tenant will also ask that the rent abatement period resulting from casualty be extended to include a fixturing period similar to that provided at the inception of the lease. The landlord will want to resist this grant of an additional contingent concession and should in any event require that the fixturing period be minimized by having it overlap with the landlord's reconstruction activities. The landlord should also be sure that its rental insurance will cover this additional period.
- 3) Many leases also provide that if there is partial damage, there is a proportionate abatement of rent. Since an allocation on a square foot basis cannot adequately cover all situations (e.g. smoke damage, interference with access, etc.), a better approach is to have an equitable adjustment together with a dispute resolution mechanism such as arbitration. Another approach is to key the amount of abatement to the actual decrease in tenant's business activities or income.

C. Decisions and Time for Repair.

- 1) Some forms allow a landlord to terminate a lease if the damage cannot be restored within a specified period of time, typically on the order of 90 days. The exposure for the tenant or the landlord is that this could be used as a basis for arbitrarily terminating an unfavorable lease. The landlord will want to extend this period considerably, and the tenant will not want to grant a termination option to the landlord unless the landlord treats all affected tenants in a similar fashion.
- 2) In a similar vein, many leases provide for an option of the landlord not to restore if insurance proceeds are inadequate or if the landlord's mortgagee refuses to allow the insurance proceeds to be used for restoration. Most smaller tenants will be forced to accept this, but the largest tenants will have sufficient leverage to shift this risk to the landlord; in essence, the landlord must undertake to fully insure and as part of the lease approval package, the landlord's lender will have to agree to this commitment. This is not an unfair approach and is the practical result in almost all cases.

- 3) The tenant will necessarily need a right to terminate if the restoration period is excessive, and this is one of the major items of negotiation in the casualty clause. For major office leases, the period is usually set between four and twelve months. The argument for the landlord, in seeking as long a period as possible, is that few tenants will be able to move into substitute permanent space in less than six to twelve months. From the tenant's perspective, the uncertainty and exposure for delays may have a substantial adverse impact on its business; additionally, a casualty requiring an extended restoration period may by its nature be so substantial as to have an adverse impact on the building which may persist well beyond the restoration period.
- 4) Careful drafting by the landlord will key the termination not to the actual time period for restoration but to a good faith estimate made promptly following the occurrence of damage. Under this concept, if the estimate proves greater than the outside limit, the tenant must make a binding decision and cannot terminate even if the actual time exceeds the estimate. This has the obvious benefit of protecting the landlord against making substantial customized expenditures in restoring the tenant space, only to find that an unanticipated delay will allow the tenant to terminate.
 - a) A careful tenant might require a right to contest the landlord's estimate – speedy arbitration is a possible approach.
 - b) The most sophisticated tenant will still be concerned about excessive delays beyond the estimate. Possible compromise positions include:
 - Allow termination after a specified time period beyond the estimate;
 - Provide for a sharing (50%-50%) of the unrecovered costs to the landlord of restoration fit-out in the case of termination;
 - Qualify any ultimate termination by force majeure language;
 - In all cases, have the landlord notify the tenant upon learning of an anticipated delay, in which case the tenant must be obligated to make a prompt decision so as to minimize the ultimate exposure of both parties, and so as to allow the landlord the ability to take steps to expedite reconstruction at extra cost.
- 5) The relative rights of the landlord and tenant for repair and restoration are rarely specified with adequate precision. This is an area which is best handled after consultation with the parties' insurance consultants. Many leases provide that the landlord will restore only those improvements which it initially constructed, or for which it furnished an allowance. The problem is that the tenant may have made its own installations, and it will be difficult to determine how the insurance proceeds can actually be allocated, especially if more than one tenant space is involved (the notion that space may be only partially rebuilt because of a specific dollar allowance is not necessarily consistent with replacement coverage insurance maintained by the landlord).
 - a) The tenant needs to manage his insurance program so that the entire space can be restored to its former condition.
 - b) Some landlords, as a matter of practice, insure the full value of all tenant space (excluding only furniture, trade fixtures, and the like) on the theory that this is the most efficient way to protect the entire building on a replacement basis. However, most landlords will not agree to this position in the lease; they are concerned that other tenants will object to a disproportionate inclusion of insurance premium increases through escalation provisions.

- c) Obvious inequities can result where certain tenants have obtained construction allowances and others have instead taken free rent or other lease concessions. The net economic package is the same, but the free rent tenant who has installed his own improvements would have an inequitable insurance or reconstruction burden.
 - d) A compromise approach might be for the landlord to insure all improvements except those resulting in a significant premium increase or attributable to specified or excessive fit-out --- or the special component of the premium increase can be borne by the tenant in question.
- 6) Landlords who agree to a specific obligation to restore or a specific obligation to insure may have an exposure to the tenant for breach of contract if they are unable to fulfill these obligations --- this could theoretically extend to damage to the tenant's business, relocation expenses, and the like. With respect to major leases, it is difficult for the landlord to avoid this contractual undertaking, but since all tenants are paying for insurance as part of their rent they are arguably entitled to be assured that this risk is covered.