

BENNETT VALLEY LAW

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REAL ESTATE TOPICS

JULY 1, 2008

COMMERCIAL LEASING CHECKLIST

(Office Lease – Tenant Oriented)

The following checklist addresses many common issues which arise in negotiating an office lease. Retail and industrial leases trigger many of the same concerns, plus additional ones unique to the proposed use.

For many companies, their leasing obligations are their largest financial commitments, so it is highly recommended that the company have its leases reviewed by an attorney with relevant experience.

WHAT IS BEING LEASED?

- ◆ Are the Premises described in sufficient detail so that a stranger could find the space? Is the square footage correct? Does the load or loss factor make sense?
- ◆ Is the floor plan accurate? Does it include any extraneous equipment rooms, corridors, vertical penetrations or other areas?
- ◆ What is the project? Is it a multi-building and/or multi-use project? Are all the buildings in place or are they being constructed in phases? If so, how will changes affect operating expenses and taxes?
- ◆ Is there a mechanism for measuring the space? Tenants prefer the following provision:

The parties hereby agree that the actual rentable areas of the Premises and the Building have been determined by Landlord's architect in accordance with the rentable standards set forth in ANSI/BOMA Z65.1-1996, as promulgated by the Building Owners and Managers Association ("BOMA Standard"). Tenant's architect shall calculate and certify in writing to Landlord and Tenant the rentable square footage of the Premises. If Tenant's architect determines that the rentable square footage of the Premises is different from that stated in this Lease, any provision which is based on rentable square footage (including, without limitation, Rent, Proportionate Share, Tenant Improvement Allowance) shall be recalculated accordingly.

- ◆ Is parking included? Are the number of spaces and charges correct? Where is the parking located? Could the landlord move it off-site? Is there a shuttle service to and from the parking areas and/or mass transit?

- ◆ Does the tenant have the right to use common areas? Does the description of the common areas make sense?

WHAT IS THE RENT?

- ◆ Full service with a base year? Triple net? Something in-between?
- ◆ What are the pass-throughs? Are they estimated annually and paid monthly? Are certain expenses paid directly by the tenant such as utilities?
- ◆ Any free rent? Are the annual increases correct? Do they occur on the anniversary of the lease commencement date or the rent commencement date?
- ◆ What is tenant's proportionate share? Would it ever change?
- ◆ What is the base year for operating expenses? For taxes?
- ◆ Does the tenant have the right to audit operating expenses?
- ◆ Are the building's operating hours what you would expect? Do they include Saturday mornings? What hours of HVAC usage are included in rent and what hours are subject to extra charges?
- ◆ How is after-hours HVAC arranged and what is its current charge? Is the charge consistent with the local market?
- ◆ Does the definition of operating expenses exclude the items and contain the adjustments to base year listed on Exhibit A? Could you negotiate an exclusion of Proposition 13 reassessments?

WHAT IS THE CONDITION OF THE PREMISES AT DELIVERY?

- ◆ Is the tenant accepting the premises AS IS and without any build-out obligation from landlord? Even so, the landlord should still represent and warrant that the condition of the premises, building and project comply with applicable laws as of the commencement date, including those relating to disability access and hazardous materials (including asbestos), and that the building systems serving the premises are in good working order.
- ◆ Is the landlord delivering a cold shell, warm shell or turn-key tenant improvements?
- ◆ Can you describe the line between the work the landlord is to perform (and pay for) and the work the tenant is to perform (and pay for)? Misunderstandings about the parties' build out responsibilities are a major source of conflict, so be sure to discuss these responsibilities in great detail.
- ◆ What is the tenant improvement allowance and how is it calculated? Per rentable or usable square foot? Is the landlord open to providing an additional allowance which would be amortized and repaid over the term of the lease as additional rent?

- ◆ If the entire allowance is not applied, who gets the remainder? Preferably it would be credited to rent. Alternatively, the funds remain available to the tenant for alterations later in the lease term.
- ◆ Are there any unusual build-out requirements, such as internal staircases, high density file cabinets, showers, training or childcare facilities, satellite dishes or extra HVAC? Have those been approved by the landlord at least in concept?
- ◆ Has the landlord approved the tenant's finishes?
- ◆ Does the lease provide a mechanism for delivering a punchlist and when is the punchlist due?

In a landlord-controlled build-out, does the work letter cover the following?

- ◆ All work should be performed in accordance with plans approved by tenant.
- ◆ The commencement date should not occur until the improvements are (i) substantially completed in accordance with tenant's plans as certified by the landlord's or tenant's architect, and (ii) a certificate of occupancy for the tenant improvements has been issued and delivered to tenant.
- ◆ If the costs exceed the allowance, when is tenant responsible for paying the excess? (There should be some hold back until after punchlist items are completed.)
- ◆ Does the tenant have a termination right if the landlord is late in delivering the space?
- ◆ May tenant enter prior to substantial completion to install furniture, fixtures and equipment?
- ◆ Will construction be bid out?
- ◆ Will tenant have the right to approve the budget, schedule, final contractor and major subcontractors? This is critical if the tenant is responsible for construction costs.
- ◆ Are the timetables for tenant's approvals and deliveries realistic?
- ◆ Does the change order process make sense?
- ◆ What is the construction management fee and is it based upon hard costs, soft costs, or both?
- ◆ What are the Tenant Delays? Is the landlord required to give tenant notice before the delay is counted?
- ◆ Is there security for tenant's obligation to pay for tenant improvements?
- ◆ Does the landlord provide a warranty for the tenant improvements? For how long?

In a tenant controlled build-out, does the work letter contain the following?

- ◆ Will the landlord provide accurate shell building plans?
- ◆ Has the landlord approved the intended architect and general contractor?
- ◆ Is the base building core to be delivered by landlord adequately described? The tenant improvement allowance should not be applied to base building costs.
- ◆ Is there any allowance and how will it be disbursed?
- ◆ May tenant use the allowance for soft costs, hard costs, moving costs, signage, cabling?
- ◆ Can tenant meet the landlord's time deadlines?
- ◆ Is there a provision for extending the commencement date due to landlord-caused delays?

IS THERE A SECURITY DEPOSIT?

- ◆ If so, how much? What form? How and when is it released?
- ◆ If a letter of credit is required, who is making arrangements with the bank on behalf of tenant?

WHEN DOES RENT COMMENCE?

- ◆ In a landlord-controlled build-out, it should be no sooner than following substantial completion of landlord's work. Is there a move-in or other free rent period?
- ◆ In a tenant-controlled build-out, it will probably be the sooner of a fixed date or when tenant occupies the premises for conduct of its business. How long does tenant have to complete construction? Is the time frame realistic?

DURING THE TERM, WHAT ARE THE PARTIES' RESPECTIVE RIGHTS AND OBLIGATIONS?

- ◆ What is the permitted use? The best is "any legal use", but if the lease specifies permitted uses are they sufficiently broad? Is the use permitted by local law, especially zoning? It is the tenant's responsibility for determining if its use is permitted by zoning, CC&Rs, etc. Not the landlord's.
- ◆ What services is the landlord providing?
 - Electrical wattage? Gas?
 - Water? If the tenant will need hot water, be sure it is specified.
 - HVAC? Any temperature standards? After-hours?

Elevators? (Freight and passenger)
Security? Lobby attendant?
Keys? How many?
Light bulbs and replacements?
Janitorial? Do you want to specify standards?
Snow removal?
Window washing? How often?

◆ Does the lease contain typical utilities interruption provision, such as the following?

If Tenant is unable to operate its business in the Premises or any portion thereof as a result of any stoppage or interruption in any of the basic services to be provided by Landlord hereunder, which stoppage or interruption continues for a period of ten (10) days, regardless of the cause, Tenant may abate its rent obligations to the extent to which such stoppage or interruption interferes with the normal conduct of Tenant's business. Further, if such stoppage or interruption continues for a period in excess of thirty (30) days, Tenant may terminate this lease effective upon written notice to Landlord.

- ◆ What are tenant's maintenance and repair obligations? This is an area where most pre-printed leases do not reflect the actual intentions and practices of the parties, so review and revise these provisions carefully.
- ◆ How capable is the tenant of maintaining the premises? If the tenant does not have the skill or personnel, then shift more maintenance obligations onto the landlord.
- ◆ A typical maintenance and repair provision on a full-service lease might read as follows:

Landlord shall, as an Operating Expense (except as provided herein), repair and maintain in good order and condition, the exterior roof, exterior walls, foundations and structural portions of the Building (including, without limitation, the columns, footings, structural floor, interior load bearing walls, and all pipes and conduit serving the Building (including, without limitation, the fire protection loop)) and the building standard plumbing, heating, ventilating, air conditioning, life, safety, and electrical systems serving the Building and the Common Areas (including, without limitation, all sidewalks, landscaping (including but not limited to irrigation systems and backflow prevention devices), driveways, parking lots, fences and signs (other than Tenant's signs). Except as otherwise provided in Paragraphs X (delivery of the premises), X (Landlord's maintenance obligations), X (restoration of damage caused by fire and other perils) and X (condemnation), Tenant, at Tenant's expense, shall keep and maintain the Premises in good condition and repair, including but not limited to the floor coverings, interior surface of the ceilings, windows, doors, skylights, interior walls, and the interior surfaces of the exterior walls; and to the extent located within the Premises, the plumbing fixtures, telecommunications equipment and network cabling, and lighting fixtures. Notwithstanding the foregoing, Landlord shall be responsible for the repair of any defects in any Landlord's Work or with any repair resulting from any breach of any warranty as to the condition of the Premises or Building made by

Landlord hereunder, and any costs arising therefrom shall not be included in Operating Expenses.

- ◆ Does the alterations provision permit the tenant to make non-structural changes below a specified cost?
- ◆ If alterations are to be removed at the end of the term, must the landlord provide a removal notice at the time it consents to such alteration?
- ◆ Who owns alterations? Who insures alterations and restores them if there is a fire or other loss?
- ◆ What is the construction administration fee for alterations?
- ◆ Must the landlord provide notice prior to entry?
- ◆ Are there any particular security issues in all or any part of the premises?
- ◆ Have the tenant insurance provisions been reviewed by the appropriate person? This is a MUST!
- ◆ Are the landlord's insurance obligations sufficient to cover its restoration obligations?
- ◆ Do the configuration, path of travel, restrooms, water fountains and general condition of the premises and property comply with applicable building codes, seismic requirements, environmental laws and laws in general. Who is responsible for the cost of any work required in order for the premises and/or property to comply with law? The tenant's obligation to make alterations in order to meet legal requirements should be limited to modifications which are triggered by tenant's alteration of the premises or its use of the premises for other than general office use. The landlord should be responsible for any compliance issues which existed prior to the lease commencement date.
- ◆ Tenant's indemnity obligations should be limited to (i) claims arising due to events within the premises (excluding those arising due to the gross negligence or willful misconduct of landlord or its agents), and (ii) claims arising due to the acts or omissions of tenant or its agents.
- ◆ Does the landlord have the right to relocate the tenant?
- ◆ Is the landlord obligated to provide the tenant with a non-disturbance agreement from any lenders?

DO THE ASSIGNMENT AND SUBLEASING PROVISIONS PROVIDE SUFFICIENT FLEXIBILITY?

- ◆ Does the tenant understand that it will remain liable for the lease obligations even if it subsequently assigns the lease or subleases the space?

- ◆ What are tenant's short-term and long-term goals for using all or a portion of the space?
- ◆ Does the lease permit assignments and subleases to affiliated and successor entities without the landlord's prior consent? A typical permitted transferee provision reads as follows:

Notwithstanding anything to the contrary contained herein, Tenant may assign its entire interest under this Lease or sublet the Premises or any portion thereof to a corporation, partnership or other legal entity controlling, controlled by or under common control as Tenant, or to any successor to Tenant by purchase, merger, consolidation or reorganization (hereinafter, collectively, referred to as "Permitted Transfer") without the consent of Landlord, and without being subject to any recapture or rent sharing provisions herein.

- ◆ If there is excess rent, how is it split? What expenses are deducted from excess rent prior to the split?
- ◆ What triggers landlord's recapture right? If landlord recaptures, may tenant rescind its request to assign or sublet? If tenant has invested a significant amount in the space, will it recoup this investment upon recapture?
- ◆ What is the landlord's fee for approving an assignment/sublease?
- ◆ When must landlord respond? (Preferably within 15 to 30 days)
- ◆ Are the conditions to landlord's approval too broad or cumbersome?
- ◆ May the tenant use its leasehold interest as collateral for its own financings?

DO THE DEFAULT PROVISIONS PROVIDE ADEQUATE NOTICE AND CURE PERIOD?

- ◆ When is the late fee charged? What is the late fee? What is the penalty interest rate and when does it start?
- ◆ Is tenant entitled to one or more late payments a year before the late fee is charged?
- ◆ How long is the notice and cure period prior to an "event of default"? (Preferably 5 days for rent and 30 days for non-monetary defaults. This may be different from when the late fee is charged.)
- ◆ Does the landlord have a duty to mitigate damages? (This is not mandatory in some states.)

DOES THE TENANT HAVE EXTENSION OPTION(S)?

- ◆ How long? When must notice be delivered?
- ◆ How is rent determined for the extension term? Is there a minimum or maximum rate?

- ◆ If rent cannot be agreed to, is there an arbitration or other third-party mechanism?
- ◆ Does the definition of “comparable market area” make sense?
- ◆ Does the tenant have the option to withdraw the exercise of its extension option if the arbitrated rent is unacceptable? (Note, however, that landlords rarely agree to give a tenant this right.)
- ◆ Is tenant entitled to an allowance or build-out for the extension period?

DOES THE TENANT HAVE EXPANSION OPTION(S)?

- ◆ Is it a “right of first offer” or “right of first refusal”? Is the lease drafted as a “must take” instead of an option?
- ◆ Is the right on-going?
- ◆ Is the expansion space clearly identified?
- ◆ What triggers tenant’s right to exercise this option?
- ◆ How and when must the notice of exercise be provided?
- ◆ What is the rent for the expansion space? How would it be determined?
- ◆ What is the expiration date for the expansion premises? Is it co-terminus with the original premises?
- ◆ Must the tenant exercise as to all the expansion space or may it take just a portion?
- ◆ What does it mean that space becomes available?
- ◆ Is tenant entitled to any build-out or allowance for the expansion space?
- ◆ Are there any superior rights?

DOES THE TENANT HAVE AN EARLY TERMINATION RIGHT OR OPTION TO REDUCE THE PREMISES?

- ◆ If so, how is it triggered?
- ◆ Is there a termination payment and when is it due?

WHAT ARE TENANT’S SURRENDER OBLIGATIONS?

- ◆ Do any tenant improvements or alterations need to be removed?
- ◆ Does tenant have the unequivocal right to remove its furniture, fixtures and equipment?

- ◆ What is the holdover rental rate?
- ◆ May tenant leave its cabling in place?

WHAT ARE TENANT'S SIGNAGE RIGHTS?

- ◆ Building? Monument? Directory? Floor lobby?

DO THE RULES AND REGULATIONS MODIFY THE LEASE?

- ◆ Review the rules and regulations to confirm that they do not undermine the lease. Because they are attached as an exhibit, they are often skipped over in review. Avoid the temptation to skip over the exhibits.

EXHIBIT A
OPERATING EXPENSE
EXCLUSIONS AND BASE YEAR ADJUSTMENTS

Exclusions from Operating Expenses: Notwithstanding the above, Operating Expenses shall not include the following:

- (a) Interest, principal, depreciation, and other lender costs and closing costs on any mortgage or mortgages, ground lease payments, or other debt instrument encumbering the Building;
- (b) Any bad debt loss, rent loss, or reserves for bad debt or rent loss;
- (c) Interest or penalties;
- (d) Costs associated with operation of the business of the ownership of the Building or entity that constitutes Landlord or Landlord's property manager, as distinguished from the cost of Building operations, including the costs of partnership or corporate accounting and legal matters; defending or prosecuting any lawsuit with any mortgagee, lender, ground landlord, broker, tenant, occupant, or prospective tenant or occupant; selling or syndicating any of Landlord's interest in the Building; and disputes between Landlord and Landlord's property manager;
- (e) Landlord's general corporate or partnership overhead and general administrative expenses, including the salaries of management personnel who are not directly related to the Building and primarily engaged in the operation, maintenance, and repair of the Building, except to the extent that those costs and expenses are included in the management fees;
- (f) Advertising, promotional expenditures and leasing expenses primarily directed toward leasing tenant space in the Building;
- (g) Leasing commissions, space-planning costs, improvement and renovation costs, allowances, relocation expenses, permitting fees, attorney fees and costs, disbursements, and other expenses incurred in connection with leasing or negotiating with tenants, occupants, prospective tenants, or other prospective occupants of the Building, or associated with the enforcement of any leases or the preparation of any space for leasing;
- (h) Charitable or political contributions;
- (i) Costs for which Landlord is reimbursed;
- (j) Damage or loss results from any casualty which Landlord has insured against, including deductibles;
- (k) Management fees in excess of ___% of gross receipts from the Building, and any rental, imputed rental or associated costs for any management office that

exceeds ____ rentable square feet and for which the rental rate exceeds the prevailing market rate for comparable office space;

(l) Earthquake insurance premiums in excess of \$____ per rentable square foot per year;

(m) Any costs or expenses that are incurred directly or indirectly with respect to Landlord's indemnity obligations under this Lease;

(n) Fees paid to any affiliate or party related to Landlord to the extent such fees exceed the charges for comparable services rendered by unaffiliated third parties of comparable skill, stature and reputation in the same market;

(o) Personal income, franchise, transfer taxes, change of ownership, estate, inheritance and capital stock taxes;

(p) Costs incurred to provide services to other tenants which are not furnished to Tenant;

(q) Costs of ownership, operation or maintenance of any parking facility for which Tenant is charged for use and parking;

(r) Compensation paid to clerks, attendants or other persons in any concierge or commercial concessions operated by or for Landlord;

(s) Fees or dues paid to trade associations or industry associations, other than the local chapter of BOMA;

(t) Entertainment, dining or travel expenses;

(u) The cost of initial construction of the Building or of correcting design errors or defects (latent or otherwise) relating to the initial design or construction of the Building or in the building equipment or in Landlord's Work;

(v) The cost of testing for, containing, removing or otherwise remediating any contamination of the property (including underlying ground water and land) by any toxic or Hazardous Material, including without limitation asbestos and PCBs, and any expenses incurred to comply with any governmental regulation, ordinance, directive or other provision dealing with asbestos or any other Hazardous Material in the Building;

(w) Costs incurred by Landlord in satisfying its warranty obligations hereunder;

(x) Any other expense which under generally accepted accounting principles would not be considered a normal maintenance or operating expense; and

(y) As to the costs of capital improvements, replacements, repairs, equipment and other capital costs, Operating Expenses shall include only such costs to the extent arising from capital improvements, replacements, repairs and equipment which can be reasonably be expected to reduce Operating Expenses that would otherwise be incurred in relation to the expense of the capital cost incurred, or which are made or installed in order to

comply with any statutes, rules, regulations or directives hereafter promulgated by any governmental authority, including but not limited to the Americans with Disabilities Act, coming into effect following delivery of the Premises to Tenant, and all such costs shall be amortized over the useful life of such improvement, replacement, repair or equipment in accordance with generally accepted accounting principles together with interest at the Prime Rate on the unamortized balance.

Base Year Adjustments: Base Operating Expenses shall also be adjusted as follows:

a. If Landlord incurs expenses associated with or relating to separate items, categories or subcategories of Operating Expenses that were not part of Operating Expenses during the entire Base Year, Operating Expenses for the Base Year shall be adjusted as if such items, categories or subcategories were included in Operating Expenses;

b. If any expenses are covered by warranty during the Base Year, then Operating Expenses for the Base Year shall be increased by the amount that Landlord would have incurred but for such warranty; and

c. Any additional premiums resulting from any new form of insurance or increase in coverage, or decrease in deductible after the Base Year shall be considered to be included in Operating Expenses for the Base Year.

Proposition 13 Protection

If during the term of this Lease, any sale, refinancing or change of ownership of the Building is consummated and as a result thereof all or a part of the Building is reassessed for real estate tax purposes the terms of Proposition 13, then that portion of any increase in real estate taxes attributable solely to such reassessment (including annual inflationary increases after the date of the change of ownership) shall not be included in Operating Expenses or otherwise passed through to Tenant.

The article above was prepared by Helen Sedwick of Bennett Valley Law.

After more than 20 years of practicing law with major firms in San Francisco, Helen Sedwick founded her own firm, Bennett Valley Law in 2007. She continues to specialize in commercial real estate transactions, primarily sales and acquisitions, leasing, entity formation, financing and management. Clients include developers, investors, start up companies, bio-tech companies, solar technology companies, wineries, restaurant franchisees and owners, and individuals. For more information, please visit www.bennettvalleylaw.com.

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