LIMIT YOUR EXPOSURE IN LEASE TRANSACTIONS

By William P. Walzer

The execution of a lease for business or commercial use involves significant financial risk not always appreciated by tenants who are not lawyers or real estate professionals. Tenants don't appreciate, for example, the fact that a commercial landlord is not obligated to mitigate its damages when a tenant defaults and the lease is terminated. The landlord is not required to use any efforts to find a replacement tenant and can sue the tenant for each installment of rent as it becomes due, even after the tenant has moved out of the premises and delivered the keys to the landlord. Indeed, commonly included "acceleration clauses" make all the rents payable over the term of the lease due and payable at the time of the tenant defaults, whether or not the landlord subsequently re-rents the premises. Many tenants remain stuck in premises that no longer work for them because of the difficulties involved in breaking a lease.

For knowledgeable landlords and tenants, the negotiation of a commercial or office lease is first and foremost a contest of whether the tenant can gain "outs" to the lease or limits to its liability. Factors which control this negotiation include the cost of any construction work the landlord is to perform for the tenant's occupancy; whether the tenant's business is significant in the landlord's mix of tenants in a shopping center; and the amount of security the tenant is required to post with the landlord. Triple A, credit worthy tenants who sign non-terminable, long term leases have greatest leverage on other economic terms of the deal because their landlords can literally "take their leases to the bank." The lease is sufficient collateral to support construction and permanent loans. More commonly, however, are leases with privately owned businesses whose balance sheets may or may not give the landlords sufficient comfort to proceed with the proposed transaction.

The simplest level of protection for a tenant is to create a new entity, either a corporation or a limited liability company, to become the tenant under the lease. The existing business is thereby protected from landlord suits. For a commercial enterprise, a certificate of assumed name is then filed so that, to the public, there is no distinction between the new location and existing locations of the tenant.

If the landlord requires that the tenant's operating company sign the lease as a tenant, then the tenant may seek to limit its downside by negotiating a termination right upon some suitable notice period, sometimes involving a termination payment. If this can't be obtained, a liberal assignment/subletting clause together with a broad use clause should be the tenant's objective, since an assignment of the lease or a subletting of the space, without landlord interference, can be an effective mitigation strategy. It is a strategy frequently employed by Shopping Center anchors. Tenants frequently don't realize that they remain primarily liable to the landlord when they sublet, and secondarily

liable to the landlord when they assign the lease. The landlord's consent to an assignment does not constitute a release of the original tenant. This, of course, can be addressed in the initial lease negotiation.

Tenants who form new leasing entities or who don't have strong balance sheets will always be confronted with landlord demands for the principals to execute guarantees of the tenant's obligations. In many situations, the deal cannot be made without a guaranty. But guarantees come in all shapes and sizes. A guaranty can be unlimited and unconditional, or can be limited and conditioned in numerous ways. Frequently, tenants seek a limit in the duration of the guarantee, such as to rents which arise during the first two years of the term. Alternatively, the guaranty can be limited in amount: a dollar limit or a limit expressed in months of rent are common. A guaranty can be conditioned upon the exhaustion of other landlord remedies, such as suit against the tenant or other guarantors, or resort to collateral. A mitigation obligation, not imposed by law, can be inserted at the tenant's behest.

"Good Guy" guarantees have tremendous appeal to tenants. Under this form of guaranty, the guarantor (who presumably controls the tenant) promises to pay all rent up to and including the month in which the tenant surrenders possession of the premises to the landlord in good condition – even if in doing so the tenant has breached the lease. The landlord is thereby protected against a tenant who doesn't act like a good guy: one who battles to avoid eviction while not paying rent and staying open for business. The guarantor is secure in the knowledge that the guaranty will never come into play if he simply surrenders the premises with current rents paid up.

Every negotiation is a matter of leverage. Risk reduction strategies will not succeed when a landlord is leasing a hot property. However, tenants are frequently surprised at the improvements that knowledgeable counsel can obtain from the landlord's standard form of lease and guaranty.