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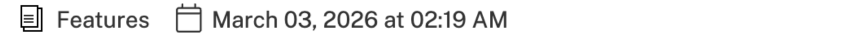
Features

Hidden Lease Risks Are Spiking as Landlords Shift More Costs to Tenants

By Richard Berger



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In today's environment of high borrowing and construction costs, tenants face significant financial risks from seemingly standard lease construction provisions.

These clauses must be considered closely, along with understanding the difference between capital replacements and capital improvements, lease language pertaining to common area maintenance, how the space will be used and addressing laws enacted after the lease has been signed.

Make Obligations Specific and Qualified

Tenants can get burned by "standard" clauses that purport to shift open-ended cost risks, such as unexpected building-wide repairs and capital projects, to tenants rather than landlords, Ashley Bynoe, attorney with Atlanta-based law firm Townsend & Lockett, told GlobeSt.com.

The tenants' solution is to make tenant maintenance and repair obligations specific and qualified (by time, location, and cause) and to omit from the lease catch-all language that lets the landlord unilaterally decide what repairs or expenses are 'necessary,'" Bynoe said.

Tenants should limit their responsibility to repairs triggered by their specific use, not building-wide upgrades unrelated to their operations or caused by the landlord or another tenant, she added.

"If a landlord won't agree to narrow the relevant lease language, then a tenant can protect themselves by requesting documented monthly operating expenses, capital improvement

schedules, and major repair history, so that the tenant is informed of typical charges prior to signing a lease and can plan for any surprises in their operational budgets," she noted.

Lindsay Ornstein, co-founder of OPEN Impact Real Estate, told GlobeSt.com that it's critical to define the scope and cost of landlord improvements to avoid expensive re-negotiations. For example, if the landlord comes back during discussions and says, "oh, I just realized the cost of XYZ is going to be higher" and then starts changing the agreement after the fact.

"In this incredibly high construction cost environment, clarity and tight lease language protecting the tenant are critical," Ornstein told GlobeSt.com, "because many organizations, especially nonprofits, lack the margin to cover unexpected expenses."

Passing on 'Extraordinarily' Expensive Capital Expenditures

Aging infrastructure, deferred maintenance by building owners, and increased regulatory compliance in some markets can all also result in landlords passing on extraordinarily expensive capital expenditures to their commercial tenants, Jason Dunietz, partner & chair of Helbraun & Levey's Real Estate Group, told GlobeSt.com.

"As a starting point, you want to take the position that operating expenses exclude capital expenditure, then carve out narrow, clearly defined exceptions," he said.

One way to restrict the pass-through of capital expenditures related to compliance with the law is to limit tenant responsibility strictly to compliance triggered by tenant-specific use or alterations, he said.

Another option to further limit the pass-through to tenants for compliance with laws is to apply it only to laws enacted after lease execution.

"Local law 97 in NYC is a perfect example, which requires landlords to bring their buildings into compliance with carbon emissions standards over time," Dunietz said. "Without these protections, tenants can be unwittingly subsidizing a landlord's deferred obligations."

Even in instances where capital costs are permitted to be passed through to tenants as operating expenses, the landlord is effectively financing a long-term improvement of the building and asking the tenants to pay for it over time, according to Dunietz.

"In a rising interest rate environment and one with high construction costs, landlords are looking to shift a portion of those costs onto their commercial tenants wherever possible," he said. "Without guardrails, landlords may try to accelerate the recovery of those expenditures, shorten amortization schedules, and apply aggressive interest rates."

To level the playing field, tenants and their representatives should ensure there's clear language stating that capital expenditures shall be amortized on a straight-line basis rather than an accelerated basis, he said.

Another way for tenants to protect themselves is to require amortization over the greater of the useful life of the improvement or the Internal Revenue Service's depreciation schedule, he said.

"Without this amortization requirement for those expenditures, landlords may pursue accelerated depreciation methods to offset their costs, which would result in tenants paying for those improvements on a front-loaded basis," Dunietz said.

"For a new tenant signing a lease, this can be prohibitively expensive in the early days of their business and is an important pitfall to watch out for."

Capital improvements are different than capital replacements, Glenn Sherman, partner at Saul Ewing, told GlobeSt.com.

For example, upgrades may include switching to LED lighting to save money over the long term. To encourage a landlord to make those changes, a tenant may be willing to accept the capital improvement costs, up to the amount saved each year, until the costs are paid. Then the tenant would reap the benefits of the lower costs in future years.

Negotiate Caps on Common-Area Maintenance

One of the most important ways to allocate risk between commercial landlords and tenants fairly is for tenants to insist on negotiating caps on common-area maintenance and other pass-through operating expenses in triple-net (NNN) leases, Dunietz said.

"These are relatively commonplace in today's letters of intent and lease negotiations, with the focus on differentiating between controllable and non-controllable expenses and agreeing to cap 'controllable' operating expenses," Dunietz said.

Typically, this cap on controllable expenses ranges from 4% to 6%. However, simply agreeing to a cap isn't the only important part; there also needs to be a clear definition of which expenses are considered controllable, with tenants trying to negotiate that category as broadly as possible, according to Dunietz.

Property management fees, routine repairs and maintenance, vendor contracts and administrative and overhead costs are all items that tenants should insist on being treated as controllable expenses, he said.

"It's equally important that the definition of non-controllable be defined narrowly, so as not to allow landlords to reclassify expenses that would otherwise be considered controllable and subject to the cap," he said.

"For tenants and their representatives negotiating these lease terms at the outset, the most persuasive argument to make is that if it's something that the landlord exercises discretion over, it should be capped, and if the cost is imposed by external factors (e.g., regulatory frameworks or market-wide pricing), it can be uncapped but subject to tightly defined boundaries."

Clear Language About Business Model

Clear language regarding the tenant's business model is also crucial, Seth I. Feldman, Esq., partner at Romer Debbas, told GlobeSt.com.

"It may sound obvious and simple, but it's amazing how often there is a disconnect between commercial tenants and landlords over how exactly the tenant plans to use the space," Feldman said.

"Most tenants, landlords, and brokers use only the most basic description of a tenant's business, and far too many tenant attorneys neglect to ask their clients for specifics."

For example, the lease states, "Tenant will use the premises as an art gallery," but it turns out the tenant's business model is to license the space to other artists and gallerists. So, technically speaking, the space is being used as an art gallery, but the business model is a license-based approach with a revolving door of users, Feldman said.

Another example: the lease language includes, "tenant will use the premises as a clothing store," but instead the location is used regularly for hosting big events and watch parties centered on its brands.

Another risk is the building itself, Feldman said.

"In my experience, far too few attorneys and brokers bother to perform any due diligence into the building, especially for small business leases," he said.

"Tenants sometimes find themselves blocked by scaffolding or dealing with a neighboring building being demolished when they are still a newly opened business in the neighborhood."

Thirdly, be careful when reading the "Good Guy" clause.

"Many landlords like to sneak in ways for them to be additionally compensated, or they use poison pills to make exercise of any good guy clause financially prohibitive," Feldman said.

Proration Square Footage's 'Hidden Cost'

Proration methodology applies to NNN leases, which is typically a percentage of the floor area leased to a tenant relative to the project's total floor area, Sherman said.

Here, issues include that some leases compare the tenant's floor areas to the project's leased and occupied floor area. That means any vacant space is excluded from the denominator of the fraction used to calculate the prorata share.

Furthermore, this means that the tenants there pay a larger share if there are vacancies.

"This is a very hidden cost," Sherman said. A tenant should use a true proration based on actual floor area, not on occupied space, or, at a minimum, limit the vacant floor area excluded (e.g., not more than 10% of total floor area).

He said some leases remove the floor area of anchor stores from the denominator, so all other tenants pay a higher percentage.

"The theory is that anchor stores draw customers to the project; to attract an anchor store, the landlord must offer concessions (such as a 'cap' on NNN charges) that limit what the anchor store tenant would otherwise pay for NNN costs," Sherman said. "This, in essence, subsidizes the landlord for what the anchor store should pay if there were a true proration.

"Some leases define anchor stores liberally, so even smaller tenants may fall within that definition, which further increases the subsidy to the landlord."

New Laws Enacted After Lease Signing

Eric G. Menkes, Partner and co-chair of the Leasing Practice at Adler & Stachenfeld, told GlobeSt.com that compliance with law costs are the sleeping dogs of lease negotiations. There can be significant dollars at issue here and the unsophisticated tenant can find itself saddled with real unanticipated expenses.

"Most leases simply provide that, as far as the leased premises are concerned, the tenant must comply with all laws," Menkes said.

"Sounds innocent enough, but what if that requires material modifications to the space? From the tenant's perspective: if alterations to the space need to be made to comply with an existing law, the landlord (and not the tenant) should foot that bill. That makes sense, except (1) if the tenant uses its space in a particular manner (such as the apparel retailer who wants to add a café), or (2) if the tenant makes an alteration that triggers the requirement to comply.

Leases typically excel at specifically addressing current legal issues, Menkes said.

"It's amusing to look through old leases and see the issue of the day spelled out in detailed provisions: sprinklers, asbestos, handicapped accessibility, and today, carbon emissions," he said.

But what about new laws? Like death and taxes, new policies affecting real estate are certain to be passed, especially here in New York and lawyers who aren't focused on these issues leave their clients exposed to costly risks, according to Menkes.

For leased premises, the treatment should, in theory, be the same as under existing laws. But for the building, it may be "fair" for a landlord to pass along to its tenant the cost of complying with new laws, at least capital improvements, he said.

"The thinking is that governmental actions are beyond the parties' control, and accordingly, they should share in the burden," according to Menkes. "But how to address? What is fair (in my view) is that if the rent doesn't otherwise include a rent increase to take into account costs of running the building, a landlord can amortize the capital improvement over its useful life (in accordance with GAAP), and charge the tenant its pro rata portion of that expense for each remaining year of its term."

But ultimately, Menkes said, there is no "right" and "wrong" here.

"Legal points in leases tend to follow the leverage in the deal — the party that wants the deal more will concede, whether it is 'fair' or not," he said. "The important thing for lawyers is that they spot the issue and make it part of the negotiation."

If new laws require capital improvements, that fits into a different category. Such laws may require ADA-related improvements (such as ramps, rails, painting, signs, etc.), seismic retrofitting, water or electricity conservation efforts.

"A landlord would like to pass the entire cost on to the tenants, although amortization is a fairer way to handle them," he said.

What is the useful life that should be used for amortization calculations? Who decides that time? Should the IRS amortization schedule be used? Does that align with the lease term?

"All these are additional issues that get negotiated in a lease," Menkes said.

"However, the outcome of those negotiations is always based on the relative leverage of the parties. A small tenant on a short-term lease is unlikely to get many concessions."