COMMERCIAL TENANT'S LEASE INSIDER®

SEPTEMBER 2014

The leading newsletter devoted to helping retail and office tenants negotiate, draft, and manage their leases.

INSIDE THIS ISSUE

Owner-Skewed Leases Lead to Mall Tenant Lawsuit

Disgruntled tenants at a Virginia mall are learning the hard way that agreeing to an owner's lease provisions that put the entire cost and obligation to repair on tenants isn't working out. While it's not typical for an owner to put all of a property's upkeep requirements on tenants, it's also not illegal.

The mall caters primarily to tenants that operate restaurants and stores that specialize in Vietnamese cuisine and products. Many tenants feel that they've been taken advantage of because English isn't their first language and at the time they signed their leases, they didn't fully understand the implications of the one-sided repair and maintenance clauses. But the owner argues that the tenants are sophisticated merchants and should've been aware.

Now, it's likely that negligence claims against the owner for its alleged failure to keep the mall up to code and resolve poor air quality, sewage, and trash disposal issues, among other complaints, will be settled in court. A lawsuit is underway, but as specified in the tenants' leases, it will be conducted in Florida, where the owner resides, despite the fact that the mall is in Falls Church and the tenants live in that area. ♦

FEATURE

Take Eight Actions Before Renewing Your Lease

If the end of your current lease is on the horizon, you may have already started weighing your options. "Negotiations of any sort can be nerve-wracking and intimidating, especially when it comes to negotiating a lease renewal," says commercial real estate broker and developer Michael Kushner, "and owners can drive a hard bargain, making you feel like you don't have any other options or say in the matter, even though you do." Kushner recommends considering the following things that can boost your negotiation power when it comes time to renew your next lease.

Action #1: Get in Good Standing

The idea of being a good tenant to make an owner want to cooperate with you is so basic, yet so often this advice isn't followed, says Kushner. Taking care of your rental space will give you leverage when

(continued on p. 2)

NEGOTIATING TIPS

Avoid Overpayments with Audit Right

A typical owner won't object if you ask for an audit right in your lease to avoid overpaying. After all, there is no justification for pushback other than wanting to cheat you. But while owners generally don't refuse to give tenants an audit right in a lease, you will have to negotiate what your right will include and how you will protect yourself if errors are found—crucial items that may ultimately be hard won.

Be Prepared for Hotly Contested Issues

Be aware of these four issues, which are commonly at the center of many lease audit right negotiations. Make sure you're prepared for them.

Issue #1: Type of lease auditor. For example, one of the most hotly contested issues will be whether you may use a lease auditor who works on contingency. The owner probably will insist on a certified public accountant being paid on an hourly basis, rather than

(continued on p. 5)

Editor: **Elizabeth Purcell-Gibney, J.D.**

Executive Editor: **Heather Ogilvie**

Production Director: **Kathryn Homenick**

Director of Operations: **Michael Koplin**

Commercial Tenant's Lease Insider [ISSN 1551-2215 (PRINT), 1938-3150 (ONLINE)] is published by Vendome Group, LLC, 216 East 45th St., 6th Fl., New York, NY 10017.

Volume 11, Issue 7

Subscriptions/Customer Service: To subscribe or for assistance with your subscription, call 1-800-519-3692 or go to our Web site, *www.vendomerealestatemedia.com*. Subscription rate: $367 for 12 issues. **To Contact the Editor:** Email: *egibney@vendomegrp.com*. Call: Elizabeth Purcell-Gibney at (212) 812-8434. Fax: (212) 228-1308.

To Place an Advertisement: Please email Erin Tyler, *etyler @vendomegrp.com,* or call (216) 373-1217.

Take Eight Actions (continued from p. 1)

it comes to negotiating your lease renewal. So if issues arise between you and the owner, resolve them quickly and amicably. "It's only to your benefit to be on good terms with the person who determines your rental rates," Kushner adds.

Action #2: Start Early and Consider Options

Particularly in a very tight commercial real estate market, you should allow at least nine to 12 months for the process to play out, says Kushner. It can take several months to research your alternatives, open up negotiations with prospective owners (especially concerning tenant improvements), and then come back to your current owner. And you'll want to allow two to four months if you have to plan a move.

Action #3: Understand Market and Your Leverage

New tenants may be able to extract concessions. While market rental rates are important to understand, there are a number of other considerations new tenants may enjoy. These include tenant improvements, rent holidays, and other benefits, Kushner notes.

"Understanding these will not only give you a sense of what you might expect if you go elsewhere, but it can also help you negotiate your current renewal," he adds. After all, why shouldn't you enjoy at least part of those benefits on the renewal?

Action #4: Ask for Broker's Advice

Talking to experts in the field, such as brokers, can be invaluable, Kushner points out. Brokers can give you a sense of the market and current conditions, and offer other valuable input. He recommends that tenants use them for representation in lease negotiations. Depending upon the size of your business, this can represent anywhere from a $350,000 to a multimillion dollar obligation over a three- to five-year period, however.

"The truth is, while a tenant may know its business better than anyone, it's probably not an expert in commercial real estate, so it should seek out advice from someone who is," emphasizes Kushner. And, if you are going to use a commercial real estate broker, he suggests using a tenant-only representative, as that broker is less likely to be conflicted than a broker who may represent either side.

Action #5: Split Costs When Possible

Just as you may want to avoid the headaches and costs associated with moving, the owner may have the same interest. Depending on how much leverage you have, you should work to share the savings.

If you've been a good tenant and are paying near-market rents, the last thing the owner wants to deal with is several months of vacancy, showing the space, negotiating and paying for tenant improvements,

and then having to deal with the unknown risk a new tenant presents. So work to value how much benefit each side is getting out of the renewal and see if you can't find some common ground.

Action #6: Understand Owner's Perspective

Kushner points out that your owner is interested in three things: (1) the underlying value of the property; (2) the current income/cash flow from the property; and (3) avoiding headaches. Understanding the relative importance of each can be very helpful in your negotiations.

For example, commercial property is essentially valued at a multiple of cash flow (specifically, a cap rate) over a period of time, with an emphasis on future cash flows. If the owner is thinking about refinancing or selling the property in two to three years, it'll want to boost the cash flow in that later period. This can provide you with a path to reducing your near-term rental outlays in return for increasing the rent at a time when it particularly matters to the owner.

Action #7: Estimate Overall Costs for Options

Put together a spreadsheet that estimates the costs of your various rental options. And feel free to let the owner know you're doing this. Make sure that you're getting all the information you need to make a balanced and informed decision. This will also alert the owner to the fact that you're exploring other options, which can work to your benefit in lease negotiations.

Action #8: Utilize Actual Leases, Extensions

Getting your hands on real lease documents and lease extensions can help give you ideas for different terms that you might want to incorporate into the lease that you may not have thought of. Of course, if you're represented by a broker, you should encourage him to do this. "You'd be surprised how often this valuable opportunity is overlooked," says Kushner.

No matter where you stand in your current lease, it's always a smart idea to follow the above advice now and to make note of the factors you need to revisit in the future. "Doing this can provide you with a valuable return, especially if it helps you to negotiate a lease renewal with favorable terms that keeps you in a space you love for less while building a good relationship with the owner," Kushner advises. ♦

Insider Source:

Michael Kushner, CCIM: OMNI Realty Group, P.O. Box 6218, Harrisburg, PA 17112; *omnirealtygroup.com.*

RECENT COURT RULINGS

➤ Tenant Off Hook for Common Area Slip-and-Fall

Facts: Both a tenant and owner of office space were sued by the widow of a visitor to the building who slipped and fell on a wet surface in the vestibule and died from his injuries. The tenant and owner each asked a trial court for a judgment in its favor without a trial. The trial court dismissed the case. The widow appealed.

Decision: A New York appeals court upheld the decision of the lower court in favor of the owner and tenant.

Reasoning: The appeals court noted that, in a slip-and-fall case, defendants asking for a judgment in their favor without a trial have the burden of demonstrating that they did not create the alleged hazardous condition or have actual or constructive notice of its existence for a sufficient length of time to discover and remedy it.

The owner and the tenant each presented evidence that it hadn't created the alleged defective condition. The owner also presented evidence that it had neither actual nor constructive notice of the alleged defective condition—that is, the alleged presence of water on the vestibule floor of the building.

Moreover, a property owner isn't obligated to provide a constant remedy to the problem of water being tracked into a building during inclement weather, and has no obligation to cover all of its floors with mats or to continuously mop up all moisture resulting from tracked-in precipitation. And a tenant ordinarily owes no duty of care with respect to a dangerous condition in a common area of a building, and the tenant's lease with the owner didn't require it to take responsibility for that area.

- Paduano v. 686 Forest Ave., LLC, July 2014

(continued on p. 4)

Recent Court Rulings (continued from p. 3)

➤ Indemnification Exclusion Didn't Apply to Shopper's Lawsuit

Facts: A tenant sublet its retail space to a national general store-type tenant with permission from the owner of the building. After the subtenant had moved in, a customer slipped and fell on a puddle of water outside the store's entrance. She sued the subtenant for negligence. The subtenant claimed that the tenant was required to indemnify it under the terms of the sublease, but the tenant disagreed. It claimed that the injuries resulted from the subtenant's negligence and that under the sublease, the tenant was entitled to a defense and indemnification by the subtenant, not the other way around. The subtenant sued the tenant. A trial court dismissed the case. The subtenant appealed.

Decision: An Illinois appeals court reversed the judgment of the lower court.

Reasoning: On appeal, the subtenant claimed that the trial court erred in dismissing its complaint because its customer suffered injuries in the shopping center's *common area*—triggering the tenant's duty to defend and indemnify the subtenant pursuant to the terms of the sublease.

The tenant asserted that it didn't owe the subtenant a duty to defend or indemnify under the sublease because those duties arose only: (1) if an injury occurred in a common area; *and* (2) if the owner, as the party responsible for maintaining the common area, indemnified the tenant for the injury-related claims. The tenant claimed that because the owner didn't indemnify it relating to the shopper's claims, the tenant, in turn, owed no duty to defend or indemnify the subtenant. Regardless, the tenant asserted that it didn't breach any duty owed to the subtenant, because the shopper fell in a puddle of water created by the subtenant's employee who had been watering flowers, not because of a maintenance failure of the owner.

After reviewing the relevant sublease provisions, the appeals court disagreed with the tenant's position. It said that the sublease contradicted the tenant's position that it owed the subtenant no duty to defend or indemnify relating to injuries occurring on common areas unless the owner maintained the common area and first indemnified the tenant. While there was *one* exclusion from the tenant having to indemnify the subtenant, that exclusion applied to only one type of claim, which wasn't the same type of claim as this shopper had brought. ♦

- Kmart Corp. v. KRC Crestwood 887, Inc., July 2014

➤ Bankruptcy Cap Applies to Claims Resulting from Lease Rejection

Facts: A warehouse owner agreed to completely remodel the space into a daycare facility for a tenant. The owner paid for the improvements up front, but the tenant was required to pay back the amount in increments during the lease term, separate from monthly rent. After the tenant filed for Chapter 11 bankruptcy, it rejected its lease.

The owner filed a claim for total damages of over $1.7 million. The tenant argued that the amount of the claim exceeded the statutory limits imposed by U.S. bankruptcy law. It said that the claim should be "capped" at $480,500—representing past due rent as of the petition date, future monthly rent for 15 months, and some real property taxes.

The owner contended that it should be allowed to recover not only those amounts, but also the balance owed for the tenant improvements that hadn't been repaid, a future real estate commission to re-rent the space, costs to remodel the premises, attorney's fees, and utilities.

Decision: An Alaska bankruptcy court allowed the owner's claim, but limited it to $647,758.

Reasoning: Bankruptcy statutes allow owners to recover "damages for lost rental income." The court noted that the law caps the damages recoverable that arise from the termination of a lease and divides the owner's claim into two distinct components: past-due rent and "rent reserved." Claims for unpaid rent due as of the bankruptcy petition are recoverable without limitation; claims for rent reserved are allowed for only the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease. A cap doesn't apply to an owner's claims against the bankrupt tenant for collateral damages that arise *independent of the rejection of the lease* in bankruptcy.

Here, the owner and tenant agreed that $27,000 in rent was past due and that the applicable "cap" period for future rent is 15 months. The court had to determine the calculation of the monthly "rent reserved" that would be allowed for 15 months, and what components of the owner's claim, if any, fell outside the cap because they didn't result from the termination of the lease.

The court applied a test to determine whether the owner's claims resulted from the rejection of the lease: Assuming all other conditions remain constant, would the owner have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it? In other words, if the tenant had assumed and performed under the lease, would the claim still remain? If so, the claim exists independently of the lease rejection, and is beyond the statutory cap.

The court decided that the owner's right to receive future rent and recover real property taxes, the balance owed for tenant improvements, future real estate commissions, remodeling costs (other than the removal of tenant improvements), and utilities existed *only* as a result of the rejection of the lease, and were capped at 15 months under bankruptcy laws as "rent reserved."

However, the owner had a valid claim for recovery of $110,000 for the cost of *removing* the improvements it made to the building so the tenant could use it as a daycare center. That amount wasn't capped because "damages other than those based on a loss of future rental income are not subject to the cap," said the court. Under the lease, the tenant was required to pay for the removal of the improvements if the owner asked it to upon termination of the lease. The owner testified that there was no market for the space in its current configuration as a daycare center and that, regardless of whether the tenant had filed for bankruptcy or stayed for the remainder of the lease term the result would've been the same: The owner would have exercised its right to have the improvements removed at the tenant's cost. ♦

- In re: Denali Family Services, March 2014

Negotiating Tips (continued from p. 1)

someone who gets paid based on the amount of money he saves for the tenant, to perform it.

Issue #2: Threshold requirement. Another controversial issue is the threshold requirement for the owner to pay for your audit. For example, if the owner agrees to be responsible for reimbursing you for the cost of the audit if its errors reach a certain amount, what will that amount be? How erroneous do the charges have to be to trigger the owner's obligation to pay? This is critical for you to negotiate because it could save a substantial amount of money later.

Issue #3: Frequency of audits. The owner will also probably want to impose a limitation on how often you can perform a lease audit and whether you can exercise your right to audit if you're in default.

Issue #4: If you don't ask, you won't receive. The top thing to remember is that if you are negotiating the owner's form, an audit right won't be in there. It's up to you to bring up the lease audit point and offer language you're comfortable with.

PRACTICAL POINTER: Be aware that if you and the owner are using *your* form lease, audit language may already be included. But sometimes, owners simply delete the tenant's proposed language and insert their own language. Be on the lookout for changes and be ready to negotiate from that point.

Settle on Method for Handling Disputes

When negotiating lease audit provisions, it's helpful to have a final and binding resolution provision to handle disputes. Without this provision, if an owner disagrees with the amount that your audit discovered, or asserts that it owes nothing, a lawsuit might ensue over the difference.

A good provision dictates what happens if there's a dispute. One option is, if the owner disagrees, the owner and tenant refer the dispute to a mutually acceptable independent certified public accountant who will work with them to resolve the discrepancy, and render a final and binding decision. For an example of final and binding resolution lease language you can adapt, see our Model Lease Clause: Draft Lease Audit Provision in Your Favor. This achieves finality without a lawsuit.

Regardless of the length of the provision, it should include what happens as a result of an audit's findings:

- If there's an overpayment, the owner pays the tenant back;
- If there's an underpayment, the tenant pays the owner; and
- If there's a discrepancy and the owner disagrees with the audit, it's handled in an agreed-upon way.

Don't just say that once a year you may look at the owner's books

(continued on p. 6)

Negotiating Tips

(continued from p. 5)

and records. That's not enough. Provisions should spell out what happens if an audit ensues.

Broaden Time Frame

Some lease audit provisions include details about how far back the tenant may go with a lease audit. For example, in your lease audit process you could find that you were overcharged for something this year and for the same line item in the past three years as well. Whether you can recoup those charges is determined by the lease language. If it's not covered in the lease, it depends on the statute of limitations—that is, the scope of the past years you want to audit must fall within the number of years the state law allows a person to go back to file a lawsuit.

Uncontested overpayments eventually will become unrecoverable, which is why many large tenants include a provision in their leases preserving their right to audit prior years if they discover mistakes in the current audit year. But if you haven't included this provision in your lease, you may have to spend time and money going to court.

Top Negotiation Tips to Remember

When you negotiate lease audit provisions with the owner, keep these tips in mind:

- First and foremost, asking for a lease audit right should be on your checklist when you review the lease.
- Negotiate the right to have your lease audited by an auditing firm that uses auditors who work on contingency, rather than a certified public accountant who is paid hourly.
- Include a provision obligating the owner to pay for the cost of your audit if the owner is off by a certain percentage.
- Remember that a dispute resolution mechanism within the lease audit provisions is helpful, saves time, and prevents lawsuits.

It's important that the building operating fees are calculated correctly, so you should have and exercise your lease audit right not only if you feel you're being overcharged, but also as a matter of good business practice. Look at the books and records to make sure that everything is correct. As far as the frequency of errors found by audits, there's no difference between an owner that's operating a shopping center and an owner that's operating an office building—it comes down to dollars per square foot per year in either case, and if you're paying dollars per square foot per year,

MODEL LEASE CLAUSE

Draft Lease Audit Provision in Your Favor

The following lease audit provisions are very tenant-friendly because they allow the tenant to choose a lease auditing firm rather than a certified public accountant to perform the audit. Try to negotiate for the option to use an auditor if that is important to you, but be aware that the owner may not budge on this issue.

TENANT LEASE AUDIT

Not more than [*insert #, e.g., 1*] time per year, Tenant shall have the right to cause Owner's books and records with respect to Operating Expenses and Taxes to be audited by an independent certified public accountant or a lease auditing firm of Tenant's choosing. Owner shall cause such books and records to be made available for such inspection during such normal business hours and at a location selected by Owner in [*insert county, state*], upon [*insert #, e.g., 10*] days' prior notification to Owner. Such audit shall be done in accordance with GAAP, consistently applied.

If, at the conclusion of such audit, Tenant's audit of such expenses for the preceding year indicates that Tenant made an overpayment to Owner for such preceding year, Owner shall remit the amount of such overpayment to Tenant within [*insert #, e.g., 30*] days after receipt of notice from Tenant of the amount of such overpayment if no default is then continuing beyond applicable notice and cure periods. If, at the conclusion of such audit, such audit reveals an underpayment by Tenant, Tenant will remit the amount of such underpayment within [*insert #, e.g., 30*] days of Tenant becoming aware of such underpayment.

Should Owner disagree with the results of Tenant's audit, Owner and Tenant shall refer the matter to a mutually acceptable independent certified public accountant, who shall work in good faith with Owner and Tenant to resolve the discrepancy. The fees and costs of such independent accountant to which such dispute is referred shall be borne by the unsuccessful party and shall be shared pro rata to the extent each party is unsuccessful as determined by such independent certified public account, whose decision shall be final and binding. Owner shall pay the cost of Tenant's initial audit if the total amount of Operating Expenses and Taxes used for the calculation of pass-throughs for the year in question exceeded [*insert #, e.g., 2*] percent or more of the total amount of such costs that should properly have been used.

it behooves you to have the right to examine the books and records behind the bill.

Think Before You Audit

If you're considering an audit, there are several points you should keep in mind:

Get the benefit of the bargain. Doing a lease audit is a no-brainer if it can be done on contingency and you don't have to pay for anything up front. But if you spend the time to negotiate lease audit provisions in your lease, it's up to you to make sure that you're getting what you bargained for. Very often, an attorney has negotiated very favorable provisions, but the tenant doesn't follow up on enforcing them.

Learn about what charges are suspicious. Keep your eyes open for things that look like they're out of line, such as charges that are increasing past inflation or charges that seem excessively high.

Don't burn bridges over an audit. If an audit uncovers overcharges, it may sour your feelings about the owner. But don't react harshly. Think about the positive aspects of your lease, such as the space you rent being good for your business. It's crucial to keep a good relationship with the owner—even if the audit uncovers substantial errors. ♦

TRAPS TO AVOID

Don't Risk Being Overlooked After Relocation

Whether you're an office or a retail tenant, it's disruptive to your business if you relocate to another space in the building or center, either permanently or temporarily. But relocation creates a special problem for retail tenants: How will shoppers find them in their new space?

If the relocation was the owner's idea, you should require it to post signs notifying shoppers that you will be—or have been—relocated. Here's how you can get the owner to post signs notifying shoppers of your relocation.

Crucial Areas for Signage

If shoppers are unable to find you after you've been relocated, they may assume you've gone out of business or left the center. That's why it's so important to require the owner to post signage in the following places to notify shoppers of your relocation:

At your original space. Such signage should tell shoppers that you'll be moving, where your new space is, and when you're expected to move. You'll want some control over the wording so the signage's tone is upbeat. And once you've relocated, new signage at your original space should say that you've moved and where your new space is.

Signage on your original space is especially important if you're forced to move out before the relocation space is ready for you. If your store goes dark, you want to let shoppers know it's only temporary and build buzz for your reopening in the relocation space.

At the relocation space. While the relocation space is being built out, you want signage posted there to tell shoppers that you'll be "coming soon." And it should also say when you're expected to open. Since the exact date may be difficult to determine in advance, the signage could just say something like, "Opening in Fall of 2014." You also want the owner to announce your relocation in its marketing or promotional material, such as its newsletter, its website, and any ads that it may run. Also, try to get the owner to announce your relocation in the center itself, such as on stand-up cards on tables in the center's food court.

Add Sign Posting Requirement to Lease

To ensure that shoppers can locate you, add the following language to the relocation clause in your lease that requires the owner, at its own expense, to post signage at both your original space and the relocation space:

Model Lease Language

In the event Tenant is to be relocated in accordance with this section, Landlord shall, at Landlord's sole cost and expense, have professionally prepared and mutually agreed upon signs affixed to:

a. The original Premises announcing that Tenant will be relocating to the Relocation Space, the location thereof, and the approximate date on which said relocation shall take

(continued on p. 8)

Traps to Avoid

(continued from p. 7)

place. After Tenant has relocated to the Relocation Space, such signage at the Premises shall announce that Tenant has been relocated to the Relocation Space and specify the location thereof; and

b. The Relocation Space announcing the Tenant will be "coming soon" to the Relocation Space and the approximate date on which said relocation shall take place.

In addition, Landlord, shall, at Landlord's sole cost and expense, include in its promotional newsletters, advertisements, and other appropriate marketing materials an announcement of Tenant's relocation, including the location of Tenant's Relocation Space and the approximate date on which said relocation shall take place. ♦