

## BASICS OF COMMERCIAL LEASE AGREEMENTS

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The primary document governing the rights and obligations of the lessor and the lessee is the lease. The complexity of the lease document which is used in a particular transaction will depend on a number of factors, including the type of property which is being leased; the use to which the property will be put; and the amount of rent. The parties' counsel may determine that a simple form lease is sufficient to memorialize the terms of the transaction, or they might conclude that each of the substantive provisions of the lease must be individually negotiated and drafted, which means either that the standard form lease will be modified through the use of riders and inserts or that the parties will abandon the form document in favor of a customized contract. In either case, the parties will almost certainly look exclusively to the lease to ascertain their rights with respect to the payment of rent, repairs to the property, what constitutes a default, and both parties' right to terminate the lease. Consequently, it is difficult to underestimate the importance of paying close attention when reviewing and drafting commercial leases.

### 1. Description of Premises

Every commercial lease agreement must include, either in its main body or as an attachment, a legal description of the property being leased by the lessor to the lessee. Depending on which system is used in the local community to record title to land, the legal description may be based on abstract recording system; or Torrens system of registered land. The legal description identifies for both of the parties the precise parcel of real estate that is being leased. This is critical to the understanding of the parties upon entering the agreement, and can assist in any litigation that arises as a result of a subsequent breach of the agreement. The legal description also helps third parties who must interpret the contract or examine the title to the land by providing a precise description of the property based upon the records maintained by the government. Counsel should exercise caution in selecting the source for the agreement's legal description. The legal description may make reference to the county records where the abstract of the property is maintained, or through a survey that is on file in such records, or by copying the legal description from a prior deed or purchase agreement. In either event, the source must be reliable. In addition, it is not necessary that the legal description be included within the body of the agreement; it is oftentimes more convenient to attach the legal description as an exhibit to the lease. This is particularly true if the legal description includes a long list of metes and bounds references.

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## **2. Use of Premises**

For several reasons, it is critical that the lessor maintain control over the use of the property by the lessee. For example, if the lessee makes use of the leased property to carry out an illegal activity, it is likely that the local government authority investigating the lessee's conduct would also seek to investigate the lessor. Accordingly, it is advisable for the lessor to include in the lease a tightly worded description of the uses to which the lessee may put the property.

The simplest restriction that the lessor can place in the lease is to state with particularity the manner in which the lessee will use the premises, and to provide that the lessee is not permitted to use the premises for any other purpose. The parties must pay careful attention to drafting the description, since the interests of the lessor and lessee in most cases are opposed: the lessor typically seeks the narrowest definition of the use which the lessee will be able to make of the property, while the lessor probably would like to have the broadest definition, so that it can pursue its objective and all related activities. In addition, the parties must be cognizant of the distinction between so-called permissive use clauses in a lease, and a restrictive use clause. To insulate itself further from liability, commercial lessors generally also negotiate to include in the lease a provision requiring that the lessee has sole responsibility to comply with all local or other governmental regulation, ordinance and statutes which might be implicated because of the nature of the lessee's business.

Another possible problem which lessors typically attempt to avoid is a breach of warranty claim based on representations made to the lessee by the lessor or the lessor's agent about the state or condition of the property prior to the date that the lessee occupies it. In order to avoid presenting the lessee with such a claim, it is best to include in the lease a provision stating that the lessee accepts the property "as is," unless the parties to the lease provide otherwise in another section of the lease.

Unlike the use provision, which requires careful drafting, the restriction on unlawful activity can be broadly worded. In this provision, the landlord seeks to ensure that the lessee will not use the premises, or permit anyone else to use the premises, for any unlawful purpose, or to create an embarrassment for the lessor. The extent to which the lessor seeks protection through this provision depends on the problems or difficulties that it imagines the lessee may create. In other words, the lessor may want to include in the lease a list of specific unlawful activities, such as the refinement of chemicals or the manufacture of pharmaceuticals, which the lessee is barred from undertaking. If the lessor decides to include such a list in the lease, it would be advisable to include also a statement to the effect that the list of unlawful activities is not inclusive.

## **3. Representations and Warranties**

One of the most important sections of the commercial lease agreement, from the perspective of both parties, is the section containing each party's representations and

warranties. (Frequently, the parties' representations and warranties are not grouped in a single section, but appear in the particular section about which the party is providing the representation.) Including such a section is a means to verify that all of the information that each party has provided to the other informally in the past about itself and the property is true and accurate. Indeed, if the transaction is placed on a "fast-track" for closing, meaning that the parties have expedited their review and consideration of the matters pertinent to leasing the property, the section on representations and warranties can provide a great deal of comfort to both parties, since, if one or more of the representations turns out to be false, the party to whom a factual matter was misrepresented usually may terminate the agreement and, depending on the terms of the commercial lease agreement, sue the other party for breach of contract. Consequently, in negotiating the section containing the representations and warranties, each party's counsel must be careful to ensure their accuracy.

Notwithstanding the importance of the representations and warranties, neither party is obligated to include such provisions in the lease agreement. Instead, it is up to the parties to agree to require that these provisions be included in the contract. In some cases, one of the parties may be opposed to providing representations and warranties, but will allow the other party to make an extensive due diligence investigation of the property. Hence, the lessor may insist that, instead of including particular representations and warranties in the agreement, the contract contain a series of "anti-representation" provisions whereby the lessee specifically disclaims having relied on particular representations made by the lessor. However, if the parties agree to include the representations and warranties in the agreement, they must also negotiate the scope of the provisions that each party will provide; the representations and warranties may be as narrow, or as broad, as the parties agree. Indeed, each party's counsel should review closely not only what the opposing party is willing to represent and warranty, but that which that party is not willing to include in the agreement, since the refusal to include a particular representation or warranty may indicate that a problem exists with respect to that aspect or portion of the property.

Additionally, one (or both) of the parties may require that it be permitted to qualify its representations and warranties by stating that the statements are made on the basis of its "best knowledge." The extent to which the opposing party will agree to the inclusion of such a qualification will likely depend on the nature of the representation: if the representation concerns a matter which the party is in the best position to be aware of, the opposing party should not in most cases agree to the qualification.

#### **4. Rent**

The rent provision of the lease requires that a number of issues be addressed, and that the landlord ensure that the property generates a stream of income sufficient to fund any of the landlord's contingent liabilities associated with the property, such as any residual obligations relating to the development of the property and construction of the office building.

Perhaps the most important component of the rent section is the first sentence, which usually contains the lessee's covenant to pay "rent", as that term is defined in the subsequent sub-paragraphs. By expressly including in the lease the lessee's covenant, the lessor retains the ability to sue the lessee for breach of the agreement (or pursue other contractual remedies) in the event that the lessee fails to make the required payments. It is also important to make clear that the lessee's obligation is to make all payments which make up the "rent," so that the covenant extends beyond the amount which is due each month for the use of the premises exclusive of the amounts, if any, which reflect cost-of-living increases and related expenses which the lessor may pass through to the lessee.

Rental obligations are always an important part of the business negotiations between the parties, and discussions will generally focus on the base rental amount, expenses associated with the leased premises that are passed on to the lessee as an obligation to pay "additional rent" (see below), and adjustments to the base rent amount over the term of the lease.

Counsel to the landlord should ensure that the lease includes a provision mandating that the monthly rent payment is due on a given date, and that such payment obligation exists regardless of any claim to withhold or set-off amounts owed to the landlord. Counsel to the lessor should include in the lease a provision allowing the landlord to require that the rental payment be submitted by the tenant in certified funds. This would be most important if drafts delivered by the tenant to the landlord are dishonored by the tenant's bank. For similar reasons, the landlord should include in the lease a provision permitting the landlord to charge a late fee for rent payments that are not received within a given period of time (usually ten days) after the date that such funds are normally due.

## **5. Expenses, Taxes and Escalation Clauses**

As noted above, it is common for the lessee to be placed under an obligation to pay certain expenses associated with the use of the leased premises as additional rent. If this is the case, the agreement should specify the particular expenses that will be included in the computation and the procedures that will be used to calculate the additional rent. Typically, the expenses include various operating costs and expenses, such as the cost of utilities and insurance, and a pro-rata portion of the real estate taxes on the premises. Since such expenses are likely to change over the term of the lease, provisions (referred to as "escalation clauses") will be included to account for such changes. One method is to base the changes on increases in the consumer price index.

## **6. Deposit**

It is common in a commercial lease to provide the lessor with favorable terms respecting the payment by the lessee of a down payment. The down payment, usually referred to as a "security deposit," will be used to repair the building in the event of destruction or damage to the structure caused by the lessee. The security deposit is typically a small fraction of the lessee's overall obligations under the lease, such as the equivalent of two

months rental payments. If the lease includes such a provision, several ancillary questions must be addressed, including:

- Whether any interest earned from the deposit of the security deposit will be retained by the lessor or paid over to the lessee.
- The scope of the lessor's ability to apply the security deposit. For example, the lessor may seek to draft the lease to permit it to apply the security deposit to satisfy any obligation which the lessee might have under the lease, while the lessee might seek to limit the lessor's ability to use the security deposit to repairs of the structure.
- The lessor's right to assign its rights in the security deposit to any purchaser of the property which is being leased.

## **7. Repairs**

The common law treated the lessee as the owner of the property for purposes of maintaining the premises. This principle has become attenuated over time, however, so that the lessor is usually responsible for any defective condition in the property that is leased to the lessee. The lessor has an interest in ensuring that the lessee returns the premises (whether the entire building, or a unit in the building) in the same condition in which it was leased. Consequently, the parties should endeavor to negotiate their respective rights and duties regarding the need for repairs and maintenance that the premises may require.

Usually, the lessee refuses to accept responsibility to maintain the premises, so that the lessor remains contractually obligated to take whatever efforts are required to maintain the property. The lessor will generally seek to limit its obligation, however, to those repairs or other efforts which are required in the normal course of ownership; any damage to the property which is the fault of the lessee, or any agent or employee of the lessee, is the sole responsibility of the lessee. Moreover, in order to assure that the lessee undertakes to make the necessary repairs for which it is obligated, the lessor will usually attempt to include in the lease a provision allowing it to make the repairs if the lessee does not make the repairs within a specified period of time after the damage has occurred. The lessee is then obligated to reimburse the lessor for the full amount of such repairs. It is also common for the lessor to negotiate to include a provision limiting its liability to the lessee for any consequential damages arising from harm to the property for which the lessor would otherwise be liable. Hence, if a tornado were to partially destroy the leased premises, the lessor would have to bear the costs of the repairs, but would not be liable to the lessee for any lost business or other "down-stream" damages, and the lessee would remain liable to pay rent.

The parties are also free to divide their respective maintenance obligations, so that the lessor is responsible for maintaining the structural aspects of the premises, and the lessee is obligated to keep up the interior of the building. In exchange, the lessee may seek to impose a limit on its liability to only those sources of harm over which it has control. Unless the lessee has in-house resources to perform maintenance services, it will usually be necessary to enter into various contracts with outside service providers. Among other

things, contracts may be needed with parties that provide building maintenance and cleaning services, as well as specialized providers such as plumbers and electricians.

## **8. Assignment and Subletting**

The assignment and sub-leasing components of a commercial lease are among the most important parts of the agreement, since they directly affect the lessor's ability to control the use and condition of the property. In particular, if the leased property is a multiple-unit building, the assignment and sub-leasing provisions will allow the lessor to maintain a profitable mix and usage of the different units available for leasing. As a threshold matter, an assignment is a complete disposition of the assignor's interest in the lease, so that the assignor relinquishes to the assignee all of the former's rights and obligations. In contrast, a sub-lease is the lease by the lessee of the same unit or portion of the property to a third-party, usually on substantially the same conditions and terms as the master lease between the lessor (the owner of the property in most cases) and the lessee. These provisions can have similar effects in the context of a sub-lease transaction, for if the master lease prohibits the assignment of the lease, but is silent with respect to the sub-leasing of the property, the lessee may sub-lease the property on substantially the same terms as an assignment (with the exception that the lessee retains a reversionary interest).

The easiest manner for the lessor to control the assignment of the lease or sub-leasing of the property is to prohibit any such transaction unless the lessee obtains the prior written consent of the lessor. The lessor should also ensure that the lease allows it to withhold such consent in its absolute discretion. However, in order to provide the lessor with the maximum flexibility, as well as to assure the lessee that it is possible under the lease to enter into an assignment or sub-leasing transaction, the lease should provide that the lessee can request, upon thirty or more days written notice to the lessor, that the lessor approve the assignment of the unit (or property) to a third-person. A lease which contains these terms usually also provides that the lessor can turn down the request to approve the conveyance; accept the proposed third-party as a new lessee and release the lessee from its obligations under the master lease; or consent to the terms of the proposed assignment or sub-lease. It is important for the lease to mandate, however, that the lessor, by consenting to the assignment or sub-lease, does not release the lessee from its obligations or covenants under the master lease. In addition, the lessor may require that the lessee assign to the lessor its right to collect rent payments from the sub-lessee in order to secure the lessor's right to payment. In this manner, if the lessee defaults under the master lease, the lessor can recover the past due rental payments from the stream of income which would have been paid to the lessee (sub-lessor) by the sub-lessee. Finally, the lessor may require that the sub-lessee enter into a separate agreement with the lessor so that there is direct privity of contract between these parties. This strengthens the ability of the lessor to assert a claim for breach of contract.

## **9. Events of Default**

The section of the lease treating the default by the lessee should be the focus of both parties' interest: the lessor has a serious financial interest in securing payment of the rent

provided for in the lease, or in ensuring that adequate remedies to obtain such payments if the lessee defaults, while the lessee typically seeks to minimize the circumstances under which the lessor can characterize the lessee's conduct as constituting a default. In either event, the section on defaults serves two important functions--it defines what constitutes a default and it describes in detail the lessor's rights and remedies with respect to the lessee and the property.

It is most common to define a default as any of a number of different events, such as the lessee's failure to pay monthly rent when due; the violation by the lessee of any of the covenants which the lessee has provided under the lease; the lessee's abandonment of the premises; and filing a petition for bankruptcy.

Depending on the relative bargaining leverage of the parties, the lessor may extend the circumstances under which the lessee may default, so that the lessee is in default if it fails to pay a debt or otherwise is deemed to be insolvent. Indeed, in order to provide the maximum protection to the lessor, the lessor's counsel may require the inclusion in the lease of a provision mandating that, to the full extent possible, any conduct by the lessee adverse to the interests of the lessor will be construed to be an event of default, allowing the lessor to terminate the lease.

#### **10. Remedies for Breach of Lease Agreement**

Once the parties have defined the circumstances under which a default has occurred, the lease must identify the lessor's rights. The most important remedy for the lessor is to recover possession of the property, since recovery will allow the lessor immediately to begin the process of finding a new lessee and arranging a new leasehold. Because of the importance of recovering possession as soon as possible, among the lessee's express remedies should be a provision permitting the lessor to re-take the property, expelling the lessee and its possessions in the process if so required. The lease should allow the lessor to pursue this remedy without the need to provide the lessee with advance notice. In addition, if, at the time that the lessor took possession of the premises, the lessor locked out the lessee, the lessee may have left behind on the premises valuable equipment or machinery. Under the laws of many states the lessor is entitled to sell such assets in order to satisfy the lessee's past due obligations to the lessor. (Of course, if the equipment or machinery is encumbered by one or more purchase money security interests this remedy is less useful to the lessor.) Alternatively, the value of the equipment may not be sufficient to satisfy the lessee's rent obligations. The critical point, however, is that the lessor's counsel should ensure that the lessor has the express right to pursue this course of action in the plain language of the lease.

Although regaining possession of the premises is critical to the lessor in the event of a breach of the lease by the lessee, it is also common for the lessor's express remedies to include the right to terminate the lease and sue the lessee for breach of contract, claiming as damages the value of the agreement plus costs and expenses in recovering such sums, plus interest at a commercially reasonable rate. Of course, the lessor should retain the right to re-take the premises and remove the lessee and the lessee's personal belongings in

addition to the ability to sue the lessee for breach of contract, or pursue any other contractual or statutory remedy.

In addition to including provisions permitting the lessor to re-take possession of the property from the lessee and recover the full value of the rent for any period which the property has not been leased, commercial leases frequently provide that the lessee is liable for any deficiency between the amount of the rent to be paid under the lease and the lower rent which any successor lessee agrees to pay. If the lease contains such a provision, the lessor is generally entitled to pursue an action against the defaulting lessee for the total amount which may be due at any time, including after the new lessee has occupied the premises. Moreover, the monthly amount which the successor lessee is willing to pay to lease the premises can safely be used as a benchmark to determine the total amount which the defaulting lessee owes the lessor, unless the lessor can demonstrate that, because of prevailing real estate market conditions, he or she was unable to obtain as monthly rent for the property more than the amount which the successor lessee has agreed to pay. If this is the case, however, the lessor should be able to make use of the other remedial provisions to assert a claim against the defaulting lessee for the resulting deficiency.

Although it is important to identify in the lease the lessor's express remedies in the event of a breach by the lessee, the lessor's counsel should also ensure that the contract addresses several ancillary remedial questions. For example, because the lessee may decide, or be ordered, to make partial payments of what is due the lessor, or make a series of payments, it is important to establish in the agreement the order in which such payments must be applied. Like a bank, the lessor will seek to apply the payments first to cover the expenses which it has incurred in collecting the past due sums from the lessee. The next payments or series of payments will then be applied to the actual rent that is past due, as well as any interest and penalties that may be applicable.

Additionally, the lease should state whether the lessor, in the event of a breach of default by the lessee, is obligated to re-let the premises. The lessor's counsel should attempt to limit such obligation by providing that the lessor may either enforce the remaining portion of the lease against the lessee, or re-let the premises. In this manner, the lessor has the option to pursue the lessee for the full extent of the damages flowing from the breach of the agreement.

## **11. Right to Quiet Enjoyment**

Under the common law, the lessee of real property enjoyed an implied covenant of quiet enjoyment. In other words, the law imposed upon the lessor an obligation to ensure that the lessee could make use of the property without interference as long as the lessee satisfied the obligations stated in the lease (such as the payment of rent). The difficulty for the lessor under the common law standard was that the implied covenant of quiet enjoyment could be interpreted by a court to be quite broad. Consequently, sophisticated real estate practitioners began to include in standard commercial leases provisions identifying the precise scope of the lessor's covenant. Usually, the covenant is expressed



in terms of the basic obligations which the lessor has agreed to assume, such as providing access to the property and the provision of basic utilities. In addition, the inclusion in the lease of a clause discussing quiet enjoyment allows the lessor to make clear that the covenant is based on the lessee satisfying certain conditions, such as the payment of rent. Accordingly, if the lessee fails to pay rent in a timely fashion (and does not cure such a default), the lessor need not satisfy the covenant of quiet enjoyment.

## **12. Condemnation**

The term condemnation is usually associated with the efforts of a municipality or other local government to prohibit the use of a building because of its dilapidated condition. In a lease, in contrast, the term refers to the right of the local governmental authority to take private property for a public use. The term "eminent domain" is also used to describe such an event. The exercise by a municipality of its right of eminent domain, in order to condemn a privately owned parcel of commercial real property, totally undermines the lessor's ability to make use of the property, and, based on a literal reading of most commercial leases, could result in a breach by the lessor of its obligation to provide the premises described in the lease. Consequently, leases should include at least one provision addressing the rights of the parties to the contract in the event that a condemnation takes place.

In general, the property is of no use to the lessor if the local government asserts its right of eminent domain. Accordingly, the lessor's counsel should attempt to include a provision in the lease providing that the lease is terminated in the event that such a governmental "taking" occurs. The lessee's obligation will correspondingly be abated until the date that the lessor elects to terminate the lease.

The chief difficulty in drafting this section is defining under what circumstances the lessor may terminate the lease. At the very least, in order for the right to terminate to have any meaning, the lessor should be able to cancel the lease where the governmental agency condemns the entire premises. The parties may also agree to allow the lessor to terminate the lease if the local governmental agency asserts its right of eminent domain over a given percentage (or more) of the property. The lessee's counsel should ensure, however, that the portion of the property that has been condemned must be the section or area which the lessee has leased. Indeed, the lease may provide that the condemnation of all of the property except for the leased section will not permit the lessor to terminate the lease.

Under the federal constitution, and the constitutions of all of the states, the condemnation of private property compels the agency asserting such rights to pay the title owner of the property its "fair market value." This raises the question of whether, in the event that a particular parcel of leased property is condemned, the lessee is entitled to receive any portion of the government agency's payment of the "fair market value" of the premises. In most cases, the lessor, as the fee owner of the property, is the only party entitled to receive the government's payment, with the proviso that the lessee may recover from the lessor the value of any fixtures or personal property lost due to the exercise of the

municipality's eminent domain rights. Moreover, the lessor may only agree to pay such funds to the lessee if the lessee has been able to obtain a judicial declaration that it is entitled to such funds.

Because the government's right to eminent domain may be exercised in whole or in part, it is conceivable that the lessor and the lessee may be confronted with the temporary loss of the leased premises. A temporary taking of the property should not normally be the basis to terminate the lease, or abrogate the obligation to pay rent, and most commercial leases reflect this judgment. In addition, because the costs of a temporary taking are most likely to be borne more heavily by the lessee than the lessor (because of the loss, albeit temporarily, of immediate access to the property), the lessee's counsel should require that the lease allow the lessee to assert a taking or similar claim to recover any sums which the lessee may have lost.

### **13. Term and Termination**

The term is an essential legal and practical provision in a commercial lease. The term defines the temporal parameters of the tenancy of the building or unit, and provides the parties with the opportunity to structure their relationship taking into account events like the end of the fiscal year, or the period in which sales are greatest. Moreover, the term is likely to dictate any requirements imposed on the tenant to maintain the structure; a tenant under a lease with a fifty year term, for example, is more likely to assume the obligation to maintain the structure than a tenant under a three year lease.

An important element of any description of the term is to identify when the tenancy begins. The lease should then identify when the term of the lease expires, which may be expressed as a particular date or as a fixed number of years from the commencement date of the lease. Alternatively, the parties may provide for continuation of the lease beyond the original fixed term until terminated by one of the parties. The identification of the term of the lease imposes obligations on both parties. For example, the term provision of the lease requires that the landlord ensure that the premises are ready and available as of the date that the lease commences. If the premises are not prepared at that time, the tenant may sue for breach of the agreement, since under most theories the ability to occupy the premises would be construed as an essential term of the lease. Similarly, the inclusion of the term provision mandates that the tenant be prepared to take possession of the premises as of the date that the lease commences.

The lessee may be granted the option to renew the lease following expiration of the fixed term on terms and conditions agreed to in advance and made part of the lease. In many cases, the rent during the option period would be adjusted to an amount set out in the original lease. Alternatively, the parties can provide that the new rent would be determined by appraisal.

While both parties anticipate that the lease will continue for the full term contemplated in the lease agreement there may be circumstances that cause the lessee to seek an early termination of the lease. For example, an unexpected downturn in business may make it

necessary for the lessee to vacate the premises before the end of the lease term. In that situation the lessor may be willing to agree to early termination upon satisfaction of certain conditions such as payment of liquidated damages by the lessee to compensate the lessor for the lost revenue and/or re-letting of the premises by the lessor to a suitable new tenant.