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Commercial Lease Provisions



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Protecting the Landlord Against Mechanics' Liens Filed by the Tenant's Contractors

The Law

- State lien law statutes enable a tenant to “pledge” the landlord’s equity in its building to secure payments that the tenant is required to make to its contractors
- The contractor’s statutory lien rights cannot be waived
- Requiring the tenant to obtain performance/ payment bonds does not protect the landlord



The Real Protection for the Landlord

- Creditworthiness of the tenant
- Security posted by the tenant
- Third-party guarantees given to landlord
- Guarantees of Completion
 - “Tail” period for extended liability
 - Provision giving landlord the option to liquidate damages for breach of the guarantee without requiring the landlord to complete the work



Protecting a Tenant's Security Deposit from the Adverse Effects of a Tenant Bankruptcy

Conventional Methods of Holding a Tenant's Security Deposit is Risky

- Landlord must make a motion in the tenant's bankruptcy case to draw upon the security deposit
- Bankruptcy Code "caps" the claim that a landlord can assert in a tenant's bankruptcy case for damages resulting from lease termination
- For a security deposit (whether cash or letter of credit) in excess of one year's rent, Code can limit landlord's ability to fully use the security deposit
- Landlord must refund amount of the security deposit that exceeds the landlord's capped bankruptcy damages to the tenant's bankruptcy estate

An Unconventional Method Could Reduce a Landlord's Risk

- Requiring a security deposit to be posted in the form of a letter of credit does not eliminate the landlord's risk
- Have a parent company or principal of tenant post an amount that would have been the security deposit as collateral security for a nonrecourse guaranty of the lease

The Advantages of the Unconventional Structure

- Guarantor is less likely to file for bankruptcy than the tenant
- Guaranty security should not be considered property of the tenant's bankruptcy estate
- Landlord would not need to make a motion in tenant's bankruptcy case to obtain permission to use the security for the guaranty
- The guaranty security should not be required to be deducted from landlord's capped damages
- This technique has not yet been tested in the courts

Example

	Security Deposit Posted <u>Under the Lease</u>	Security Deposit Posted Under a Non-Recourse <u>Guaranty of the Lease</u>
Landlord's State Law Damage Claim	\$1,300,000	\$1,300,000
Landlord's Capped Damage Claim in Tenant's Bankruptcy Case	\$500,000	\$500,000
Security Deposit	\$700,000	\$700,000
Amount of Security Deposit Permitted to be Used by Landlord	\$500,000	\$700,000
Amount of Security Deposit Required to be Returned to Tenant's Bankruptcy Estate	\$200,000	\$-0-
Landlord's Allowed Unsecured Claim in Tenant's Bankruptcy Case	\$-0-	\$500,000
Unusable Balance of Landlord's State Law Damage Claim	\$800,000	\$100,000

Non-Bankruptcy Risks of Using a Letter of Credit and Ways to Minimize These Risks

- If accepting a letter of credit instead of cash as security, landlord needs to monitor the credit rating of the bank issuing the letter of credit and obtain lease provisions requiring the tenant to replace the letter of credit
- Letters of credit, unlike cash, expire or can be terminated by their terms



The Effect of ICAP/ICIP Tax Exemptions on Tax Escalation Provisions of the Lease

The Tax Exemption Begins to “Burn Off” at Some Point in Time

- The “burn-off” may be phased-in over some period of years until the tax exemption is eliminated
- A tenant’s tax escalation payment will increase each year of the burn-off period
- Landlord will enjoy a windfall in additional tax escalation payments from the tenant



But What Would the Savvy Tenant Do?

- A savvy tenant will require that the escalation payment that the tenant is required to pay for each tax year occurring in the lease term be reduced by the tenant's proportionate share of the amount of the increase in taxes that is attributable solely to the burn-off in such tax year of the building's tax exemption
- The taxes for the base tax year, however, should be determined with full regard to the tax exemption
- Why is the savvy tenant entitled to this adjustment?



The Full Occupancy Gross-Up Clause for Operating Cost Escalation



The Typical Gross-up Clause

- “For any year the Building is not fully occupied during any Operating Year, then Operating Costs for such year will be increased to reflect what the Operating Costs would have been had the Building been fully-occupied.”
- Important concern because an office building which averages less than 100% occupancy will operate at a reduced overall cost, while the cost of providing service to the occupied portions of the building will not be reduced



This Provision Artificially Increases Building Expenses Which Vary as a Result of Occupancy

- If the “gross-up” of operating expenses were not done, tenants would receive an undue monetary benefit by virtue of space being vacant in the building
- Tenants will try to negotiate for a calculation based on 90%-95% occupancy, arguing that it is unreasonable to assume that the building will ever achieve 100% occupancy for any extended period

What a Savvy Tenant May Argue

- Gross-up should be performed on the base year as well as each operating year
- A certain portion of the building's operating expenses should be allocated to the building's common area and shared with the vacant space, and only the balance of the operating expenses, representing the costs of servicing the occupied space, should be grossed-up



The Effect of Using Separate Base Years and Escalation Provisions for Certain Operating Costs

Landlord's Advantage in Drafting a Lease That Creates Separate Base Years

- Landlord is insulated from the “netting effect” of reductions of costs, and may be able to charge the tenant a higher escalation payment than the tenant would have paid had all costs been combined into one escalation clause with one base year

Example

(Assume tenant's proportionate share is 100%)

	<u>Insurance Costs</u>	<u>Security Costs</u>
Escalation Year Costs:	\$11,000	\$4,000
Base Year Costs:	\$10,000	\$5,000
Tenant's Escalation Payment:	\$1,000	\$-0-

In the above example, tenant will pay a \$1,000 escalation charge for Insurance Costs and \$0 for Security Costs, for a total escalation payment of \$1,000. If Insurance Costs and Security Costs had been combined into one escalation clause, tenant's total escalation payment would have been \$0 instead of \$1,000, as shown below:

	<u>Insurance and Security Costs Combined</u>
Escalation Year Costs:	\$15,000
Base Year Costs	\$15,000
Tenant's Escalation Payment:	\$-0-

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Assignment & Subletting



Assignment

- When a tenant assigns its lease, the assignee comes into privity of estate with the landlord, but not privity of contract
- Assignee is liable to the landlord under the lease only for as long as it remains the holder of the tenant's interest
 - The landlord should require the assignee to “assume” in writing the lease and this should be a condition to the effectiveness of the assignment
- An assignment does not release the assigning tenant from its obligations under the lease unless the landlord gives a specific release, but a savvy tenant will require a limitation on its liability for modifications made after the lease was assigned



Subletting

- There is neither privity of contract nor privity of estate between the subtenant and the landlord
- Some landlord lease forms require that the subtenant assume the obligations of the tenant under the main lease
- From the landlord's perspective, the importance of reaching the sublease rental stream is often overlooked
- Ideally, as a condition to permitting a subletting, landlord should obtain a written agreement signed by the tenant and the subtenant that the sublease is subject to the main lease and the subtenant pays the landlord directly



Subletting (cont.)

- From the subtenant's viewpoint, if the main lease terminates because of a default by the main tenant, the sublease will terminate, and accordingly, subtenants often seek “non-disturbance” protection from the landlord

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Benjamin Kursman
Herrick, Feinstein LLP
2 Park Avenue
(212) 592-1446
bkursman@herrick.com
www.herrick.com

Matthew Mayer
Boston Properties
599 Lexington Avenue
(212) 326-4025
mmayer@bostonproperties.com
www.bostonproperties.com

Robert Fink
The Winter Organization
730 Fifth Avenue
(212) 616-8960
rfink@winterorg.com
www.winterorganization.com