

Commercial Lease Provisions and Issues

John C. Livingston
Kilpatrick Townsend & Stockton LLP
Suite 1400, 4208 Six Forks Road
Raleigh, NC 27609

John C. Livingston
Kilpatrick Townsend & Stockton LLP
4208 Six Forks Road, Suite 1400
Raleigh, North Carolina 27609
Phone: (919) 420-1768
Fax: (919) 510-6143
jlivingston@kilpatricktownsend.com

I. Commercial Lease Provisions and Issues

The commercial lease is a hybrid between a demise of property and a contract for the operation; a much more difficult construct to navigate than a simple sale of property where the seller and buyer do (or at least should) not interact following closing. This paper discusses some overriding issues in commercial leases by first discussing the interaction between legislation and case law and the provisions of commercial leases, then discussing the players and procedure in the drafting and negotiation process, and then discussing specific provisions that are typically included in commercial leases. While by necessity these subjects are dealt with sequentially, the lease negotiation process should be viewed holistically.

A. Commercial case law and legislative updates

This section discusses the interaction between legislation and case law and the provisions of commercial leases.

Unlike residential real estate leasing, very few statutes govern commercial leasing in North Carolina; the vast majority of the provisions in a lease are governed solely by the terms of the lease itself. There are notable exceptions, such as a prohibition against waiving the right to a jury trial in a contract;¹ however, assuming that no statute or caselaw affects a particular provision, the assumption that the lease language controls will be proven right in almost all instances. While the lack of formal legal restrictions on provisions of a commercial lease offers advantages to the parties and attorneys who are trying to tailor a lease to specific facts and circumstances; however, it poses dangers for

¹ N.C. Gen. Stat. § 22B-10 (2014).

those who do not carefully review their commercial leases or have leverage to change the terms of a lease. It is very much a case of *caveat emptor* (or lessee beware); reviewers of commercial leases should carefully review all provisions.

One particular clause that illustrates this deference from the legislature and the courts relates to the landlord's obligation to mitigate damages. When the lease is silent, the landlord has a duty to mitigate damages just like in any other contract;² however, the North Carolina Court of Appeals has now twice ruled that express waivers of a Landlord's duty to mitigate damages are enforceable in a commercial setting.³ In the first case, the Court based its ruling in part on the relatively equal bargaining positions of the parties to the transaction, noting: "In examining commercial real estate lease transactions in light of public policy considerations, we recognize that negotiations generally involve relatively equal bargaining power due to the availability of other space and the fact that neither party is compelled to make a deal. Each lessee has to determine whether the lease offered is acceptable in business terms."⁴ This distinguished the treatment of a commercial lease from the treatment of a residential lease which the court notes "presents an entirely different situation."⁵ This deference by the courts to the terms of the commercial lease that in effect overturn the courts own ruling demonstrates the concept that commercial lease provisions will be enforced as written even while the court noted that the ruling would likely be different in a residential lease situation. It is also

² See, e.g., [*Isbey v. Crews*, 55 N.C.App. 47, 284 S.E.2d 534 \(1981\)](#) ("With respect to the question of mitigation of damages, the law in North Carolina is that the nonbreaching party to a lease contract has a duty to mitigate his damages upon breach of such contract.") *Id.* at 51, 284 S.E.2d at 537.

³ [*Sylva Shops, Ltd. P'ship v. Hibbard*, 623 S.E.2d 785 \(N.C. Ct. App. 2006\)](#); [*Kotis Props., Inc. v. Casey's, Inc.*, 645 S.E.2d 138 \(N.C. Ct. App. 2007\)](#)

⁴ *Sylva Shops*. 791, 429.

notable that the legislature has not moved to legislatively create a duty to mitigate in the more than seven years since the initial ruling.

B. Negotiation and Drafting:

Given the lack of formal restrictions on leasing and the deference given to the terms of the lease, the drafting and negotiation of leases becomes critically important as discussed in this section of the paper. This deference is present even though the stated premises for it – that the parties are in equal bargaining positions – is likely false and potentially growing even more false as more institutional owners saturate the markets. For instance, sovereign wealth funds have been purchasing properties at a record pace the last few years.⁶ Should a small tenant be considered an equal negotiating partner with the investment arm of a country heavily invested in real estate?

Other institutional owners such as REITs, which may own multiple properties in multiple states, and even local developers' business often rely solely on the leasing of property for the generation of their revenue. Therefore, the landlord is often the party preparing the lease. And controlling the documentation gives the landlord an additional advantage. There are some form commercial leases prepared by various groups but none is widely used outside of certain, limited submarkets.

Whether the tenant actually is in an unequal negotiating position and needs to accept most provisions without revision or is a large tenant who may, in fact, be able to

⁵ Id. at 791, 429

⁶ See, e.g., Sovereign Funds to Expand Property Buying After Record Year, Klaus Wille, available at <http://www.bloomberg.com/news/2013-02-06/sovereign-funds-seen-expanding-property-buying-after-record-year.html>

negotiate many provisions, it is critical to understand the important terms and the negotiation process.

What is the Worst that Can Happen.

When thinking about how to draft and negotiate leases, it is often important to consider what the worst case scenario is for any given lease situation. While each case may be different, one presenter at a national continuing education conference⁷ summarized, I think rather well, the worst case scenarios in order as:

- 3rd worst: No deal;
- 2nd worst: A bad deal (not correctly reflecting the business terms agreed to or containing hidden terms or costs for either or both parties);
- Worst: No deal after negotiating a significant amount of time and expending significant funds.

Accepting this paradigm argues for identifying potential issues early in the process and focusing on the most important items for each party. In order to do so, I would argue it is important to know and understand the players and procedures of the negotiation, which are discussed next.

⁷ John Busey Wood at PLI's Negotiating Commercial Leases 2013.

1. Players

There are many potential players in the negotiation of most commercial leases, and it is important to ensure that they are all working together to achieve the goals of the ultimate parties to the lease, the landlord and tenant. The potential players in any such negotiation on the landlord's side can include: the landlord, a ground lessor, one or more lenders, an attorney and a broker and on the tenant's side can include: the tenant, a broker, an attorney, a franchisor, a lender, a design professional, and other consultants. A chart attached as Attachment A summarizes some common potential players in the transaction and their typical roles. While the chart may not exactly match any given situation, it helps demonstrate the number of players often involved in a transaction and how their roles and interests may diverge. Hopefully, it also demonstrates the importance of coordination among the various players.

Given the need for coordination, it is often asked who is the most important player (after the landlord and tenant, respectively) and who should be brought in first. While the practice is often to first hire a broker, I would argue that both landlord and tenant would be best served by hiring their attorney first. In any event the landlord should assemble its team prior to marketing premises for lease and the tenant should assemble its team prior to the potential tenant talking with a landlord or visiting a potential site for reasons discussed in the following paragraph generally and in more detail in the section below on procedure.

One main reason for selecting the attorney first is in helping to select and manage the rest of the players on the team as highlighted by the role the attorney can play with

respect to selecting the next member of the team, the broker. A good attorney will have interacted with numerous brokers on many transactions and has a good understanding of the capabilities of various brokers; perhaps it comes from being in the attorney's role, but it seems attorneys have a better understanding of the difference between a good and mediocre broker than a broker would have in differentiating between attorneys. Additionally, an attorney can help draft a brokerage agreement that protects the client and describes an appropriate scope of responsibilities and compensation of the broker. (The sample North Carolina Realtor form landlord broker agreement is available at: <http://www.ncrealtors.org/uploads/sample-572.pdf>, and their sample form tenant broker agreement is available at <http://www.ncrealtors.org/uploads/sample-530.pdf> or <http://www.ncrealtors.org/uploads/sample-531.pdf> or <http://www.ncrealtors.org/uploads/sample-532.pdf> depending on circumstances) The same benefits holds true for other professionals in the transaction.

While the order of selecting professionals is important, having at least the beginnings of the team assembled prior to marketing the premises or visiting a potential premises is important in order to protect important rights and being prepared for an orderly and timely negotiation process as described below.

2. Procedure

This section discusses the typical procedure in negotiating leases as well as some suggestions on improvements to the process in ways that can preserve rights beginning with the first marketing of the premises by the landlord or visit to potential premises by the tenant and moving through the letter of intent, lease negotiation, and occupancy.

Marketing the Premises and Visiting a Potential Premises.

The first step in obtaining a tenant for your space is letting potential tenants know it is available.

For an already leased space, the first potential tenant should, unless there are significant issues, be the tenant currently in the premises. By renewing or extending a lease for an existing tenant, the landlord can save significant effort, costs, and time. Costs are saved in direct marketing costs as well as a lack of break in the rental income stream and potentially less tenant improvements (since the existing premises presumably fills its needs).

The most common drafting question with a renewing or extending tenant is whether to use an amendment to the existing lease or repaper. For cost and timing reasons, I would encourage amendments unless there is a fundamental change in business terms. If there is not an existing tenant, the landlord will need to market the space. At the very least a broker will be needed for the process, but, as discussed above, an attorney may be able to help guide the landlord in selecting a broker and entering into a brokerage agreement.

In marketing the premises, a broker will likely distribute vital information about a project through listing services, place signs in the premises, promote the property to potential tenants known to its brokerage firm and, potentially, promote the premises through professional organizations of brokers.

A potential tenant without a broker may see some of this material and be tempted to respond prior to selecting and engaging a broker for itself, but that would be a mistake

that could cost the tenant substantially. For an initial matter, the right broker can help a potential tenant determine its needs and realistic budget prior to visiting any premises, saving time and potentially increasing the chances for an appropriate fit to tenant's needs. Additionally, discussing potential space with a landlord or landlord broker may inadvertently create a brokerage relationship with such party or an oral lease or at least give such party a reason to deny compensation to the tenant's eventual broker through a claim that the tenant's broker is not the procuring cause of the tenant being interested in the space. If there is a brokerage relationship created with the landlord or its broker, the tenant could be denied its ability to have an impartial broker and an independent advocate in the process. If compensation is denied to the tenant's broker, the tenant may need to come out of pocket to pay such commission. Additionally, the tenant loses some leverage in negotiating rental rates that hiring an experienced broker would provide. It should also be noted that brokers can successfully maintain confidentiality for a client where that is important.

Additionally, a broker may suggest for a significant project that instead of reviewing landlord offerings that the potential tenant should issue an RFP.

RFP

In some significant transactions, a tenant will issue a request for proposals ("RFP") with its space needs and desired terms. If the space is large enough to generate interest, an RFP is a good way for a tenant to obtain proposals from landlords in a competitive environment and obtain early concessions from landlords. An RFP can range from short to very long; however, the best and most successful RFPs will be well

thought out with input from at least the broker and attorney and include a breadth and depth of desired terms.

The most important benefit of the RFP is that it arises during a time period in a negotiation when the tenant has the most leverage as the possibility to go to other space is highest. As such, I would recommend including as much as possible in the RFP.

After review of submitted proposals and acceptance of one or more of the proposals (I would suggest keeping at least one additional option open both as a negotiation tool and in case negotiations break down on the first choice), the tenant and selected landlord will either move to a letter of intent or directly to the lease.

Letter of Intent

The Letter of Intent (“LOI”) sets forth the material business terms of the lease; however, there are a number of different views on the correct content and effect of an LOI.

The first question is whether an LOI should be binding or nonbinding. Almost always the LOI is nonbinding to prevent later claims that it has created a lease or an obligation to negotiate for a lease that could be held against either party, so the bulk of the LOI will be nonbinding. That being said, there are certain provisions that can and should be made binding even if the broader agreement is not. For instance, confidentiality provisions are often binding, and, if a tenant can negotiate it, there is sometimes a binding exclusivity provision preventing the landlord from leasing space to another tenant while a lease is being negotiated.

The second question is how much detail should go into an LOI. Typically, additional detail helps the tenant given the landlord will likely be drafting the lease and the tenant maintains higher leverage at this stage than at lease negotiation. Additionally, all potential deal breaking points should be addressed to prevent a break in the deal after lease negotiation has commenced (as discussed above, the worst case in lease negotiation is long negotiations that result in no deal being done). However, there are limits and diminishing returns to inserting too much into the LOI. Particularly given that the LOI is not binding in most instances and just an interim statement of agreement. Tenants and landlords often balk at the idea of prolonged negotiations of an LOI and will defer most discussions to the lease stage.

My experience is that landlords and tenants generally will put too much emphasis on moving forward from the LOI before all pertinent issues are addressed. Either party may not have considered important points or both sides may have gotten tired of negotiating a non-binding document. In either event, too often LOIs are sent on before being complete and lead to lease documents that do not accurately reflect the terms or fairly protect both parties (the bad deal that is the second worst outcome discussed).

The third question is related to the first two but slightly different, and this is whether the LOI should be signed. I always recommend that they are for two important reasons: (i) it focuses the parties to clean up the details and make a coherent document (one of the biggest issues and mistakes I see when receiving an LOI is that the LOI has been marked through track changes during a number of round of negotiations making it unclear what the final terms are to be or ending with terms that are conflicting) and (ii) it

makes a psychological and moral bond to the terms even if there is no legal binding. For both of those reasons, I have found that signed LOIs are more likely to lead to smoother negotiations, saving parties time and money in the long run through easier lease negotiations.

While saved for last, an overriding question is when or whether to get an attorney involved. My answer would be the sooner the better. A good attorney can make documents more clear, identify issues early on, prevent the LOI from being unintentionally binding, ensure that there are not conflicting provisions in the LOI, eliminate conflicts with the form lease that landlord will be using, and give the attorneys deeper insight into the business deal. However, attorneys should be careful to avoid the temptation to negotiate the entire lease at the LOI stage, which can lead to the breaking of a deal too early (third worst outcome) or the attorney being ostracized and pushed out of the process (this is why attorneys are not invited to parties). Despite these reasons for involving an attorney, it is the exception and certainly not the rule that either party will involve its attorney.

After the LOI, the parties will turn to the negotiation of the lease.

Lease

As previously discussed, the landlord will usually take the lead on the drafting of the lease. This is usually accomplished at a broad level by the landlord's broker sending the landlord's attorney an LOI purporting to memorialize the business deal and asking the landlord's attorney to prepare a first draft of the lease on landlord's form. Then after reviewing the lease draft with landlord, landlord's broker will circulate to tenant, who at

this point is likely going to engage an attorney and send the first lease draft to them. Then the lease negotiation would likely proceed with several drafts and redlines being circulated by parties and maybe a conference call until all parties are satisfied with the lease and preparation of an execution version can be made.

I am going to stop there to identify several inefficiencies that are often present in start to the “typical” leasing procedure that can skew the entire negotiation process moving forward:

- First, the landlord’s attorney was likely not involved in the LOI negotiation, which likely means that the LOI is not clear in its terms and does not match the landlord’s base form. Since the attorney was not likely involved in the LOI stage, he has to interpret these inconsistencies cold, which leads to a higher likelihood that the lease will not match the intent of the parties (usually to the detriment of the tenant), which will either get caught later on at greater cost and time or not get caught and the lease ends up not matching the intent of the parties (second worst outcome).
- Second, the landlord’s form is usually overly landlord friendly, which will be discussed more below, which could lead to excessive negotiation.
- Third, the tenant’s attorney probably has not been involved in the LOI process, leading to two types of errors: either missing important discrepancies caused by landlord’s attorney trying to interpret the LOI or catching too many issues that had already been resolved during LOI negotiation, wasting time.

- Fourth, often information is missing in what is sent to the landlord's attorney, including space plans and construction plans that will need to be collected later in the process before execution.

- Fifth, often the negotiation process does not proceed smoothly or efficiently due to failure to plan the negotiation. Sometimes because there are too many turns of redlines, poor negotiation tactics, and/or attempts to have calls addressing too many issues to be effective.

There are some simple adjustments or best practices that would help the negotiations run more efficiently and effectively. First, as discussed above, involving attorneys earlier in the process at the LOI or RFP stage would help in the later drafting and negotiation stages. Second, the landlord and landlord broker could take more time to ensure all relevant information is passed on to landlord's attorney to ensure that the first draft more closely aligns with the intent of the business parties. Third, landlords may be better served by having a lease form that is more neutral in the beginning to avoid negotiations on points that landlord is okay giving on (and in some cases not even enforceable). On the tenant's side, its attorney could be brought into the process earlier and/or be fully informed of the transaction and negotiations prior to review of the lease. With respect to negotiations, the parties could help each other by providing timely comments without unreasonable requests. Additionally, the parties can use the most efficient negotiations by exchanging drafts until there are few enough issues to finalize on an all hands conference call.

A Better Way?

Some tips that may increase efficiency and effectiveness of the process by addressing some of the most common issues faced are summarized below:

<u>Stage</u>	<u>Issue(s)</u>	<u>Possible Solutions</u>
Marketing	1. Broker's responsibility and scope not optimized; 2. Broker relationship established where not intended; 3. Tenant becomes bound to a space without being intended to.	1 and 2, selecting and involving an attorney early to assist in selecting and drafting agreements with broker. 3, having the broker represent the tenant in negotiations with potential landlords from the first contact.
RFP	Not including relevant issues.	Have attorney and broker fully review and discuss RFP.
LOI	1. Not including relevant issues; 2. LOI not clear or conflicts; 3. Terms that should be nonbinding being binding and vice versa.	2, having the parties execute the LOI helps clean up the LOI some. 1, 2, and 3, having the attorney review and comment on the LOI can help.
Lease Drafting	1. Details of negotiation do not get communicated to draftsman; 2. Lease form is overly landlord friendly.	1, have attorneys be involved earlier in the process. 2, moving to a more neutral form at the outset.
Lease Negotiation	Inefficient negotiations.	Begin with exchanges of redline drafts until 10-15 issues remain and then have all hands call (being reasonable).

C. Specific Lease Clauses

This Section addresses some common specific questions that often arise in preparing and negotiating leases. In addressing specific lease issues, attorneys need not only concern themselves with not just the specific lease term but also how they relate to the lease as a whole and with provisions of other leases. The use of overly landlord friendly leases is discussed above; however, there is a legitimate concern on the part of landlords to ensure consistency in leases to, among other reasons, to aid in administration of the lease and not needing to apply different provisions to each tenant. But despite landlord's best efforts, most individual lease terms will be negotiated to some extent and negotiated in different ways by different tenants. The best real estate lawyers can use their knowledge of specific terms to make the negotiation process more efficient without giving up important rights of its clients. Given the overview nature of this paper, this list is not comprehensive and it could be argued that there are important provisions (such as insurance, condemnation, and casualty missing) but hopefully, this provides a helpful overview of the issues selected.

1. Parties to the lease and Premises

While it might seem basic, there are often questions and mistakes as to the proper parties to a lease. It should first be confirmed that (i) the land owner is listed as the landlord and not a property manager or other agent and (ii) the party whose financials were reviewed is the actual tenant and not a subsidiary (or some division that is not a

legally separate entity). Then both parties should be confirmed to be registered with the Secretary of State.⁸

The lease should be signed by a party who has actual or apparent authority to execute the lease. Some specific tips follow. For a corporation, try to have signed by the President or CEO or Vice President with real estate in title; otherwise, consider obtaining confirming documents to ensure actual authority. For an LLC, managers are better than members. For individual landlords, ensure that their spouse, if any, executes the lease as well.

Likewise, the premises must be correctly described. The lease language itself should be reviewed carefully to ensure that the description includes the correct square footages if agreed to or the method of measurement if not (the Building Owners and Managers Association's measurement provisions are often the most commonly used standards but not universally); however, issues may be even more common in the exhibit describing the premises. Often the lease is negotiated and then an exhibit slapped on right before execution as an afterthought, but if the premises are not shown correctly or are unclear it could cause significant issues down the road. Attorneys should make sure the premises are shown without showing extra areas that should be landlord's responsibility (stairwells, elevators, etc.) and have a provision for areas outside of the premises that tenant may have rights to, such as balconies, outdoor seating areas, etc.

⁸ <http://www.secretary.state.nc.us/corporations/csearch.aspx>

2. Use restrictions

Landlords will have an interest in restricting the use of the tenants under the lease to ensure that it does not conflict with laws and regulations or interfere with the use of other tenants in the project and not degrade the project; failure to state such restrictions would allow tenant free reign over the premises.⁹ The need is especially important in retail centers where tenant mix is important and some tenants may negotiate exclusive use provisions; in those instances the permitted use may be specific (e.g., “upscale, women’s shoe store”). Tenants need to ensure that the use specified is not overly restrictive and thereby being an obstacle to its operation of its business or any natural expansion thereof and does not effectively prevent a future sublease of the premises or assignment of the lease if needed in the future. Additionally, tenants should be concerned about prohibitions on uses that are purely subjective (e.g., “immoral uses”) and should push for either an objective standard or a requirement for landlord to be reasonable in its determination. Likewise, provisions requiring compliance with all applicable laws may be too broad if they do not exclude preexisting conditions or do not relate only to tenants’ operation at the specified premises.

Landlords also want to ensure that the use clauses are not so restrictive that the clauses themselves of the lease in its entirety is deemed unenforceable.¹⁰

⁹ *Friedman on Leases*, § 27:3:1 (5th ed. 2007).

¹⁰ *Friedman on Leases*; § 27:3:2.

3. Rent

Rent is often divided between “base rent” and “additional rent.” Base rent is the flat monthly charge for the space and additional rent is typically any other charge under the lease, importantly including operating expenses, insurance, and taxes.

Base rent is often expressed as a per square foot rate with annual increases that can either be a standard annual increase, stated increases that change by year, or increases tied to the CPI (becoming less common). Base rent should be paid monthly in advance on the first day of the month. One question that arises is when is the failure to pay rent a default. Often a grace period is allowed (5 days may be typical) for tenant to pay but without an obligation for landlord to send a notice of failure to pay. Tenants often also want notice of a missed payment to avoid an innocent mistake (the check slipped behind the counter) to lead to termination of the lease or other remedies. Representing landlords, I would advise them not to agree to require notices for each late payment as tenants sometimes use that delay rent payment each and every month and often a compromise on agreeing to give notice 1 or 2 times a year. Base rent should be prorated for any partial months at the beginning or end of the term. There should be a late penalty charge for any late rent (again can argue about requirements for notice or a grace period).

A different form of rent is percentage rent, which is applicable almost exclusively in retail contexts and is common there. In a pure percentage rent regime, the rent is calculated as a percentage of the gross sales (usually 5% but can be lower for national tenants) with no other base rent. However, most leases use base rent for a, well, base and then percentage rent over that if gross sales exceed a natural breakpoint (i.e., the rent due

is the larger of: (i) the base rent and (ii) the amount calculated by the percentage rent calculation). Landlords will require the right to review and/or audit appropriate records to be able to properly enforce and administer a percentage rent provision. There are common fights over what is or is not included in gross sales, including internet or phone orders, tips, discounts to employees, and items that are refunded.

The payment of rent should be a separate obligation of tenant with only limited offset rights against landlord. Additionally, landlords should ensure that there is a late payment penalty (tenant will want notice before instituting such a penalty) and a penalty for payment by a bad check (tenant will want to limit to actual expenses or some reasonable number rather than some attempts to make a percentage of rent being paid).

4. Operating expenses, insurance, and taxes

There are three broad categories of leases in terms of treatment of the payment of operating expenses, insurance, and taxes: (i) gross leases (such expenses are included in the base rent); (ii) gross leases with a base year or expense stop (the expenses for the year in which the lease term commences [base year] or a set value [expense stop] are included in the base rent and tenant pays for any increases from that amount [proportionate if there are multiple tenants]); and (iii) net leases (such expenses are borne completely by the tenant). Gross leases are common for small spaces or short-term leases and are easier to administer on both ends but leave risk of increases with the landlord and there is some disconnect between use and expense (*e.g.*, a tenant may not be incentivized to conserve energy or water). Net leases are common for ground leases, single tenant users (*e.g.*, a free-standing drug store), and industrial leases, generally times when the tenant will be

performing most of the work, repairs, and maintenance; these too have some ease to administering as all expenses are passed through but have some issues with respect to landlords being disconnected from the impact of some costs that they incur (in leases where the landlord is performing work and passing through costs). However, a large number of leases, including most office leases and many retail leases, have an expense stop or base year.

The expense stop and base year leases require significant administrative work to ensure that expenses are properly accounted for. Tenants will want a right to review the expenses and possibly audit (including the base year) to ensure proper accounting. Business terms that can be negotiated include a cap on increases in expenses (often limited by landlord to “controllable expenses”), requiring expense calculations to comply with GAAP, and exclusions of certain classes of expenses from being passed through. Difficulty lies in trying to determine some categories, ensuring that there is a fair comparison of expenses between the base year and other years (a gross-up provision as well as provisions preventing changes in services helps), and accounting for differences in base years and exclusions between tenants.

For any option where tenant is paying some or all of the operating expenses, they are typically paid monthly in advance based on annual estimates. There should be a provision for reconciling overpayments or underpayments at the end of any given year.

5. Term

The length of the term is often, and correctly, thought of as a business issue; however, there are a number of wrinkles that should be reviewed and can cause issues

without careful review. First, there are a number of dates that can be used to delineate the term and it is necessary to understand the importance of each: (i) the effective date typically refers to the date of execution of the lease and only effect should be in the measurement of other dates; (ii) the commencement date signifies the date that tenant's occupancy of the premises can begin, which could be a date certain or tied to a number of days following the effective date or tied to completion (or substantial completion) of construction (and often if so tied to future events gets accelerated if tenant actually opens for business in the premises); (iii) the rent commencement date, if not the commencement date, to allow a free rent period between the start of occupancy and the obligation to pay rent; and (iv) the expiration date to mark the end of the term, often based on a number of months or years following the commencement date.

There are some additional considerations to be given to commencement date determinations. If the landlord is doing the construction, the commencement date should not be until the construction is complete to a point tenant can use the premises plus the tenant should often be given time to move into the space and consider abatement of rent or termination rights if the landlord cannot meet a certain date. If the tenant is doing construction, the commencement is more appropriately a set date (whether the commencement date should be delayed as a result of force majeure is a difficult question without a definitive answer; on the one hand, the tenant should not be penalized for force majeure; however, the tenant has the ability to overcome the force majeure through overtime work, etc.). If the measuring period is completion of construction, there should be an objective test as to completion (certification by architect or certificate of occupancy

from a governmental entity) and a reasonable time period for landlord to complete any punchlist items. The parties should execute a commencement date agreement when the actual date is known.

6. Renewals and extensions

Tenants of mid to long term leases are often granted renewal or extension rights (while both terms are used, sometimes interchangeably in leases, there is a slight legal difference in that renewal implies a new lease to be negotiated while extension implies merely a lengthening of the term; since the latter is usually the intent, I try to use “extension” wherever possible). Five or 10 year extensions are common. The drafting considerations for these extension rights are the procedure and time required for extension and what the rent will be during the extension term. Some procedural issues include the conditions on exercising an extension (tenants should be leery of too many restrictions but reasonable ones, like not being in default beyond any applicable cure period at the time of extension, should be acceptable) and the timing of giving notice (6-9 months is fairly typical but might be longer for a unique space where the landlord’s time to find a replacement is longer or shorter for smaller less unique space). The rental in the extension term is also a major point. Sometimes it can be a straight increase over the existing rent and sometimes it is tied for fair market value. Tenants should request a neutral arbitrator of the fair market value, which is often achieved through a method of selecting either one or three neutral arbitrators; the definition of fair market value should also be reviewed to ensure it does not improperly benefit either party. Often the base year, if applicable, is updated to the first year of the extension. There should be an

express statement that the terms of the base lease are applicable to the extension (but be careful to exclude tenant incentives granted at the beginning of the initial term unless they are to be included in the extension). Also, it should be made clear that the tenant can only extend for the entire premises and not a part unless there is a different agreement.

7. Tenant improvements

There are two different times when tenant improvements will or can be made: at the beginning of the term and during the term. The treatment of those different times should be different in the lease.

The initial improvements are typically governed by a Work Letter, which is often very detailed in procedures in rules. Main issues include: (i) what improvements will be completed, which is usually resolved through a process of approval of plans; (ii) who will perform the improvements, landlord or tenant or both; (iii) who will pay for the improvements; and (iv) when will the improvements be completed.

Usually only larger tenants or tenants with experience in the construction project will handle the construction; however, tenants who are able to control the process can gain control over time and cost by performing the construction itself. In many cases, landlord will have construction obligations relating to the base building and tenant will then construct its build-out. In some cases, mainly smaller, contained projects, the landlord will assume all costs for the construction. In others the landlord will grant an allowance for improvements up to a certain dollar amount with tenant being responsible for costs over that amount. Before agreeing to such an arrangement a tenant should become satisfied with the ultimate costs that will be incurred. A tenant should have its

architect and engineer carefully review the workletter to ensure it covers tenant's needs and is priced within tenant's price range or to suggest methods to cut costs. To the extent plans and specifications can be agreed prior to Lease execution, they should be.

During the term, tenants should have to obtain landlord consent for any improvement or modification to the premises.¹¹ Tenants will often negotiate that the consent be reasonable and, for larger tenants, carve out improvements not needing consent, such as interior improvements not affecting the building systems or structure (often limited to a certain dollar amount as well).

Additionally, questions often come up about what improvements need to be removed at the end of the term with both tenants and landlords having legitimate reasons to control the scope of removal. A typical compromise is that landlord controls what is required to be removed but must notify tenant of such requirement to remove at the time the improvement is made, giving tenant the opportunity to decline to make the improvement or change in a way that landlord would allow to remain.

Landlords should include in the lease reasonable rules and regulations and have the right to make additional rules and regulations regarding the conduct of improvements to protect its building and other tenants. Tenants should be responsible for damage caused by them in the installation and removal of improvements.

¹¹ Note some provisions are so restrictive in this regard that they prevent hanging of pictures or placing nails into the wall. Even if enforceable, I would question whether landlord really wants that level of control.

8. Default and remedy clauses

The main tool that landlords have in ensuring that tenants comply with the terms of the lease is declaring them in default; conversely, tenants need to ensure that a minor default does not result in them losing their lease. Therefore, a default clause should be balanced. Typical defaults include failure to pay rent on time, failure to deliver estoppel certificates on time, declaring bankruptcy (question enforceability of that under the bankruptcy code but landlords will always require it to remain), and violating any other provision of the lease. To protect the tenant there should be some notice and cure time granted: in the case of rent, notice one or two times a year and five additional days to pay is common; in the case of bankruptcy there is typically no cure period except in cases of an involuntary filing, which leases often grant 30 or 60 days to discharge; and the case of general defaults, 30 days is a typical cure period and tenants sometimes negotiate an automatic extension of that time if the default cannot reasonably be cured within 30 days and tenant starts to cure within 30 days and diligently pursues the cure to completion.

One of the most basic remedies for a landlord is to apply some or all of a tenant security deposit to damages incurred by a tenant breach. Landlords should ensure that the lease requires a prompt replenishment of any security deposit that is applied by it and that there is no requirement to hold the security deposit separate or pay rent on the deposit. Tenant's should ensure that security deposits can only be applied in case of a default that extends beyond any applicable notice or cure period and that the security deposit (or remaining amount) is returned within a reasonable time after the end of the term (usually 30 or 60 days). Some trends in security deposits are either to waive it

completely for credit tenants (usually a risky move for landlords), the use of letters of credit for particularly large deposits (some free cash benefit for tenants and bankruptcy protection for landlord), and tenants demanding security deposits only apply to monetary deposits (I have yet to hear a compelling reason for this change from tenants but have made it if necessary to move forward).

Other remedies include termination of the lease, termination of tenant's right to possession, acceleration of rent, landlord self-help rights, and any other remedy available at law or equity. The remedies are cumulative and, in most instances, not exclusive. The difference between terminating the lease and tenant's right to possession is that in the latter the rent continues to accrue. Acceleration of rent clauses are looked at somewhat skeptically, but it appears that they would be upheld if they apply a discount factor to the rent stream to net present value and reduce that amount by the fair market value for the remainder of the term (basically being landlord's actual damages and not a penalty liquidated damages).

Landlords should be careful not to accept rent following a default to avoid a claim of waiver of the default or, relatedly, the claim of waiver of the right to terminate as the result of a default. It should be noted that N.C. Gen. Stat. § 42-26(c), which passed in 2012, attempted to allow landlords to provide for the ability to accept partial lease payments; however, at this point it has not been tested to my knowledge.

Tenants should push for an express obligation of landlord to mitigate damages in the event of a tenant default, but the landlord should ensure such provisions do not limit its ability to properly market the premises or underwrite replacement tenants. As noted

before, landlords can actually waive any obligation to mitigate damages (though I have seen very few landlords attempt that).

With respect to landlord defaults, a typical landlord provision is to be silent, but other form provisions that require long notice requirements and severely limit the rights of tenant for default remedies are even less tenant friendly. A tenant will often ask for a stated landlord default provision allowing for offset rights, termination, and/or exercise of common law rights in the event of a landlord default after notice (often 30 days). Landlords would obviously have concern about a termination right and should resist other than in special cases. Additionally, some landlords do not like self-help rights. However, a provision just stating that any legal or equitable remedy is available after a notice and cure period would, in some ways, help landlord as those legal and equitable rights are likely available anyway and the stated cure period may be better than the silence of common law.

9. Assignment and subleasing

Subleasing and assignment are the important exit rights for a tenant in the event that the tenant's business needs change and it needs to give up all or part of the premises. A landlord base form is typically restrictive in allowing subleasing (a transfer of less than all of tenant's rights in the lease either by being for less than all of the premises or less than all of the term) or assignment (a transfer of all of tenant's rights in the lease), granting the right only with the consent of landlord; however, tenants often request accommodations to those restrictions, such as requiring the consent not to be unreasonably withheld, conditioned or delayed and providing for free assignment to

affiliated entities or entities resulting from a merger of the tenant with another entity or purchasing all or substantially all of the assets of the tenant, which would seem reasonable if the original tenant remains primarily liable for the obligations under the lease (a standard landlord lease provision). Typically a landlord will request any excess rent obtained from a sublease or assignment (often this can be compromised to one-half of the excess and adding provisions excluding the costs of obtaining the sublease) and sometimes a landlord will reserve the right to recapture the premises in lieu of approving or denying an assignment. Tenants should be cautious about granting a recapture right, especially in situations where the tenant subleases a portion of the premises for less than the entire remaining term. A recapture provision also has a chilling effect on potential assignees or subtenants. A point of contention is often whether consent could be deemed given if landlord does not respond within a certain period of time.

If the lease is silent, the tenant typically has the right to assign the lease, so landlords should be careful to protect their interests in having control over future subtenants or assignees by setting forth limits in the lease. It should also be noted that in some instances a bankruptcy court can ignore assignment provisions in a lease where the tenant is in bankruptcy.

As opposed to tenants, landlords are typically (and rightly) given the unfettered ability to transfer the lease. The landlord should be released from liability after a transfer and delivery of any security deposit (such liability transferring to future owners). It should be noted that even if not expressly stated in an assignment section, the typical lease provision limiting actions against landlord to its interest in the property could be

read to limit liability after a sale of the property (i.e., the former landlord has no interest left in the property).

10. Rights that cannot be waived or modified

There are few rights that cannot be waived or modified in commercial leases, but there are some. In North Carolina, jury trials cannot be waived in advance. Attempts to prevent the ability of parties to waive or modify leases except in writing may not be enforceable. Additionally, equitable principles may limit some provisions of the lease.

11. Arbitration clauses

It is not standard to have a mediation or arbitration clause in most commercial leases; however, some tenants desire to have one for cost and time considerations. An arbitration clause is of questionable utility given that courts handle lease dispute cases regularly and the landlord remedy of summary ejectment must go through the court process in any event.

12. Guarantees

Most landlords will require leases to be personally guaranteed by the principals of the tenant (or a parent entity if one exists) to enhance the credit of small to medium sized tenants. Tenants should consider the appropriateness of a guarantee generally and if there is a way to limit exposure (limits to the total dollar amount guaranteed as well as limits to the time period that the guarantee is effective are common limits on guarantees). Guarantees should contain waivers of the statutory and common law defenses often raised by guarantors. A form of guarantee is attached hereto as Attachment B.

Attachment A

PLAYERS IN NEGOTIATION

<u>Party Represented</u>	<u>Player</u>	<u>Role</u>
Landlord	Landlord	Owns premises. Receives revenue and profit from leasing space. Must administer lease.
Landlord	Broker	Markets space for lease. Assists in negotiation of business terms and generation of letter of intent. Will have varying degree of involvement in remainder of transaction, including negotiation. Is paid a commission upon lease execution (sometimes tied to actual occupancy or rent payment).
Landlord	Attorney	Prepares form lease and is typically main lease negotiator for landlord. Will have varying degree of involvement in letters of intent. Is paid an hourly rate.
Landlord	Ground Lessor (if any ground lease)	May or may not have approval right over lease. Is paid a ground rent from landlord.
Landlord	Lender (if any mortgage)	Likely has approval rights over lease. Is paid interest from landlord.
Landlord	Architect	Ensures continuity of design for entire building. Sometimes prepares designs for tenant interiors. Is paid either a fixed fee or hourly rate (or combination).
Landlord	Property Manager	Coordinates showing premises. Administers lease during term. Typically paid fixed fee with some hourly additions or salary if internal employee.
Tenant	Tenant	Will lease premises in order to operate a business that either profits from the business conducted at the premises (e.g., retail), uses the premises as part of its manufacturing or distribution (e.g., industrial or warehouse) or performs business functions in the premises (e.g., office). Must comply with terms of the lease.
Tenant	Broker	Locates suitable space for the tenant. Assists in negotiation of business terms and generation of letter of intent. Will have varying degree of involvement in remainder of transaction, including negotiation. Is paid a commission upon lease execution (sometimes tied to actual occupancy or rent payment).

<u>Party Represented</u>	<u>Player</u>	<u>Role</u>
Tenant	Attorney	Reviews legal terms of the lease and is typically main lease negotiator for tenant. Will have varying degree of involvement in letters of intent. Is paid an hourly rate.
Tenant	Lender (if security interest in tenant personal property)	May be concerned about landlord liens and right to remove personal property used as collateral. Is paid interest from tenant under loan where personal property is the collateral.
Tenant	Franchisor (if franchise)	Often has required provisions relating to ability to control franchisee in the premises, exercise franchisor's rights under a franchise agreement, and use the premises or assign the premises to another franchisee. Paid through franchise fees and royalties under franchise agreement.
Tenant	Architect	Evaluates appropriateness of space; prepares space plan for interior construction; oversees measurement of premises. Often coordinates construction process with other consultants. Is paid either a fixed fee or hourly rate (or combination).
Tenant	Engineer	Inspects premises. Typically only involved in leases of large premises. Is paid either a fixed fee or hourly rate (or combination).
Tenant	Insurance Agent	Confirms appropriate insurance is obtained in compliance with lease. Is paid a commission from insurance sold.
Tenant	Accountant	Addresses tenant's financial and tax issues. Is often paid an hourly rate.
Tenant	Project Manager	For large construction projects, a project manager may be used to oversee the construction process. Is paid either a fixed fee or hourly rate (or combination).
Tenant	Internal Office Manager (or facilities team)	Coordinates operations in the Premises. Paid a salary as employee of tenant.

Attachment B

GUARANTY OF LEASE

This Guaranty is made as of the ____ day of _____, _____, by _____ whose address is _____ ("Guarantor"), in favor of _____, a _____ ("Landlord"), whose address is _____ (the "Guaranty").

1. *Lease.* The "Lease" shall mean that certain Office Lease dated _____, _____, by and between Landlord and _____ ("Tenant") for the property located at _____, North Carolina _____, and all extensions, renewals, amendments, supplements or modifications thereto.

2. *Purpose and Consideration.* The execution and delivery of this Guaranty by Guarantor is a condition to Landlord's entering into the Lease with Tenant and is made to induce Landlord to enter into the Lease. Guarantor is a stockholder, partner, member, manager, officer or director of Tenant.

3. *Guaranty.* Guarantor hereby absolutely, unconditionally and irrevocably, guarantees the compliance with and performance by Tenant of each of the provisions, covenants, agreements and conditions applicable to Tenant contained in the Lease and guarantees the full and prompt payment by Tenant of the Base Rent, Additional Rent and other amount payable by Tenant under the Lease, as and when the same become due, whether by acceleration or otherwise. This is a Guaranty of payment and not of collection.

4. *Guaranty as Independent.* The obligations of Guarantor hereunder are independent of the obligations of Tenant, and Guarantor expressly agrees that a separate action or actions may be brought and prosecuted against Guarantor whether or not any action is brought against Tenant and whether or not Tenant is joined in any action against Guarantor and that Landlord may pursue any rights or remedies it has under the Lease and under this Guaranty in any order or simultaneously or in any other manner.

5. *Authorizations to Landlord.* Guarantor authorizes Landlord, without notice or demand and without affecting Guarantor's liability hereunder, from time to time to (i) change, amend, modify or alter any of the terms, covenants, agreements, or conditions contained in the Lease; (ii) extend or renew the Lease; (iii) change, renew, compromise, extend, accelerate or otherwise change the time for payment of any amounts payable under the Lease; (iv) consent to any assignment, sublease, pledge or transfer of the Lease by Tenant or of Tenant's interest in the Premises; (v) release Tenant and substitute any one or more parties as Tenants or sublessees under the Lease; (vi) waive or fail to take

action with respect to any default by Tenant under the Lease; and (vii) waive or fail to take action with respect to any remedy under the Lease.

6. *Application of Payments Received by Landlord.* Any sums of money that Landlord receives from or on behalf of Tenant may be applied by Landlord to reduce any obligation of Tenant to Landlord, as Landlord, in its sole discretion, deems appropriate.

7. *Waiver by Guarantor.* Guarantor hereby waives (i) any right to require Landlord to proceed against, give notice to or make demand upon Tenant; (ii) any right to require Landlord to pursue any remedy of Landlord; (iii) any right to participate in or to direct the application of any security held by Landlord; (iv) any defense arising out of any disability or other defense of Tenant, including cessation, impairment, modification, or limitation, from any cause, of liability of Tenant or of any remedy for the enforcement of such liability; and (v) any rights under *N.C.G.S. 26-7 et seq.*

8. *Subordination by Guarantors.* Guarantor hereby agrees that any indebtedness of Tenant to Guarantor, whether now existing or hereafter created, shall be subordinated to any indebtedness of Tenant to Landlord.

9. *Notices and Demands.* All notices and demands under this Guaranty shall be in writing and shall be deemed properly given and received when actually given and received three (3) business days after mailing, (i) if sent by registered or certified United States mail, postage prepaid, return receipt requested, addressed to the party to receive the notice or demand at the address set forth for such party in the first paragraph of this Guaranty or at such other address as either party may notify the other in writing or (ii) delivered to a nationally recognized overnight courier service for next business day delivery, to its addressee at such party's address as set forth above. A copy of any notices given by Guarantor to Landlord shall be sent, to CPG PIA Health Park, LLC, c/o CB Richard Ellis, 4208 Six Forks Road, Suite 1220, Raleigh, NC 27609.

10. *Payment of Costs of Enforcement.* In the event any action or proceeding is brought to enforce this Guaranty and if Landlord is held entitled to recovery against Guarantor, Guarantor agrees to pay all costs and expenses of Landlord in connection with such action or proceeding, including reasonable attorneys' fees.

11. *Binding Effect.* This Guaranty shall be binding upon Guarantor and its heirs, personal representatives, successors and assigns and shall inure to the benefit of Landlord and its successors and assigns.

12. *Severability.* If any provision of this Guaranty shall be held invalid or unenforceable, the remainder of this Guaranty shall not be affected thereby and there shall be deemed substituted for the affected provision, a valid and enforceable provision as similar as possible to the affected provision.

13. *Governing Law.* This Guaranty shall be interpreted under and enforced according to the laws of the State of North Carolina.

14. *Captions for Convenience.* The headings and captions hereof are for convenience only and shall be not considered in interpreting the provisions hereof.

15. Unless otherwise defined herein, all capitalized terms shall have the same meaning as set forth in the Lease.

IN WITNESS WHEREOF, Guarantor has caused this Guaranty to be executed under seal the day and year first above written.

GUARANTOR: _____

CO-GUARANTOR (SPOUSE): _____