



NEGOTIATING A REAL ESTATE LEASE

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Sooner or later your business may need more real estate than it has at present (not necessarily a bad thing if you've been operating out of your garage or basement for any length of time). It may be required for establishment of a retail outlet or for manufacturing facilities, to house staff, storage or something else, but signing a lease can represent the crossing of a major threshold for a start-up. This constitutes a substantial commitment of time, money and direction for a new business. In fact, this may be the first large outlay of capital and the longest term of commitment in the otherwise gleefully fluid young life of an emerging company.

Suddenly, you may find your feet set in concrete. Concrete, of course, can be a useful material for your enemies' overshoes (extrapolating liberally from Sun Tzu's "business" classic, *The Art of War*, or, more recently, from Al Capone). It's also pretty useful as a foundation, but be careful you're not stepping in it as you pour, if your concrete came in a sack labeled "Quick Set."

Presumably, you've already made an informed decision that you absolutely must rent some real estate. This should be because your failure to do so is more likely to retard the growth of your young business than is the potential of default on a lease or application of your rental payments to some other business need. If these preliminaries check out, then let's examine how you can get the best deal.

LOCATION, LOCATION, LOCATION

As they say in the real estate business, the three most important factors in assessing the value of real estate are: location, location, location. It's a rare situation when location of real estate is not a factor in the decision making process. Obviously, if you're after a retail outlet, you must do some demographic research to determine if you are about to plant yourself in or out of the prime "feeding area" of your target customers. Local chambers of commerce and business consultants can get that information to you.

Recently, my garage closed suddenly and without prior notice. I was therefore forced to quickly find a new parking space in the neighborhood. I looked around and found the only one in the area which had some openings was several blocks further away, although it was a few dollars a month cheaper. I kind of enjoyed the extra walk for a week or two, until rainy

weather set in. Then I had a couple of days where I had to make quick trips away from the office to see a client or pick up a sick child from school.

I realized very quickly that the few dollars of apparent savings resulted in me not doing some things I had done before, such as jumping in my car to go to lunch with a client. I also realized I was losing the potential of around 15 minutes a day, when I was on the sidewalk instead of in the office returning phone calls or doing almost anything else I could normally be billing for. Even billing at \$100 per hour, substantially less than my real hourly rate, I was losing the potential of several hundred dollars a month.

If I had calculated the impact of this slightly longer walk at my then regular rate of \$200 per hour, I could arguably have put a down payment on a pretty nice new car. According to my math, the financial result of "saving" \$7.00 per month on parking resulted in me losing a minimum of 15 minutes per day in extra walking time. This snowballed into 1.25 hours a week, presuming a five day week and only one trip to and from the car per day, which was less than my real average, both in terms of average days a week at work and average trips per day. If I worked 52 weeks a year, that amounted to 65 hours a year "lost" to the sidewalk. That's about a week and a half each year when I could have been on vacation instead of walking further to and from my car. At \$200 per hour, my math indicates I could have lost around \$13,000 a year in billable hours. There might be no loss, of course if I plugged a cell phone into my ear and returned calls as I walked. I'd be missing the ability to access files or office personnel, but might get some work done on the trip.

Many law firms have "runners" who file pleadings at the courthouse, pick up or drop off documents at opposing counsel's office and are constantly driving some place to fulfill their duties. Insurance agents, real estate brokers, salespeople and others, who are constantly moving to and from the office and clients, obviously might multiply my numbers by a factor of "X," arriving at a substantially higher number. In this light, my little parking decision became more significant to my bottom line. Even more important, I might have altered my opportunity to get some new business out of contacts I would have made at lunches I never ended up eating. In other words, the alteration of my routine could have cost me dearly.

This is obviously just one possible result of locating your office or parking just a few feet further away from the location in "Plan A." You can certainly make other location mistakes, or find a gem. I practice in both Kentucky and Indiana, for instance. I've often thought of moving my office from downtown to the "burbs," where I live. There are some nice corridors with good line of sight to many potential clients.

The problem is, if I move east, I'm further from my Indiana clients, who now come in from the north and west. They can find me pretty easily if I'm downtown in the "big city," but they would be several minutes further away and might not have an easy time finding me if I moved

COMPLIMENTS OF STUART ADAMS LAW OFFICE, P.S.C.

Lynnhurst Office Condominiums, Suite 1

8009 New LaGrange Road

Louisville, Kentucky 40222-4791

PHONE (502) 587-7750 \ FAX (502) 585-7177

E-mail: biz-law@juristechology.com Web Site: <http://www.juristechology.com>

to what might be a more convenient location for me personally. My staff would also be further away, and one member now has a very convenient bus ride from her home directly to my office. Additionally, I'm within an easy walk of the law library, courthouses, the majority of other local law firm's offices, banks, and, of course federal and state courthouses, as well as within a short drive of major expressways.

Presuming you can find a place in the right location for your needs, the next thing you'll need to do is contact the landlord, or more likely, the leasing agent. Seems like most commercial property these days seems to be listed by real estate companies which can presumably handle marketing and maintenance of the property and collection of rents. One of the important things to know about leasing agents and landlords is that time is money to both of them. Unless the owner has paid off any loans on the property, a little financial clock is always running when the property is vacant. Many property owners leverage acquisition of real estate by simply charging more for their rent than they are paying on their mortgage and other expenses. When the property is vacant, it's up to them to come up with the cash to make the expense payments. This is obviously bad for them and potentially good for you.

If you can find a vacant property or one about to become so, you've got some leverage. Landlords typically are looking for someone to make their mortgage payments and give them enough security and additional positive cash flow on the property, so they can not only sleep at night but have enough extra money in the morning to possibly buy another property to add to their portfolio. Rather than letting the property sit vacant, the landlord or leasing agent, who is typically working on commission, may offer you some of the incentives they have available.

There really is no such thing as a "standard" lease. Sure there are form leases lots of people use and there is language, which we'll discuss later, often found in many leases. What you must understand is that there are lots of ways to peel a banana. For instance, who said you have to pay the same amount of rent every month or even pay every month?

My last two leases have involved negotiations which resulted in me not having to pay several months rent at the beginning of the term or a security deposit. The market was tight enough that my landlord was willing to buy me out of the last few months of my then current lease, in one case with over a year still left, in order to get me to commit to a five year lease with him. In both cases, security deposits have been waived and other allowances made.

I could just have easily have asked for a lower rent per month, which I did earlier in my career when starting a new firm, or could have asked for a balloon at the end. In both cases, the landlord gets basically the same gross rental over the period of the lease. With an escalating rent schedule, the rent starts lower and ends higher, presumably when a start-up will have better cash flow to pay it. The same is true with a balloon payment. The major problem with

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a balloon is the need to budget to pay it. Many people simply forget or think the money will come to pay a relatively large amount and can get themselves in trouble. That may be better, however, than having to struggle up front to meet the rental payment before your customer base is established.

Granted, in both cases I shopped around quite a bit and found prime property (for my needs) which had been vacant for a substantial amount of time. During all that vacancy time, I knew the owner was not getting any rent and the leasing agent was not getting a commission. When I renewed a couple of years ago, I researched the building occupancy history, rates other tenants were paying and the basis on which the leasing agent was paid. I found out for instance, that the leasing agent was a little short of a bonus which the landlord had agreed to pay if the leasing agent could get the entire building up to "X" percent occupancy by a specific deadline. The deadline was approaching fast and it looked unlikely the leasing agent would make a considerable bonus.

As a result, I used a strategy of delay and demand which allowed me to keep my renewal rate down, and to get another renewal option with an increase tied to the the Consumer Price Index. This came in pretty handy when the building was sold a few months later, subject to the terms of my lease, and the landlord decided to make a couple of million dollars of improvements. Improvements are a good thing for tenants, except that landlords have a tendency to want to tenants to pay for them, one way or another. Sure enough, as other tenant's leases came up after the improvements were completed, the landlord dramatically increased the rent. In the case of another law firm on my floor, this amounted to an increase of approximately fifty percent. That firm and others are moving, but I'm able to stay, if I want, at the price I negotiated years ago.

I also got some additional unused adjacent space in the building for "free," which I use for storage (and have a right of first refusal to rent if I want to expand) while others pay monthly for cages in the basement. I got the office space repainted upon renewal and some other allowances. Frankly, I can't remember ever signing a lease when the landlord, in the final analysis, wasn't willing to literally throw in the kitchen sink, if I wanted it. Of course, I didn't necessarily get everything I wanted, but going in with some "throw away" items I was willing to give up, and knowing what the landlord could do at little or no cost to the owner, I was able to get essential items that made the lease a great deal for me. I've had leasing agents kill more than one deal, but locally, office buildings are going up faster than tenants are currently leasing. That means leverage.

LET'S MAKE A DEAL

None of this took any masterful negotiating skill. It simply took some research and application of that information to a reasonable strategy. Lease negotiations must be a win-win proposition.

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The owner or leasing agent has something to offer and something to gain. You do too. If the right combination of variables are combined in an appealing package, you should have a deal. When paying "Let's Make a Deal," it helps to have a program. Know what sorts of things you must have, those it would really be nice to have, and those things which would be of no consequence or could even diminish the value of your lease.

Would you like to get in early to make some improvements. No reason the landlord wouldn't give this to you "free," as long as the previous tenant has vacated. This could allow you to paint, install carpeting, shelving, signs for your customers, phones and computer cabling, carpet or just move a few lamps and pictures yourself. Did I say carpet? Why would you pay for paint or carpet if your landlord will do it for you. Depending on the condition of the property and the urgency of the need for the owner or leasing agent to get it leased again, certain "allowances" are commonplace. Typically, these can include either the landlord doing the work (which some will mandate) or giving you money (often by way of rent reduction) to have the work done or to do it yourself.

If you do get some sort of allowance for improvements, make sure you get the work done right. I had a client who rented a great new space next to a growing retail district. The building was rented as a shell, since it was new, and tenants were pretty much allowed to put in any interior walls they wanted. My client and his son got early possession and spent several thousand dollars on materials for new walls. They then spent several weeks putting in the stud walls, putting up drywall, sanding and painting it and then installing carpet.

TRAINED PROFESSIONALS

Not being "trained professionals," they had missed one rather important point. The wall studs had to be metal instead of wood. This was a new strip mall and the building code required interior studs to be metal because of fire safety standards. After the building inspector paid a visit, my clients had to tear out all their walls, ruining the carpeting, costing them money they had not planned to spend and more that doubling their time to completion. They went way over budget, having to pay for materials, demolition, and rebuilding with different materials. They missed their "grand opening," which they had desperately counted on to counterbalance their negative cash flow from rent and other expenses. As a result, the business failed. It was too thinly capitalized to start with and this time delay and extra expense were simply more than they could bear. Unfortunately, the rent did not terminate because of their error. They had signed a long term lease with personal guarantees. The landlord tried to rent to another tenant, but was not able to do so in time to prevent a family economic disaster. Regrettably, I referred them to bankruptcy counsel.

Be sure you thoroughly check out both the draft of the lease you might be signing, as well as the real estate itself. Years ago when our downtown "Galleria" food court first opened, I had

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some clients who had worked in the Alaska oil fields for years building a large pot of money to come back home and open a restaurant. The shiny new space downtown in what appeared to be a prime location for foot traffic, grabbed their attention.

The brothers came to me just to review the lease. It was a typical big company commercial lease which was well over fifty pages long, plus schedules. Also typically, it had a rental schedule which included base rent, which my clients understood, a "royalty" type factor where they also had to pay the landlord a percentage of their gross profit over a certain base level of sales, as well as a contribution to the shopping mall's advertising budget for joint marketing of the new facility. Added cost elements were common area maintenance contribution, security guard contribution and a requirement that the tenants spend a minimum stated amount for their own advertising expenses, both initially and throughout the lease on no less than a quarterly basis. These types of terms are not unusual in shopping malls, just as regime fees for common maintenance are typical in office and residential condominium associations. Major tenants, sometimes called anchor tenants, have the ability to dictate that only they may sell certain items in the shopping center, such a groceries or prescription drugs. Other shopping malls may be devoted only to discount or high end stores, where there is a synergistic effect of attracting shoppers looking for the same type or price of item. My clients seemed to understand all of this but wanted me to just give the lease a once over.

They wanted a quick review because when they first contacted me they had a "final" meeting with the local leasing agent the next day. They were all but sold, since they had managed to secure an option for a space next to a well recognized national fast food chain, which would undoubtedly lead lots of foot traffic right to their door. After pouring over the lease, everything looked about like they had told me, until I got to the improvements schedules. Since this was shell space (i.e. just concrete floors and walls with raw electrical and water hookup) the tenants would have to pay for everything else. My clients had made arrangements for all the fixtures, including counters, stoves, freezers and other materials they thought they needed.

BAR-B-Q or BARBEQUED?

What they had overlooked, was the fact that the building code required one level of venting but the landlord required a substantially higher level. The landlord was worried about odors from this new food court wandering throughout the rest of the shopping and office areas of the mall. Apparently the early retail tenants had been insistent upon insuring pizza and fried chicken smells didn't permeate their clothing and other retail stock. I do have sympathy for this. A tenant left my building last year because the landlord was never able to stop the smell of smokers in the adjacent suite from wandering though the duct work and making his staff irritable. He moved at the end of his lease.

Although some mall eateries count on their cooking smells, such as cinnamon or herbs and

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spices, enticing shoppers down the hall to wander their way, this landlord would have none of it. Consequently, there was a relatively huge expenditure required for duct work and exhaust fans, which each tenant of the food court would have to build out for the new shell space. When a tenant left, the next one would probably get a fairly low cost to hook up to the oven venting, but the first ones would get barbecued, rather than selling it. My clients couldn't stand the heat, so they wisely opted to get out of the kitchen.

They were on a tight enough cash flow plan as it was. After all, they had an ethnic menu which would be good for lunch but they had to make all their money in about two hours or so a day, five days a week. The mall was not destined to be open on weekends, to any realistic extent. Their food was not likely to entice early morning shopper for breakfast, and in our transient downtown, few people remained after six in the evening, so dinner was not worth the cost of labor to staff the space. The venting amounted to tens of thousands of dollars, and this was simply a deal killer.

They could not make the cash flow work and they gave up the space, knowing someone else would grab it up. This "prime" space actually remained vacant for several years, and since has been the venue of a rotating band of similar entrepreneurs, all of whose fate ended in their departure. Had my clients decided to risk it, they likely would have left within a year, struggling, because of personal guarantees, to pay of a lease they couldn't afford in the first place, and leaving expensive fixtures behind. Don't forget, the law of fixtures typically mandates that anything you nail, screw or epoxy onto the shell you lease, becomes the property of the landlord upon your departure. This, of course, can be negotiable, but the right to remove fixtures must be specifically stated in writing in your lease.

There are dozens of other items to consider in negotiating your lease, but always remember to have the space inspected by a professional if you are assuming maintenance or replacement of anything of consequence. Often the landlord will take care of the outside but you must maintain the inside. This could make you liable for replacement of very expensive commercial grade heater elements and compressors, plumbing or other problems. Make sure the property is zoned for the use you intend to make of the space and that the building code does not interfere with improvements you want to make or the use you intend to make of the space. Warehouses with small up front offices are typically problematic when someone intends to convert the use to non-warehouse space.

Many a "dotcom" has learned the hard way that packing lots of Dilbert cubicles into a space designed for pallets, may require additional restrooms, fire exits, ventilation, parking and other expensive, or even impossible, improvements. If you need retail space or expect many visitors, make sure they can find you. What looks like a great new space, may simply be on the wrong side of the highway and impossible to cross at peak traffic times, or be hidden behind the landscaping buffers now required for many such areas. Local retailers around this area

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routinely run afoul of our local sign ordinances. Some have tried to remedy their poor line of sight from the roadway by paying for expensive oversized balloons, which float over their location. Along comes the building code department, and yet another set of leases are in jeopardy; the one for the building and the one for the balloon. Don't let your hopes float away. Research this major expenditure and commitment of your resources before you sign on the dotted line.

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