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Strategies for a changing economy

Entering into a lease? Keep these legal issues in mind

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Most commercial tenants use a real estate broker to find and negotiate the economic terms of their new space. That takes care of the business terms of the transaction. But then the letter of intent becomes a draft lease -- what issues are important then?



The good news is that most commercial real estate brokers in San Diego County are relatively sophisticated and are capable of spotting a good many of the critical lease points. However, putting pen to paper to resolve the issues, or opining on the legal consequences of certain provisions, may be beyond their comfort zone (and beyond their insurance). Here are the makings of a lawyer's issue list in today's leasing market:

Confirm the use. When we see the term "use," most of us think of zoning, and zoning doesn't seem like it usually is a problem. In a down market, though, prospective tenants can be lured by alternative space, and an office tenant may start considering warehouse space, or a church congregation may look into an industrial park building. Those uses need to be double-checked.

More likely than these use problems, though, are subtle use issues, which aren't discovered until the industrial park CC&R's are read (look for outdoor structure, noise and odor limitations which may prohibit that welding shed or satellite dish), or until the building rules are reviewed (check for after-hours access and after-hours utilities for the Internet-based tenant that fields telephone orders from 6 a.m. until 9 p.m.) And to drill down even deeper on the use issue, does the building have enough telephone lines to accommodate the tenant? Does it have cabling? How about enough employee or customer parking?

Clear up start date issues. Tenants want a seamless move -- on the 30th, they're in their old space, and on the 1st, they're in their new space, up and running. But as the tenant will learn in the draft lease, the landlord may not want to take any of the financial risk of that date being met. The tenant can give themselves some degree of comfort by insisting on confirmation that the existing tenant intends to vacate within the necessary timeframes, requesting rent abatement for any start date delays resulting from the landlord's failures (try to obtain sufficient abatement to cover the resulting delay -- an unexpected three-day delay in delivering access or possession may cause a five-day delay in the tenant's preparation), and obtaining recourse rights against any contractor whose timeliness will be critical to the move-in.

Limit the pass-throughs. Most leases contain provisions entitling the landlord to pass-through to the tenant building-wide costs. Pass-through charges are allocated to tenants pro-rata, based upon their respective square footage.

From a tenant's perspective, the pass-through conversation really involves two kinds of issues: one involves routine operational expenses that nevertheless may seem remote to the particular tenancy (such as marketing and leasing expenses, legal expenses and cost of off-site management) and the other involves major expenses (such as capital improvements and repairs, compliance with building code and similar regulatory requirements and property tax increases due to reassessments).

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The routine-but-remote expenses can usually be eliminated, provided the tenant and its counsel can identify them. The larger expenses can give rise to tense negotiations, and the tenant's position will depend upon the length of the lease, the number of other tenants and the relationship of the base rent to the market.

Sometimes these issues cannot be resolved, but at least the tenant can limit its exposure by requesting that the amount be capped on landlord-controlled pass-through expenditures, and/or that the cost of capital improvements be amortized over the life of the improvement.

Hazardous materials: the ultimate pass-through. This issue warrants its own paragraph. Read the fine print in the hazardous waste indemnity, and in the pass-through provision; some leases actually try to impose financial responsibility on the tenants for liability arising out of pre-existing hazardous materials.

The tenant should also resist being financially responsible for hazardous materials that have migrated onto the leased property. The tenant does not have the financial capability and the motivation, especially if the lease term is short, to prosecute a clean-up lawsuit against a neighbor.

Ask for audit rights. One final pass-through topic: The tenant should request the right to audit the pass-throughs to determine that the tenant's successful deletion of offensive pass-throughs is being observed. Arbitration is typically used in a lease to settle audit disputes.

Obtain more flexibility in the assignment and subleasing clause. Leases typically require the landlord's consent in the event of a request to assign or sublease. The fine print, however, sometimes provides that the sale of a 25 percent interest in the tenant amounts to an assignment or transfer.

If the tenant intends, as many tenants do, on taking on investors or even issuing more stock to existing owners, then the tenant's plans may be held up while the landlord insists on reviewing all of the details, simply to determine whether to keep the lease in place. The tenant can ask for a higher threshold; ask that the threshold be deleted when a certain number of months remain on the lease; or, ask that the internal ownership clause be deleted altogether.

Let's close with some landlord issues. Most leases seem so favorable to landlords that it may be hard to imagine the need for any suggestions in their direction. But here are a few anyway:

- * Make sure your lease form selects California law and a California venue. If you're evicting your tenant in San Diego, there's no point in having a lawsuit about it in Houston.
- * Don't let your arbitration clause include eviction suits. California will accelerate the trial date of an unlawful detainer lawsuit, while an arbitration may consume a month simply to choose the panel.
- * Don't unequivocally prohibit assignments. You'll limit your remedies for post-default rent.
- * Finally, don't waste the goodwill you built up while wooing your prospective tenant by clinging to arcane lease language.

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