A Commercial Lease Primer (With Forms)

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The key to a strong commercial lease is careful use of the basic terms.

COMMERCIAL LEASES ARE OFTEN the subject of complex, lengthy, and intense negotiations. To be proficient at such negotiations, one must be familiar with certain basic concepts and be able to anticipate and protect clients from issues that may arise during the term of the lease. This article addresses some of the principal legal and financial terms applicable to commercial leases. Examples are included where applicable. All examples provided are for illustrative purposes only, and should be used as a guide and starting point only by practitioners in preparing their own forms in compliance with applicable laws, and with the terms and conditions of each particular transaction.

RENT BASICS • Charges for commercial office building, industrial, and flex space are often calculated as “triple-net,” which means that the rent the landlord receives does not include payment for taxes, operating expenses, and insurance. Tenants pay separately for their share of these charges, which is
based upon the square footage leased by the tenant. Generally, landlords will estimate the tenant’s share of expenses in a triple-net lease and the tenant will make a payment each month with its rent to pay its share of expenses. At year’s end, the landlord will review its total costs for expenses and reconcile the payments made by the tenant.

Some landlords compute lease charges using a “gross” or full-service lease which includes an all-inclusive rent charge. The rent charge includes all expenses, including taxes, insurance, and operating expenses. This type of lease is used more frequently by landlords who have a well-established estimate of their building expenses. Many tenants like the concept of a full-service lease as it provides them a clear picture of their total lease costs.

Most square footage leased is computed based upon the concept of the “rentable” square foot. Rentable square footage is the total area of space leased to the tenant and includes columns, projections, lobbies, utility rooms, and bathrooms. In contrast, the usable square footage is the area that will actually be occupied by the tenant, a lesser total than the rentable square footage. If the usable square footage were used to calculate tenant charges instead of the rentable square footage, portions of the leased premises would be exempt and not covered by tenant payments. The distinction in usable versus rentable area is often explained as the area for which tenant buys carpet versus the area that gathers dust. The rentable square foot concept is used in calculating rent and expense charges so that the totality of the leased premises is allocated amongst the tenants in a building. Tenants should confirm the measurement standard that is used by the landlord, and verify that their square footage as computed by the landlord is accurate. The Building Owners and Managers Association (“BOMA”) promulgates measurement standards that have garnered broad acceptance.

LEASE TERMS • Depending upon the interests and leverage of the parties to a lease, almost any lease term is subject to negotiation. Some of the provisions that may be negotiated include the following.

Rent

The amount of rent paid by a tenant is calculated based upon market conditions, type of building (office vs. industrial center), quality of building (an A type building vs. a C type building), profit margin sought by the landlord, and leverage of the tenant (anchor tenant vs. tenant with small square footage, or first tenant in new space vs. last tenant in space).

In determining the amount to charge a tenant for rent, the landlord makes certain assumptions about the charges it will incur for taxes, expenses, management fees, and insurance. These assumptions should be made after
thoroughly investigating the actual cost of such expenses for similar properties. A figure for debt service must also be included, as well as a percentage of profit margin for the landlord. All expenses must be calculated carefully. If expenses are underestimated, the profit margin of the landlord may be adversely impacted.

**Base Rent**

Base rent is a fixed amount of rent per square foot of the space leased. Calculations of base rent must be sufficient to recoup all of the landlord’s expenses with a gross or full-service lease, and all of the landlord’s expenses, except for net items, with a triple-net lease.

**Increases in Rent**

Increases in rent are often based upon Consumer Price Index (“CPI”) increases. Tenants will seek to cap such increases by requiring that the increases cannot exceed, for example, five per cent of the amount paid the previous lease year.

**Rent Abatement**

Tenants may negotiate a rent abatement for a portion of the lease. During the recent recession, abatements could be as much as 12 months. In better economic climates, abatements are generally from one to three months. Where leased space remains in low demand, or where leasing to a particular tenant is particularly desirable to a landlord, rent abatements have become very common. An example of a rent abatement addendum is attached as Exhibit A. Rent abatements are especially useful for a tenant who needs an opportunity to get in its space, conduct business for a few months, and then begin paying rent. In providing a rent abatement, a landlord should consider and address how the rent abatement affects its damages upon the tenant’s default.

**Renewals Or Extensions**

Rent during renewal terms may be established as a set amount, or calculated based upon:

- Increases in the CPI;
- Market rates at the time of the renewal; or
- A certain percentage increase agreed upon by the parties.

An example of a CPI calculation is attached as Exhibit B. An example of a lease renewal provision is attached as Exhibit C. If the terms of a right to renew are vague, or left to later resolution by the parties, the right to renew may arguably be void. All conditions of a right to renew should be addressed, including rent, term, space leased, expenses, any allowances, and whether the
remaining lease provisions continue to apply.

Operating Expenses

Tenants are generally required to pay a share of the expenses required to operate, maintain, and repair the common areas of a building. With triple-net leases, the tenant payment are based upon the landlord estimate of expense at the beginning of each lease year. With multi-tenant buildings, operating expenses are generally based upon the tenant’s proportionate share of the building. An example of a proportionate share calculation is attached as Exhibit D. With gross or full-service leases, a base year may be referenced, and provide that after the first lease year under the lease, any increases over the amounts paid by the tenant in the base year shall be borne by the tenant as additional rent payments. Some leases have the landlord bearing a certain portion of the expenses up to a set dollar amount which is called a “stop.” Any amounts incurred in excess of this stop are borne by the tenant, and assessed by the Landlord as additional rent.

Taxes

Payment by tenants of taxes generally follows the same manner as payment of operating expenses. Taxes should be defined to specify what types of taxes, charges, and assessments are included. The tenant may seek a right to contest the amount of the taxes, especially in single-tenant buildings.

Insurance

Insurance payments by tenants generally follow the same manner as payment of taxes and operating expenses. Tenants may seek to negotiate the types and amounts of insurance coverage; the manner, timing, and incidence of repair; and the reconstruction of a building in the event of casualty or condemnation. A waiver of subrogation should be included for both landlord and tenant by the other party, and each party should seek evidence of the other party’s insurance.

Audit

Tenants may seek to audit a landlord’s charges for taxes, insurance, and common area expenses to verify the types of charges included in the calculation and the basis for apportioning the charges amongst all tenants. Tenants should ensure that estimates of such charges and actual amounts are reconciled by the landlord within a certain period after the end of the landlord’s calendar year to assist the tenant in budgeting its expense. Landlords should reconcile such amounts promptly to ensure that the tenants do not have a right to argue that the landlord has waived its right to collect such charges.