

The Pitfalls, Land Mines and Booby Traps of Leasing

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Today's commercial real estate market is ripe with opportunities for savvy companies, but with opportunity comes risk. Even companies not looking for space must be careful. The dot-com bust, a sluggish economy and in some markets, overbuilding, is forcing landlords to become increasingly creative in finding ways to maximize their cash flow. Here are ways to minimize your risk and avoid common pitfalls.

A common trap for tenants is the annual increase in operating costs or "expense pass through." Originally designed in the late 1970s to protect the landlord against increases in utilities, property taxes and other operating expenses, they have become a profit center for many landlords.

The primary issue is to know what's included as an operating cost. In the landlord's standard lease document the definition will be vague which is in the landlord's best interest. Alternatively, the more specific the definition, the better for the tenant. A well-drafted lease addendum for building operating costs can run several pages with a list of inclusions, exclusions and audit rights.

Many landlords strive to correctly calculate the annual expense pass through. Sadly, some are not so inclined. For example, one tenant's landlord had understated the base year operating expenses by \$250,000. The building's square footage was overstated by 25,000 square feet when adjusting the current year operating costs to 100 percent occupancy, which inflated the total by \$235,000. Since the lease only contained the percentage for the tenant's pro rata share, the tenant had no way of knowing it was being fleeced.

Even for small tenants this can mean substantial extra costs. In a lease review for a 3,500-square-foot branch office, the landlord had overcharged \$9,500 for operating costs in the first two years of a five-year lease. The property manager included costs that were the landlord's responsibility. Overcharging tenants 10 to 15 percent is not uncommon, but here it was a whopping 38 percent.

Pitfalls

Lurking inside almost every tenant's lease are loopholes, traps, major ambiguities, and dozens of issues that were never discussed. From the tenant's standpoint they are poorly drafted. The language is unclear and important clauses omitted.

Buried among the legal rights and obligations are hidden costs, unreasonable risks and outright mistakes that could have expensive consequences. Even the most sophisticated of companies, architects, attorneys and experienced real estate professionals can overlook the most basic item. That happened to a major financial firm that leased several floors in a major office building. Upon moving in, it learned that its gross lease didn't include janitorial service. It was irrelevant that gross leases in that city's Class A office buildings usually included cleaning services. "If it ain't in writing, you don't get it," was the landlord's position. The firm wound up paying an extra \$100,000 a year for cleaning.

The need for landlords to keep their buildings full has given many tenants the opportunity to cut their rents and move into new buildings. Still, for the unprepared there are some very costly pitfalls.

In late 1990, Solomon Equities Inc., offered the New York City law firm of Proskauer, Rose, Goetz & Mendelson a lease that was \$10 per square foot less than its former lease. The firm moved into 423,000 square feet at 1585 Broadway. Meanwhile, Solomon was unable to lease the other 33 floors of the 42-story high-rise, slowly draining the project's cash reserves. As the grime built up on the windows, other signs of deferred maintenance appeared. Elevators were slow to arrive, landings were bumpy and call buttons didn't work. The heat was out for weeks in the early spring of 1991 and work stopped on the building's exterior. Finally, the partnership that owned the building declared bankruptcy.

Tenants need to be as concerned about their landlord's financial strength as the landlord is theirs. Remember that your landlord today may not be your landlord tomorrow. That's why so called boilerplate issues like subordination, nondisturbance and attornment are important to tenants. When lenders take back a building, it is possible for them to tear up leases and legally evict the tenants. That was the case when NCNB Corp. took back the Lakecrest Building in Nashville, Tenn., and evicted 15 tenants. Why would a lender evict rent-paying tenants? By giving the tenants the boot, NCNB could then sell the four-story building to Bridgestone/Firestone Inc., and get a "non performing loan" off its books and keep the government off its back.

Another way for lenders to cause prospective tenants problems is by withholding approval of already signed leases. Just ask Marv Romanek, the developer of 633 N. St. Clair, a 535,000-square-foot spec project in Chicago's Michigan Avenue submarket. In 1991, Romanek brought the project in at about \$1 million less than originally budgeted and five months ahead of schedule. Romanek brought 191,000 square feet of leases to his lenders for approval. Yet, he was unable to make deals because the banks wouldn't approve leases. According to Romanek, the banks' yearly appraisal of the building's value concluded that market conditions would get worse. The banks then use this to justify withholding the funds for the leasing effort

and tenant improvements. With no leasing effort nor any money for tenant improvements, and by not approving signed leases it became a self-fulfilling prophecy.

Avoiding the Lease From Hell

Landlords are in the business of leasing space. They have calculated every angle far before any negotiations, with help from asset managers, attorneys, financial analysts, property managers, real estate brokers, risk managers, architects, space planners, engineers and contractors.

Tenants, on the other hand, often do not have the financial, professional or personnel resources commanded by the landlords. Despite their expertise and success in their core business, they are in foreign territory and outnumbered when it comes to dealing with the maze of fine print and legalisms in a lease.

A lease is a very complex document that often contains hundreds of small agreements. Sometimes, just changing one or two words can be the difference between a fair lease clause and trouble. Real estate often represents a firm's largest single financial commitment, and its largest annual expense other than payroll. It can have a major impact on earnings for many years. Avoiding just one trap can save thousands or millions of dollars each year. In today's economy, one cannot afford to be caught unprepared. The stakes are too high.

Alan Whitson, RPA, is author of: 327 Questions to ask Before You Sign A Lease, plus other books. For more information visit www.squarefootage.net.