Tips For Negotiating The Small Office Space Lease (With Form)

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Even if the tenant’s leverage is limited, a thorough knowledge of the critical issues can result in a better lease.

ATTORNEYS REVIEWING and negotiating leases for small space for clients with limited resources must be pragmatic, attuned to the economics of the transaction (including both the tenant’s and landlord’s tolerance for attorneys’ fees), and knowledgeable enough to understand and focus on the most important issues. The attorney must also understand the tenant’s business enough to determine if there are any “hot points” that must be addressed. For example, if the tenant operates its business 24 hours a day, the lease should have a provision permitting the tenant to have 24/7 access and the tenant needs to give serious thought about how to heat and air condition the premises outside of normal business hours.

An attorney negotiating a small space lease in a small building has far more negotiating leverage than an attorney negotiating a small space lease in a large building. Generally landlords of small buildings will entertain a reasonable set of comments. However, a small tenant leasing small space in a large office complex will have very little negotiating power, and the lawyer’s role may be limited to advising the client of the risks, reviewing the economic terms of the lease with the tenant, and focusing on a very few issues (such as the initial construction). In a sinking real estate market, even small space tenants gain leverage in lease negotiations. However, because both the landlord and the tenant have a limited tolerance for attorneys’ fees (even in a tenant’s market), the tenant’s attorney should use that leverage to negotiate the critical obligations of the lease, and not to present the landlord with a laundry list of 500 comments. Although there may be a great temptation in a tenant’s market to negotiate every unfair provision, the attorney should, before embarking on such a course of conduct, have a frank discussion with the tenant about the effect of such a negotiation on attorneys’ fees.

The attorney for a tenant leasing small space needs to explain the realities of the lease negotiation to the tenant. What are those realities? That the lease will be an onerous, one-sided document heavily weighted in the landlord’s favor; that if the tenant wants to keep its legal fees in check, the tenant will need to focus on a few important issues, rather than attempting to turn the lease
Many tenants ask for an estimate of the lawyer’s fees for reviewing and negotiating the lease. The tenant needs to understand that fees bear a direct relationship to time spent. The attorney should ask to see the proposed lease, estimate the time it will take to review the lease and give the tenant comments, give the tenant an estimate of those costs (and live with the estimate), explain the attorney’s hourly rate, and point out that additional time spent discussing the lease with the tenant, organizing comments for the landlord and negotiating the lease will be billed at that hourly rate. Generally, the tenant will want to limit the negotiation to those issues that are likely to have a direct economic impact on the tenant.

CRITICAL ISSUES CHECKLIST • Below is a checklist of issues that often occupy center stage in the author’s negotiations for small space leases. The list will necessarily vary from attorney to attorney and market to market. In addition, each lease must be reviewed individually and any serious problems addressed.

Physical Plant Issues
• Does landlord supply heat and air conditioning? During what hours? Is the air conditioning adequate for the space? Is the cost of electric to operate the air conditioning unit (or HVAC unit) during normal business hours already included in the base rent, or is it billed separately as part of the tenant’s electric charges? If the tenant expects to use the space frequently after normal business hours, the tenant needs to understand whether overtime HVAC is available in the building, and the cost of overtime HVAC. In some buildings, the cost is quite substantial (perhaps $300 or more per hour). In older buildings, overtime air conditioning costs sometimes can be dealt with simply by installing window air conditioning units, but not all buildings permit window air conditioning units. Sometimes the tenant will decide to install a supplemental air conditioning unit, but it must then determine whether the space has adequate electric capacity for the supplemental air conditioning unit, whether the landlord will consent to the installation, and, if the building offers condenser or chilled water to operate such unit, what the cost is of the condenser/chilled water.
• Is there adequate electric for the tenant’s needs? An electric consultant can help make that determination. Sometimes the tenant simply discusses the issue with the building’s managing agent. Although new office buildings generally have adequate electric, that is not always the case with older buildings.
• Is the building open 24/7 and does the elevator operate 24/7?

Landlord’s Work Letter
• If the landlord is building the space for the tenant, the tenant needs to focus on whether the work letter includes everything the tenant wants built in the space, and needs to understand that “extras” can be very expensive. If the tenant is given a work allowance and will be billed for the amount by which landlord’s costs for performing the work exceed the allowance, the focus should be on getting the landlord to commit in writing to a price for landlord’s work, although that will not be possible if the tenant’s plans are too preliminary to price. The tenant should engage an architect to review the landlord’s work letter to make sure it is both adequate and complete. The tenant’s attorney must confirm that the scope of the work description is correct and whether or not the landlord is performing the work solely at its own cost.
• If the tenant wants the landlord to perform extra work that is not included in “landlord’s work,” then the tenant should be requested to provide the landlord with a description of the work and the landlord should be requested to commit to that number in the lease.

**Tenant’s Initial Construction**

• As a practical matter, the tenant is most likely to encounter problems and unexpected costs in its initial construction. Accordingly, it is advisable to carefully review with the tenant its proposed construction and flush out potential problems.
• Is the tenant required to use union labor and does the tenant plan to use union labor?
• Does the landlord charge any fees for construction? Often the landlord will waive fees for initial alterations and this should be requested.
• Does the landlord require the tenant to reimburse it for its expenses in engaging an architect to review tenant’s plans and for other out-of-pocket costs? If it does, the tenant should ask the landlord to waive fees for initial construction.
• Will the tenant have to pay for freight elevator and loading dock use? If so, will the landlord agree to waive the costs?
• If the tenant pays a fixed amount for electric (e.g., $3.50 per rentable square foot), consider asking the landlord for a reduction in the electric cost during the estimated construction period.
• Requirements for payment and completion bonds increase tenant construction costs and may require tenant to post cash as security for the surety bond company. If the landlord won’t waive the requirement, the tenant must find out if it will be able to obtain such a bond, if it will be required to secure the bond with cash, and the cost of the bond.

**Guaranties**

• Many small leases require personal guaranties. From the tenant’s standpoint (or that of the tenant’s principal), the guaranty is often the most critical component of the lease obligation because it creates personal liability, potentially putting the guarantor’s home and personal assets at risk. Sometimes the guaranty is a full guaranty; sometimes the liability of the guarantor is capped, in which case the capping language should be carefully reviewed and negotiated if necessary; sometimes the guaranty is capped and the amount of the cap declines over time, in which event the conditions to the reduction should be carefully reviewed; and sometimes the guaranty is a “good guy” guaranty (in which the guarantor’s liability for future rent terminates on the date the tenant vacates the premises), in which event (1) careful attention should be paid to what charges are covered by the guaranty (e.g., base rent and escalations) and the definition of the “Vacate Date” (the point at which the guarantor’s liability terminates), and (2) if the lease provides for acceleration of rents on the tenant’s default, liability should be determined without reference to such acceleration. Guaranties create significant personal obligations, and the tenant’s attorney, even in a small lease, should be very careful about reviewing and negotiating the guaranty.

**Economics**

**Base Rent and Concession**

• Make sure the lease’s basic economic terms conform to the term sheet.
• Base rent. Is the base rent correct?
• Rent concession:
  __ Is the amount of the concession correct?
  __ Make sure the rent concession runs from the commencement date and that the commencement date only occurs when the landlord delivers vacant possession of the premises to the tenant with any required base work (e.g., repairs) or landlord’s work (landlord’s build-out of the premises) substantially completed.
  __ Make sure the rent concession isn’t tied to unreasonable conditions—for example, there being no default. Either the rent concession should be deferred until the default is cured, or the condition should be structured so that the tenant doesn’t lose the rent concession unless there is a default not cured within the applicable cure period after notice.

Hidden Economic Costs
• A major problem for tenants is hidden costs that are not disclosed on the term sheet. For example, a New York City office lease usually provides that the tenant will pay a percentage of increases in the building’s real estate taxes and operating expenses (rather than a direct pass-through). However, some landlords also include in their leases provisions that directly pass through to the tenants their share of “special” expenses, such as costs to comply with law and/or business improvement district assessments. Those “special” expenses are usually not mentioned in the term sheets, so the tenant’s attorney must spot such costs and alert the tenant to them. Sometimes such costs can be modified or eliminated. For example, business improvement district assessments can sometimes be made part of the real estate tax escalation. Sometimes direct pass-throughs of legal compliance costs can be eliminated or capped. For office buildings, cleaning specifications are often a source of hidden costs. For example, the landlord may charge a $150 monthly “restocking” fee for common area bathroom supplies. A major part of the attorney’s job is to disclose to the tenant these hidden costs.

Electric
• Does the method of charging for electric match the term sheet? Are there any hidden traps?

Real Estate Taxes
• Does the tax provision conform to the term sheet?
• How broadly are taxes defined? The landlord won’t usually significantly alter its definition for a small tenant, so the question is usually whether there’s anything outrageous about the clause. However, the tenant’s attorney should seek to exclude any items that are customarily excluded from real estate taxes (e.g., transfer taxes, income taxes, franchise taxes, estate taxes, and mortgage taxes).

Operating Expenses
• Does lease conform to the term sheet?
• Operating costs should only include costs incurred in “operating and managing” the building.
• Generally, the big money issue is capital improvements—whether they are included in the definition of operating expenses, and, if they are included, the amortization period. The tenant should be advised that the inclusion of capital improvements in an operating expense clause can cause a significant increase in rent.