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Legal Alert: Managing Lease Costs in Today's Real Estate Market

The real estate market in New York City presents unique challenges to nonprofits, particularly community-based organizations. Lawyers Alliance and its volunteers can provide expert legal advice and help organizations confront the challenges presented by a sophisticated and fast-paced environment. For example, when entering into a lease, there are provisions that can be negotiated to provide the tenant greater protection against costs and expenses the landlord might be able to recover or foist upon the tenant. This legal alert highlights the provisions that can have a negative impact for the long term if not negotiated to the tenant's advantage, and where there is the greatest potential for a nonprofit organization to be confronted with an unanticipated cost, large expense, or costly delay under its lease or any amendment or renewal of a lease (referred to herein as a Lease). It is not intended to address every provision of a Lease, nor is it intended to substitute for the advice of counsel. Further, bear in mind that Lease negotiations are exactly that – negotiations between parties with opposing views and different strengths and weaknesses. Not all of these provisions may be applicable to your Lease, or your needs.

Considerations When Starting Lease Negotiations

- While a real estate broker or your prospective landlord may pressure you to sign a Lease within just a few days after receiving a copy, it is vital to understand and analyze the details of the Lease. Make sure you review the Lease carefully, hire a lawyer to represent you in the negotiation, and don't be afraid to negotiate Lease provisions that are unfavorable for your organization.
- Don't be intimidated if your broker or prospective landlord uses real estate jargon during negotiations. The broker may refer to a "full service gross Lease" or "triple-Net Lease". In essence, these terms refer to whether the landlord or tenant will pay certain (or all) taxes, utilities, insurance, and other expenses. Beware, a Lease is a contract and no matter how the broker describes a Lease, what matters is the language contained in the Lease!

Significant Lease Provisions

- **Dates:** Pay attention to key dates and the definitions of those dates.
 - *Commencement Date:* The date a Lease term and your right to occupy the space begin. If you are doing work in the premises, typically this is the date you may begin any work the landlord has given you permission to perform.
 - *Rent Commencement Date:* The first day you begin to pay rent. This may differ from the "Commencement Date" if either the tenant or the landlord are doing work in the premises. In some instances, there will be a rent concession granted for a few months while the work is being done.

- **Use:** Generally, a tenant should bargain for the most expansive use of the leased premises, which should be set forth clearly in the Lease. Expect a landlord to negotiate for more specific or limited uses. One of the broadest provisions is “any use permitted under law” or “any lawful use.”
 - *Permitted Uses* – if a general use provision is not allowed, permitted uses should be described as generically as possible. This helps both to avoid any default by the tenant if its use changes over time and protects against unintentionally limiting whom the Lease may be assigned or sublet to.
 - *Common Facilities* – if the property includes common facilities that you will need access to (e.g., a lobby, cafeteria, conference rooms), be sure to bargain for such access in the Lease. Ensure that there is an understanding as to when such facilities are open and available to tenants (i.e., hours and calendar days) and the maintenance standards the landlord will keep with respect to the same (the landlord should be responsible for keeping all common areas clean).
 - *Storage Areas* – if storage space at the property is available and needed, bargain for it in the Lease. Generally, access to such space should be on the same terms and conditions as the leased premises, with co-extensive termination provisions and inclusive rental payments.
 - In all cases make sure that the use is permitted by law and confirm whether certain uses require fulfillment of any additional governmental regulations, permits or licenses and the like.
 - *Ideal Provision:*

Use: Any use permitted under law shall be permitted under this lease.

- **Assignment/Subletting:** Though related, assignment and subletting are actually different mechanics. Typically, in a Lease, both will be defined or discussed in the section restricting “transfers”.
 - *Assignment* – is the process by which a tenant’s entire interest in its Lease is assigned to a successor party, which may or may not be affiliated with the initial tenant. Under New York law generally, assignment does not relieve a tenant of its responsibilities under a Lease, absent an express provision in the Lease to the contrary.
 - *Subletting* – is the process by which a tenant subdivides its leased premises and leases certain portions of that space to another party (a subtenant, through a sublease). Under New York law, subleasing does not relieve a tenant of its responsibilities under its master Lease (i.e., the Lease between the landlord and the tenant).
 - *Considerations Important to Both Concepts* –
 - *Consent* - Ideally, try to seek the most expansive sublease and assignment rights possible, which would include the right to undertake either without the landlord’s consent. If the landlord insists on a consent right, make sure the landlord acts reasonably when deciding whether to consent to the proposed action, and consider

setting forth particular circumstances demonstrating reasonable or unreasonable behavior. The objective is to ensure that you, as a tenant, are aware of the criteria the landlord will rely upon when deciding whether to consent to the proposed action. One way to do this is to rely on objective criteria that a subtenant or assignee must meet and, if it does, require the landlord to consent to the proposed action (e.g., subtenant/assignee performs same or similar work as tenant, is an established organization with “x” years of experience in its field, etc.). Obviously, landlords want to exercise a great deal of discretion with respect to subtenants and assignees, so bear in mind that this is often a contentious issue.

- *Process* – If landlord consent is required, insist on a simple approval process. Try to ensure that the landlord need not receive fully executed assignment or subletting documents (such as a Lease assignment or the proposed sublease), or be permitted to make voluminous requests about a prospective subtenant or assignee (such as their net worth, background information, etc.), because either will have the effect of lengthening the consent/approval process. Insist that a description of the proposed transaction and a term sheet summarizing important considerations be the only documentation required to be delivered by you, the tenant. Agree to a consent form laying out all of the requirements for rendering consent and attach the same as an exhibit to the Lease, so that the form need not be negotiated at the time consent is required. Always provide timeframes within which landlord action must be taken, and propose that failure to respond within such timeframes is a deemed acceptance of the underlying action.
 - *Affiliates/Known Transferees* – Carve-out from the consent process any affiliates (i.e., related entities), or third parties that you may be likely to transfer or sublet to. The definition of an “affiliate” should be as broad as possible. Transfers to affiliates should not incur any additional costs (e.g., brokerage commissions, landlord review fees, etc.). In the context of a not-for-profit corporation, you should argue that language regarding transfers of stock or ownership interests (typically in the context of a merger) are not necessary because a not-for-profit, under New York law, has no stock or ownership interests.
 - *Recapture* – If the landlord has a recapture right upon the tenant’s request for a transfer (i.e., the landlord can take back the leased premises and terminate your Lease), and if you do not want to take the chance the landlord will exercise such right, insist that you have an opportunity to withdraw the consent request to avoid the recapture.
 - *Splitting profits* – If the Lease includes a profit split between the landlord and tenant for any subrent charged in excess of the rent, seek to negotiate no split or a greater split for the tenant.
- *Ideal Provision:*

Assignment/Subletting. No assignment or subletting shall be permitted hereunder without the landlord’s consent, which such consent shall not be unreasonably withheld, conditioned or delayed.

- **Hell or Highwater Clauses:** These clauses provide that rental payments and other Lease obligations continue irrespective of any difficulties a tenant may encounter accessing or utilizing its leased premises, whether through the fault of the landlord (e.g., poor maintenance) or not (e.g., flood). Obviously the goal should be the elimination of these clauses. Alternatively, insist on carve-outs for difficulties caused by the landlord, or a tenant termination right if any issue, after being identified and brought to the landlord's attention, is not remedied within an agreed-upon period of time. You may also consider whether rent abatements or reductions are available during occurrences that restrict access to or utilization of the leased premises.

- *Provision to Avoid:*

“Tenant is not entitled to terminate this lease, or to claim actual or constructive eviction, partial or total, or to receive any abatement or diminution of rent, or to be relieved in any manner of its other obligations hereunder by virtue of any reason whatsoever.”

- **Additional Rent/Operating Expenses:** In some cases, a landlord may impose additional rent on a tenant, which is rent paid in addition to any base rent. Typically, additional rent is composed of common maintenance charges, which are incurred by the building generally and shared by all occupants. Additional rent payments are typically estimated on a going forward basis and then, at the end of the year, recalculated after the landlord determines the full costs of operating the building or property. Ensure that additional rent is proportionate to the size of a tenant's leased premises at a property (i.e., tenants that take up larger space should pay more additional rent; smaller tenants, less).
- *Audit Rights* – after the landlord calculates with certainty additional rent for the prior year, bargain for the right to audit or review its operating statements setting those calculations out. Don't rely on a landlord's statement about what a property's monthly operating expenses are or have been; ask for evidence demonstrating what those expenses are or are comprised of and how additional rent is being calculated by the landlord. You can ask that prior years' operating statements be shared with you, to understand what costs to expect going forward and even suggest that a sample operating statement be attached to the Lease as an exhibit. The audit right should include a right to object to any additional rent assessment that you disagree with and a dispute resolution mechanism for handling such objections. Note that this right to challenge should survive the expiration of the Lease (so that you can review the last year of a Lease term's operating expenses, which would be fully known after your Lease expires). Consider whether, if you are owed money (because the estimated additional rent was higher than actual costs), you'd prefer a refund or to have the same applied to going-forward base rent or additional rent.
- *Constituent Elements* – how common maintenance charges are allocated among tenants should be specifically set forth in a Lease, with the understanding of what constitutes “operating expenses” and “capital expenditures,” among other terms. All expenses should be reasonable, actual, and customary.

- Particular expenses that tenants may ask to be excluded from the definition of operating expenses may include (i) compliance with the Americans With Disabilities Act if incurred because of another tenant, (ii) contributions to any political or charitable campaigns made by the landlord, (iii) costs of any environmental compliance, (iv) excessive management fees (i.e., those that are not reasonable and customary for similar buildings of similar quality), (v) salaries and benefits expenses for any employees of the landlord that do not work on or at the particular building or property, (vi) costs for which landlord is reimbursed as a result of casualty insurance or otherwise, and (vii) any other costs that should be borne exclusively by the landlord (e.g., mortgage or financing payments, build-outs of other tenant space, payments for advertising or promotion of the property, legal fees for negotiating or enforcing other leases, and overhead).
 - *Timing* – insist that any operating expense statements be prepared within a certain period of time after the prior year and argue that until such time as all statements are prepared and agreed-to, the current year’s monthly additional rent payments stay the same as the prior year.
 - *Ideal Lease Provision:*

Additional Rent. At least [x]¹ days prior to the commencement of a [lease year], landlord shall provide tenant with an estimate of [additional rent / operating expenses] for such [lease year]. Tenant shall pay 1/12th of such estimated [operating expenses / additional rent] each month of such [lease year]. Within [x] days after the end of a [lease year], landlord shall provide tenant with actual [operating expenses / additional rent] incurred for such [lease year], in addition to backup and supporting documentation reasonably requested by tenant. Tenant shall be permitted to audit such [operating expenses / additional rent] and provide landlord with notice of objection to any charges within [x] days from receipt of actual [operating expenses / additional rent] from landlord. All disputes shall be handled by [arbitration]. If, after both parties agree with respect to actual [operating expenses / additional rent] for the prior [lease year], estimated expenses were higher than actual expenses, landlord shall credit subsequent additional rental payments in an amount equal to such excess paid by tenant. If, after both parties agree with respect to actual [operating expenses / additional rent] for the prior [lease year], estimated expenses were lower than actual expenses, tenant shall pay to landlord the amount of such difference within [x]

¹ Note that bracketed terms are to alert you that in a written lease, these terms are usually defined and have a precise meaning. It is important to review definitions and negotiate them if they are unsatisfactory to you.

days from receipt of notice to tenant that such monies are due.

- **Repairs:** Generally, tenants are required to maintain and repair the leased premises as well as any damages caused by the tenant and its invitees, while landlords are required to maintain and repair common or shared areas of the building, building systems and the building's exterior. Tenants should bargain for the right to use a contractor of their choosing, or subject such choosing to the landlord's reasonable approval (required within a certain period of time and, if not obtained within that time, the landlord shall be deemed to have approved the contractor). Also consider the effect if the landlord is required to make a repair and does not, which could include a rent abatement or reduction until such repairs are made.
 - *Casualty/Condemnation* – often in an event of a casualty (like a fire) or a condemnation, the landlord is required to repair and restore the leased premises and the building or structure the same are a part of.
- **Landlord Services and Utilities:** The cost of utilities is routinely a tenant cost. What differs is how the tenant is charged for those costs. Understanding the billing mechanism for utilities arranged for by the landlord but passed through to the tenant is critical. The tenant also needs the ability to audit such costs and pass-through expenses. While submetering is ideal, it can be costly to install and not all landlords will want to bear that expense. A Lease might provide that if the tenant wants the space to be submetered, the tenant must bear the cost.
- **Alterations:** A landlord is not likely to sanction alterations to the leased premises without reserving approval rights. However if you know there are specific alterations contemplated in the future, you should carve out an exception for such alterations on signing the Lease. The landlord will most likely reserve the right to approve alteration plans. You will want to limit the amount of time the landlord has to review and approve plans to avoid unnecessary delay. Delay usually translates to increased costs.
- **Termination Rights:** Early termination of the Lease by the tenant (without an express right to terminate in the Lease) will result in giving the landlord an ability to recover all of the rent due under the Lease from the date of termination to the end of the Lease term. To avoid paying any damages, bargain for termination rights that would permit you to prematurely end a Lease. Common termination rights include casualty/condemnation, uninhabitability of the premises for other reasons, and landlord's breach of obligations under the Lease. Consider whether your organization will require special termination rights. For example, if space is being leased for a particular program, or because of a particular activity, and funding for that program or activity is eliminated, bargain for the right to terminate the Lease with respect to that space (whether such space constitutes the entire area under the Lease or a portion of it).
 - *Ancillary Effects* – bear in mind that termination may affect other provisions of the Lease too. For example, if you have a right to terminate at any point in a year, ensure that any rent and additional rent is only payable with respect to the portion of time prior to termination and that there are no lingering tenant liabilities thereafter.

- *Ideal Lease Provision:*

Termination. In the event [*INSERT FUNDING AGENCY'S NAME*] or any other governmental agency or authority from which tenant is now or hereafter obtains funding, cancels or materially reduces tenant's funding, tenant may terminate this lease upon thirty (30) days' prior written notice to landlord, and this lease shall terminate with the same force and effect as if such date were the date herein finally fixed for the expiration of the term of this lease, and on such date, tenant shall deliver the demised premises in accordance with [*Section ____, insert a reference to the section of the lease pertaining to delivery of the demised premises at the end of the term*] of this lease.

- **End of Term:** Landlords may insist on a number of conditions that affect what a tenant must do at the conclusion of a Lease term. For example, if a tenant has altered the leased premises by adding furniture to it, etc., the landlord may insist that the space be returned to the condition it was in prior to the start of the Lease (thereby requiring removal of such furniture or other items). Consider whether to avoid undertaking this obligation by insisting that any alterations or additions to the space be left in it, thereby becoming the property of the landlord. As a compromise, bargain with the landlord by identifying particular things that would require removal. Bear in mind too that, if you have a removal obligation and it is not undertaken prior to Lease expiration, you can become liable for holdover rent or other penalties if you must access the leased premises after Lease expiration.
 - *Receipt and Release* – require that the landlord deliver a certificate to you noting that all Lease obligations have been complied with and nothing further is required from you.
 - *Subtenants* – subtenants must have their sublease terms end with, or earlier than, your Lease term. If a subtenant does not leave when you do, you may be liable for holdover rent or other penalties (including a Lease default). Try to ensure that any penalty or holdover rent payable because a subtenant has not vacated at the stipulated time is only payable with respect to the space subleased by the subtenant and not in respect of the entire leased premises. Make sure the sublease has appropriate indemnification and other provisions so you can seek reimbursement from the subtenant for all of these costs and expenses.
 - *Ideal Lease Provision:*

End of Term. Upon the expiration or earlier termination of this lease, tenant may, at its discretion, remove any furniture, alterations or other personalty belonging to tenant from the leased premises. If tenant chooses not to remove any furniture, alterations or personalty, the same shall become the property of landlord and tenant shall have no further obligations with respect to the same whatsoever.

- **Guarantees:** Guarantees are contracts made by another entity (typically an affiliate of the tenant or an individual) that obligate such entity to perform under the Lease if the tenant defaults for any reason. A guarantor can be said to “step into the shoes” of a tenant when a tenant defaults. Guarantees are additional security for a landlord and a form of credit enhancement. It is best to avoid providing a guaranty, particularly because they bring another party into privity with the landlord (i.e., a legal relationship is established between the landlord and another entity) and can create significant liabilities for such party. If a guaranty is absolutely required, ensure that the obligations being guaranteed are set forth in great detail in the guaranty and that the same terminates at the conclusion of the Lease term.

Additional Resources

If you are a nonprofit organization, or are forming a nonprofit organization, and you are entering into any lease, sublease, renewal, or amendment to a lease, and you otherwise qualify for legal representation, consider becoming a client of Lawyers Alliance for New York. The organization would be happy to serve you. See below for contact information.

This alert is meant to provide general information only, not legal advice. Please contact Hedwig O’Hara at Lawyers Alliance for New York at (212) 219-1800 x 226 or visit our website www.lawyersalliance.org for further information.

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