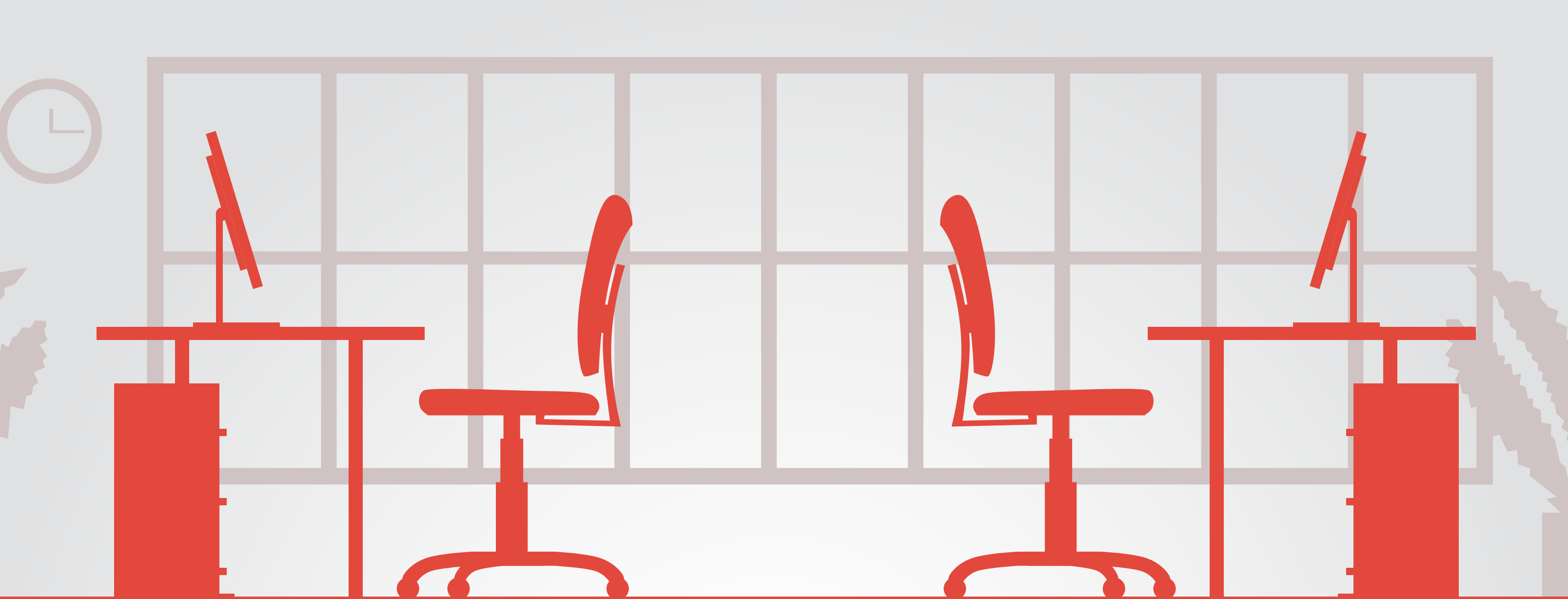

SMALL-FIRM OFFICE LEASING REALITY CHECK

Tips for Negotiating a Lease in a Landlord's Market

Laura Drossman

An office lease is a pivotal tool for small law firms to attract better clients and expand their practices. But it is also frequently a small firm's largest fixed capital expense and longest commitment. Negotiating favorable lease terms is critical to ensure that a lease contributes to, and does not hamper, a firm's success.

Landlords' Market

Today's San Francisco office leasing market is a landlord's game. In the first quarter of 2015, average asking rental rates for class A office space in downtown San Francisco has broken north of the $70 per square foot per year mark for the first time since the first quarter of 2000.[1] Looking ahead, rates are not expected to fall anytime soon, as technology growth companies have helped fuel the lowest vacancy rates since 2000 and have preleased 89 percent of the 2.2 million square feet of new buildings under or approved for construction in the city.[2]

Small firms cannot compete financially with their market competitors, who will pay higher rents and prepaid rent upon demand. Failure to maintain adequate financials brings creditworthiness into question and kills tenant's leverage in lease negotiations.

Tenants' Approach

While base rent and escalations seem like an obvious starting point, due to sky-high demand and flush competition, prospective tenants better serve their interests by focusing on other points, including those set forth below.

SPACE IMPROVEMENTS. Even in a tight market, tenants can negotiate for landlords to perform or contribute funds toward a build-out, since some improvements will increase the long-term value of the landlord's asset. In negotiating for improvements:

- Understand that landlords seek to recoup their contributions through other lease terms, such as increases in expenses passed through to the tenant, or in determining rental rates.
- Clarify all landlord requirements and costs, such as vendor qualifications, materials requirements, and insurance requirements.
- Strike a landlord's right to require removal and restoration of improvements to their original condition upon lease expiration—such work can be costly and is difficult to assess. Alternatively, require the landlord to confirm any restoration requirements at the time it grants approval.

COMMENCEMENT DATE. Where a space is being built out, lease commencement should be tied to issuance of a certificate of occupancy rather than "substantial completion of construction." Determining substantial completion can be problematic if construction milestones are technically met but the certificate of occupancy is delayed, in which case the tenant cannot open for business but is obligated to perform all monetary and other lease obligations. Also, provide for the tenant's right to terminate the lease if the certificate is not issued within sixty days of submission for approval.

TERM LENGTH AND OPTION PERIODS. Strategically negotiate term length and extension options.

- Term length should match a firm's business plan. Heidi Hoch, founder and broker of Hoch Consulting, which specializes exclusively in tenant representation, and coauthor of the book *Business Success with Ease*, says tenants should "think with the end in mind" when leasing commercial space. Tenants can often avoid costs and legal implications by anticipating whether the business will outgrow a space or determining whether the efficiency of the space layout meets the tenant's short- and long-term goals for its business prior to signing a lease agreement.
- If needs shrink, or if the market tanks, tenants can find themselves locked into paying for more space than they need, at above-market rates. On the flip side, if the market continues to rise, they are locked in at the current rate.
- For longer terms or options, cap operating expense escalations and cap or exclude tax increases, since over a longer term, reassessment or building repairs are more likely to occur.

PASS-THROUGH COSTS AND TEMPERING SPIKES. Many office leases are modified "gross" leases, where the landlord pays property taxes and common area operating expenses, and tenants pay their share of increases of such costs over the amount in a base year. A tenant cannot completely predict or control these charges, but make sure the tenant understands the property's bottom line and mitigate the risk of increases.

- Request the past two years of building operating expenses to compare to the defined lease terms negotiated, and forecast potential operating expense pass-through to the tenant.
- Gauge the risk of tax spikes attributable to Proposition 13. Find out the appraisal value and determination date, and whether the landlord intends to sell, refinance, or perform financed improvements. Then push for exclusions or caps on related tax increases.
- Limit operating expenses to appropriate costs expended for the benefit of the building. Exclude costs related to a single tenant's space and any reimbursable or insured costs.
- Limit pass-through costs, such as management fees, to competitive market rates.

- Request the right to inspect the landlord's books at the tenant's cost—with a reasonable time period for review.

SECURITY DEPOSITS AND LETTERS OF CREDIT. Most small law firms cannot afford to pay the high security deposits some landlords are demanding. Tenants should try and offer alternate security options.

- Include a "burn-down" clause whereby the landlord refunds all or a portion of the deposit upon set reduction triggers, provided the tenant is not in default.
- Post a letter of credit instead a security deposit, to maximize liquidity (ideally with a burn-down clause as well).
- As a concession for reduced deposit requirements or weak financials, a landlord may require a personal guaranty. If so, mitigate risk by negotiating (1) a hard cap on the guaranty amount, (2) an early release date based on good performance, or (3) a "good guy" clause that releases the guarantor upon the tenant's vacating the space and surrendering the keys.

SUBLEASING AND ASSIGNMENT. Commercial leases stringently restrict a tenant's ability to transfer its leasehold interest, so that landlords can control who is occupying their asset. That said, it is important for a tenant to have flexibility regarding transfers, especially when paying top-dollar rent for a space it may outgrow. Accordingly, tenants should do the following:

- Landlord's approval criteria should be "reasonable." Criteria based on transferee net worth or financial performance are appropriate, but the criteria should not, for instance, bar a transferee simply because it may have once toured a space in the same building.
- If a landlord has rights to share in the profits resulting from a sublet or assignment, make sure "profits" are calculated *net of* the tenant's costs related to the transfer, including brokers' commissions and attorneys' fees.
- Push for a "permitted transfer" provision that forgoes consent requirements for transfers to affiliates or successors by merger or acquisition—to stay in good standing under the lease, without the landlord's involvement.
- Be strategic in negotiating the landlord's rights to take back the space, or "recapture," and terminate upon the tenant's request to assign or sublet. Strike it entirely, or restrict recapture rights to total, but not partial, transfers (with the right to rescind the transfer request).
- Negotiate the right to "license" part of the space on a short-term, desk-by-desk basis without landlord consent.

MAINTENANCE COSTS AND HVAC. Tenants should ensure appropriate allocation of maintenance costs for the premises and building.

- Limit the tenant's obligations to items related to its use of the premises only, not common areas, structural components, or major building systems. Also, exclude any items separately charged as operating expenses.
- Inquire about compliance under the Americans with Disabilities Act and limit the tenant's responsibility to the premises itself—hold the landlord responsible for compliance in common areas and paths of travel.
- Limit the tenant's obligations regarding heating, ventilating, and air conditioning (HVAC) units to general maintenance and minor repairs, and hold the landlord responsible for major repairs and replacements.

RELOCATION RIGHTS. Leases often grant landlords the option to relocate the tenant to another space in the building. These rights are typically exercised when the opportunity to rent to a full-floor tenant arises. Relocation is highly disruptive to tenants.

- The landlord should pay moving costs, unamortized costs of tenant improvements, and abate rent for the relocation period.
- The replacement premises must be equal or superior to the original in terms of usable square footage, general condition, layout, light, views, improvements, and usability.
- Rental rates and increases should be based on the original lease terms and limited to the maximum square footage of the original space.
- The landlord should waive restoration requirements for any tenant improvements or alterations to date.
- Restrict the landlord from exercising the right within the first or second years of the term, and grant the tenant a right to terminate the lease if relocation is exercised within twenty-four months of expiration.

While certain lease points are still negotiable, in today's tight market, small firms must approach the leasing process with eyes wide open, be willing to pick their battles, and understand their risks in order to secure an office space to help their practices thrive.

Laura Drossman practices commercial real estate and business law, with an emphasis on representing tenants in commercial lease negotiations. She is a member of the executive committee of The Bar Association of San Francisco's Solo and Small Firm Section.

Notes

1. CBRE MarketView Report, San Francisco Office, first quarter 2015.
2. *Ibid.*
