THE COUNTY OF CARLETON LAW ASSOCIATION

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GOOD THINGS COME IN SMALL PACKAGES:

6R's for Small Tenants

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INTRODUCTION

People have the mistaken assumption that small leases are somehow easier to do. Nothing can be farther from the truth. In fact, some of the most challenging transactions you will ever do is to act for small space tenants; particularly if the tenant is a large national or international company leasing small space.

In this paper, I canvas the six provisions of a lease that a lawyer acting for a tenant proposing to lease premises of less than 5,000 square feet or so ought to address in the offer to lease, and if not there, in the ensuing lease.

These five areas of particular concern are:

- Rent
- Relocation
- Re-sale
- Release
- Restoration
- Reasonableness

MANAGING EXPECTATIONS

None of us, and in particular business people, think of ourselves as "small". This is too much like thinking of ourselves as irrelevant or not important. Yes, it is hard to think small.

It is imperative, however, in acting for tenants leasing a small portion of a building or shopping centre to focus their time, energy and resources on amending those parts of a landlord's form of lease that will really matter to them over the course of the lease. Every tenant has only so much leverage with its landlord in negotiating the terms of the offer and ensuing lease. To a very large extent, this leverage is a direct function of what percentage of the landlord's property the tenant is proposing to lease. This is, of course, not always the case. Certainly a national or international tenant will have greater leverage based on its covenant and reputation. And certainly, a destination tenant will enjoy more leverage based upon its draw. Most small tenants, however, even the national and international tenants, will find that even if a landlord wants to attract them to its building, it cannot re-write its lease or procedures to accommodate a small space tenant, regardless of the tenant's other attributes.

In negotiating a lease for a small space, we need to manage our client's expectations as to what can be achieved. We must take our "wish list" of desired amendments and distill it into a list of "must haves". Given the more limited leverage of a small space tenant, we will want to focus all of our energy and goodwill with the landlord on achieving these must haves.

Very often, when acting for landlords, we receive offers to lease from small space tenants that are a cornucopia of wishful thinking. They include, most often by cut and paste, every possible right, option, and operating cost exclusion ever contemplated. Clearly, the person preparing the offer takes the view that it never hurts to ask . . . or does it? Certainly, preparing an offer or providing lease comments that include everything from soup to nuts, will lengthen the time it takes to complete the transaction; most often to the tenant's detriment. More importantly, it makes it far more likely that the final lease product will be less favourable to the tenant than if we had restricted ourselves to providing a more thoughtful list of requirements and amendments.

Firstly, when we include rights or amendments that are not reasonable (and by this I mean not normally given to a tenant of this size), we start off our discussion with the landlord on the wrong foot. More often than not, the landlord's response is to refuse to review the offer or lease in the proffered form and to send the tenant back to the drawing board. This does not reflect well on the tenant's advisors. It often also leads the landlord to wonder whether this tenant is going to be a problem tenant.

Perhaps more importantly, as soon as we include in an offer or in our lease comments a requested term, the tenant invariably believes that this is something that they must have and that it is totally unreasonable for a landlord to decline. I very strongly believe that it is up to the tenant's counsel to manage their client's expectations. We have to remember that a lease transaction is not like an agreement of purchase and sale. It is the beginning of a long-term relationship between two parties. It is incumbent on counsel to start that relationship on the right footing.

COMMUNICATION

Every tenant is different. Each will come to the table, not only with their own unique business model, but also their own unique personal history of successes and failures. There will be certain provisions that they have had trouble with in the past, and as such will be particularly concerning to them. Despite what I have said about managing our client's expectations, we do need to ask and to listen carefully to what is really important to them.

R#1 - RENT

When negotiating an offer to lease or the ensuing lease, most of us will put most of our energy into examining the operating costs and realty tax definitions and the manner in which they are allocated amongst the tenants or other occupants of the property. We do this because rent equals money and money always matters. This may seem counter-intuitive, but it makes no sense to try to negotiate the operating costs or realty tax provisions for a tenant taking a small amount of space in a large property. With the exception of a clearly ascertainable line item, as for the example whether the management fee will be charged against operating expenses and realty taxes or just operating expenses, there is no cost effective way for a small tenant to audit or otherwise confirm how operating costs are being charged at the property. This is a hard truth but one that is worthwhile acknowledging. If you are a 5,000 square foot tenant in a 300,000 square foot shopping centre the cost to audit a shopping center operating cost will be in the plus $20,000 range. It will never make financial sense for that tenant to audit those operating costs. It would have to save $15 a foot as a consequence of the audit just to recover the cost of the audit. Generally speaking, when I act for small tenants, the only provision I will address is the management fee as this is usually a line item on the statement and easily ascertainable. There is no point in negotiating the treatment of capital expenses and how they will be amortized or whether or not salaries of the landlord's employees above the level of property manager can be included. Even if the landlord wanted to try to accommodate your tenant, they cannot, acting as a reasonable commercial landlord, agree to amend the manner of calculating operating costs for a small space tenant. It is just not do-able.

R #2 - RELOCATION

A small space tenant is very susceptible to being relocated during the term of its lease. This is a provision that most landlords will not agree to remove from their lease. There are, however, many terms of a relocation clause that are negotiable. In my view, if I have to agree to a

relocation clause (and I certainly do in the case of a small space tenant), I want to make it as seamless for my tenant as possible.

The first issue is always going to be location, location, location. We need to canvass with our tenant if there are better or worse sites at the property. Even office tenants should care about where they are in the building. In the downtown core of Ottawa, space on the north side of the building is generally considered to be more desirable and the rental rates go up the higher the floor you are on. Retail tenants have even greater concerns, both as to the location of the relocated space, but also with respect to its configuration and how much frontage it will have. All of this should be specifically addressed in the relocation clause.

In addition to requiring the landlord to provide space that is fit-up to a standard that is equal to or better than the tenant's current space at the time of the landlord's notice, I try to obtain the landlord's agreement that if the relocated premises are larger than the tenant's original premises, neither the minimum rent nor the tenant's proportionate share will be increased. After all, it is not the tenant that is seeking larger space. I also request one or two months free rent in order to compensate the tenant for the disruption to its business as a consequence of dealing with the landlord's desire to relocate the tenant. I am significantly less successful with this request than the others but I always ask.

R#3 – RE-SALE

Every commercial lease restricts the tenant's right to assign its lease. In addition, most landlord's leases give the landlord the right to terminate the lease on a request to assign.

I do not know of any business owner that has started a business and is building it for the purpose of receiving a weekly pay cheque. They all have their eye on creating a saleable asset at some point in the future. Your client will be eternally grateful if you address this in their lease.

In a perfect world, you will want to negotiate a right to certain assignments, on notice to, but without the consent of the landlord. These permitted assignments are an exception to usual rule and as such should be narrowly and carefully proposed. Very often these will include inter-corporate transfers, a sale of a specified number of the tenant's retail locations, or in the case of an office tenant, the sale of all or substantially all of its business undertaking.

A landlord is highly unlikely to agree to this if the tenant has only one location but a provision like this should go into every tenant's commercial lease so that as they grow, a sale can be accommodated. Even office tenants should be concerned. More often than not, large national office tenants are leasing many, many small locations across the country as sales offices or satellite offices. It is important that all of these locations be included in a transfer of the tenant's undertaking. Otherwise it can be a logistical nightmare to obtain all the requisite consents and it could, in the case of a particularly strategic location, be fatal to a sale transaction.

R#4 – RELEASE

Most small tenants will be required to give personal guarantees to their landlord. We should, however, think about at what point these guarantees should diminish or be extinguished altogether. While the guarantee will be all encompassing for the first few years of the term, a landlord may be amenable to limiting the guarantee and then diminishing it as the term proceeds. It is certainly worth exploring.

R#5 – RESTORATION

Once upon a time, a tenant's obligation at the end of the term of the lease was to leave its premises in the state they were required to be maintained and to repair any damage caused by the tenant's removal of its chattels and trade fixtures. Over the past twenty or so years, however, the tenant's obligations at the end of the term have become increasingly more stringent and costly. Twenty years ago, we would notionally carry $4 to $6 per square foot as a contingent liability to satisfy our removal obligations at the end of the term. At a recent conference a major landlord admitted that the per square foot cost to satisfy the restoration obligations in their standard form of lease was in the neighborhood of $32 per square foot - $16 for the demolition and $16 for the rebuild obligation.

The difficulty of this issue is compounded by the fact that the dispute arises at the end of the lease. During the term, most disputes are resolved on the basis of the relationship between the parties. Unfortunately, at the end of the term relationships no longer hold much currency. Landlords are unhappy that the tenant has chosen to leave and are not inclined to make concessions and will insist on the tenant's strict compliance with the terms of the lease.

Most landlord's leases now require the tenant to not only demolish its leasehold improvements and those of any prior tenant, but to restore the premises to the landlord's then current base building standard. Moreover, tenants are very surprised to find out that the lease permits the landlord to invoice them the cost of doing this work even if the work is never done or intended to be done. An invoice of this magnitude is particularly problematic for a tenant at the end of the term, when the tenant is already paying to fit-up its new space, to move into its new space, to buy new furniture, and to pay new deposits etc. Cash flow is particularly problematic at this time.

I suggest that a significant amount of time and energy be focused on negotiating the restoration provisions of the lease. Given this is a money issue, I suggest that it is most desirable that the terms of the restoration obligation be dealt with in the offer to lease. This is when the tenant has its most leverage and when the landlord is considering the terms of the deal as a whole. For a longer term lease, I suggest that you try to have the restoration clause deleted so that the premises can be left in the state they are required to be maintained. If this is not possible, I suggest that you negotiate a buy-out fee in lieu of the restoration obligation. Not only will this give cost certainty to your tenant, you are more able to negotiate a favourable deal at the time of the offer than when your tenant is trying to leave the site.

R#6 – REASONABLENESS

A landlord's commercial lease gives the landlord a lot of discretion. I have had good success in having landlords agree to what I call a "reasonableness clause". Here is my sample clause:

> **Parties Acting In Good Faith**
>
> Save as otherwise expressly provided herein to the contrary, the Landlord and Tenant and each person acting for the Landlord and Tenant, in making a determination, designation, calculation, estimate, conversion or allocation under this Lease, will act reasonably and in good faith and each accountant, architect, engineer or surveyor or other professional person employed or retained by the Landlord or Tenant shall be at arm's length to such party and shall act in accordance with the applicable principles and standards of that person's profession. Any consent or approval of the Landlord or

> Tenant that may be required pursuant to this Lease shall not be unreasonably withheld nor delayed save and except as otherwise specifically provided herein.

This clause will give your tenants a lot of comfort that, regardless of what the lease says, the landlord will not be permitted to act arbitrarily or unreasonably. This will also save you a significant amount of time adding the words “acting reasonably” after each of the landlord’s covenants.

CONCLUSION

Some of my most satisfying transactions have been acting for small tenants, particularly the moms and pops of the world. These are the hard working owners of small businesses and they deserve excellent representation. In my view, managing expectations does not mean expecting second best but rather strategically negotiating the terms of the offer to lease and ensuing lease to get the best deal possible for this tenant.

Part of why I love my practice is that no two deals are the same. I hope that you will take all of the above comments as they are intended, as a guide and not a rule book.
