Lawyer-Broker Collaboration in Commercial Real Estate Lease Transactions

by Gary L. Lozoff & Shelby R. Lozoff, CRE

A sea change has occurred over the last 15 years in the approach to real estate taken by large, publicly owned businesses in the United States. Companies with large-scale needs for office and industrial real estate have generally shifted from owners and operators to tenants of such properties.

Many factors drive a decision whether to own or rent real estate. The chief reasons to rent include the decision to use working capital in the company's primary business and the long-term flexibility of leasing rather than owning an illiquid asset. Publicly owned firms in particular, with the discipline of the public capital markets to maximize current earnings, often find sale-leaseback transactions advantageous for corporate-owned real estate, and seek leasing opportunities to satisfy additional real estate requirements. Unfavorable federal tax laws concerning depreciation of improvements to real estate are another factor.

Some large companies devote sophisticated internal resources to the company's real estate requirements. These include staffing real estate departments for the site selection, leasing, acquisition / disposition, and management of the company's real estate needs. Many other companies, however, especially those with relatively static real estate requirements, do not have experienced internal real estate professionals. Those

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companies instead rely heavily upon their commercial real estate brokers, consultants, and attorneys as the company makes the relatively rare (and usually anxious) steps into the "minefield" of a commercial real estate lease transactions.

How can real estate brokers and transaction attorneys work together at the outset of the process to better serve the goals of their shared clients? The authors offer the following guidelines for attorneys and brokers representing tenants in user-based corporate real estate transactions.

KNOW THE CLIENT—KNOW THE DEAL

To best serve our shared clients, we must strive to know their normal business operations—and their expectations arising from the proposed real estate transaction. But rarely does the typical terms sheet or letter of intent for a commercial lease transaction reflect a complete understanding of the nexus between the new space requirements and the client's normal business operations. For example, if the client's sales or inventory build is seasonal, or if the space is to be filled with inventory with exotic or unpredictable sourcing, project delivery lock-out periods have to be negotiated into the transaction. Sufficient leverage should be supplied to cause the space to be delivered during the period of time that best corresponds with the user's capacity (and willingness) to absorb the new location.

An out-of-cycle delivery of the real estate can not only create unusual (and generally avoidable) disruption in the user's business operations, it can threaten one or more of the essential economic assumptions on which these transactions are advocated to senior management of the company. That is, of course, unless the broker, attorney and client, collaboratively rather than antagonistically, develop program requirements well in advance of the site selection and lease negotiation processes. This approach emphasizes the shared understanding of how the real estate transaction harmonizes with the tactical and strategic goals of the company.

IMPORTANT ISSUES

Material issues to be discussed and evaluated by the team before the lease negotiations include, among others, the following:

- **Development Risks** — Is the project new construction? If so, the client will require a candid and complete assessment of practical risks of the land development process. These include special zoning, building and fire safety, environmental, sewage and other permitting issues or, more unusually, risks attendant to proposed phased delivery of the improvements or risks inherent in developing a project located in multiple jurisdictions. This assessment should be made regardless of whether the client's manager assigned to the real estate project understands this at the outset of the process.

- **Identity of the Landlord** — Record ownership of existing office and industrial property inventory and equitable ownership of prime development sites often are held by special-purpose entities that are affiliated with large, well-capitalized real estate companies. As such, the user should determine early in the process whether an unconditional guaranty from a "net worth" affiliate of the landlord is prudent to assure timely, complete performance of the landlord's construction obligations—all within budget.

- **Special Building Requirements** — All of the user's representatives, including its attorneys, brokers, architects, and engineers, need to be fully informed of the company's unique spatial and fit-up requirements for the project, such as clear floor height, HVAC and project security systems, 24/7 vehicular and pedestrian access, telecommunications, lighting, vehicle loading and parking facilities, special sanitary sewage, and toxic waste disposal. Will the architects or engineers be engaged by the client or the landlord? This can be a major issue, particularly, regarding the duty and loyalty of these professionals.

- **Signage** — Significant (and unusual) signage requirements are often present in large-space office and industrial lease negotiations. We underestimate our clients' commitment to promote their corporate identities on-site at our mutual peril. The user's broker and legal team should coordinate their efforts to ascertain the client's signage requirements as soon as practicable in the process—if only to obtain a relatively painless concession by the landlord to satisfy these requirements. Of course, quite often the landlord is powerless in this matter, as the municipality's signage requirements can be onerous and require a long lead time to complete (including frequent resort to an appeal process).

- **Project Plans and Specifications** — If the project's plans and specifications are not to be agreed upon at the time the lease is delivered by the parties, a fair, understandable, and responsive

process for review and approval of the project plans and specifications should be in included in the lease, and agreed upon early in the lease negotiation process. In addition, the effect of change orders on the basic rent structure, whether proposed by the landlord or the tenant, should also be determined early in the negotiation process. Recommend that the client engage a qualified construction or design representative to review the construction plans, specifications, and contracts, and to represent the client throughout the construction process.

- **Size of the Premises** — The economic return to the landlord is pegged to the area of the space being rented. The prudent user should require independent verification of the area of the leased space to be performed by a licensed professional in accordance with an agreed upon, objective written standard of measurement, such as the Standard Method for Measuring Floor Areas in Office Buildings approved June 7, 1996, by the American National Standards Institute, Inc. and the Building Owners and Managers Association International. The lease should permit adjustment of the basic rent and proportionate share attributable to such space (for computing the user's liability for its share of common area maintenance costs and real estate taxes assessed against the project), all in accordance with such as-built measurement.

- **Delivery Dates** — As discussed in the example above, a determination should be made about when the user requires delivery of the space, and whether phased delivery of portions of the project is sensible given the project timetable and the company's fit-up and use requirements. Due consideration in the early negotiations should be given to the economic and other consequences of a delay in the project's completion, whether caused by the tenant or developer, or arising from *force majeure*.

- **Common Area Maintenance and Real Estate Taxes** — Corporate users are sometimes reluctant to negotiate late in the deal over such points as exclusions from or limitations on the landlord's common area maintenance charges and real estate taxes assessed against the site, or audit rights and consequences pertaining to such charges or taxes. The best way to deal with this predisposition is to resolve early in the lease negotiations the limitations/exclusions, audit rights, right to contest tax assessments for which the tenant is contractually liable under the lease, and consequences of overpayment.

For the commercial real estate broker and transaction attorney alike, their engagement on behalf of corporate users of real estate is different in many important aspects from their work undertaken on behalf of sophisticated real estate companies or corporate users with large internal real estate groups. An important difference lies in the extent to which the client must be educated about the basic limitations—and opportunities—the leasehold relationship present to the user of the property.

- **Lease Term** — Companies that only occasionally transact in real estate generally require some schooling on the range of realistic alternatives for the length of the lease term. In addition, these users are rarely attuned to the range of preferences to extend the term, expand the leased premises, or purchase the project. These preferences, when applied to term extension, expansion of the premises, or purchase of the property, include a firm option, a right of first offer, or a right of first refusal.

- **Alterations/Assignment and Subletting** — The mantra from our user clients on these related issues typically is "we're not going to let the landlord control our business." As such, every significant lease negotiation includes substantial discussion on the permitted scope of tenant alterations to the building and the conditions under which removal of these improvements is required upon surrender of the leased premises at the end of the term. These negotiations also include what has become a major item for most companies—permitted corporate transfers. Regardless of the size or complexity of the underlying real estate transaction, users uniformly require the discretion to engage in "change of control" or "going public" transactions without interference from institutional or other landlords. Because of the comparative importance of this issue to our mutual clients, brokers and attorneys should strive to learn of any landlord resistance on this point during the initial phase of the negotiations, and communicate any obstacles to their client.

- **Broker's Compensation** — Experienced practitioners' reports from the field on this issue read like war stories with the user (or broker) as the ultimate victim. The corporate user typically presents the prospective real estate transaction to the attorneys, along with a general economic arrangement in place between the company and the broker. The broker and user (we hope with the assistance of counsel) then must complete the documentation that reflects all of the terms of the business deal. Concurrently, with the commencement of active lease negotiations, (rather than after eight hours of deliberation at the lease signing event, for example), the broker, user, landlord, and user's attorney should complete a simple written recognition agreement to cap this needlessly combustible issue, unless it has been previously agreed upon. Commercial real estate brokers often act as a "tenant representative" and usually are compensated by the landlord, unless initially agreed to be compensated by the client.

- **Lease Subordination** — The standard landlord-form lease subordination provision is unacceptable for most tenants. Large-space users and their landlords often agree, in the alternative, that subordination of the lease is conditioned upon the existing and any future mortgage holders' (and ground lessors') agreement not to disturb possession, absent a continuing tenant default. The form of this separate agreement, known as an SNDA, should not be left to negotiate until after the lease is signed.

- **Waiver of Landlord's Lien** — In many jurisdictions, a superior statutory lien on the tenant's personal property located on-site is granted to the landlord. As such, if the tenant intends to institutionally finance inventory, equipment, or other personal property to be stored or used at the leased property and its lender requires a first priority lien over such items, the landlord will be asked to waive (or subordinate) the statutory as well as any contractual liens on this personal property. Don't count on the landlord's beneficence in granting such a request absent, of course, an express agreement to do the same contained in the lease.

- **Landlord's Default** — Should the tenant be permitted to engage in self-help (with the ancillary right of set-off against next rents due) for a continuing default of the landlord? This is a simple, and often provocative, question raised during traditional lease (as distinguished from synthetic lease) negotiations. Based on our experience in lease negotiations, this question has a reasonable probability of being favorably resolved for the user in the lease only if raised *before* the landlord perceives the tenant has committed to the overall transaction.

- **Estoppels** — The typical form lease obligates the tenant (but not the landlord) to deliver a written statement, upon request from the other party, confirming certain factual information pertaining to the lease and disclosing any known defaults of the requesting party. The tenant's need, from time to time, to obtain this statement from the landlord is equally important and useful, especially in larger corporate financing or transfer transactions. Accordingly, this obligation should be made mutual in the lease.

WHAT TO AVOID

For the commercial real estate broker and transaction attorney alike, their engagement on behalf of corporate users of real estate is different in many important aspects from their work undertaken on behalf of sophisticated real estate companies or corporate users with large internal real estate groups.

An important difference lies in the extent to which the client must be educated about the basic limitations—and opportunities—the leasehold relationship present to the user of the property. As such, all of us intuitively know what to avoid in these representations—that is, anything less than an unconditional mutual commitment:

1. To inform the client about the effects of each contingency upon the prospective user's expectations of the underlying business deal; and
2. To assure that the final bargain struck between the parties is reflected accurately in the documents.

Both are more effectively achieved when commercial real estate brokers, transaction attorneys, and their clients communicate candidly and analytically from the outset of the site selection process about the transaction at hand.REI

NOTE

The article above is an adaptation of an article appearing in American Lawyer Media publications: *The Legal Intelligencer* and *Commercial Leasing Law*.