

KEY LEASE ISSUES FROM A BUSINESS OWNER'S PERSPECTIVE

BY ANDREW JACOBSON

Securing physical space can be one of the most critical aspects to the success of any business. For many businesses, the costs for bricks and mortar is one of the most significant recurring costs, often second only to payroll costs. Many start up and growing businesses elect to lease rather than purchase facilities, in order to avoid the initial commitment of capital resources required for property ownership. In the end, leasing often provides the most efficient, affordable and flexible means of securing space.

When entering into a lease, a business owner needs to focus on lease provisions that will have the most impact on their business. While most tenants focus on the major business points of the lease (e.g., the specific premises, length of term, permitted use and monthly rent), a number of other provisions in a commercial lease can have significant impact on a business's operation and ultimate success. As a result, when reviewing a lease from a tenant's perspective, it is important to pay attention to lease provisions that can: (i) create unexpected or unfair cost impacts on the tenant, (ii) unduly impair or restrict the tenant's business operations, (iii) adversely constrain corporate level transactions by the tenant (e.g., financing, sales or mergers), and (iv) foreclose reasonable exit strategies for the tenant.

Below is a discussion of a few key lease issues that can have a significant impact on a tenant's business operations and profitability.

GROSS AND NET LEASES. Rent under commercial leases is typically charged on a "gross" or a "net" basis, or somewhere on the spectrum between the two. In a "gross" lease, the monthly rental includes all, or almost all, of the charges to the tenant under the lease. With a "net" or "triple net" lease, on the other hand, the tenant is required to pay additional charges for its share of taxes, insurance costs and operating expenses (the three "nets"). When evaluating a lease proposal, a business owner needs to understand whether the lease is "gross" or "net," so that it fully understands the total monthly charges it will be paying under the lease.

CREDIT ENHANCEMENT. Landlords tend to be risk averse and are typically concerned with the creditworthiness of their tenants. This concern often increases proportionally with the landlord's investment in a lease. For example, as an incentive to the tenant, landlords will often invest in a new tenant's space in the form of a tenant improvement allowance provided by the landlord or by the landlord agreeing to construct improvements for the tenant. Many start up businesses do not have the creditworthiness of larger established companies. As a result, landlord's will often require some form of credit enhancement before agreeing to enter into a lease with a start up or fledging business. These credit enhancements typically take the form of security deposits, letters of credit, security interests in the tenant's personal property and/or personal guaranties. Tenants need to carefully consider the potential business and personal risk impacts of each of these forms of credit enhancement. For example, a tenant that has limited capital resources may prefer providing a personal guaranty rather than large cash security deposit.

OPERATING COVENANTS. Some leases, particularly leases for retail space, include a requirement that the tenant be open for business during specified times. Where possible, tenants should avoid such requirements. Where it is not possible to avoid an operating covenant, the tenant should try to put reasonable limitations on the requirements so that the operating covenant does not conflict with the tenant's intended business plan. For example, most businesses will not want to be required to be open on days or during hours when similar competing business are not open. Another important aspect of any operating covenant is the landlord's remedy if the tenant violates the requirements. These remedies can range from a right to terminate to significant increases in rent during periods of nonoperation. If possible, the tenant will want to minimize or eliminate any penalty arising from the tenant going dark.

ASSIGNMENT AND SUBLETTING. The assignment and subletting provision in a lease is often critical for a start up or fledging business. A primary goal of most start up or growing businesses is to eventually attract investors and/or purchasers for the business. If overlooked, an unfriendly assignment and subletting provision in a lease can prove to be a significant obstacle to a sale of the business or a merger. Most commercial leases provide that any assignment of the lease or subletting of the premises requires the landlord's prior consent. In addition, a sophisticated commercial lease is likely to include provisions that define assignments to include changes of ownership in the tenant business entity (e.g., additional partners, mergers, significant sales of stock, etc.). At a minimum, the tenant will want to make sure that the landlord is not permitted to unreasonably withhold or condition its consent to an assignment that results from a sale of or investment in the tenant's business. Reasonable assignment and subletting rights are also important to provide the tenant with potential exit strategies in case the leased space does not work out for the tenant.

COMPETITION RESTRICTIONS. Tenants need to be cautious for lease provisions that may restrict its business operations. Competitive restrictions can come in several forms and are most often found in retail leases. One form is where the tenant's use of its premises is subject to the exclusive use rights previously granted by the landlord to other tenants in the complex or building (e.g., an Italian restaurant tenant in a shopping center may have been granted the exclusive right to sell pizza). In this situation it is important that the tenant find out if any such restrictions exist prior to signing the lease. A second type of restriction occurs where a lease includes what is commonly known as a "radius restriction." A radius restriction prevents the tenant from having any involvement in any competing business within a certain distance of the premises.

CONCLUSION. The lease provisions discussed above are just a few aspects of commercial leases that can significantly impact the operations and success of a start up or growing business. It is important that business owners understand that many lease provisions are negotiable and that it is crucial to carefully review and understand how the lease affects the tenant's business operations, prior to the tenant executing the final lease document.

For further information regarding Maslon's Real Estate Practice, please visit our web site at www.maslon.com or contact:

ANDREW JACOBSON

612-672-8333

ANDY.JACOBSON@MASLON.COM

These materials offer only a general overview of several complex leasing issues, are not transaction specific and are not intended as a substitute for legal, financial or tax advice.

© Maslon Edelman Borman & Brand LLP 2006