

Commercial Leasing

Commercial Leasing

A Transactional Primer

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DONLEY AND MARJORIE BOLLINGER CHAIR IN REAL ESTATE, LAND USE,
AND ENVIRONMENTAL LAW

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To Lisa, Alex and Ethan. Hey, look: it's finally finished!

D.B.B.

*To my husband, Michael E. Pensack and to "all" my children: Geoffrey & Heidi
Morales Hammond and Elizabeth & Christophe Foubert.*

C.H.

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Introduction

In this book we will introduce you to a key practice area of real estate lawyers: the representation of landlords, tenants and lenders in the evaluation, drafting and negotiation of commercial leases. The book will focus largely on the office lease scenario. However, from time to time, where especially appropriate or informative, we will examine lease provisions in the context of a retail lease.

This book is unusual, because 1) this is the first law school text specifically and solely covering commercial lease law, 2) although it addresses substantive law, this book is transaction oriented, and thereby reflects actual practice, and 3) this book departs from the normal case opinion oriented text by integrating the various realities of the “deal” (including the motivations of key players to the lease), lawyering skills, ethics and substantive law. We therefore ask that you spend a few moments with this introduction. In it we will explain why commercial leasing is an exciting and rewarding practice area, the value of studying leasing as a key to understanding transactional practice generally, and the *document driven* organization of this book. Finally, we will acknowledge the importance of a number of sources in their own lease law education. With only a few exceptions, these sources are readily available to students and lawyers alike. We think that you should spend time with these materials as you progress through the course.

As you work through this book, you will encounter three primary parties to the lease transaction: Landlord, Tenant and Lender. Lender is the lending institution that loans money to a commercial borrower necessary for the purchase or development of the commercial office tower (the “Building”) in which Tenant leases space. Once the Building is built or purchased, the borrower becomes Landlord in each of the individual lease transactions in the Building.

Why study commercial lease law and practice? Commercial leasing is the life blood of the real estate business, and consequently, of real property lawyers. You might think that purchase and financing transactions involving commercial property are the “be all, end all” of real estate practice and that leasing is secondary. But leasing is the necessary predicate to any purchase of commercial property, or to any loan that makes the purchase possible.

The significance of leasing becomes clear when you reflect on the critical importance of leases (or the prospect of leases) to the financing of commercial property acquisition and development. Remember that purchasers or developers of commercial property almost *never* have sufficient cash to buy property outright. They must borrow the bulk of their acquisition funds, much as residential purchasers must borrow money to cover the price of buying a house. *And it is an axiom of normal lending behavior that a lender will only loan money to a borrower the lender believes capable of repaying the loan plus interest.* Therefore, institutions that lend to developers or purchasers of commercial property only do so if there is reason to believe that the commercial project will “lease up” and generate sufficient rent revenues.

In fact, lenders typically demand that developers of large office towers or new shopping centers find two or more “major” tenants *prior* to obtaining the loan and commencing construction. These initial tenants may be persuaded to commit to an as yet un-built office building, but only if they receive significant concessions from the Landlord (for example, favorable rental rates, free rent periods or significant Premises improvement allowances.) Lease negotiations between Landlord and Tenant in such situations will be intense and will test the abilities of the lawyers involved.

To a real extent, “once the building is built, all the rest of the lawyer’s work is leasing.” Daniel B. Bogart, *The Right Way to Teach Transactional Lawyers: Commercial Leasing and the Forgotten Dirt Lawyer*, 62 U. Pitt. L. Rev. 335 (2000). With the Building complete and financing in place, Landlord must make good on its representations to Lender that it can find the requisite tenants. The money generated by commercial lease rentals is startling:

Now imagine the dollars involved. In even a modest new office tower (one perhaps no greater than 15–20 stories tall) with an urban rental rate of \$25 a square foot, a five-year lease involves a lot of dollars. A 20,000 square foot lease at \$25 a square foot, with a term for five years, will generate 2.5 million dollars in revenues. Large businesses, law firms and accounting firms can lease well in excess of 100,000 square feet with options to expand their space and to renew the term. When these tenants sign on the dotted line for expensive and premium space in a new office tower, the dollar amount is staggering. These documents are therefore very thoroughly provisioned and heavily negotiated.

Bogart, 62 U. Pitt. L. Rev. at 342.

For the young attorney, leasing has its special attractions. Law firms train real estate associates to do leasing work early in their careers. Senior attorneys expect that their young associates will quickly develop the ability to do this work with little supervision. What is more, the client (particularly on the Tenant side) may be the CFO of a corporation or the primary individual partner of the client. Even younger attorneys may therefore find themselves in working contact with individuals who really matter to a law firm. Leasing practice is fast-paced, and new lawyers have the satisfaction of seeing deals conclude successfully. A lawyer may have a number of lease transactions in process at any one time. That lawyer will develop real expertise that he can share and demonstrate.

Leasing teaches general lessons about transactional practice. If you think that you will engage in a transactional practice after completion of your legal studies (even if that area is not real estate), then leasing provides a neatly contained environment to learn both the mindset and skill set of a successful transactional lawyer.

Drafting and negotiations lessons, and a lawyer’s approach to the practice of law, are largely (but not entirely) the same regardless of the kind of transaction involved. Whether a transaction involves the purchase of real estate or the purchase of a corporation, parties to the transaction reach an agreement on price and terms, and then ask their lawyers to “paper the deal.” One side will have the responsibility of generating initial documents, which invariably favor the drafter. These documents are then reviewed by opposing counsel, who check to see 1) that the agreed upon terms appear in the written agreements, and 2) that the remaining language of the documents (which represents the bulk of the material) is acceptable. After this review, and after consultation with clients, the attorneys negotiate. Further revised documents change hands, and perhaps additional negotiation takes place, until eventually a finished set of documents emerges. The transaction “closes” with execution of the documents and an exchange of rights for money.

Lease transactions follow the above-described general pattern. Landlord will provide a written understanding of terms to its attorney. (In some transactions, the attorney will participate in creation of this terms sheet, sometimes called a Letter of Intent.) The Landlord's attorney then creates the initial lease document, and provides a copy of the lease to both Tenant and Tenant's attorney. Tenant's lawyer then reviews the lease, provision-by-provision, often in the form of a "memo to file." Tenant's lawyer then transforms the memo into a letter to Tenant. After conferring with his client, Tenant's attorney sends a letter to Landlord's attorney (again, consisting of a provision-by-provision analysis). The two lawyers then negotiate. In the best of worlds, the two parties reach an agreement quickly, and Landlord's lawyer revises the lease to reflect the agreement of the parties. After Tenant's lawyer examines the revised lease to ensure that necessary changes have been made, the parties sign the lease. Throughout this process, careful lawyers who read documents with a trained eye, and who make deliberate notes on the conversations they may have had with their clients or opposing counsel, fare better than those lawyers who do not.

Some practice areas are almost entirely transactional, (corporate practice.) Other areas of legal practice, while not exclusively transactional, involve "deal making." (Bankruptcy practice requires transactional skills, in addition to appellate advocacy and litigation skills. Indeed, bankruptcy lawyers handle real estate matters, including the purchase and sale of properties, and the evaluation of lease documents, regularly.) Unlike any of these other areas of the law, however, the lease transaction continues to revolve primarily around one document—the lease. (Commercial leases may involve personal guarantees, letters of credit, and other negotiated documents, but the lease is paramount.) A study of lease law and practice allows students to focus on the key negotiated agreement, with time for skills development as well as discussion of substantive law.

In this course, you will confront commercial lease documents, examine the substantive law that lies in back of the contractual provisions, apply your knowledge to true-to-life fact sets and problems, draft provisions to meet the need of clients, and negotiate and revise lease documents. Furthermore, you will be asked to consider the ethical issues that commonly arise in transactional practice.

Perhaps most importantly, you will learn two central lessons to good transactional practice. First, you will come to understand that the skills that make a good lawyer (drafting, negotiation, and review of documents) cannot be separated from a sound understanding of the substantive law. Accomplished transactional lawyers keep the present state of the law and trends in the law in mind when deciding which rights to trade away during negotiation. Second, good transactional lawyers thoroughly understand the meaning and impact of each provision in the documents that embody the deal.

This book is document driven. If, as stated above, transactions are document driven, then it seems only sensible that this book should be document driven. The document that does the driving in this book is the Basic Commercial Office Lease contained in the ABA Leasing Forms Book, compiled by attorney Dennis Horn of Holland & Knight and attorneys who are members of the Real Property Probate & Trust Law Committee. It is a very well crafted initial lease document. Although it is an essentially pro Landlord form (which is typical), it is not egregiously so. Provisions from this form are reprinted in each chapter, and very often problems will require you to consider how you would revise a provision to meet the needs of clients. We gratefully use this form with the permission of the ABA, the Editor of the book and Orlando Lucero of Stewart Title who is primarily responsible for the Office Leases that are published in the book. We do take one literary license, however.

To the extent that we reprint or refer to this lease form, we call it the “Starting Point Office Lease.” We do so to remind you that the initial lease form is just that—a starting point. Each and every provision is subject to modification by the parties.

We will confront you with other lease forms from time to time. In actual practice, real estate lawyers see a multitude of different forms. A lawyer representing a tenant with ten offices may have dealt with and reviewed ten different forms. It is not enough for the lawyer to be conversant with just one form. *Expertise* arises as the lawyer develops a mental checklist of problems, concerns and fixes that she can apply efficiently when reviewing a new lease. In this text book, for example, we will occasionally require you examine another lease form from the ABA commercial lease forms book. This lease is known, *even in the ABA book itself*, as the “Killer Lease.” As you might expect, the Killer Lease, drafted by Landlord, is almost outrageously pro Landlord.

These two forms are modern, up to date documents that you may encounter in actual practice. Therefore, not only do they serve as potent learning tools, but they have the practical value of exposing you to forms that that some lawyer, in some future negotiation, may spring on you.

Organization of the Book. The initial and concluding chapters of this book deal, respectively, with Letters of Intent and Negotiations and Ethics. However, all of the remaining chapters are devoted to specific provisions of the lease. For the most part, these chapters move chronologically through the lease, following the table of contents of the lease. The book does not provide a chapter for every lease provision; one objective of the book is to provide enough content to come to terms with lease law while permitting the students and instructor time to actually finish the book. Covering each provision, while ideal, would require a four hour course. We try to address the most important provisions, and those provisions that provide an opportunity to think about transactional practice generally.

The chapters analyzing lease provisions always follow the same order. There is a brief introduction, placing the provision in the broader context of the lease. We then reprint the lease provision that is the subject of the chapter. As you work through this text book, please do *not* simply skip over the lease provisions that are reprinted at the beginning of each chapter. Instead, read these provisions carefully. Everything that follows in the chapter presumes that you have read the pertinent lease language. (Remember, lease law is as much an advanced contracts course as it is a property law course. The lease language is the starting point for any transactional lawyer.)

The remainder of each chapter is divided into three parts. The first part simply explains the meaning of legal words or terms of art that appear in the provision. The fact is that legal documents are filled with arcane or unusual terminology, or with words that seem to suggest one meaning to the layman, but are understood entirely differently by practicing lawyers. The second part of each chapter examines the motivations of the parties to the lease transaction. How can you expect to apply the law to a transaction, or understand the development of the common law over time, unless you are cognizant of the specific concerns and goals of Landlord, Tenant, and in many cases, Lender? The third and final part of each chapter addresses the substantive law implicated by each provision.

Note that the substantive law material, which includes case opinions, textual explanation of the common law and problem sets, comes at the end of each chapter and not at the beginning. We believe that, in a course devoted to transactional practice, this is as it should be. The substantive law (including case opinions) of necessity draws upon lease provisions and explores transactions gone awry. Indeed, many case opinions will

reprint the pertinent lease provisions in the body of the opinion or in a footnote. To read these case opinions without understanding the terms of art or the motivations of the parties, is equivalent to reading the opinion “in the dark.”

Most chapters conclude with a discrete application of what you have learned. You will be asked to read the relevant provision from a different lease form. You may, for example, be asked to suggest revisions for the Tenant’s benefit. In many cases, the form you will be asked to review will be the ABA Killer Lease.

Good lawyers find good materials. Some law school courses, notably those offered in the first year, are important building blocks to an overall understanding of the law, but they are not directly useful to practice. As you move closer to graduation, courses tend to be more “practical” or practice-specific. One aspect of this dynamic is that, as you encounter practice-specific courses, you will also find an increasing wealth of resources in the library aimed at practicing lawyers. This lease law course fits that profile. We have used a number of commonly available sources as we created this book, and we believe that you should become familiar with these resources and use them as you complete this course. We are not exaggerating when we say that the truly “excellent” lawyers know these materials and often keep sets of these resources in their offices.

For the record, we continuously read and learned from MILTON R. FRIEDMAN & PATRICK A. RANDOLPH, JR., *FRIEDMAN ON LEASES* (Patrick A. Randolph, Jr., ed., 5th ed. 2005). This book, originally written by Milton R. Friedman, is in its latest incarnation revised by Professor Patrick A. Randolph, Jr. Many lawyers consider this three-volume set to be the “bible” of lease law, and that status is justified once again in this exemplary edition. We mention the Friedman and Randolph treatise by name from time to time in the text book, but just as importantly, we found ourselves constantly referring to it during the text-drafting process. The treatise not only explains the history and present state of the law of leasing, but it provides a cogent analysis of the law. The treatise explains the trends in case opinions and leasing documentation. It would not be possible to write a text on leasing without relying to a real extent on this resource.

Another extraordinary treatise is JOHN B. WOOD & ALAN M. DI SCIULLO, *NEGOTIATING AND DRAFTING OFFICE LEASES* (11th ed. 2005). Although the authors of this treatise explain the black letter law, the real value of this book is in its practical evaluation of lease provisions, the motivations of the parties, and the reasonable (and unreasonable) positions that parties to a lease often take. The treatise provides sample lease provisions, and explains the strengths and weaknesses of each. The authors explain relevant terms of art. Mr. Wood and Mr. Di Sciullo draw upon many years of sophisticated lease practice. A student taking the time to read this two book treatise, or to refer to it as the course progresses, will come to understand that the provisions of the lease are interdependent. (John Wood is also known as one of the key architects of the Killer Lease form that swept through New York City and beyond).

We rely greatly on the excellent treatise MARK A. SENN, *COMMERCIAL REAL ESTATE LEASES: PREPARATION, NEGOTIATION AND FORMS*, (Aspen Publishers 2003). This book’s scholarly approach to practicing leasing law has made it invaluable. Mr. Senn is a frequent speaker at International Council of Shopping Center (ICSC) conferences and those presented by ALI-ABA. Lawyers rely upon him for careful and practical analysis of legal issues that arise in the commercial leasing setting.

Professor Randolph is also Editor of a three volume series entitled *THE COMMERCIAL PROPERTY LEASE* (Patrick A. Randolph, Jr., ed. 1993). This work collects a variety of articles discussing virtually every aspect of commercial lease law.

Finally, The Practising Law Institute publishes some of the very best continuing legal education materials on the market, and some of those are devoted to Commercial Leasing. The authors have used these and other published materials throughout the process of writing this book, and these sources are specifically cited in the text from time to time.

When in practice, good lawyers make it a point to develop friendships with individuals who have already developed expertise in their area, and to the extent possible (without abusing these friendships), to draw information and perspective from these individuals. You should be prepared to engage this process. Professor Bogart was privileged to discuss lease practice with his father, Larry I. Bogart, a partner at Powell, Goldstein, LLP in Atlanta, Georgia; Mr. Bogart engaged a very sophisticated real estate and leasing practice over a more than forty-year period. Professor Bogart was also fortunate to discuss lease law and practice with John C. (Jack) Murray, Senior Vice President and Counsel to First American Title Insurance, formerly of Travelers Companies, as he began the process of initially teaching his commercial leasing course many years ago.

In addition to learning from these conversations, Mr. Murray shared a number of leasing materials he collected over the years, including a set of Leasing Guidelines developed by Denise McWatters and Ken Holzberg. These materials are not available as a resource to students, but it is appropriate nevertheless to acknowledge their importance in Professor Bogart's learning process. Ms. McWatters' and Mr. Holzberg's materials approached lease practice by examining the relevant lease provisions first, with a focus on the meaning of relevant language and an explanation of the motivations of the parties to the lease transaction.

The authors are also grateful to Professor Wilson Freyermuth of the University of Missouri (Columbia) Law School for testing these materials in class and providing helpful suggestions and criticisms. Professor John Nolon of Pace Law School read and commented on a chapter of the book. Theodore Yi of DLA Piper and Karen Ercoli, Associate General Counsel for General Growth Properties, Inc., also used draft materials of this book in an LL.M. Leasing Ownership & Management course that they teach at the John Marshall Law School in Chicago. That they found the book 'practical' is a very positive signal that it may meet our goal of preparing lawyers for leasing practice. We greatly appreciate Ted's and Karen's comments and suggestions. Finally, Virginia Harding of Gould & Ratner used some of the book to teach a Drafting & Negotiations Workshop that is part of the LL.M. in Real Estate Law curriculum at John Marshall. She adds her years of experience as a 'dirt' lawyer to the helpful comments from which the authors have benefited.

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One Final Thought. You should keep in mind one last idea as you encounter commercial lease law and practice in this course. The tenor of even the best and most "transactional" law school courses is akin to a game of poker where the chips are free. In such a setting, players often make ridiculous decisions (for example, to hold out for "four of a kind" rather than sitting happily with "two pair.") In this class, you should avoid this behavior. Instead, you should try hard to read, negotiate and draft as though the parties and the money are *real*; after all, in practice, they will be.