

New business moved in? Time to read fine print



When signing on a new tenant in commercial spaces, the details of the lease and how it's structured are paramount.

The pace of mergers and acquisitions in Southern California has been frantic for the past five years.

With interest rates on the rise, this rabid appetite for businesses has cooled somewhat but is still well ahead of historical numbers.

If you doubt for a moment what I say, think about the company from whom you draw a paycheck. Has it recently been sold? If you own your own business, I'm sure your inbox has been flooded with private equity groups looking to sign a confidentiality agreement to take a peek at your books and records.

Whenever a merger or acquisition occurs, commercial real estate bobs in its wake.

Recently, I had the experience of reviewing a lease that was structured on the sale of an operating company. Candidly, there were some elements included in the lease that make a sale of the building highly unlikely in case the family decides to go that direction.

Today's column addresses some important considerations in a lease structured with a purchaser of your company. In this narrowest of circumstances, I am assuming the entity that buys your operation remains in the building that you own.

- **Assignment and subletting clause:** If the purchasing entity decides it wants to move locations or shut down the operation, it might want to sublet or assign the lease to another party. A lease should include the terms under which this is permissible. As a landlord, you generally cannot refuse a sublease arbitrarily. Your approval must be reasonable and should be based on some objective considerations such as a net worth of the new entity not less than the previous.
- **Lease term and extensions:** The term of the lease is also a crucial factor, typically aligning with the strategic plan of the group that buys your company. Option periods — if structured properly — allowing the tenant to extend the lease term can be a beneficial aspect. I would suggest tying options to renew to the prevailing market conditions as opposed to some fixed amount. Remember, options are to the benefit of the occupant and not you as the owner. Therefore, tying extensions to prevailing market conditions protects you.
- **Rent amount and escalations:** The lease should detail the initial rent and any escalations over time. Annual increases in rent are a must. Generally, these days we see annual rent increases in the 4-4 1/2% range. Yearly bumps are loosely tied to inflation. I would not recommend, however, aligning rent increases with changes that occur in the consumer price index as the calculation becomes challenging.
- **Tenant improvements and maintenance:** The lease should clarify who is responsible for maintaining the property, including any necessary repairs or improvements. As an owner of the building, you ideally would have the occupant be responsible for maintaining your building. At the start, you may need to warrant the condition of certain systems such as the roof and the heating ventilating and air conditioning. I've seen certain circumstances where the occupant requires the owner to address all of these at the beginning of a lease term.
- **Right of first refusal or option to purchase:** A right of first refusal can give the tenant an opportunity to buy the property if you decide to sell. Similarly, an option to buy provides the tenant with the opportunity to buy the property at a predetermined price. I would suggest granting neither of these, as again, your flexibility as the owner of the property is diminished. As an alternative you could consider a right of first offer which gives your occupants first crack at purchasing the building if you decide to sell it.
- **Business continuity provisions:** In case of a disaster (fire, flood, etc.), a good lease should define how quickly repairs will be made and who is responsible for them, whether rent abatement will occur and how long the lease will be extended to make up for the downtime.
- **Termination clause:** This outlines the conditions under which either party can terminate the lease, as well as any penalties for early termination. Depending upon the size of the

company that requires your enterprise, you may need to deal with a termination clause. I generally advise against termination clauses as you must take a look at the worst-case scenario that your occupant will terminate at its first opportunity. The termination clause limits the lease term that you sign with the occupant and reduces your cash flow and potential ability to finance the building.

- Insurance and liability: Clearly define who carries the insurance on the building and who is responsible for liability issues that may arise.
- Environmental considerations: If the operation of the business involves the use of substances that could potentially cause environmental damage, the lease should clarify who is responsible for remediation.

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