COMMERCIAL LEASE LAW INSIDER®

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The Practical, Plain-English Newsletter for Owners, Managers, Attorneys, and Other Real Estate Professionals

INSIDE THIS ISSUE

Tenants Retain Advantage in Improving Market

The latest Commercial Real Estate Market Survey from the National Association of Realtors (NAR) shows positive improvement in vacancy rates across all commercial real estate sectors, without a significant decrease in the majority of office and industrial tenants' concessions and rent discounts.

NAR analysts predict vacancy rates will continue to shrink in 2012, most likely leading to better market performance. Meanwhile, New York City; Minneapolis; Portland, Ore.; and San Jose, Calif., tenants are already feeling a CRE uptick. However, the NAR CRE report predicts that an owner's market could be quickly approaching, commanding bigger rent increases for tenants that have enjoyed some leverage with rents and concessions since the downturn in the market.

NAR chief economist Lawrence Yun credited sustained job creation with tenants' increasing demand for space. He noted that falling vacancy rates are strengthening rents. NAR forecasts

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FEATURE

Cap, Spread Out Insurance Deductible Pass-Through

Keeping the operating costs that you pass through to tenants low gives your shopping center or office building a competitive edge. So, to keep insurance costs low while making sure that you have adequate coverage, consider a policy with low premiums and a high deductible. But if you pass through a portion or all of those low premiums to tenants, you should negotiate the right to pass through a portion or all of the high deductible as well.

We'll explain how to use your lease's insurance provisions to make the tenant share as much of the costs as it will agree to, which, as usual, will come down to bargaining power. And we'll give you a Model Lease Clause: Make Reasonable Compromise for Insurance Deductible Pass-Through, that you can adapt and use in your leases.

Sharing Deductible Expense

Typically, owners maintain property insurance that covers major casualty events, like a fire or roof collapse. Every policy that's bought

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DRAFTING TIPS

Specify 'Ongoing' Right to Terminate Tenant's Lease

Your lease will specify under what circumstances you and the tenant may terminate the lease. It'll also spell out the procedure you must follow to do so—for example, by giving 30, 60, or 90 days' written notice. If the provisions in your lease that govern termination rights are drafted ambiguously, you may be left with a more limited right to get out of the deal than you intended. For example, you might intend to give yourself an ongoing termination right when certain events take place, such as the tenant failing to pay common area maintenance fees. But if your lease language doesn't make that clear, you may miss

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Insurance Deductible (continued from p. 1)

for the building is likely to have a deductible. "The issue is whether the owner can pass through to tenants all or a portion of the restoration costs not paid by insurance because of the the deductible," says Los Angeles attorney and *Insider* board member Sheldon A. Halpern.

"The tenant will say that the owner should have adequate insurance and look to that insurance if there's an occurrence covered by insurance," Halpern notes. "But the owner will point out that if it had a zero deductible, its premiums would be higher and the tenant would pay a higher insurance pass-through amount than it would pay if the insurance policy had low premiums and a high deductible," he points out. Many owners feel that if they're saving tenants money by charging them their share of low insurance premiums, they should at least be able to pass along a portion of the high deductibles to the tenants, he notes.

If there's a casualty triggering coverage under your property insurance policy, you don't want to be left paying the deductible alone. Determine during lease negotiations whether you want to—or can—pass through the cost of your insurance deductibles.

PRACTICAL POINTER: Check any loan documents, REAs, and other documents that may contain insurance requirements, Halpern warns. They may limit the amount of permitted deductibles. In addition, consult with an insurance professional about the types of insurance for which higher deductibles might be appropriate; this article focuses only on property insurance, not liability and other types of insurance.

Prepare for Pushback

Prospective tenants often balk at paying for capital improvements. And this includes paying for deductibles to replace capital improvement items that are covered by insurance.

The tenant's position will be that it shouldn't be responsible for expenditures that relate to the ownership of the building and are not part of typical operating costs. It will argue that it shouldn't be unexpectedly hit with a big expense if a deductible for a big-ticket item, like a new roof, must be met after an insured casualty. (Of course,

Tenants Retain Advantage (continued from p. 1)

commercial vacancy rates over the next year to decline 0.4 percent in the office sector, 0.8 percent in industrial real estate, and 0.9 percent in the retail sector.

The Society of Industrial and Office Realtors reports that office and industrial space remains a tenant's market, with 87 percent of survey participants feeling that tenants are getting benefits ranging from moderate concessions to deep rent discounts.

the tenant will be responsible for only its proportionate share of the deductible, but even its share may be substantial.)

From the tenant's point of view, it's already paying for its share of your insurance policy through operating cost pass-throughs, and it's your responsibility to make sure that the insurance is adequate to cover whatever might happen. But this leaves you in the position of footing the bill for an improvement that, although long-term in nature, still benefits the tenant while it rents from you.

Two-Step Solution

To appease a tenant that's afraid of being unexpectedly hit with a big expense and wants to exclude your insurance deductibles from its operating expense pass-throughs, do two things: (1) agree to limit the amount of the insurance deductible that you can pass through in a year; and (2) insist that the tenant pay the portion of the deductible that exceeds the limit in later years. This way, you're not ultimately responsible for absorbing the excess, and the tenant can pay the excess over time rather than all at once. This compromise is similar to the one that's frequently reached with regard to other capital expenditures.

To achieve this compromise, your insurance clause, like our Model Lease Clause, should first obligate you to maintain all-risk property insurance; boiler and machinery insurance; and, if the owner chooses, earthquake, flood, and terrorism insurance. To give the tenant some assurance that your insurance costs won't be out of the ordinary, provide that your insurance coverage (and perhaps even insurance deductibles) don't differ greatly from the insurance coverage and deductibles of owners of comparable first-class buildings in the area [Clause, par. 1].

You'll also need to provide that the insurance deductibles passed through don't exceed a set dollar amount—or "cap"—in any calendar year [Clause, par. 2]. You'll want to negotiate higher caps for earthquake, flood, and/or terrorism insurance, since the deductibles for these types of insurance are likely to be substantially higher. But note that the tenant may try to require you to pick up a more substantial percentage of

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MODEL LEASE CLAUSE

Make Reasonable Compromise for Insurance Deductible Pass-Through

A savvy tenant will argue that capital improvements aren't properly included in operating expenses, so the insurance deductible amount for them shouldn't be included either. A tenant may also argue that letting you pass through the insurance deductible removes your incentive to buy insurance with a low deductible; you'll instead pick the insurance package with a high deductible and low premiums. That high-deductible, low-premium strategy helps you keep the average monthly operating expense number low and make your building or center look more attractive.

But if the insurance policy is ever triggered, the tenant will be left footing a substantial bill if a tenant must suddenly pay its share of a very high deductible. To compromise so that neither you nor the tenant is financially jeopardized, ask your attorney about adapting a variant of this property insurance clause for your lease's insurance provisions.

INSURANCE

1. **Landlord's Property Insurance.** Throughout the Term, Landlord will maintain as an Operating Expense: (a) all-risk property insurance covering the building, building standard tenant improvements (to a maximum of $[*insert dollar amount, e.g., $35*] per usable square foot), and all equipment owned by Landlord and used in connection with the Building in an amount not less than its full replacement value; (b) boiler and machinery insurance; and (c) if Landlord so elects, earthquake, flood, and/or terrorism insurance. Such insurance coverage shall not materially differ from insurance coverage maintained by landlords of comparable first-class buildings in the vicinity of the Building.

2. **Insurance Deductibles.** Landlord may pass through to Tenant property insurance deductibles as an Operating Expense; provided, however, that in no event shall Landlord pass through to Tenant any insurance deductibles in excess of $[*insert dollar amount or varying dollar amounts*] in any calendar year. The portion of the deductibles in excess of the aforesaid amount (if any) for any calendar year shall be amortized and paid by Tenant over the useful life (as reasonably determined by Landlord) of the improvements being repaired or replaced with the proceeds of Landlord's insurance coverage, together with a commercially reasonable interest factor, consistent with that used by other landlords of comparable first-class buildings in the vicinity of the Building or consistent with Landlord's own financing costs.

Insurance Deductible

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the deductible for these types of insurance.

You'll have to amortize, over the "useful life" of the improvements that are being repaired or replaced with the insurance proceeds, the portion of the deductible that exceeds the cap [Clause, par. 2]. Note that if the useful life extends beyond the term of the lease, the tenant will probably insist that its payments cease at the expiration of the term.

Finally, the tenant's payments of the amortized cost of the excess portion should include an interest factor—based on a rate similar to those used by owners of comparable first-class buildings in the area, or perhaps based on your actual financing costs [Clause, par. 2].

For example, you buy boiler and machinery insurance with a deductible of $750 for your building. But you and the tenant agree to cap the amount of the deductible that can be passed through in any calendar year at $500. When a fire destroys your building's boiler, you file an insurance claim for a new boiler, a capital improvement. You pay the entire deductible, but you can pass through only a certain percentage of the amount in that year. Determine the useful life of the new boiler and the interest that owners of comparable buildings charge, then amortize the excess over what the tenant is required to pay in that year over the useful life at the comparable percent, so that over the useful life, the tenant will pay a smaller amount per year instead of paying all at once, up front.

Use Clause Uniformly

Tenants with bargaining strength may feel that they should be exempt from insurance deductible or other pass-through costs. But, if feasible, owners should try to insist that since other tenants have agreed to this, they won't make exceptions for one tenant. "Otherwise, it becomes a mess trying to deal with operating cost pass-throughs," says Halpern. "If an owner is consistent about applying charges, it works in the owner's favor," he suggests.

"Be upfront and clear from the beginning," says Halpern. "It behooves an owner to ask for what it needs up front and then work through negotiations with the tenant," he says. "For example, don't limit insurance pass-throughs to the common areas unless 'common area' is defined very broadly to include the building structure," he adds.

Insider Sources

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RECENT COURT RULINGS

➤ Renewal Rent Must Be Determined by Appraisers, Not Court

Facts: An office building owner rented space to a bank under a five-year lease with two five-year extension options. Under the lease, if the tenant exercised its options to extend, the owner and tenant were to attempt to agree on the renewal rent. If they were unable to agree, the lease provided that the rent would be determined by appraisals conducted by two appraisers selected by the owner and tenant. If the appraisals differed by less than 10 percent, the rent would be the average of the two appraisals; if the appraisals differed by more than 10 percent, the rent would be determined by a third appraiser whose sole responsibility would be to determine which of the determinations made by the first two appraisers was most accurate.

At the end of its original term, the tenant exercised its right to extend the lease for an additional five years. The tenant and owner each selected an appraiser, whose resulting appraisals were *more* than 10 percent apart. When the tenant and owner couldn't agree on a third appraiser, the tenant asked a trial court to appoint one. The owner opposed the tenant's request for an appraiser to be appointed by the court, contending that a third appraiser shouldn't be appointed because the tenant's first appraisal wasn't consistent with the terms of the lease.

The trial court agreed with the owner and denied the tenant's request. The tenant appealed. A Califor-

nia appeals court reversed the decision in favor of the owner. The appeals court concluded that under the plain language of the lease, a third appraiser—not a court—was to determine which appraisal most accurately reflected the fair rental value of the space. The appeals court sent the case back to the trial court for further instructions.

The tenant and owner then submitted their dispute to a third appraiser whom they jointly selected. The appraiser determined that the tenant's appraiser's proposed rent was the most appropriate. The trial court confirmed that decision, and the owner appealed.

Decision: A California appeals court upheld the trial court's confirmation of the award in the tenant's favor.

Reasoning: On appeal, the owner contended again that the court's award in favor of the tenant didn't comply with the lease's provisions. Rather, the trial court should have made an independent determination of the award's compliance with the lease.

The appeals court disagreed. It said that the appraisal provisions of the lease constituted an agreement to arbitrate, and thus the appeal "must be resolved with reference to statutory arbitration provisions." It stated that several well-established arbitration cases make clear that a court's review of arbitration awards is permitted in "extremely limited circumstances," none of which are present in this case. The appeals court further concluded that, under the plain language of the lease, the tenant and owner intended a third appraiser, not a court, to review the appraisals' accuracy and whether it conformed to the appraisal provisions of the lease in the first instance. Therefore, the trial court mistakenly failed to order the appointment of a third appraiser in the first instance. It shouldn't have itself made a determination on the case.

The appeals court explained that the lease explicitly specifies that *appraisers* should make substantive determinations about the content of the appraisals—but provides no such role for the court. Specifically, it provides that the initial two appraisers "shall use their best efforts to fairly and reasonably appraise and determine rent *in accordance with the terms of this Lease,"* and it provides that the appraisers' sole function shall be to determine rent "in accordance with this Section" of the lease.

Further, the lease states that the third appraiser shall decide which of the determinations made by the first two appraisers "is most accurate." Thus, it expressly charged the appraisers with making determinations "in accordance with" the lease's terms, the appeals court stressed. But it doesn't provide for any such determination by the court. Instead, it provides that the presiding judge of the trial court shall appoint a third appraiser if requested to do so by either the owner or tenant. The appeals court concluded that the lease "seeks no substantive determinations by the court regarding the appraisals' content."

- Wells Fargo Bank, N.A. v. Camden Properties, LTD, February 2012

Drafting Tips (continued from p. 1)

that chance to terminate, or try to terminate the lease late and face a lawsuit from the tenant claiming that by doing so, you breached the agreement.

That's why it's critical to carefully word the termination provisions so that you aren't locked into terminating the lease on a specific day or during a specific period of time. And don't inadvertently give your tenant broad termination rights without also reserving them for yourself. Draft your lease so that it protects your interests throughout the lease and doesn't give you just a one-time right to terminate if things don't go well with your tenant.

Owner Locked into One-Time Option

Consider a recent lease dispute between the owner of a shopping center and a large national retailer of arts and crafts materials. They signed a lease in 2001 in which an "ongoing cotenancy" requirement was especially important to the tenant.

The provision required the owner to lease the anchor store in the center to a regional or national tenant meeting certain requirements. If the owner didn't main-

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Drafting Tips

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tain such an anchor tenant, the lease allowed the tenant to pay reduced "alternative rent." The owner initially satisfied the ongoing cotenancy requirement by entering into a lease with a large supermarket as the anchor tenant. But the supermarket later closed, and the owner failed to find another anchor tenant. Meanwhile, the tenant continuously paid the alternative rent from the time the supermarket closed. The lease provided the tenant a *continuing* right to terminate if the ongoing cotenancy requirement was not met for *six* months or more, by giving the owner 60 days' written notice.

However, the lease also provided the owner with a right to terminate the lease in the event that it failed to satisfy the ongoing cotenancy requirement. It stated: "Landlord shall likewise have a right to terminate this Lease at the end of the twelfth (12th) month following the initial nonsatisfaction of the Co-tenancy Requirement by giving sixty (60) days prior written notice to Tenant of the termination."

When the owner tried to terminate its lease with the tenant several months *after* the 12 months were up, the tenant claimed that it didn't have the right to do so—that it missed its chance to terminate at the 12-month mark. The owner disputed the meaning of the provision. The tenant argued that it gave the owner a *"one-time* option, at a fixed point in time, to terminate the lease in the event it fails to satisfy the On-Going Co-Tenancy Requirement." The owner said its right to terminate was *continuing,* the same as the tenant's.

The owner asked a trial court for a judgment in its favor without a trial, saying that it intended the lease terms to give it an ongoing, not a one-time, right to terminate the lease. It said that the lease terms were ambiguous and it wanted to reform the contract as a result to reflect its original intention. The trial court disagreed. It noted that the terms of the lease were totally unambiguous, and determined that the owner didn't have the right to termination.

Court's Reasoning

The court pointed out that the main issue was whether the owner properly exercised its termination rights. "The sole issue is whether the lease provides the owner with a continuing right to terminate the lease upon the nonsatisfaction of the co-tenancy requirement for twelve months, or rather a one-time option to terminate exercisable only *at the end* of the twelfth month following initial nonsatisfaction of the co-tenancy requirement," the trial court clarified.

The section of the lease addressing the owner's right to terminate followed immediately after the provision granting the tenant the right to terminate after six months of nonsatisfaction and "for so long as such nonsatisfaction shall continue."

The owner claimed that by using the word "likewise" in the sentence providing it with its termination right, the section clearly applied the same procedure to both the tenant's and owner's termination rights—with the only difference being that the tenant could terminate after *six* months and the owner had to wait 12 months. That is, although the owner had to wait 12 months to exercise its right, once it reached the 12-month mark, the right became continuous and could be exercised at any time after.

The tenant pointed out that the parties used language granting the tenant an ongoing right to terminate by using "and for so long as such non-satisfaction shall continue," but did *not* use the same language with respect to the owner's right to terminate. This, it argued, showed that the parties knew how to grant a continuing option but chose not to do so with respect to the owner. The trial court agreed and pointed out that the owner was really asking it to impermissibly alter the plain language of the contract by replacing "at the end of the twelfth month" with "at any time after the twelfth month." The tenant argued that the use of the word "at" rather than "after" was a deliberate decision.

The court found that the provision granted the owner a one-time option to terminate at the end of the twelfth month following nonsatisfaction of the cotenancy requirement—but it didn't exercise its right to terminate in time and was barred from doing so later when it found a viable replacement tenant.

"The fact that the parties used language granting a continuing option in the tenant's termination provision and did not use that same language in the owner's option to terminate is convincing evidence that the owner does not have an ongoing option," conclud-

ed the trial court. It said that the inference was that the parties considered whether to grant the owner an ongoing right to terminate but ultimately decided to limit that right to the tenant [Regency Realty Group, Inc. v. Michaels Stores, Inc., March 2012].

Pay Attention to Every Word

In this case, the owner unsuccessfully asked the court to alter the plain language of the contract by changing *"at* the end of the twelfth month" to *"after* the end of the twelfth month." The case came down to one word, demonstrating how crucial it is for you to pay attention to the exact language you use in your leases. Here, as in many cases, the court wouldn't change the wording of the lease. Don't count on a court allowing you to essentially rewrite your lease because you weren't vigilant about the terms you used in the first place. Err on the side of getting an ongoing right, rather than being restricted to having only one chance to change your position if, like the owner here, you aren't able to hold up your end of the bargain.

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Q & A

Don't Let Minor Oversights Give Tenant Right to Terminate

Q The maintenance team at my shopping center occasionally forgets to make very minor repairs. I'm working with them to make sure that they're more diligent about these things. But in the meantime, a tenant is threatening to stop paying rent, and even terminate its lease. It says that I've breached the lease by failing to keep up the common areas as I'm required to under the lease. I've suspected that this tenant wants to move to another property because of financial difficulties. I think it's using my so-called breach of the lease as an excuse to leave my center. How can I obligate future tenants to continue complying with their lease obligations even if I violate mine?

A There is a way to prevent tenants from stopping paying rent or terminating their leases based on your violation. Include a requirement in your lease that tenants pay their rent and comply with all other lease obligations, even if you violate the lease. Without this requirement, a minor lease violation on your part—say, failing to adequately dispose of the trash one time—could lead to arguments and possibly expensive legal proceedings.

If you think that your leases bar tenants from retaliating by not paying rent or even by terminating the lease and moving out of the space, check them again. They may leave you unprotected from this type of retaliation if they don't say that the *tenant's* lease obligations are "independent" of *your* lease obligations. So if you fail to perform any of your lease obligations, a tenant could claim—and a court might agree—that the tenant has the right to withhold rent or terminate the lease.

Make the tenant agree that its lease obligations are independent of your lease obligations. That way, if you violate the lease, the tenant can't retaliate by withholding its rent or terminating the lease. To do this, ask your attorney about adding this Model Language to your leases:

Model Lease Language

Tenant acknowledges and agrees that all of its covenants and obligations contained herein are independent of Landlord's covenants and obligations contained herein. Tenant shall neither be relieved from the performance of any of its covenants and obligations (including, without limitation, the obligation to pay Rent) nor entitled to terminate this Lease, due to a breach or default by Landlord of any of its covenants or obligations, unless expressly permitted by the terms of this Lease.

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