



HOT TOPICS IN LEASING

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Real Property Section of the San Diego County Bar Association

Key Topics

- Commercial Lease Basics
 - Net, Gross, Modified Gross
- Operating expenses
 - Typical Costs and Exclusions
 - Audit Provisions
- Assignment and Subletting Provisions
 - Relevance in Today's Market
- General Business Issues
 - Market and Economic Conditions



Commercial Lease Basics

- **Net Lease:** Real estate lease in which the tenant regularly pays not only for the space but for a portion of the landlord's operating costs as well. When all three of the usual costs (taxes, maintenance and insurance) are passed on, the arrangement is known as a "triple net lease."
- **Gross Lease:** The landlord pays for taxes, insurance and maintenance. The gross commercial lease is used most often in multi-tenant and single tenant office buildings, industrial and some retail properties. The landlord collects fixed rents and pays the expenses out of them.
- **Modified Gross:** There are numerous types of modified gross leases that are commonly utilized in multi-tenant office buildings. A modified gross lease is similar to a full service gross lease, except that some of the base services are not included by the landlord (taxes, maintenance, insurance and utilities). The most common types of modified gross leases excludes maintenance, janitorial and electrical.



The Net Lease

- A Net Lease: In a net lease, tenant pays some or all of the operating expenses.
- Types of Net Leases In a net-net lease, tenant pays both property taxes and hazard/fire insurance. In a triple net lease, tenant is responsible for all of its proportionate share of operating expenses.



The Gross Lease

- Gross Lease: All inclusive, full service.
 - Almost everything is included. Typical of the leases executed on downtown multi-tenant office buildings. Even in a gross lease, landlord will try and pass-through certain operating expenses to the tenant.



The Modified Gross Lease

- In the modified gross lease, the tenant pays a portion of taxes, maintenance, insurance or utilities. This type of lease is commonly utilized in medical office buildings or multi-tenant single floor office buildings, where different tenants have varying needs for electrical or janitorial services.



Lease Measurement and Core Factor (Rentable v. Useable)

- How does the lease control the rentable square footage and measurements? 1996 BOMA measurements and right to change measurements.
- An increase in the BOMA measurements allow the lease to increase costs and Base Rent to tenants.



Annual Base Rent Increase to CPI

- Any increase in annual Base Rent should be tied to Consumer Price Index (with a floor) if representing Landlords and Capped if representing tenants.
- Think about inflation and who should benefit in this environment.



Operating Expenses

These costs may be limited by either exclusion, expense stops or exclusions to pass-through language in the expense pass-throughs.

- Typical Costs: Labor, Market Management Fees, Insurance Costs, Security Costs, Utility Costs, Real Estate Taxes
- Exclusions: Capital Expenditures, General Corporate Expenses, Parking



Current Issues with O.E.'s

- This is the “back door” for developers and Landlord’s to increase Net Operating Income (NOI)
- Prop 13 taxes were the concern when building sales were increases, now the concern is energy costs and other inflationary items not included in the CPI or Base Rent increases.
- Long Term Leases/Extra Protections



Operating Expenses (cont'd)

- From tenant's perspective, try to strike any operating expenses from the lease or at least put a cap on controllable expenses
- Expense Stops: Owner pays operating expenses up to a specified amount, usually stated as an amount (psf)
- Expense Pass-Throughs: Based on a base year, anything in excess is paid in a pro-rata amount by the tenant



Audit Rights

- Audit Right Provision
 - Issues to Consider: Can a tenant audit, review and copy LL's records?
 - May a tenant conduct an audit if it is in default under the lease?
 - Should an overcharge of operating expenses by LL entitle a tenant to termination?
 - Should a LL or Tenant be barred from asserting rights if such rights are not asserted via arbitration or litigation within a set time (usually 6 ms. To 3 years)?



Audit Rights (cont'd)

- May a tenant conduct the audit itself or by utilizing an accounting firm or a firm conducting audits that is compensated on a contingent fee basis? Typically a bar on using an “auditor” that is compensated on a contingency fee basis.
- In the event the audit reveals an overcharge, should the amount of overcharge be credited against rents or refunded? Who decides? With or without interest?
- If the amount of the by the landlord exceeds a certain percentage (3-5%) then should LL pay for the audit?
- Should a tenant’s recovery for audit costs be capped at an amount equal to the amount of the overcharge?
- Should any arbitrator deciding be limited to a real estate lawyer handling leasing issues with at least 10 years experience?

Assignment and Subletting (The “Exit” Provision)

- Tenants frequently have a change in business plan and find that they either have too much space or too little space and need to get rid of the space that they have leased. Most Leases impose unreasonable restraints on a Tenant’s ability to assign or sublet.



Assignment and Subletting (Cont'd.)

- The Landlord's primary concern - not accepting a sublessee or an assignee who would cause the Landlord to be in violation of an exclusive that the Landlord has granted to another tenant or which would allow the Tenant to sublease or assign to somebody who is not comparable in quality and stature to the then-existing Tenants.



Assignment and Subletting (Cont'd.)

- Assignment: When a new party “steps in the shoes of” an existing party. Can be a landlord or a tenant.
- Why is it an issue? Tenants who are sophisticated will spend as much time focusing on their entrance strategy as their exit strategy.



Assignment and Subletting (Cont'd.)

- Subletting: When the Lessee becomes a Sublessor to a Sublessee who is responsible to the Master Lessor under the Master Lease.
- Huge issue today in almost every market. LL's almost always unwilling to release original tenant. How much burden is placed on the tenant for finding a subtenant? Who can tenant sublease to? Set price? Carve out provision for a certain amount of the premises? Can LL withhold consent?



General Business Issues

- Commercial market is presently facing the worst of all worlds for recent owners, developers and landlords – **“When the tide goes out you can see who is swimming naked.”**
 - Buildings purchased or developed at low cap rates and with high material costs facing declining lease rates/high vacancy
 - The sublease or “shadow market” is a major issue.



General Business Issues (cont'd)

- Debt for commercial real estate is scarce and expensive. Offices are seeing increased vacancies and a lack of capital with which to refinance debt. High-leverage private equity will be replaced with more conservative financing.
- The regulatory environment is going to change as the government tightens its grip on lenders.



General Business Issues (cont'd)

- Commercial real estate transactions to have gone down due to the credit crisis. Private equity is reluctant due to lack of capital waiting for prices to fall further. The bid-ask gap and lack of financing has caused sales in all sectors to fall.
- Take advantage of the market destruction if you are a tenant; plan accordingly if you are a landlord.

