

Chapter 4

The Fundamentals of Commercial Leases

“Analyze first; then leap.”

- Dr. Peter Linneman

An essential dimension of real estate finance is understanding leases. A **lease** is a legal contract related to the use of real estate over a finite term. With the exception of hotels and multifamily properties, the pro formas (income projection models) we discuss are to a large degree driven by the terms of existing leases. Real estate is a business, and lease terms dictate how specific aspects of that business must be conducted. If you as the current owner, or the property’s previous owners, agreed to specific lease terms, those terms dictate the property’s planned performance through the life of the lease(s). This is true even if the current market dictates very different lease terms.

The general rationale behind lease negotiations is that the landlord (the **lessor**) provides the space (the “premises”) to the tenant (the **lessee**) in exchange for rental payments sufficient to yield an adequate return on the real estate. In addition, the tenant should pay all operating and maintenance costs associated with their premises, as those are their costs of conducting business. This simple rationale is complicated by the fact that in weak market conditions, landlords often compromise in order to attract and retain tenants. Reality is also complicated by the fact that most properties have operating and maintenance costs associated with the **common areas** of the property (lobbies, elevators, stairwells, roofs, parking decks, etc.). Are these common costs part of the individual tenants’ costs of doing business? “Yes,” as these costs maintain the tenant’s general operating environment and vary based on property occupancy (**variable expenses**). But also “no,” to the degree that many of these common costs exist whether the tenant is in the building or not (**fixed expenses**). Prevailing market conditions will dictate how these common costs are allocated between the landlord and tenants, as well as any **cost recoveries** or **reimbursements** of operating expenses specific to each tenant’s space.

What are the significant aspects of leases, and the reasoning and negotiations that create lease terms? We will primarily focus our discussion on retail leases, as shopping centers and regional mall leases most vividly demonstrate many of the issues that you need to consider. The relevant issues for retail leases tend to be more extensive than for non-retail properties. However, each property type has its own lease nuances.

To understand the rationale of key lease terms, assume that you own a 1 million-square foot regional mall and are negotiating a lease with a potential tenant for 5,000 square feet. What are some of the most important terms you need to address? Bear in mind that the space being leased is only a small part of a large retail property.

ECONOMIC TERMS

Rent

Students invariably suggest the rental rate is the most important lease term. Of course, rent is important, as it determines how much money you will collect from the tenant, and to a large extent dictates your revenue stream from that space for the length of the lease. Rent is comprised of three components: **base rent**; **base rent escalations**; and **percentage rent**. Base rent is the initial rent for the space (i.e., that of the lease **base year**), while the rent escalation specifies how, if at all, this rent changes during the life of the lease. This escalation may be based upon inflation measures, for example, with base rent growing each year proportionate to changes in the Consumer Price Index. Alternatively, it may grow at specified dollar or percentage increments over the lease term, or there may be no rent escalations in the lease at all.

The third component is percentage rent, also known as **overage**, which is unique to retail leases. Percentage rent is a form of **additional rent** that specifies the percentage of the tenant's gross sales revenue that the landlord receives in addition to the base rent and escalations. For instance, the lease may specify that the landlord receives 2% of store revenues in excess of sales of \$300 per square foot, the gross sales **breakpoint**, monitored monthly. Why is percentage rent used in retail but not in other types of properties? A good store mix and overall retailing environment, both of which are controlled by the landlord, can increase tenant sales. In contrast, the productivity of office and warehouse tenants is rarely impacted by their neighbors. In addition, since store sales are relatively easily monitored, it is easy to assess the sales productivity of the space.

Percentage rent helps to align retail tenant interests with those of the landlord. If the landlord has no economic incentive to enhance the tenants' sales, the landlord will primarily focus on leasing the space to whomever will pay the highest base rent. If, on the other hand, the tenant rewards the landlord for their superior sales that result from an enhanced tenant mix, the landlord will focus more on creating a tenant mix that maximizes total center sales. The landlord will attempt to create the optimal mix of tenants by avoiding redundant stores, optimizing the location of tenants, and signing leases with complementary stores. For example, a good tenant mix might position tenants like Bostonian, Brooks Brothers, and Trudeau in proximity to each other, as people who shop at one of these stores are likely to shop at the others. Another synergistic combination would be a Gap near a Victoria's Secret and a Lady Foot Locker store. The goal is to generate positive externalities across stores, which the landlord shares with tenants via percentage rents. Percentage rents typically represent 5-10% of a tenant's total rent payment.

Marketing Budget

Shopping centers can be very complicated in their execution as they are operating businesses. For example, centers generally charge anchors a low base rent, while in-line stores, which are the smaller stores located between the anchors, pay notably higher base rents plus percentage rent. Historically, landlords often gave away space to department stores and, to a much lesser extent, supermarkets, even though their stores cost as much as \$100 per square foot to build. In return, these anchor stores advertise (including your center's location) and draw customers to the center. Your center's design and tenant mix attempt to channel that traffic to the in-line stores, whose rents are your primary sources of revenue.

Leases will generally require that each tenant pay a share of the center's marketing budget. For example, you will hold promotional days at your center, sponsor a local youth organization, advertise in local newspapers, etc., and each lease will specify how much of these marketing expenses are paid by each tenant.

Utilities, Insurance, and Property Taxes

Another key lease item is the treatment of utility charges (water, electric, gas, oil, trash removal). There are two general components of utility costs. The first is the utility expense you as the landlord pay for the **common areas** of the property, including lighting the walkway in front of the stores, water in the public bathrooms, air conditioning for the hallways, etc. These common areas are amenities of the center that benefit all tenants. While the expenses associated with **common area maintenance (CAM)** are not specific to any tenant, they are a critical part of a store's operating environment. You will negotiate how much of these CAM expenses will be passed through to each tenant.

The second component of utility costs relates to expenses that are specific to each tenant's space. In older properties there may not be meters that gauge each tenant's utility usage, but rather only a single "master" meter for the entire property. For such properties you attempt to determine the appropriate allocation of the property's expense for each tenant, with each lease detailing the allocation of these expenses. Modern buildings are metered individually to gauge each tenant's usage of water, electricity, gas, etc. Leases in modern buildings generally specify that each tenant is responsible for their own metered utility bills.

Property tax and casualty insurance payments paid by the landlord are part of the cost of the property's operation. Tenants are usually allocated their pro rata share of these expenses based on their share of the property's rentable square footage. However, there are frequently **expense caps** specified in the lease that limit the extent to which these items can rise during any single year or over the term of the lease. These caps may be negotiated for any component of operating costs, including utilities, property taxes, and insurance.

Expenses for these items are sometimes passed on only to the extent that they exceed levels at the time the lease is signed (the lease's **base year**). The base year expense amount is known as the **expense stop**. For example, the property tax at the time the lease was signed is \$1 per square foot per year, and the lease specifies that only increases in property taxes above the \$1 per square foot expense stop are passed through to the tenant, up to a maximum of \$0.10 per square foot per year, and not to exceed an increase of \$1 per square foot over the 15-year term of the lease. These base year designations, recoveries, and caps are determined by market conditions at the time the lease is negotiated, as well as the risk-sharing preferences of the landlord and tenant.

HVAC – Heating, Ventilation and Air Conditioning

In order to save money, a landlord in Phoenix will attempt to limit air conditioning usage, while a landlord in Buffalo will try to turn down the heat. In addition, tenants have different temperature preferences and usage patterns. As a result, you will negotiate when, and how much, HVAC you need to provide to each tenant and to the common areas, as well as who pays these expenses during and after defined "normal business hours." In newer buildings, tenants are generally able to control the HVAC in their respective space. Like individual metering, this makes usage patterns and expense allocation much easier, as the lease generally states that the tenant is responsible for their own HVAC usage. However, you still must specify the policy for common areas. In older properties, the lease will specify when heat or air conditioning must be provided (for example, starting at 8 AM on weekdays).

Security and Property Maintenance

The lease will specify the type of security provided at the property, and who pays for this security. This is also true of property maintenance, including the common areas and grounds. For example, how often are the grounds and buildings cleaned? How often are windows washed? Who selects the cleaners? Who is responsible for building maintenance? Are security cameras provided in parking areas? Are employees escorted to their cars after hours by security personnel? These, and many similar terms should be addressed in each lease.

Tenant Improvements

Tenant improvements (TIs) include those items necessary to make a tenant's space fully operational. Commonly, the landlord provides the tenant with "as is" space. For a new building, this will be base ("shell") space, while for existing buildings, it will be the space as left by the last tenant. However, the tenant may want new fixtures, carpeting, a kitchen for restaurants, shelving, etc. to run the business. Who pays for these tenant improvements? It depends on the market. In a weak leasing market, the landlord may have to provide the tenant with much of the necessary funding for their TIs in the form of a **TI allowance ("TIA")**, which is typically quoted in dollars per square foot.

The parties will not only negotiate over who pays for the TIs and how much will be paid, but also who is responsible for completing the work, who the contractor will be, who has rights to the improvements after the lease expires, who pays for the removal of any TIs after the lease expires, etc. Remember that after the lease expires, the space returns to the landlord, irrespective of which party paid for the TIs. Therefore, the landlord has a significant interest in what the work is, who does the work, how it is done, and what the quality of the space is. Again, the market will dictate which party has the negotiating power to favorably resolve these matters.

Why would a landlord pay for improvements made to a tenant's space? First, consider the case of a new building under construction. Rather than paying to paint, install lighting fixtures, erect divider walls, etc. that the tenant may not want, you will say to a tenant (who has the alternative of leasing fully completed space in another property), "Why don't I just give you the money to finish the space as you want, instead of me putting money into finishing the space in a way you may not want?" In this way, you attempt to turn your unfinished space from a negative to a positive. In turn, owners of finished (but vacant) space frequently have to offer TI allowances in order to attract tenants who do not like the existing finishes.

A second reason landlords provide TIs is that weak markets force you to offer discounted economics to attract tenants. Why not just reduce rents rather than providing TI dollars up front? After all, aren't you indifferent between offering \$35 a foot in TIs up front versus reducing rents over the term of the lease by an equivalent present value? Not really. While tenants may be indifferent between TIs and equivalent NPV rent concessions up to the point where the TIs exceed their desired improvements, TI expenditures go into your building, while rent concessions walk out your door. As a result, if you must give concessions, you would rather give TI concessions in order to keep the money in the building, as you hope that these improvements will have some value to future tenants if the current tenant leaves the space.

TI costs can run as much as the equivalent of 1-2 years of rent, especially in weak markets with substantial amounts of new empty space coming on the market. As a result, commercial landlords seek longer-term leases to better amortize the cost of the improvements.

Free Rent

Free rent or rent abatement occurs when no rent is paid during the first weeks, months, or years of the lease term. In a weak market, you may prefer to give a period of free rent, rather than discount rents over the term of the lease by an equivalent NPV amount. This is done to protect the property value by keeping rents closer to typical rental rates for when you plan to sell or refinance the property in future years. In the grand tradition of "everything is negotiable," sometimes the value of offered free rent can be converted into TIA dollars.

Capital Costs

Leases often specify that the tenant is responsible for all or part of common area **capital costs**, including items such as the repair and maintenance or replacement of the HVAC system, elevators, parking decks, and structural components. This may take the form of a requirement that the tenant pays capital costs as they occur, or that they annually reimburse the landlord for such costs on an amortized basis. Alternatively, the lease may specify

that the property be returned at the end of the lease “in commercially acceptable condition” or in its “original condition.” The typical lease in London, for example, requires tenants to pay all capital costs as they occur and return the space to its original condition at the tenants’ expense.

Net Rent

Net rent refers to the rent after all operating costs are paid. The term **triple net lease** (often abbreviated as “NNN”) generally refers to situations where the tenant pays all operating (and frequently capital) costs, including insurance, utilities, and property taxes in addition to the contractual base rent and escalation payments to the landlord. **Net leases** shift the risk of increases in such costs from the landlord to the tenant, altering the ownership risk of the property.

Net effective rent is used somewhat ambiguously in the commercial real estate industry. Generally stated, it is the base year annual rent, net of: unrecovered maintenance and operating costs (property taxes, insurance, utilities, etc.), the amortized value of free rent, the amortized value of leasing commissions, and the amortized value of TIs. For example, a gross rent of \$30 per square foot per year, with a \$5 per square foot per year cost recovery on \$10 per square foot per year of maintenance and operating costs, yields a net annual rent of \$25 per square foot. If one year of free rent was provided on a 10-year lease, this amounts to amortized free rent of \$3 per square foot per year (\$30 per square foot / 10 years). If \$40 per square foot in TIs are provided on this 10-year lease, this amounts to amortized TIs of \$4 per square foot per year. If the leasing commissions are 2% of the face value of the 10-year lease, they are \$6 per square foot ($\$30 \times 10 \times 2\%$), which amortizes to \$0.60 per square foot per year. Thus, in this example the landlord’s net effective rent is \$17.40 per square foot per year ($\$30 + \$5 - \$10 - \$3 - \$4 - \0.60) as summarized in Figure 4.1.

FIGURE 4.1

Annual Net Effective Rent PSF Calculation	
Gross Rent	\$30.00
Cost Recoveries	5.00
Maintenance and Operating Costs	(10.00)
Amortized Free Rent	(3.00)
Amortized Tenant Improvement	(4.00)
Amortized Leasing Commissions	(0.60)
Annual Net Effective Rent	\$17.40 PSF



Online Companion Hands On: Go to the Online Companion and select the link for Chapter 4. Scroll down to the Excel Figures section and download the Excel file and open it to the Exercise tab. Using the Assumptions provided at the top of the tab, fill out the remaining 9 years of the 10-year projection of the above example, and calculate the NPV of the cash flow at a 10% discount rate. What is the value of the lease to the landlord when calculated on this basis? What would the NPV be if instead of rent growing at 2% a year, it was flat for Years 1 through 5, bumped up \$4.00 PSF in Year 6 and then remained constant?

Note that this approach to net effective rent ignores the time value of money, as TIs, free rent, and leasing commissions are all up-front costs, while rents are received in the future. However, since this term is not the basis of valuation or lending calculations, but rather a simple summary statistic, there is no harm in this simplification.

NON-ECONOMIC TERMS

Thus far, we have discussed lease terms which are primarily concerned with payments made by the tenants. These monetary components are generally viewed by students as the most important terms of a lease. But never forget that the tenant is just a small part (0.5% in our example) of a larger whole. By effectively organizing your space, the center can be worth more than the sum of its parts. In a way, shopping centers are like a sports team. You could have an NBA team made up of just high scoring shooting guards, but the team would be unsuccessful without good defenders, passers, and rebounders. Below are some of the most important lease issues that you must consider, particularly for retail centers. In fact, they can be far more important aspects of retail leases than the monetary issues we have discussed, because if they are not correctly contracted, they can destroy your retail environment.

Signage

One of the most important terms of a retail lease is the location, size, and design of each tenant's signage. If you have no restrictions on signage, each tenant will only be interested in maximizing his or her visibility. For example, a small tenant that sells products geared towards young men might put a huge sign of a naked woman in front of the store absent signage restrictions in the lease. Such a sign might attract young men to that tenant, but is such signage optimal for your overall retail environment? Only if every store in your center is geared towards young men! But usually, the bulk of your stores are geared towards children and young and middle-aged women, who will find such signage offensive. Therefore, the lease will carefully regulate the size, location, format, content, colors, and other details of each tenant's signage.

Going Dark

What happens if an anchor tenant at your plaza, who pays little rent, decides to close their store with a lease in effect for 15 more years? For example, the tenant could decide to stop operating in your center and move to a competing newly constructed center, while still making their minimal lease payments to you. This prevents a potential competitor from moving into their vacated space.

If the lease does not protect against such behavior (known as **going dark**), and it occurs, you will have dramatically reduced traffic at your property. This will destroy the performance of your in-line tenants, who are your primary sources of rental income. Therefore, you will try to negotiate terms that prevent a tenant from continuing to pay rent while not operating in your center. You will try to ensure that the anchor operates until the lease expires or until you are able to more productively rent the space.

Walmart, the largest retailer and grocer in America, presents landlords with a particular dilemma. Since Walmart draws shoppers to their stores, you want them in your center, right? Not so fast. Walmart is also the largest tenant of dark space in America, time and again going dark in older stores with low-rent long-term leases, in order to move a mile down the road into a larger store. Walmart continues to pay rent on the old store, but the fact that it is not operating destroys your in-line tenants, and hence the center's profitability. So why not simply prohibit them from going dark? Leverage, or more accurately, the lack of leverage. The reality is that Walmart may not sign such a lease. If you insist upon this clause, they might go down the road and sign a long-term lease without a go-dark provision at a competitive center, drawing customers from your center. Hopefully, you are beginning to understand the importance of negotiating leverage, especially when you do not have any. The industry has evolved into being damned if you sign Walmart to a long-term lease or being damned if you don't. Fun business, isn't it? This is further complicated by the risk that online retail erodes the economic viability of your tenants.

Hours and Days of Operation

The lease will specify when the store and center must, or can, be open. If you do not do this, tenants will operate only when they want, and without standardized hours of operations, customers may not experience a rich shopping environment. For this reason, all stores in the mall open and close around the same time, even though not all retailers may like this restriction. For example, certain restaurants may only want to be open at night, but your center needs food available at all hours of operation.

Why do you limit when stores can be open? If a store decides to operate very late at night (i.e., in the early morning), it may create security issues. Therefore, you may decide to restrict the permitted hours of operation to “shopping hours.”

Length of Lease

You need to specify how long the lease will run. Remember that a long-term lease will impact your revenue and operations for many years. If you sign a long-term lease in a hot market, you will receive a relatively high rent for years. On the other hand, you could suffer for years if you sign a long-term lease at low rents due to a current excess-supply environment.

Tenants usually want a very short-term lease with a lot of extension options. With that structure, the tenant can walk if business does not go well, a better location arises, or market rents fall. On the other hand, if they want to remain, they have the option to stay at the location. Depending on the economic environment, landlords usually prefer the security of a long-term lease, but remember that today’s “red hot” retailer may be tomorrow’s dud.

Expansion Rights

Larger tenants, particularly in office and warehouse properties, want the option to satisfy growth at the same location. Therefore, landlords often sell the **expansion rights/option** to additional future space near or adjacent to the tenant’s current location. In the meantime, the landlord can lease that space to another tenant. The problem is the temporary tenant will have to leave if the option is exercised. As a result, you may have a problem leasing space that is optioned. Frequently you rent option space to short-term users, such as political campaign offices. Juggling option space is an art which can yield unexpected revenues.

Usage Restrictions

You do not want to sign a tenant to occupy space as a woman’s clothing store and find out the tenant decides to run a slaughterhouse from the space. That is not the retail environment you envisioned! Therefore, the lease must be extremely precise in describing the kind of business activities the tenant can and cannot conduct in the space.

Sublet Rights

Assume that a woman’s clothing store has a lease with 15 years to run. Can they sublease their space to another retailer? If the tenant subleases space to a lesser-quality store or to a computer repair shop, it can greatly reduce the productivity of your center. Therefore, the lease will specify sublet rights, including whether the landlord has the right to approve all sublease activity.

Location Assignment

If you are a retail tenant in a strip shopping center, where do you want to be located within the center? Close to the anchor tenant might be best for your sales. Close to the street might give you more visibility for people driving or walking by the property. The importance of where tenants are located within a property is not unique to retail. In an apartment building, you want a higher floor for a better view, less ground noise, and (if on the top floor) no neighbors stomping around overhead.

There are unique location dynamics in regional malls that shape mall design. First, you have to understand that there is a tradeoff between land costs and building additional floors for all types of buildings. The incremental hard construction costs of an additional floor generally increase disproportionately more than the cost of the floor directly beneath it. That is, a three-story building will be more than three times as expensive to build as a one-story building. This is because you need more concrete, more steel, and more support structures to handle three floors rather than one. How many floors there are in a building will partially depend on the cost of land. If it costs more to build higher, and land costs are low, you will spread the structure over more land. If land costs are high, such as in Manhattan, you would rather incur the additional costs of building higher in order to spread the cost of the land over more floors. You will use engineers to help analyze this trade off.

Human nature also determines the design of the exterior and interior of a mall. Roughly 90% of the products sold in a regional mall are purchased on impulse. Therefore, you want to maximize the retail stimuli to which a shopper is exposed, as the more stimuli, the more shoppers will tend to spend. Assume your mall is one story. Shoppers will park their cars, walk through your mall, and then walk back through the mall to return to their cars. On the way back, buyers will generally walk faster and shop less than on their initial walk through the mall, because they are seeing "old" stimuli. You will realize lower sales productivity from impulse shoppers on their way out, as they are exposed to fewer "new" impulses.

To "solve" this problem you could build a two-story mall. With two stories, you are providing additional retail stimuli, as people can walk back through the second floor experiencing entirely new impulse shopping stimuli. If the second floor generates enough impulse buying, you can generate enough rent to justify the additional costs of building a second floor. However, you must contend with the fact that most people would rather go down a flight of stairs (unless that flight leads down to a basement) than up a flight of stairs. Why? That is for psychologists to determine, but for you, it is just an unfortunate fact of life. Therefore, few tenants reliant on impulse shopping want to occupy space on the second floor, as fewer shoppers will make it to the second story (even with elevators and escalators).

Then why do you see so many two-story regional malls? In some cases, it was an ill-informed development decision. This second-story space was surely leased in the financial models for these centers, and justified the cost paid for the development. But retail reality does not conform to your ill-conceived pro forma. As a result, there are a lot of centers with vacant second floors.

In other cases, it is because clever design addressed the problem. For example, if people will not go up a floor or down into a basement, you need to make them think they are on the main floor even though they are on the second floor. The late Alfred Taubman figured out a way to make people believe they are on the main floor when they enter a mall. To construct a building, you have to dig a hole for the foundation. Instead of paying to haul away the dirt from the excavation, he decided to build an embankment with it. As customers drive onto this elevated surface and enter what looks like the first story of a one-story mall, they are actually entering the second floor of a two-story mall. When shoppers enter on the second floor, whether they shop on that floor first or not, they will eventually go downstairs to shop on the first floor because they know it is not the basement. Then for the return trip, they go back upstairs and walk to their car. This return trip generates new impulses, and hence purchases. With the addition of shoppers who enter on the second floor and are willing to go down the stairs, you are able to generate sufficient productivity for tenants on both floors, particularly if the majority of the shoppers enter on the second floor. This design, which can also be executed by exploiting a natural elevation difference, reduces some of

the biases of floor location in a multi-floor mall. Another design solution is to locate “destination,” rather than “impulse,” stores on the second floor. Examples include food, theatres, bars, doctor’s offices, and spas.

Interior design, including corridor width, common areas, and amenities are also important. For instance, if the corridor is too narrow and becomes overcrowded, people will not shop. On the other hand, if the corridor is too wide, the mall appears empty. Think about a comedy club, where you do not want to be the only one there and feel obligated to laugh, but you also do not want to feel like you are in a concert mosh pit. Therefore, regional mall developers seek an optimal corridor design to enhance the shopping experience, boost tenants’ revenues, and create more desirable retail space.

Detailed Description of the Space

In addition to identifying the location, the lease will include a detailed description of the space to be leased. Further, you must specify what is included in “the space.” Is the carpet included? What about the light fixtures, the counter, wiring, windows, shelving, etc.? Do these physical elements stay when a tenant leaves? Do they have to be removed? The lease describes these details.

Tenant Mix

Percentage rents encourage you to create an exciting shopping environment. Some tenants refuse to lease if other similar stores are in the center, as they want complementary stores, but not direct competition. Therefore, you will have to negotiate the terms under which you can lease space to competitors. Many conflicts arise as a result of these **non-compete clauses**. For example, if you signed a lease with a woman’s clothing store that states you cannot lease space in the center to another “top quality woman’s clothing store,” is Burlington Coat Factory a top-quality woman’s clothing store? They sell clothing for women, but does that classify it as a “top quality woman’s clothing store”? Or does the lease clause prohibiting the presence of a second florist in the center prohibit Walmart from selling poinsettias and Christmas trees during the Christmas season?

In other cases, a tenant will lease only if other tenants remain in the center. As a result of these **co-tenancy clauses**, a center could lose several tenants if one key tenant goes under, goes dark, or refuses to renew their lease. On the other hand, the landlord may prohibit the tenant from opening other stores within a certain distance. These **radius restrictions** protect the landlord from the tenant potentially cannibalizing sales at the center. For instance, if an anchor grocery store tenant was not subject to a radius restriction, they could open a new store across the street at a competing center. This would no doubt lower sales for your in-line tenants, reduce your percentage rents, and could even cause in-line tenants to go out of business. That is why landlords seek a radius restriction, particularly for anchor tenants.

Parking

Tenants are concerned with the amount, location, and maintenance of parking. If there are not enough spaces to service the customers, the stores will lose business. As a result, you will lose percentage rent and/or have tenants vacate the space. In addition, tenants will also want sufficient parking close to their location. If customers cannot park within proximity to their destination, they may not visit the location. The lease may also specify the layout of the parking lot, which may inhibit the redevelopment of the center for several years. In addition, maintenance and lighting of parking lots is of critical importance to tenants.

Recourse and Security Deposit

Who exactly from the tenant side is responsible under the terms of the lease? Is it a new division of a high credit company? If so, and the new division ceases to operate, you are stuck with no tenant and no payment **recourse** to the high credit parent. This issue of recourse frequently arises in office leases. For example, Coca Cola U.S. is a very high credit tenant, but the tenant who leases from you in Moscow is Coca Cola Russia. If they cannot establish a profitable business in Russia, Coca Cola Russia will fold, and you cannot look to Coca Cola U.S. for the rent payment. Therefore, you will try to get both the subsidiary and the parent as signatories to the lease. Not surprisingly, the tenant will generally try to keep the parent off the lease.

You will want the individual entrepreneurs and partners of the tenant to be on the lease in addition to their firm. Thus, if the firm goes bankrupt, you can look to these individuals for continued rental payment. Law firms, consulting firms, and accounting firms often must sign the lease as individual partners if they want to get the space they desire.

Alternative forms of landlord protection include requiring the tenant to put up a **security deposit** or **letter of credit** that is only available to you as recourse if the tenant fails to perform on the lease. A problem frequently arises when the tenant goes bankrupt, and you attempt to lay claim to the security deposit or draw upon the letter of credit, as the bankruptcy court may rule that these are corporate assets that must be used to satisfy the claims of the most senior lenders. But what about the rights specified in your lease? Unfortunately, they are generally trumped by bankruptcy law, which we will discuss in Chapter 13.

CLOSING THOUGHT

We have just scratched the surface concerning the numerous terms that are critical to leases, most of which are non-monetary in nature. I trust you are beginning to appreciate why leases are so thick! Remember that real estate is a business, and smart operations are what generate profits over the long term. You must understand the underlying business to successfully negotiate effective leases that protect your interests under various scenarios that may never occur. This is especially challenging in difficult markets.



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